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Statement by the Hon. **ELENA SALGADO**,
Governor of the Fund and the Bank for **SPAIN**

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Governor of the Fund and the Bank for Spain**

International Economic Outlook

Today we are still facing a challenging time for the global economy, where recovery remains fragile and uneven. After a stronger-than-anticipated recovery in the first half of 2010, led by the emerging (and especially the Asian) economies, growth is likely to ease to some extent in the second half of the year. In fact, the slight improvement is far from widespread and its success is by no means guaranteed. Financial markets remain weak and are not functioning normally, credit is not flowing smoothly to the economy, unemployment has reached high levels in many countries, and the balance sheets of economic agents—both in the real and in the financial sector—have not been fully restructured yet. Achieving stronger and more sustainable growth will depend on the ability of private demand to recover, on the restructuring of the productive sector in some advanced economies and on the ability of emerging economies to move toward growth that is more based on domestic factors.

Economic policy

In this context, our policy decisions must reconcile the necessary adjustment in the medium and long terms with a short-term outlook in which growth remains challenging and the social costs of the crisis are substantial. Furthermore, there are additional difficulties deriving from the high level of global uncertainty, the magnitude of the challenges ahead, and the fact that the broader impact of our decisions calls for an international effort to coordinate our policies on a much more far-reaching and complex scale than ever before. At the same time, however, we should recognize that the strengthening of the institutional framework of the global economy that the crisis itself motivated is a key tool for laying the groundwork for better-balanced and more sustainable growth.

Regarding monetary policy, I concur with the IMF's message that maintaining a monetary policy of low rates for a while will facilitate the necessary rebalancing of public and private demand. However, we need to remain vigilant to the possible indirect effects of this monetary orientation on the economy and the return of financial markets to a more normal functioning. Capital flows to emerging economies and pressure on exchange rates and asset prices constitute a new challenge to economic and financial policy that needs to be dealt with in a coordinated manner.

To ensure that the financial system can play its proper role in growth and employment once again, we must take action in three areas. First and foremost, we must ensure that all financial institutions are solvent, by supplementing cleansing and restructuring efforts where necessary. Second, we must persevere with the implementation of financial reform, adopting a regulatory and supervisory framework that addresses the market failures exposed by the crisis. And third, we must restore the principles of free markets and unrestricted competition in the financial industry, principles which have been compromised by the necessity for public intervention.

With respect to the key challenge of financial reform, vital steps have been taken, as evidenced by the Basel III Accords. Now is the time to complete other ongoing initiatives. I am referring in particular to measures pertaining to the operating framework for financial markets (infrastructure, derivatives, rating agencies), crisis resolution mechanisms, and the design of a framework for supervising and regulating systemically important financial institutions. The latter framework must be strong and consistent in order to prevent moral hazard and regulatory arbitrage. Last but not least, all these efforts will be in vain unless the rules are equally enforced at all financial centers. Here, we have confidence in the work of the Financial Stability Board and in the political will of all of the stakeholders involved.

Spanish economy

In line with the global recovery, as well as the recovery of other countries in the euro zone, Spain's economy is showing signs of improvement. Although domestic demand remains hampered by the need to adjust household and corporate balance sheets, the main economic indicators moved into positive territory in the first half of the year. GDP in quarter-on-quarter terms grew moderately during the first two quarters of 2010, driven by the recovery of private consumption and investment in capital goods. This ended a streak of six quarters of negative growth. This trend is in line with the government's macroeconomic scenario which envisages a gradual recovery. Notwithstanding the quarter-on-quarter growth, however, we expect 2010 to end with a year-on-year rate that remains slightly negative for the year as a whole. For 2011, we are projecting a more dynamic recovery that will allow for moderate growth in employment, paving the way for a reduction in the high unemployment rate. This will also help to cut the public deficit while enabling us to achieve our objectives under the Stability and Growth Pact. Job creation and deficit reduction are our two priorities, as we are aware that without fiscal sustainability, it is not possible to achieve growth and lower unemployment in a sustained fashion.

The Spanish private sector is correcting the imbalances that accumulated during the earlier expansion. This process is already well under way, as made clear by the high

financing capacity of the private sector (6 percent of GDP in 2009). The household savings rate has reached 18 percent of household disposable income; this will enable households to boost their consumption even as they bring down their indebtedness. Businesses have also rebalanced their positions and are reducing their leverage. In this way, households and businesses will contribute to a gradual increase in private demand, which will be complemented by a positive contribution from the external sector. The financing needs of the economy have fallen by half already and will continue to decline, albeit more gradually. At the same time, far-reaching sectoral shifts are unfolding within the economy, including a lesser weight of the real estate sector, and a more prominent role for the tradable sectors. This process will help to bring about lasting improvements in the productivity and competitiveness of our economy.

