Miguel Fernández Ordóñez: Recent developments in the Spanish economy

Testimony by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, before the Parliamentary Committee on Budget Affairs, Madrid, 17 April 2012.

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Ladies and gentlemen,

I appear today before this Committee as I have regularly done so each time the State Budget has been debated in Parliament. This picture of normality is in stark contrast to the exceptional circumstances which mark the economic background against which the 2012 Budget is being debated.

The Spanish economy is currently immersed in a complex and costly adjustment process which entails, among other things, a major fiscal consolidation drive. The adjustment must, moreover, be made in an external context strongly influenced by a sovereign debt crisis in the euro area which, for reasons not very different from those that have made this adjustment necessary, is affecting us most severely. Under these conditions, the State Budget for this year takes on singular importance.

Allow me first to remind you that the sovereign debt crisis in Europe, far from being resolved, took on a new dimension last summer. Then, tensions spread to the debt of certain Member States with sounder fundamentals and economic policies more in step with the patterns of behaviour befitting a monetary union than those of the countries initially affected. From being confined to a relatively limited group of particularly vulnerable economies, the crisis became systemic.

It is not easy to pinpoint the ultimate reasons behind this qualitative leap. True, at the root of the crisis as it initially unfolded, various macroeconomic imbalances of a fiscal, financial and competitiveness-related nature built up by some economies played a pivotal role. Yet, at the same time, the very accumulation of these imbalances and the difficulty of devising a widely accepted strategy to redress them in an orderly fashion within the euro area highlighted the existence of substantial weaknesses in the European economic governance framework. These included most notably the absence of a powerful and flexible crisis-management mechanism to provide financial support to members in difficulty. These mechanisms are essential for heading off tensions at a sufficiently early stage in the process, which is when tackling them is less difficult.

The duality of the problems, with one purely national component and another genuinely European one, coupled with the growing interrelatedness of euro area economies as a whole, created a breeding ground in which the tensions took on a systemic nature.

Moreover, it is widely known that, to correct the weaknesses detected in the initial design of the euro project, the Member State governments have embarked on a thorough revision of the mechanisms for European governance. This process has already yielded some results, including the legislative initiatives adopted in what is known as the “six plus two package”; the Treaty establishing the European Stability Mechanism, the new permanent European crisis-management mechanism; or the Treaty on Stability, Coordination and Governance in the euro area. But the flip-side is that this process has moved forward in fits and starts, it has not enjoyed a broad degree of consensus and it has sometimes failed to be as rigorous and ambitious as the gravity of the situation required.

Likewise, since the onset of the tensions there has been – occasionally notable – headway in the ongoing adjustment of the most vulnerable national economies, sometimes in step with the strict conditionality imposed under the financial support programmes under way. But here, too, action has broadly tended to be behind instead of ahead of events.

In these conditions, it is the European Central Bank that has positioned itself as the fundamental bulwark against the crisis. And, ultimately, this is buying time for the Member State governments, in both their responsibility for domestic economic policies and as co-managers of the common European Project, to make resolute progress in resolving the problems at the root of this crisis.

We should not forget that the extensive range of non-conventional measures deployed by the ECB since the start of the crisis – the 3-year LTROs being one of the most recent and successful examples here – are, by their very nature, limited over time. And, more important still, these measures do not affect the fundamental imbalances which are ultimately at the source of and responsible for the crisis.

Unfortunately, the tensions we have once again experienced in recent weeks are a powerful reminder that the crisis is still far from over and that our economy's situation remains a particular cause for concern in Europe.

And this despite the fact that since the start of the sovereign debt crisis, and more forcefully so in recent months, Spain has implemented major reforms.

