Miguel Fernández Ordóñez: The state of Spain's economy

Testimony by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, before the Parliamentary Budget Committee in relation to the draft State Budget for 2011, Madrid, 5 October 2010.

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Ladies and gentlemen,

I appear before this Committee in connection with Parliament's discussion of the State Budget for 2011. In my view, this Budget will be crucial for Spain's economic future and it will be subject, more than on any other occasion, to in-depth analysis and close scrutiny not only by Spanish society as a whole but also by the main supranational agencies, by our European partners and by the international financial markets on which Spanish households, firms and governments obtain the funds they need to finance much of their activity.

As is known, Spanish budgetary policy responded most forcefully to the global economic and financial crisis, in step with the support programmes for the financial sector, coordinated at European level, and with the firm, resolute action by the European Central Bank, which drastically cut its interest rates and implemented a wide range of conventional and non-conventional measures to prevent liquidity tensions from ultimately shutting down the European financial system.

The fiscal policy response undoubtedly contributed to softening the adverse effects of the crisis on the Spanish economy. Set against this, however, the surplus on public finances rapidly turned into a burgeoning deficit and public debt moved into an accelerating dynamic which, had it not departed from relatively comfortable levels, would have also placed the debt ratio at excessively high levels.

Such was the position of our public finances when the Greek fiscal crisis, which first became discernible in late 2009 and ultimately burst onto the scene in spring this year, shifted the focus of international economic and financial attention onto the situation of public finances in a broad set of countries.

Investors rapidly took stock of the potential problems of unsustainability implicit in Greek deficit and debt dynamics and they began to closely examine the possible existence of similar risks in other Member States. The upshot was that the instability on sovereign risk markets spread to the European economies evidencing the greatest vulnerabilities, whether because of the speed of the recent deterioration in their public finances or because of the scale of the macroeconomic imbalances that had built up before the crisis.

I honestly believe that the financial tensions in recent months in Europe, in general, and in our country, in particular, were largely due to an overreaction by the financial markets, which were unable to appreciate the strengths of our economy and of our public finances.

But I likewise believe it would be a serious error to attribute the bouts of exceptional tension witnessed during these months solely to the gregarious behaviour of the financial markets. Indeed, the tensions were amplified by the weaknesses of European institutional arrangements and by the prevailing doubts over the willingness and ability of national governments to tackle the structural and budget deficit problems of their economies.

Evidently, the Greek crisis has highlighted the incapacity of the Stability and Growth Pact and, more generally, of the European economic governance framework to prevent the excessive build-up of imbalances and to pursue timely corrective action. As you know, the European authorities have reacted to this need by initiating a deep-seated review of European governance mechanisms, some of the results of which are already coming to light. It can thus be said that as a result of this crisis, economic policies and, in particular, the fiscal policy of the EU Member States, will be subject henceforth to closer and more detailed control by the European institutions so as to anticipate and forestall inconsistencies and imbalances. Any build-up of the latter will ultimately entail major costs not only for the countries concerned, but also for the European single currency project.

Further, attributing events exclusively to market excesses would mean ignoring the importance of the effects of the decline in activity and employment, of the deterioration in public finances and of financial systems on the possibilities of recovery, and the major economic policy challenges posed thereby, most particularly in the fiscal realm and in the field of structural financial reform.

From this perspective, it is easy to understand how the Spanish economy was subjected to singular pressure. The deterioration in its public finances was evident not only because the budget deficit had climbed to an excessive level, but also because of the rapid increase in the public debt ratio, despite the fact that general government debt remained substantially lower than that in other European economies facing similar pressures.

But there were also other factors amplifying the vulnerability of the Spanish economy in such exceptional circumstances. Firstly, the dysfunctionalities of our labour market, which heightened the impact of the shock on employment, giving rise to a surge in the unemployment rate that called into question the possibility of reversing the course of public spending in the absence of reforms that would enable a significant and lasting reduction in unemployment. As I stated before this Committee a year ago, the viability of any credible budgetary consolidation strategy would require the adoption of labour market reforms providing for far-reaching change in employment behavioural patterns.

At the same time, the Spanish economy's high reliance on external funding made it particularly sensitive to any loss of confidence blocking access to such financial resources, in particular access for credit institutions, which channel the bulk of these resources to households and firms.

