Luis M Linde: Reflections on the crisis in the Spanish economy and its European context

Address by Mr Luis M Linde, Governor of the Bank of Spain, at the Spanish Medical Surgery Academy, Madrid, 31 January 2013.

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Mr President, distinguished members, ladies and gentlemen,

It is a pleasure and a privilege for me to participate in this ceremony marking the appointment of new members, all the more so given my own honorary nomination.

I much appreciate the invitation by the President of the Academy, Professor Ortiz Quintana, a friend of mine, albeit only for a little over 50 years. It gives me the opportunity to share with you some reflections on the crisis the Spanish economy is undergoing and its European context.

A particularly severe crisis

Certain parallels can be drawn between the work of those of us who attempt to understand the causes of economic crises and how to treat them, and that of doctors, who seek to understand illnesses and how to cure or alleviate their effects.

Almost invariably, economic crises contain common elements, meaning that each new outbreak reveals problems that are familiar to us and which we have already learned to treat in the past. Not infrequently, however, these old and well-known viruses are accompanied by singular characteristics, which put to the test our diagnostic capacity and our ability to devise new treatments. And crises, like illnesses, are also more or less acute, may overlap one another and may have interconnecting feedback loops, with the consequent increase in risks to the health of the patient or, in this case, of the economy.

Viewed from this perspective, the current crisis in Spain is very serious. It has seen the confluence of different tensions and problems, which tend to exacerbate one another and make diagnosis and treatment more complex. And, as a particularly worrying characteristic, its social, institutional and political dimensions go beyond those of previous crises.

The constraints arising from Monetary Union membership

To understand the situation facing the Spanish economy, I must first briefly explain how the mechanisms of economic adjustment work in a monetary union and what the consequences are for economic policy management.

First and foremost, in my opinion, the fact that Spain is part of the European Economic and Monetary Union has been and will continue to be an enormously positive factor for our economy. As a founding member of the euro, Spain has benefited over the 13 years the single currency has been in place from conditions of economic stability which, most probably, would not have been possible outside monetary union, and which have led to an improvement in our standard of living that the current difficulties should not let us forget.

Yet that should not mask the fact that belonging to a monetary union entails a series of constraints or commitments which, among other things, involve the necessary adaptation of economic agents' behaviour and of the means of pursuing economic policy.

In a monetary union, the control of two essential instruments usually at hand to combat crises passes to a supranational level and, therefore, they cease to be available to meet the specific needs of the member countries: both very short-term interest rates – the key tool used by a central bank when setting its monetary policy – and the exchange rate have been set in the European Monetary Union, since 1 January 1999, on the basis of the aggregate situation of the area as a whole. They cannot be managed to serve the specific needs of any national economy. It is the national economies that have to be in a position to live with the standards set for the whole.

National authorities retain control of the other economic policies, which remain under their responsibility; however, the proper functioning of the area evidently requires that their handling should observe specific common principles, preventing misalignments in one country from prompting imbalances in the rest, or from destabilising the monetary union as a whole.

The way in which these common principles have been implemented has differed depending on the specific economic policy tool in question. Thus, for instance, fiscal policy coordination mechanisms have been the focus of particular attention, with monitoring and surveillance procedures to avoid excessive budget deficits (of over 3% of GDP) and high public debt proportions (over 60% of GDP) coming into play. Indeed, these thresholds, along with the procedures for their prevention and ultimate correction, took the form in 1997 of an agreement known as the Stability and Growth Pact.

In contrast, the rules for coordinating "structural" policy (e.g. those governing the workings of the labour market or the markets for goods and services) were fairly lightweight as a result of their broader scope for application and of the difficulties involved in setting common objectives. Also, in the area of financial regulation and supervision policies, countries continued to enjoy a high degree of independence.

The limitations of the monetary union's adjustment mechanisms

As events have shown, the constraints imposed by the institutional framework were not powerful enough to ensure the appropriate response by national authorities in the face of potential slippage from the stability levels required.

