

## **Luis M Linde: Snapshot of the Spanish economy within the international environment**

Testimony by Mr Luis M Linde, Governor of the Bank of Spain, before the Parliamentary Committee on Economic Affairs and Competitiveness, Madrid, 17 June 2014.

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Ladies and gentlemen,

I appear before this Committee in connection with the presentation of the Banco de España Annual Report for 2013.

I will briefly review the international economic environment before setting out developments in the Spanish economy, which has been characterised by a gradual recovery in activity and progress in the internal adjustment process. I will then address aspects relating to the situation of and outlook for the banking system, concluding my testimony with some thoughts on the challenges our economy faces in seeking to set sustainable growth firmly in place.

### **The international environment**

In 2013 the global economy grew by around 3%, slightly down on the previous year, although it did move on a gradually recovering path which is expected to hold in 2014. The euro area initiated a phase of recovery in 2013 Q2, starting then to emerge from the recessionary phase affecting it since late 2011.

This recovery has been marked by the strengthening of the developed economies – particularly in the United States, where expectations have held that monetary conditions are progressively normalising – and by lesser momentum in the emerging economies, central to which is the moderation of growth in China.

Contributing to this lesser momentum, on one hand, has been the change to a more moderate growth model in China; owing to lower Chinese demand for commodities and the interrelated effect on global production chains, this has been instrumental in the lower growth in the other emerging economies.

Further, the expectations that global financial conditions will normalise have led to fewer capital flows towards certain emerging economies, exposing their vulnerabilities linked to their dependence on external funding. In any event, exchange rate flexibility or sizeable volumes of reserves have enabled them to withstand, in better conditions than in past periods, this episode of reversed capital flows.

In sum, this new outlook reveals greater certainty about the recovery of the global economy and a shift in the central points of uncertainty from the developed economies – and in particular from the euro area countries – to the emerging economies.

As regards price developments, the current phase of recovery is marked by the absence of inflationary pressures in the main advanced economies, with the exception of Japan, with inflation rates significantly below the targets set by central banks being recorded. Contributing factors here were the persisting slack in labour markets, the low levels of capacity utilisation and the moderation of commodities prices, in particular of oil.

The absence of inflationary pressures has been conducive to an accommodative monetary policy stance being maintained globally, with official interest rates anchored at levels very close to zero and extraordinary liquidity provision measures still in force.

This monetary policy stance has meant that long-term interest rates in the advanced economies have held at very low levels, while very generous pricing in certain financial markets has been the case. Indeed, some prices are at all-time highs, in a setting in which

investor yield search appears to be playing a predominant role compared with other considerations based more on the fundamentals of these assets.

This scenario on international money and financial markets poses risks, as it is likely to undergo abrupt changes in the face of expectations emerging over the withdrawal of monetary stimuli or, what comes down to the same, of expectations over sustainable improvements in growth rates that advise less expansionary monetary policies.

### **Developments in and outlook for the Spanish economy**

In the course of 2013 the Spanish economy showed a degree of dynamism and, from the third quarter onwards, positive GDP growth rates. This trajectory has continued into 2014, meaning that the year might finalise on a path in line with the forecast forwarded in the Spanish Economic Projections Report published by the Banco de España in March, that is to say, with annual average growth of 1.2%.

This recovery has also been discernible in the labour market. The pace of job destruction slackened in 2013, until showing slight job creation in the closing months of the year.

The improvement has progressively strengthened to date in 2014. On the latest available data for May, the official number of registered unemployed fell by almost 112,000, placing the year-on-year rate of change at  $-6.5\%$ , 0.8 pp better than in April. Social Security registrations increased this same month by 198,000, or at a year-on-year rate of 1.6%, 0.4 pp above the growth recorded in the previous month, marking four consecutive months of growth.

This change in the Spanish economy has arisen from a combination of external and domestic factors. Let me take the former first.

### **The external boost to recovery in the Spanish economy**

First, the rise in activity and global trade in the second half of 2013 and the resumption of economic growth in the euro area shaped a favourable environment for our exports.

Second, a favourable impact has also been exerted by the measures adopted by euro area Member State governments in terms of fiscal consolidation and the approval of structural reforms, particularly visible in those economies that were subject to financial tensions.

The support programmes for Greece, Ireland, Portugal and Cyprus also unfolded favourably. Indeed, Ireland and Portugal have already exited their respective financial assistance programmes without resorting to any additional precautionary mechanism. Greece, for its part, posted a primary fiscal surplus in 2013, indicating that its public finances have been redressed.

But the challenges ahead remain significant, as highlighted by the European Commission in the annual revision of the exercise on macroeconomic imbalances within the area.

Measures by the ECB are contributing to shaping a setting favourable to recovery. Since the onset of the crisis, monetary policy has been strongly accommodating, more so both in 2013 and in 2014 to date.

On the conventional front, official interest rates have been cut on three occasions since January last year. As a result, the main refinancing operations rate has reached, for practical purposes, its lower bound ( $0.15\%$ ). And the remuneration banks receive for their deposits in the Eurosystem stands, following the recent decisions adopted on 5 June, in negative territory ( $-0.10\%$ ), which should promote a greater and lasting injection of liquidity into the markets.