All these factors contributed to the contagiousness of the sovereign debt crisis and to the serious external funding difficulties experienced from May to July. Had this situation continued, it would have jeopardised the soundness of the financial system and the vital funding of the economy.

In order to break the dangerous dynamic unleashed and to restore confidence in the Spanish economy, which had become the main objective, it was vital to set new bearings for economic policy through the adoption of substantial fiscal, labour and financial measures.

I previously had the opportunity to inform you of the numerous financial measures pursued to oversee the necessary restructuring of the Spanish banking system, an essential condition for the sound and sustainable recovery of the economy. Allow me today to refer to the role played by the stress tests of the banking system in late July. These are a marker of the progress made in restructuring and, above all, they have provided for an exercise in transparency, allowing us to break the vicious circle of lack of confidence that was building up on the basis of relatively unfounded assumptions and expectations.

As you will recall, when I presented the Banco de España Annual Report for 2009 in June, I set out our intention to publish the stress tests of all Spanish banks and savings banks. This initiative was assumed at European level by the European Council under Spain's presidency, and the results of the exercise, harmonised by the Committee of European Banking Supervisors, were published on 23 July. In Spain's case, the stress tests covered virtually its entire financial system and were conducted in great detail and with a high degree of transparency, providing extensive information on exposure to the principal asset classes. The results showed the system as a whole to be sound, whereby their publication undoubtedly contributed to dispelling the doubts over our financial system.

The final piece in the far-reaching reform of the financial system has been the savings bank legislation approved by this House. In opening up savings banks to private capital, the legislation will not only allow savings banks to move ahead without having to request assistance from taxpayers, but it will also enable them to meet the demanding capital requirements set under the new international financial regulation known as Basel III.

In the budgetary domain, the government reinforced and accelerated the implementation of the fiscal consolidation programme which, in compliance with Community commitments, it had announced in January. To this end, it approved a new raft of measures on 20 May entailing spending cuts of somewhat over €15 billion to be made between 2010 and 2011 (around 1.5% of GDP), on top of the previously approved spending cuts and tax rises. The new deficit target path was thus set at 9.3% of GDP in 2010, 6% in 2011, 4.4% in 2012 and 3% of GDP in 2013, which would steady the public debt ratio at a level slightly below 75% of GDP as from 2012.

Adopting a package of adjustment measures to come into force immediately, for a significant amount, in sufficient and specific detail, and affecting items as sensitive as public-sector wages, welfare benefits and public investment, gave credibility to the commitment to reduce the budget deficit. Also contributing to this was the bringing forward of the fiscal adjustment targets, whereby almost two-thirds of the adjustment envisaged by 2013 would be completed in 2011.

Finally, having noted the failed negotiations between the trade unions and employers' associations, the government approved a labour market reform on 16 June aimed at encouraging permanent hires and increasing internal flexibility at companies, two of our labour market's most serious shortcomings.

The adoption of these measures, along with the publication of the banking stress test results, saw the tensions on financial markets abate. There was a significant reduction in funding costs for the Treasury and a reopening of funding channels for credit institutions.

Yet this does not mean that the period of instability is over, as the tensions still bearing down on other European countries show. Accordingly, following this initial response it is essential to maintain the credibility earned without losing sight of the fact that for a long time we will be subjected to very close scrutiny, and that episodes likely to spread suspicion and a lack of confidence may arise.

This is the particular juncture we have reached and at which we are discussing this Budget. And these are the reasons why the recovery of the Spanish economy and employment will depend, more so than on past occasions, on a suitable budgetary policy mix and on its interplay with other economic policy tools, most particularly with supply-side and structural reform policies geared to improving employment-generation capacity, smoothing the switch to other productive activities and increasing the economy's effectiveness and productivity.

The cyclical juncture at which the Budget for 2011 has been drawn up is marked by the muted start of a phase of recovery which became discernible in the opening months of 2010 and which will foreseeably continue over the coming year. Nonetheless, exceptional domestic and external factors of uncertainty are clouding the outlook.

So far, the recovery is proving very subdued and dependent on temporary stimuli linked to the government plans supporting spending and to the possible bringing forward of consumption and residential investment decisions by households and firms in the face of the rise in indirect taxes on 1 July. Moreover, funding conditions remain restrictive and both the public and private sectors have a pressing need to restore health to their financial position.