This rebalancing in the private sector is taking place hand-in-hand with fiscal consolidation. The strong tensions in financial markets in 2010 have considerably affected Spain's economy this year. The government responded swiftly and resolutely, frontloading deficit reduction and giving an ambitious push to structural reforms, which is in turn rebuilding market confidence. We are convinced that, in the present context, the beneficial impact in terms of confidence will offset the negative impact on growth from curbing public expenditure. Furthermore, the sustainability of government accounts and structural reforms are laying the groundwork for sustained growth in the medium and long terms.

The restructuring of the financial sector and the reform of our labor market are two of the most important initiatives adopted to increase our growth potential. Similarly, we have eliminated bottlenecks in the services sector and introduced fiscal adjustments to correct the existing distortions in the housing sector. We are also continuing to work on further reforms in the areas of pensions, energy policy, and the transfer of technology.

On the fiscal side, the measures taken in May represent a significant cut in expenditure, including, among other measures, a 5 percent wage reduction for civil servants, the control of expenditure on pensions, and a decrease in public investment (after several years of great efforts in this area), will enable us to achieve our objective of narrowing the deficit this year. For 2011, the Budgets recently submitted to our Parliament provide for further austerity measures that will ensure we meet our overriding priority objective of reducing the deficit to 6 percent of GDP in 2011, in line with our adjustment path until we attain a deficit of 3 percent in 2013. This fiscal consolidation process will also facilitate a downward revision of the forecast for public debt, which is estimated at 68.7 percent of GDP in 2011, or 20 points below that of our partners in the euro area. Spain is thus demonstrating its ability to meet its commitments and create a positive climate for a sustainable recovery.

IMF Agenda

The International Monetary Fund has continued making progress over the past year as it adapts to the new challenges it has faced as a result of the international crisis.

First, although work remains to be done in this area, I consider a success the strengthening of the Fund's surveillance work through the more widespread use of its assessment of financial system sustainability in the principal countries. We support whatever efforts it makes in that regard. I encourage the Fund to work with the Bank for International Settlements and the Financial Stability Board in all the fields of global financial supervision.

The improvements recently introduced in financial support instruments and programs are also important and strengthen the Fund's ability to provide the member countries with insurance tools that give them the confidence to face any future crises and to respond in a flexible, appropriate way to the needs of each country.

Increasingly, however, the legitimacy and effectiveness of the IMF depend on a comprehensive reform of its governance structure, so that it can adapt to the new global realities and give appropriate recognition to the weight of each economy on the international stage. A centerpiece of this approach is, of course, the reform of the quota structure, which should allow for a considerable increase in the weight of the most under-represented members and so fulfill the mandate given by the International Monetary and Financial Committee to its members a year ago, in Istanbul. It is well known that Spain is one of the most under-represented countries in the IMF, both in terms of voice and of representation; our current quota reflects neither the weight nor the role of Spain in the world. I feel confident that this situation will be satisfactorily remedied in the process in which we are currently involved.

World Bank

Let me refer now to the World Bank agenda. With only five years to go before the deadline for achievement of the Millennium Development Goals, and after the setback resulting from the recent international financial crisis, it is now more than ever that however that we focus on achieving results.

The International Development Association (IDA) is taking steps in the right direction, focusing increasingly on its impact on the development of countries and perfecting its system for measuring results. IDA will thus become an increasingly efficient tool for poverty reduction.

It is therefore crucial to ensure the success of the Eighteenth Replenishment of IDA, currently under negotiation.

For its part, the World Bank has played a key role in ensuring that the developing countries have greater resilience when dealing with the recent global financial crisis, not only through its counter-cyclical response over the past two fiscal years but also thanks to its qualitative aspects, in particular the support it has provided to countries in designing their economic and social policies.

Still, there is room for improving the counter-cyclical support provided by the IDA to its client countries. We therefore welcome the creation of a crisis response facility as a means for providing timely assistance to countries affected by exogenous crises. Over the past two years, it has been demonstrated that the multilateral financial institutions have to fulfill a significant counter-cyclical role. Accordingly, we feel that this new facility will be an important milestone in the IDA replenishment under negotiation.

We are also pleased to see that the Bank is moving forward with the launch of the new post-crisis strategy that was agreed in April of this year, as well as with the introduction of various internal reforms that affect its instruments, processes, and organizational structure. These will make the Bank even more effective in the implementation of its strategy and in meeting the needs of its clients. Those reforms should be accompanied by an improvement in the governance of the institution, striking a balance between agility in the service provided and the accountability of the decision-making bodies.

In closing, I wish to reiterate Spain's support for these two institutions and emphasize our readiness to make progress decisively in the reforms we have before us, reforms that will no doubt enable us to improve the necessary coordination of our economic policies and so help ensure high levels of sustainable growth in the future.