It was hoped that the very fact of monetary union membership would activate sufficient response mechanisms. Among these potential mechanisms, particular importance was accorded to the so-called "competitiveness channel", which works as follows: when an economy's inflation rate stands systematically above the average for the rest of the area, the very loss of competitiveness involved – or, what amounts to the same, the relative rise in the cost of output in that economy – tends to reduce demand-side pressures and ease the tensions on prices that led to the initial slippage. However, for this channel to work economies should, inter alia, be adaptable and sufficiently flexible, something which, for social and political reasons, is evidently not easy to achieve.

It was also thought monetary union membership would prompt greater discipline in economic policy management. It was assumed that, if a Member State's management of the economic instruments available to it was inadequate, the subsequent adverse effects on its growth and employment-generating capacity would lead international investors to demand greater returns for investing in the country, or even to freeze such investment. The subsequent tightening of financing conditions would discipline economic agents and ultimately redress economic management. But this mechanism did not work because financial markets, rather than punishing divergences, instead financed excesses, contributing to exacerbating tensions.

Unsurprisingly, then, the crisis has called into question the consistency of the institutional arrangements underpinning the euro. The solution would involve a reformulation of the initial project, geared to fuller integration.

The adaptation of the Spanish economy to the euro was incomplete

Turning now to the Spanish economy, our adaptation to the new rules of play derived from, or imposed by, monetary union has been insufficient and belated.

Our membership of the euro area compelled us to desist from long-established practices among economic agents who regarded exchange rate devaluation as the “normal” means of resolving the problems of competitiveness caused by inflation and did not consider fiscal discipline as vital for maintaining economic growth.

True, in the years before we joined the euro area, we took steps to adjust economic policy rules to a low-inflation environment and set in train some reforms so it would function more flexibly. Two factors were particularly important in achieving this goal. First, the anchoring of inflation expectations, which required fulfilment of the price stability convergence criteria. And second, in the area of budgetary policy, the enactment in 2011 of an initial Stability Law laying the foundations for preventing excessive budget deficits.

The transition to Monetary Union was also easier because the peseta/euro conversion rate agreed in 1999 was quite competitive as a result of the devaluations which had taken place between 1992 and 1995 during the functioning of the European Monetary System. However, those devaluations were a clear sign of the difficulties awaiting countries that make exchange rate commitments if these are not accompanied by price and cost discipline.

In the first ten years of membership of the euro area, Spain enjoyed a long phase of growth in an environment in which monetary policy, with relatively low interest rates, was highly expansionary. This period saw rapid increases in the standard of living and in economic welfare, as reflected by the rapid rise in GDP per capita, which in 2007 edged above the average of that of the countries then comprising the euro area. This achievement largely reflected very labour-intensive growth.

The insufficient adaptation to the euro gave rise to significant imbalances

However, the expansion in those years was based on a pattern of household and corporate spending which, driven by the property sector boom and by cheap and easy credit, systematically exceeded the economy’s productive capacity. This imbalance has been at the root of the difficulties of the Spanish economy since the international financial crisis began.

First, demand-side pressure led to significant pressure on costs, margins and prices, which tended to grow systematically faster than those of our European partners, with a notable worsening of our external competitiveness. This was not at all consistent with the decision to forgo the exchange rate as an economic policy instrument.

Second, the lack of sufficient domestic output to meet domestic demand had to be increasingly covered by imports. This caused a sizeable imbalance in our foreign trade, as reflected by the balance of payments, which in 2007–2008 ran a deficit of around 10% of GDP. At the same time, the financing of this process required huge flows of funds which, given the insufficiency of domestic saving, had to be met by turning to foreign saving, channelled to Spanish households and firms by credit institutions. Behind this whole process lay a real estate sector growing at an excessive pace in terms of both houses built and house prices. The excessive surge in construction was unquestionably fuelled by low interest rates and the practically unlimited supply of financing provided by foreign saving.