In these circumstances it will be difficult for domestic demand to post the same figures it did in the first half of the year. The rate of increase of household consumption, one of the most dynamic items in that period, will foreseeably slacken, in line with the diminished growth rate of earnings and the lower contribution of other sources of income, in particular those stemming from general government measures. The response of consumption is expected to be consistent with a declining trajectory of the saving ratio, in step with the changes observed since the start of the year, after almost two years of successive increases in this ratio. It is very likely the other domestic demand components will continue to reflect the weakness of their main determinants. In the case of investment in equipment, this will be due to the excess capacity built up during the crisis and the still-prevailing uncertainty over financing conditions; and in that of residential investment, to the need to complete the adjustment set in train back in 2006.

In contrast, net external demand is expected to be more buoyant once the high growth rates of imports of the previous quarters ease, rates which were linked largely to the bringing forward of certain spending decisions, and exports continue on their rising course. For this to occur, perseverance will be needed in anchoring the cost- and price-competitiveness improvements obtained in recent quarters and entrenching them with genuine productivity gains.

In sum, the outlook for the Spanish economy is one of gradual recovery which will take some time to attain the dynamism proper to an expansionary phase with sufficient capacity to generate employment. The restoration of confidence, the positive effects of fiscal consolidation on agents' expectations and the lessening of uncertainty in the labour market, further to the reform under way, will need to be the essential ingredients of any sustained recovery. The private sector must take up the baton from the public sector in support of activity, and net external demand should play a predominant role.

The success of the fiscal consolidation programme is a centrepiece of this strategy. Correcting the budget deficit has become an unavoidable priority for Spanish economic policy.

The budget outturn data currently available suggest the targets set for 2010 will be met, at least as far as central government conduct is concerned. On this basis, it is therefore vital to design a budget for 2011 that is fully consistent with meeting the budget deficit target of 6% of GDP for that year.

To ensure no deviations arise, monitoring and surveillance procedures for the budget outturn must be reinforced and, should deviations be detected, corrective measures must be rapidly applied. The availability of contingency plans designed sufficiently in advance would contribute greatly to the success of these measures.

The draft State Budget details appropriately the revenue- and spending-side measures that should allow compliance with the State target set. In terms of its composition, moreover, the draft Budget has most of the adjustment falling on public spending. And this, on past experience, raises the effectiveness of the consolidation strategy.

Yet the presence of risks threatening the attainment of these targets should not be understated. The Budget is based on a macroeconomic scenario of significant recovery which, if not confirmed, might lead to a revenue path worse than projected. As I said, if this were the case, offsetting measures should immediately be applied.

But perhaps the biggest risk to general government meeting its targets stems from the potential deviations that may arise at the regional and local government level. As known and reiterated on many occasions, the high decentralisation of public spending in Spain means that the collaboration of the regional and local governments is essential for achieving budgetary stability. At the end of this year it will be possible to make a full assessment of the consolidation drive made by the regional budgets, but my impression is that, as matters stand today, the measures announced by most regional and local governments far from respond to the reduction in public spending needed.

I therefore believe formulas must be sought to strengthen regional and local government commitment to budgetary stability and to encourage compliance. In this respect, we should not rule out a revision and strengthening of the national budgetary framework, in particular in the case of regional and local governments, a framework that resides essentially on the Budgetary Stability Law. Such action would be in line with the recommendations recently made by the European Council for all European countries in the framework of the review of governance in Europe.

A key element of the Budgetary Stability Law for achieving fiscal discipline is transparency. The dissemination of data relating to the non-financial activity of the State is abundant, detailed and released with a relatively small lag. This is regrettably not the case for regional or local governments, which curtails the ability to control their activity in time and accountability. In my view, these shortcomings must urgently be redressed. At a time such as the present, a lack of transparency may lead to a lack of market confidence that takes the form of a further premium on the cost of financing.

Given the circumstances, all available instruments should be used to ensure compliance with the targets set. In particular, authorisation for regional and local governments to issue new debt should be conditional upon compliance with consolidation plans. A spending ceiling might even be considered for these governments, an instrument which has proven enormously useful in strengthening budgetary discipline in the case of the State.