A frequently voiced criticism of the ECB's 3-year LTROs is that such an extremely generous provision of liquidity will tend to mask the underlying problems of the most vulnerable financial systems, thereby weakening the thrust of governments' reforms in this area. This has not, of course, been Spain's experience. A glance at the measures adopted in Spain shows that the process to clean up, restructure and recapitalise the Spanish credit system has lost no momentum whatsoever. Rather, the opposite is true. Throughout last year and in the opening months of 2012 the process has been stepped up to adapt it to changing circumstances, marked by a growing deterioration in economic and funding conditions. After resolving the governance and ownership-structure problems affecting the system in the initial stages of the tensions, efforts have focused recently on further strengthening banks' capital and provisions, thereby keeping up the pressure for the necessary restructuring of the sector.

In a different sphere, a labour market reform has recently been approved which affects core aspects of this market's workings. On one hand, its aim is to decentralise collective bargaining and increase firms' internal flexibility. As I previously stated in this House, both of these aspects are essential for adapting labour market conditions to firms' specific circumstances and, ultimately, for allocating the productive resources available more efficiently, in particular labour, to different economic activities and sectors. On the other, by rationalising the conditions under which permanent contracts may be terminated, the reform shapes an environment which will be more conducive to job creation and job stability, once the current difficult circumstances are behind us. Overall, the labour market changes should help promote the adjustment of working and productivity conditions as means for restoring competitiveness.

However, it cannot be ruled out that some of the effects of this reform will not be immediately discernible and that, given the setting of sluggishness and uncertainty in which Spanish economic activity is currently unfolding, there may be some further adjustment in employment levels. This effect would be softened if firms were swiftly to use the various forms of internal flexibility provided by the new labour legislation.

In turn, the favourable effects of this reform will be amplified if they are accompanied by measures that enhance the competitive environment in which firms take decisions and that provide for the liberalisation of sectoral aspects that are key to ensuring efficient and flexible economic behaviour. Ambitious measures here would help bring about a virtuous circle which, through job creation and growth, would see more rapid progress in the difficult tasks of the financial deleveraging of the private sector, the normalisation of the banking system and fiscal consolidation. Confining myself to this latter consideration, without a recovery in employment it will prove costlier to further budgetary adjustment, since the increases in revenue will be limited and because turning expenditure around will require an additional effort to offset the necessary increase in unemployment benefit payments.

In any event, budgetary policy is key in circumstances such as the present. As I stated earlier, we are in the middle of a sovereign debt crisis. There is no doubt that the Spanish economy's vulnerability has a significant fiscal component, although our difficulties are compounded by the persisting downturn – and its dreadful impact on employment – and the still-high dependence on external funding. The budget deficit ended last year at a level of 8.5%, far off the 6% target set in the Stability Programme. And the year-end public debt/GDP ratio was 68.5%, more than 30 pp up on 2007, before the international financial crisis broke. In turn, the deficit targets have been set at 5.3% for 2012 and at 3% for 2013, which entails a most significant budgetary effort. It is crucial, however, to rigorously meet these targets. Attaining them is vital for restoring credibility in the Spanish economy, and here the overall interests of all economic and social agents and all levels of government converge. A high degree of unity and consensus among the respective parties will be pivotal to success in the arduous task ahead. Failure in fiscal consolidation would lead us to scenarios involving further contraction and further losses in employment and welfare.

The exceeding of the deficit targets last year has highlighted the difficulty of correcting fiscal dynamics in adverse cyclical situations. But it has also revealed the faults existing in the monitoring, early warning and budgetary control procedures then in force, especially for the regional governments, which the budgetary stability law currently before Parliament and which I shall refer to later must correct.

In this respect, the experience of the last two years shows how important it is that budgets be prepared on the basis of a prudent macroeconomic scenario and that the measures are suitably designed to ensure their effectiveness. It is also important to have early information available on the budget outturn, so that any deviations can be corrected in time. These principles affect both the Stage Budget, the reason for my appearance here today, and the regional government budgets, which I am not going to discuss, although I do wish to take this opportunity to convey my concern regarding the obsolescence of some of the assumptions on which the latter were prepared during the latter months of 2011. These assumptions need to be updated and the appropriate measures urgently adopted to ensure that the regional governments achieve their targets.