The sound fiscal performance by the Spanish economy before the crisis, between 2005 and 2007, masked the actual situation of public finances which were distorted by extraordinary revenue of a strictly temporary nature, linked to the exuberant real estate sector. These abundant inflows discouraged the adoption of the necessary public expenditure rationalisation and control measures needed in both central and regional government.

In short, the path followed by the Spanish economy in those years brought about substantial macroeconomic imbalances which crystallised in, among other things, a large external deficit and a sudden sharp rise in total external debt, both of which reached highs in 2007–2008. Finally and inevitably a far-reaching adjustment took place, unfortunately amid the turmoil of the international financial crisis. On top of all this, in the middle of the recession, Spain's public finances worsened markedly from a surplus of nearly 2% of GDP in 2007 to a deficit of more than 11% of GDP in 2009, and, in addition, the severe job destruction over the last five years has raised the unemployment rate to over 25% of the labour force.

The labour market was also subject to certain illusions during those years. The enormous growth in the construction sector lay, without a doubt, behind the major immigration flows, and this strong population growth drove buoyant consumption and, by extension, the increase in activity and employment in all sectors, delaying the reforms that would have led to a more balanced adjustment between wages and employment.

To overcome the crisis further reforms are needed at the national and European levels

However, it should also be noted that the size of the imbalances that built up in the Spanish economy was not only a consequence of insufficient adaptation to the conditions and restrictions of euro area membership. They are also related to the deficient functioning of the disciplinary mechanisms with which the euro area is equipped and the fragilities inherent in its institutional design and its system of governance. Hence the Spanish crisis is closely related to the euro crisis, and overcoming it also depends on Europe's ability to respond to the institutional problems of the Monetary Union.

Aside from the important role that the solutions being considered in the European Union to better control budget deficits must play, overcoming the recessionary tendencies experienced by the Spanish economy since 2008 requires the correction of some structural features that hinder its ability to adapt. The fall in employment, which has been much greater in Spain than in the other euro area countries during the crisis, is largely explained by the insufficient adaptation of labour conditions. Indeed, wages and prices continued to grow as if no significant cyclical change had occurred. The labour market reform has addressed the serious distortions that have existed in this area for decades. Their effects on wage moderation have already begun to be noted and, although the improvement in terms of job creation is taking longer, I have no doubt that it will materialise, if the possibilities opened up by the reforms are fully harnessed and completed.

The sharp deterioration in public finances since 2008, which only began to be corrected seriously in 2012, has unavoidably required the implementation of severe and unpopular austerity measures and reforms. Despite their initially restrictive impact, they are vital for restoring confidence in the sustainability of our public finances and for normalising our access to international financing, which is essential for our exit from recession and for the resumption of growth in the euro area. Great efforts are being made, involving significant sacrifices from broad sections of society; but they will eventually bear fruit and help to absorb the mass unemployment that is currently Spain's most serious problem.

To overcome the deterioration in solvency stemming from the economic crisis and the end of the unsustainable growth in construction and related lending activity, part of the banking sector has required an extensive clean-up, restructuring and recapitalisation. The main thrust of this process is already well-advanced, and this is having positive effects on the ability of our banks to raise funds abroad. Its completion will be a fundamental step in the recovery of confidence, activity and employment.

We can affirm that the tensions experienced by the Spanish economy over the last 18 months have begun to abate, as a result of greater confidence in both the ability of the euro area to reform and in the adjustment drive of our economic policy. The deep-seated change in our trade balance, which will be manifest in a significant balance of payments surplus in 2013, is the prime example of the adjustment under way in the Spanish economy and of the competitiveness gains that are materialising.

To conclude: you ask me what my prognosis is (not surprisingly, given who you are). I think you will understand if I reply that I still reserve my judgment. But, it was significantly worse a few months ago. I believe that the patient can of course be cured, must continue to take the prescribed medicine and should not be out on the town at night.

Many thanks, again, to the Academy and the President for your invitation and to all of you for your attention.