Along the same lines, medium-term planning necessitating analysis of the structural dynamics of the various public revenue and spending items and enabling those areas where the scope for rationalisation and adjustment are greater to be detected may prove appropriate, especially when adjustment measures going beyond a temporary correction of imbalances are required.

In this setting, the reform of the pension system currently under discussion is especially important. Indeed, it goes beyond the major goal of ensuring the long-term sustainability of our pensions system in the face of the challenge of population ageing. This reform may also have significant and beneficial short-term effects on the credibility of the authorities' commitment to budgetary discipline and the ability to see through far-reaching structural reforms and favourably influence the risk premia on public debt.

The promptness and ambitiousness of the reform are essential. A suitable combination of changes in certain parameters of the system, raising the legal retirement age, the minimum number of years necessary to qualify for a pension and the period over which the pension is calculated would help ease substantially the pressure on future public spending on pensions and resolve one of the Spanish economy's major outstanding problems.

Fiscal consolidation is an essential condition for ensuring future economic growth. The effort will no doubt be rewarded because it will place the Spanish economy in a sounder position to anchor the recovery. Its long-term effects will in any event prove more forceful if accompanied by structural reforms that raise the economy's growth potential. The elements interconnecting both policies are on an enormous scale: potential growth influences the sustainability of public finances, while an appropriate distribution of adjustment efforts across the various spending and revenue items is conducive to activity and has expansionary effects on output and employment. Harnessing these links is particularly important for absorbing high unemployment and correcting the imbalances built up during the boom years.

Economic policy action geared to strengthening growth foundations is of vital importance, particularly the reforms promoting job creation. Such action makes possible the achievement of gains in competitiveness and enhances the economy's long-term efficiency and productivity. And it is also essential for boosting the external sector and providing for the rapid reallocation of resources towards potentially dynamic goods and services branches.

As I have reiterated on many occasions, labour market reform is pivotal here. Indeed, significant progress has been made with the recent approval of the legislation on urgent labour market reform measures. Among the changes made that may contribute to improving the functioning of our labour market, I feel it is important to stress the greater possibilities available to firms to adjust working and wage conditions to the changes arising in demand or in supply-side innovations, thereby limiting the impact of these shocks on employment. It is now for employers and employees to take full advantage of the new opportunities provided by labour reform so that the necessary gains in competitiveness can be had as soon as possible, swiftly ushering in a new phase of economic dynamism and job creation. Slowness in harnessing the internal flexibility offered by the reform would but hamper recovery and delay the generation of new jobs.

It is important to take advantage of the conditions in place so that the wage moderation begun in the first half of the year may take root in the coming quarters, and so that ailing companies may maintain employment and ensure their survival by drawing on the new avenues of flexibility offered to them, through negotiations with their workers. The austerity measures adopted in the public sector, which include wage cuts, will help bring about the adjustments the private sector needs to entrench its competitiveness. On top of wage restraint in those companies that need it to restore competitiveness, there should be genuine productivity gains based on greater efficiency, since so far their expansionary behaviour chiefly reflects the severity of the employment adjustment.

A further key ingredient to ensure gains in structural competitiveness is the continuation of the current low-inflation scenario once the recovery firms. The return of the core inflation rate to its low level before the VAT rise, once the base effects are stripped out in the second half of next year, would be a good indicator that cost- and price-setting processes are moving in the right direction and are capable of surviving comfortably within an area of price stability. The absence of indexation clauses in wage bargaining for 2011, as stipulated in the agreement in force, will help prevent the rise in VAT from exerting second-round and inflation-inertia effects. This experience is another example of the advantages to be had from abandoning indexation clauses, which are no more than a legacy of inflationary habits from a past firmly behind us, but whose continuing use has been a source of problems, as the Banco de España has reiterated.

Improving our economy's productivity in the medium and long run will require seeing through other, deeper structural reforms, including most notably sectoral liberalisation, the rationalisation of the public sector's role in economic activity and improvements to the education system. These are reforms whose introduction needs time and whose effects will be deployed over a lengthy period; but the resolve to adopt them also has positive effects in the short run by improving expectations about our economy's economic growth, which is particularly welcome in these testing times.

Thank you.