Allow me to refer briefly to the delicate cyclical situation that frames the context of the State budget for 2012. The intensification of the sovereign debt crisis from the summer of last year interrupted the mild recovery that the Spanish economy had begun a year earlier, with a decline in GDP of 0.3% in the final quarter of 2011. This pattern ran into the first quarter of this year, so that the Spanish economy is, once again, in recession.

As in the case of the 2008–09 recession, national demand is displaying the greatest weakness. All domestic demand components declined in the fourth quarter of 2011 and have continued to do so during the first few months of this year. A strongly negative factor during all these ups and downs has been the need to reverse the accumulated imbalances (the assignment of excessive resources to housing, high indebtedness and competitiveness losses), as part of an adjustment process that has still to be concluded. More recently the intensification of the sovereign debt crisis and its effects on the financial system has compounded matters, leading to a tightening of the economy's financing conditions and eroding agents' confidence. The downward revision of euro area growth prospects and the stepping up of fiscal consolidation have contributed to a further contraction in consumer demand and investment, and the acceleration in the decline in employment has further fuelled these trends.

In the face of slack national demand, the external sector has once again acted as a shock absorber, alleviating the negative impact of lower spending on output. In recent quarters, however, this relief has come about more through the channel of lower imports than that of more buoyant exports, which is attributable to the parallel weakness of some of our main European customers.

In these conditions, the outlook for 2012 is not favourable and remains subject to a high degree of uncertainty. Broadly, the Banco de España's view does not differ greatly from that of the Government implicit in the macroeconomic table accompanying the Budget. The process of adjustment of national demand will continue. Private consumption will be affected by the decline in employment and by the lower support that general government will be giving to household income. However, the impact of these two factors will be partly offset by more moderate price increases and, probably, by a continuation of the decline in the saving rate, although the margin available for this to smooth the pattern of private consumption is increasingly limited.

Business investment will undoubtedly be affected by the slackness of domestic spending and because many firms will continue aiming to reduce their level of indebtedness. Nor are significant changes in the ongoing adjustment of residential investment foreseeable. On the demand side, no improvement can be expected in affordability conditions given the outlook for private sector income and wealth and, on the supply side, the overhang of unsold housing will continue to hold back the launching of new construction projects.

The need to reduce the levels of indebtedness of all sectors and the prevailing conditions of access to external financing will continue to curb the possibilities for any expansion in domestic spending. Exports might be the only component of output to increase in 2012. Admittedly, the international situation is subject to a high degree of uncertainty and, in particular, the activity of the euro area as a whole is expected to flatline or fall slightly. But it is also true that the behaviour of exports has been very favourable over the last two years and Spanish firms have been increasingly diversifying their exports towards third markets with more dynamic demand.

Unfortunately, the stimulus provided by external demand will not suffice to offset the effect of the other contractionary forces on employment, which can be expected to fall further. If the labour reform were to begin to produce its effects soon, wages might grow somewhat slower than in 2011. And along with productivity gains, that would lead to further declines in unit labour costs, thus enabling competitiveness gains to be made. Prices will continue on the moderating path on which they embarked in the second half of last year, although the risk of rising energy prices has not disappeared.

To sum up: the scenario described indicates that domestic demand will continue to adjust in step with the ongoing financial deleveraging and fiscal consolidation. In these circumstances, it is vital that the gain in the share of our sales, both abroad and at home, should be the main driver of activity in Spain. And, accordingly, achieving sustained competitiveness gains, which must come from the implementation of ambitious supply-side reforms and measures, is crucial. If these reforms and measures should restore confidence in the Spanish economy, reduce financing costs and improve the foundations for future growth, 2013 may witness a recovery.

In this situation, the 2012 Budget forms part of a more general medium-term consolidation strategy, requiring the collaboration of all levels of government. Details will be available in a few weeks, when the Government presents the Stability and Growth Programme to the European authorities. The Stability Programme should contain precise and explicit details of all the elements on which this consolidation process will be based. The targets set by this Programme must anchor the budget measures of the coming years, ensuring that the general government deficit can be reduced to below 3% of GDP in 2013 and, subsequently, that a balanced budget can be achieved. In addition, they must seek to stabilise the public debt ratio and subsequently reduce it to below 60% in 2020.

