

## Miguel Fernández Ordóñez: Developments in Spain

Testimony of Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, before the Senate Budget Committee in relation to the draft State Budget for 2012, Madrid, 30 May 2012.

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Ladies and gentlemen,

I appear before this Committee at a vitally important juncture for our country. A severe crisis continues to assail the Spanish economy, making it a centre of attention not only for the euro area countries, but probably for the world economy. Against this background, the 2012 Budget is a key instrument for shoring up the credibility of our public finances and our economic policy in general, and for restoring confidence in our economy.

The seriousness of the current situation is inextricably linked to the European sovereign debt crisis, which worsened last year, spreading to countries with sounder economic fundamentals than those initially affected. The depth of the crisis and the difficulties in overcoming it can be attributed to the macroeconomic imbalances built up by various economies, imbalances that reached an excessive scale owing, perhaps, to the apparent protection afforded by the Monetary Union. But the current critical situation may not be understood without considering a European element relating to the absence of suitable mechanisms within the Union to tackle problems on this scale and to the difficulties of shaping a strategy enabling them to be corrected in an orderly manner.

The depth of Spain's problems, along with the lack of a suitable European response, has led moreover to the crisis becoming systemic, acutely affecting countries with problems of a different nature and magnitude.

True, there has been some progress in European governance in recent years, with the strengthening of procedures already in place, the design of new macroeconomic surveillance procedures and the implementation of new Treaties. These treaties include that establishing the European Stability Mechanism, and the Treaty on Stability, Coordination and Governance in the euro area, which makes provision for the so-called Fiscal Compact. But this progress has not been sufficient to stabilise the situation, partly due to the lack of broad consensus that is apparent in the stance and statements of different European authorities.

In these circumstances, action by the European Central Bank has been key to easing the moments of greatest tension and extending the time available to adopt the necessary measures in other economic policy areas. Evidently, the ECB cannot resolve the serious underlying problems of this crisis, be they national or related to the European architecture. It can only address some of the manifestations of these problems, in particular those reflected in financial markets, with a view to smoothing the way so that governments can take the corresponding measures.

Spain is a clear example of an economy in which Eurosystem action has overcome critical situations and has provided the time needed to set in train ambitious reforms in various areas. Significantly, this reforming drive has in no way been slowed by the fact that the Eurosystem has taken specific measures, such as the three-year long-term refinancing operations. In the specific case of the ongoing clean-up, restructuring and recapitalisation of the Spanish credit system, this process has intensified, to adapt to a new set of increasingly worse economic and financing conditions, by imposing stricter capital and real estate provisioning requirements on banks.

Of the recently adopted structural reforms, I would underline the importance of the labour market reform. This is an area where Spain had built up evident inefficiencies that have now been tackled to some extent by the new legislation. The essential role of employment in any

scenario for exiting the crisis should also be highlighted, since only with a recovery in jobs can a stable path of public finances, a reduction in private debt and bank restructuring become entrenched.

The labour market reform is intended to provide companies with various means to achieve greater internal flexibility, so that they may adapt working conditions more rapidly and effectively to their position in the cycle. In this respect, it allows the decentralisation of collective bargaining and shapes an environment more conducive to job creation and job stability, once the current difficult circumstances have been overcome. Overall, these changes should in time bring about a recovery in the competitiveness of Spanish companies.

It is very important that the reform should be accompanied by measures that improve the competitive environment in which companies take decisions, promoting the liberalisation of activities where there are still obstacles to competition.

But let me move on to the main part of my testimony: the examination of Spanish budgetary policy. I said at the outset that Spain is the centre of attention for the international economic community. This is because we face a particularly complex situation, where there is an overlap between various adjustment processes and imbalances, generated following a long upturn. Possibly, Spanish fiscal policy was not the source of the current difficulties. But clearly, overcoming these problems will require us to swiftly move public finances towards a path of stability, as this is crucial for restoring agents' confidence and reducing uncertainty about the economic outlook.

As you know, following the recent revision, the budget deficit ended 2011 at 8.9% of GDP, a long way off the 6% target set in the previous Stability Programme. The public debt/GDP ratio stood at end-2011 at 68.5%, more than 30 pp above the 2007 figure. The deficit targets have been set at 5.3% of GDP for 2012 and at 3% for 2013. If these targets are met, the public debt/GDP ratio would stabilise in 2014, albeit at a level somewhat higher than 80%.

The consolidation involved in meeting these fiscal targets will be tremendously hard to achieve. Events in 2011 show the difficulties of reducing the budget deficit at times of economic weakness. And they highlight the need to improve budgetary monitoring, early warning and control procedures, especially in a country such as Spain with highly decentralised public finances.

A realistic macroeconomic scenario is the starting point for achieving budgetary targets. Here, as you know, the Spanish economy has double-dipped, with GDP declining by 0.3% in both the final quarter of 2011 and the first quarter of 2012. And the outlook for the coming months is not favourable either.

In terms of composition, the pattern of economic activity observed in recent quarters does not differ from that seen at the start of the crisis in 2008, when national demand was considerably weak and its impact on output was softened by the positive contribution of external demand to growth. In any event, Spain has not been immune to the slowdown in world trade and, in particular, to the greater sluggishness of some of our main trading partners, such as Italy and Portugal, meaning that exports have recently been seen to be less buoyant.

Foreseeably, then, in 2012 we will once again see a substantial decline in GDP. In this respect, the Government's macroeconomic forecast of a 1.7% fall seems realistic and prudent. But it should be stressed that the uncertainty permeating the current macroeconomic climate is very high. In terms of the composition of the macroeconomic figures, the view of the Banco de España does not differ greatly from that of the Government; the adjustment of national demand is projected to continue further, while net demand will remain the linchpin of the Spanish economy, although its considerable contribution to growth will not suffice to prevent a contraction in activity and employment.

As earlier stated, it is vital here that companies should harness the flexibility afforded by the new labour legislation to respond to the changes in demand without having to shed staff. If

used appropriately, not only will this prevent the demise of certain companies, but production will also be much more competitive and Spanish products more attractive, both domestically and abroad. Evidently, in a situation like the present, the recovery in Spain should be export-led. Accordingly, all measures and reforms that enhance competitiveness should be considered a priority.

In this connection, the State Budget for 2012 is part of a broader, medium-term consolidation strategy that requires the participation of the different levels of government. The Stability and Growth Programme unveiled in late April to the European authorities details these objectives up to 2015, with a breakdown of the efforts required by each level of government.

From my standpoint, the fiscal consolidation process is one of the cornerstones of the recovery of the Spanish economy, although the adjustments needed to meet the fiscal targets may in the short term exert adverse effects on demand and activity. As for the financial tensions that have shaken the Spanish economy in recent weeks, holding resolutely on a course towards fiscal consolidation is a pre-requisite for dispelling the mistrust stifling the economy. Therefore, the potential short-term costs will be amply offset once it becomes apparent that the efforts made are yielding results.

The State and Social Security budgets for 2012 are pivotal to this strategy. Fortunately, while they have not yet been approved, many of the measures they envisage have already been implemented, thereby preventing precious time from being lost in adjusting the fiscal imbalance. In this respect, it should be stressed that cutting the budget deficit requires an unprecedented structural effort. The measures that have to be adopted must reduce debt in an environment in which the interest burden will be growing and where the double-dip in economic activity will affect tax revenue and some cyclical expenditure. In light of these conditioning factors, the consolidation strategy must obviously use all the instruments available, on both the expenditure and revenue sides.

As regards revenue, various measures have been adopted affecting, above all, the direct taxes households and firms pay. A reduced rate has also been introduced to bring undeclared assets out into the open. Here, although the macroeconomic forecast for 2012 may be realistic, there are risks of slippage in projected revenue. This is in light of the composition activity is likely to evidence, given the sizeable weight of exports and the weakness of private consumption and the real estate market, which may lead to lower revenue than the course of output might suggest, as was the case in 2011. The foreseeable decline in employment also appears to suggest Social Security contributions will be more modest than budgeted. Finally, there is substantial uncertainty surrounding projected revenue takings in respect of the special treatment accorded to undisclosed income.