The fiscal consolidation so defined must be considered unavoidable and necessary to restore economic growth in the medium term, although the size and timing of the adjustment required may have negative effects on activity in the short term. In an environment like the present one, characterised by the extreme sensitivity of economic agents to economies' fiscal situation, in particular in the euro area, any other strategy that might jeopardise the achievement of the fiscal targets in the terms established would have very negative consequences for market confidence in the Spanish economy, seriously damaging its growth possibilities both in the short and in the medium and long term. By contrast, strict compliance with the commitments made may generate a virtuous circle of improvements in confidence and expectations that is conducive to the recovery.

The 2012 Budget for the State and the Social Security system, along with the budgets of the regional and local governments, are the first link in this strategic chain. It is vital that these budgets be fully consistent with achievement of the target set for the budget deficit of 5.3% of GDP this year, down from 8.5% of GDP in 2011. This reduction in the budget deficit requires an unprecedented adjustment in the primary structural deficit, since it must offset the expected increase in the interest burden and the effect that the fall in economic activity is forecast to have on public finances.

The draft State Budget for 2012 details the measures proposed to meet targets in the case of the State and the Social Security system, distributing the adjustment on both the public revenue and expenditure sides. Admittedly, as I have noted on previous occasions in this House, the evidence on the effectiveness of previous fiscal consolidation processes implemented in other developed economies shows that it increases when they are concentrated on public expenditure, in unproductive expenditure. However, the scale of the adjustment required in our country is so great that we need to make use of all the instruments available, including taxes.

The 2012 Budget envisages an increase in revenue from tax measures falling basically on household and corporate income. Also, a special charge is imposed for the regularisation of hidden assets. The revenue-raising potential of these measures is expected to offset the fall in revenue due to the unfavourable trend in tax bases deduced from the macroeconomic scenario accompanying the Budget. Last year's experience, when the bulk of the budget deviation stemmed from the adverse performance of government revenue, showed that it is essential to budget prudently for this variable. In this respect, the projected course of overall budget revenue is subject to downside risks. The reasons for this are various. First, because both the expected corporate income tax receipts and any other tax revenue will depend on the ultimate effectiveness of the numerous legislative changes, which is particularly uncertain in the case of the special charge on undeclared income. It should also be emphasised that the Spanish economy is in the midst of a process of macroeconomic adjustment and, as noted above, its growth prospects depend on the external sector, which tends to yield only moderate increases in tax revenue in the short and medium term, particularly if this is accompanied, as in the Spanish case, by an adjustment in the real estate sector.

On the expenditure side, the draft Budget proposes highly significant reductions concentrated in capital expenditure and also in current transfers and goods and services purchases. In the case of transfers to government-owned corporations, it is important for the planned reduction to be accompanied by adjustments of similar size in the effective expenditure of these entities, so as to achieve a lasting reduction of the imbalances. Here, too, the Budget projections are generally not free from risk. First, because it is often difficult to restrain the high inertia of certain items, frequently resulting in the past in overshooting with respect to the initially budgeted figure, particularly in the case of goods and services purchases. Nor can we rule out further unfavourable changes in those items, such as unemployment or pension benefits, whose size depends on external factors, such as the unemployment rate, population or inflation. This is related to the fact that the risk of deviating from the budget is higher in social contributions.

It is essential to prevent these risks from materialising by ensuring a meticulous and rigorous budget outturn allowing budget deviations to be detected in time and any required remedial action to be taken. Should this be necessary, additional adjustments would have to be made in current expenditure, given that the freedom of action in relation to capital expenditure has shrunk enormously, and new tax measures would have to be taken, preferably in the area of indirect taxation, which has fewer distorting effects on growth and the allocation of resources and where the tax burden in Spain is lower than in other developed countries. Looking ahead, moreover, it cannot be ruled out that the temporal tax increases applied may have to be replaced in time by measures of a permanent nature.