Turning to expenditure, the draft Budget outlines highly significant cuts in public investment, current transfers and goods and services purchases. These projections are not without risk, given the substantial inertia some of these items show, which hinders any permanent change in their trajectory. Precisely to reinforce this trajectory, the government added further education and health-care measures following the presentation of the draft Budget, which should contribute to attaining the targets set. That said, overspending on items such as unemployment benefits or pensions cannot be ruled out, since they depend on factors beyond the control of the authorities, such as the unemployment rate, demographics and inflation.

Given these risks, the Budget must be rigorously implemented and mechanisms activated to enable any emerging deviations to be detected sufficiently in advance, so that additional countervailing measures may be taken. If this were necessary, measures to contain current expenditure or to increase indirect taxes could be adopted, as already contemplated in the Stability Programme ahead of 2013. Nor can it be ruled out that the temporary tax increases approved this year may have to remain in place for longer or be replaced in time by other permanent measures.

I believe that in a country as decentralised as Spain, and in light of the deviations that arose in 2011, what was needed was to accompany budgetary consolidation with a significant strengthening of the institutional framework, so that all tiers of government might be called on to meet their commitments. Fortunately, the recently approved Organic Law on Budgetary Stability is a substantial improvement here. Moreover, it is fully attuned to the recent EU reforms on governance. Also, the agreement reached a few days back between the central and regional governments under the aegis of the Fiscal and Financial Policy Council on the deficit targets for 2012 and on the consolidation plans to attain these targets is excellent news. This lays the foundations for avoiding overruns such as those witnessed last year.

What is crucial now is the swift and effective implementation of the instruments envisaged in this Organic Law, in particular the monitoring and control mechanisms for public finances at all levels of government, and those intended to enforce compliance with the targets set by all of them.

The law proposes substantially improving general government transparency at the different stages of the budgetary process. In particular, timely detection of budgetary deviations is considered essential so as to adopt measures. Consequently, it would be advisable to begin publication of the regional government monthly revenue and expenditure outturns as soon as possible, as envisaged in the Organic Law (Article 27.3). The law further includes coercive instruments to ensure compliance with budgetary targets by all levels of government. Such instruments can be effective in ensuring discipline if rigorously applied and if the appropriate procedures for overseeing the budget outturn throughout the year are set in place.

But the pressure of everyday events should not make us lose sight of the medium and long term. Allow me to refer here to the major reform of the pensions system approved in July last year. This checked a pension spending dynamic that was endangering the sustainability of public finances over the medium and long-term horizon. But it should be recalled that this reform did not cancel out all the risks arising from population ageing. It would thus be desirable to properly define the so-called sustainability factor, so that the parameters of the system may adapt automatically to future demographic developments.

Admittedly, the economic difficulties such as high unemployment and low growth that we face are most serious. But the main problem currently confronting the Spanish economy is the fall in all confidence indicators in recent months, exacerbated in recent weeks by the management of the latest banking crisis. Restoring confidence is the imperative at present, since without it, none of our problems will be resolved. All government measures and all actions taken by economic policymakers and agents should be aimed at restoring the confidence we have lost. And one of the pre-requisites for doing so and for dispelling all uncertainty is that Spain should bring its public finances back on to a path of stability in line with its European commitments.

I believe there is a sizeable consensus that Spain needs to redress its fiscal imbalance and move towards a path of stability, in line with its European undertakings, and that this is a pre-requisite for restoring confidence and dispelling uncertainty. Consolidation measures have been tabled that are capable of bringing about this change of direction in budgetary dynamics. And, above all, the national budgetary framework has been substantially reinforced in order to allow the coordination, monitoring, surveillance and, where appropriate, correction of deviations by the different tiers of government, which we were previously lacking and which is vital to achieve the fiscal targets set.

The authorities at all levels of government have taken a significant first step in ratifying these targets and agreeing on their contribution to the consolidation drive that must be undertaken in the coming months. Now it is of the essence to restore credibility with a rigorous budgetary outturn, transparent management and, when necessary, corrective measures that shore up the fiscal targets set. That will attest to the strength of the commitment to the budgetary stability enshrined in the new Organic Law. The State Budget for 2013, which will begin to be drafted in the coming weeks, must uphold this commitment and give expression in specific

measures to some of the announcements made in the context of the latest Stability Programme. It is no overstatement to say that much of Spain's future is at stake in complying with these fiscal targets, and that failure in this process of consolidation would set back considerably the possibility of an economic recovery in our country.