Simultaneously, it is important that the process of budgetary consolidation be accompanied by a strengthening of the national budgetary framework, so as to allow governments at all levels to meet their commitments. In this respect, the reform of the Constitution in September 2011 so as to include the deficit and debt ceilings set at European level, which was subsequently implemented in the draft budgetary stability law, was designed to meet this need and is fully consistent with the recent EU governance reforms.

Following the approval of the budgetary stability law by Parliament, it is crucial that all the instruments envisaged in it, particularly the monitoring and control mechanisms and those aimed at ensuring that the targets set are met by all levels of government, be set in train immediately. I think it is worth looking more closely at this law because the success of the fiscal consolidation process depends largely on whether it is applied properly.

The 2011 budget outturn highlighted the consequences of the unavailability of information, which prevented budget deviations from being detected in time and delayed the activation of mechanisms to ensure the consolidation targets were met. The new stability law should significantly improve the transparency of government action in at least three respects. First, it is essential for the budget outturn of local and regional governments to be published regularly, with the same periodicity, level of detail, lag and ease of access as that of the State. Second, the information contained in the State and regional government budgets must be improved, so that the assumptions underlying revenue and expenditure projections are known and the information is made available on these items in national accounts terms, which is the relevant definition for the existing fiscal rules. Finally, the information in the adjustment plans at the various levels of government should be made public and presented in a format allowing it to be analysed and compared with the initial budgets.

In addition, the mechanisms obliging government deficits to be corrected have clearly proved to be insufficient. In this case, the draft stability law includes new coercive instruments to ensure the budget targets are met by all levels of government. Provision is made for imposing sanctions, regional government expenditure must be automatically adjusted in certain cases of non-compliance and it is even envisaged that the central government may impose compulsory adjustment measures on local and regional governments. I consider that these new legal mechanisms can be extremely effective in ensuring discipline if they are applied rigorously and appropriate procedures are established to supervise the budget outturn during the year. In this respect it is vital, as established in the law's passage through Parliament, that these provisions are applied as from their approval, in time to be used in the current consolidation process.

Finally, the draft stability law retains the clause stipulating "no bail-out" between governments which was introduced in the previous law. I consider that, as at European level, this clause is crucial to prevent the cost of a government's inadequate fiscal conduct from being passed on to others and to ensure that the capital market exercises disciplinary effects. At the same time this draft law allows regional and local governments to request extraordinary liquidity support measures from the State. In this case a plan to ensure that the fiscal targets will be fulfilled must be submitted and the payment of each tranche of financial aid must be dependent on such fulfilment. In this respect, in the opening months of this year, the Government set in train various regional and local government support mechanisms in order to smooth the refinancing of their existing debts or payment to trade creditors. The financing mechanisms agreed also require fulfilment of adjustment plans. It is now crucial to insist on strict compliance so that this type of aid does not provide inappropriate incentives.

The consolidation strategy must, finally, be completed while keeping in mind the medium- and long-term factors affecting public finances, particularly those deriving from the pressure exerted by population ageing on certain items of expenditure. In this connection, following the enactment in July 2011 of the Social Security Reform Law, an appropriate definition of sustainability is needed as soon as possible so that the system's parameters may be automatically adapted to demographic changes.

In short, the current budgetary imbalance has become one of the main obstacles to growth of the Spanish economy. Correcting it is urgent and unavoidable. What is thus needed is a fiscal adjustment strategy based on commitments made at European level. This strategy has to be accompanied by a strengthening of the national budgetary framework, as reflected in the constitutional reform, and by the application of the medium and long-term reforms that enable the challenge of population ageing to be addressed. The credibility of this strategy, which calls for absolute rigorous compliance with the short-term objectives set in the 2012 draft Budget law, will determine whether economic agents regain their confidence in our economy, which is the key to a sustained recovery of activity.

Thank you.