As regards liquidity, moreover, it was resolved at the Governing Council meeting on 5 June to extend the current policy of fixed rate full allotment tender procedures at least until

December 2016. It was also decided to suspend the fine-tuning operation sterilising the purchases under the Securities Market Programme. The ECB thereby ensures the continuity and scope of the policy of generous provision of liquid funds adopted since what was practically the very onset of the crisis.

Finally, regarding unconventional measures, and following the adoption last year of forward guidance, significant additional steps have been taken in June. Firstly, targeted long-term refinancing operations explicitly geared to promoting bank lending to households and firms were announced. Further, it was decided to step up the work under way to enable a framework to be designed for outright ABS purchases by the ECB. The aim of these purchases is to improve the functioning of the monetary policy transmission mechanism, which is still adversely affected by the financial market segmentation induced by the crisis.

### **Progress in the internal process of adjustment**

The turnaround in the Spanish economy would not have been possible had the internal process of adjustment not been sustained and deepened. Thus, in 2013, there was progress in correcting the imbalances in terms of competitiveness, fiscal consolidation, private-sector debt and financial system reform. I shall briefly discuss each of these developments.

### **Competitiveness and correction of the external imbalance**

The continuity of the ongoing moderation in labour costs and prices allowed further gains in competitiveness to be built up during 2013. On the indicators available, based on unit labour costs, the gap opened up since Spain joined the euro area is expected to have closed.

The internal devaluation process is exerting a favourable effect on our foreign trade. The year ended with our first current-account surplus since 1997. That said, our continuing excessive dependence on imported energy and the persistent deficit on the incomes balance, owing to our high external debt, stood in the way of an even bigger improvement.

### **Fiscal consolidation**

Turning to public finances, once the extraordinary effects of the aid to financial institutions is excluded, the year 2013 closed with a deficit of 6.6% of GDP, 0.1 pp above the objective set, in a macroeconomic environment marked by cyclical weakness and by higher interest payments. The fiscal adjustment drive has been most significant, as shown by the structural primary balance (the cyclically adjusted balance, excluding interest payments), which posted a correction of 1.2 pp of GDP.

2013 was the first full year of application of the mechanisms of the Budgetary Stability and Financial Sustainability Law approved in 2012. Moreover, measures were taken to improve the sustainability of public pensions (the sustainability factor and revaluation index).

### **Private-sector deleveraging and bank lending**

To conclude this section, I will refer to the correction of private-sector overindebtedness. The Spanish economy's cyclical position suggests, along with past experience, that several quarters of economic growth will still be necessary before lending at the aggregate level resumes positive growth rates.

However, there were actually signs of an improvement in this connection in 2013.

Since mid-year, lending to companies has been shrinking at increasingly lower rates, a change which has begun to be discernible also in the case of households since early 2014. The more disaggregated analyses conducted by the Banco de España support the idea that the contraction in debt at the aggregate level is proving compatible with a shift in the mix of

debt towards those companies in a sound position which are, therefore, better placed to channel funds to new investments that translate into more growth and more employment.

## **Spanish banking sector**

I will now refer to the position of and outlook for our banking sector.

For the Spanish banking industry, the year 2013 marked the culmination of a major reform in the framework of the financial assistance programme agreed with the European authorities. This programme began in 2012 and, as you know, concluded last January. The reform has seen the clean-up, recapitalisation and restructuring of the sector.

In a complex macroeconomic and financial environment, which required the adjustment of the imbalances that have built up in the previous expansionary phase, the Spanish banking sector has demonstrated notable adaptability.

I will briefly review some of the basic parameters marking developments at our banks, in particular the changes in the structure of their balance sheets, non-performing loans and results. I will then underscore the importance of the capital conservation measures in the current setting.

## **Changes in the structure of bank balance sheets**

Last year, the banking sector significantly reduced the size of its balance sheet, as well as changing its structure.

On the asset side, the reduction in lending to the private sector persisted. This reduction was, however, compatible with an increase in the weight of assets relative to the total balance sheet, whereas other asset items – such as deposits at central banks and credit institutions, and derivatives operations – contracted at very high rates. In turn, on the liabilities side, there was a shift towards private-sector deposits, thereby furthering the reduction in funds borrowed from the Eurosystem. In addition, the sector also increased its own funds, the relative weight of which on the balance sheet has gained in significance.

## **Non-performing assets**

Private-sector non-performing assets continued to rise in 2013. This increase and the aforementioned decrease in credit explain the growth in the non-performing assets ratio. Also playing a role in this increase was the reclassification of refinanced loan portfolios required by the Banco de España in 2012.

In any event, banks' non-performing loans have a clearly cyclical component. In this respect, in line with the onset of the recovery of the economy, the latest data, which relate to early 2014, show a slight fall in non-performing assets in month-on-month terms. This trend can be expected to firm as the recovery of economic activity gathers steam.

## **Results**

The banking sector in 2013 reported consolidated profit of €11 billion in 2013, following heavy losses in 2012, basically due to the sizeable provisions made by banks. Although provisions continued to eat up a considerable portion of profit, their relative significance in 2013 was appreciably less than in 2012.

## **Margins and efficiency**

The more moderate provisions noted above helped to offset the lower margins in the 2013 income statement compared with 2012. Thus, against the background of a smaller volume of

activity and of lower interest rates, net interest income (the difference between accrued interest revenue and costs) dropped by nearly 10% year-on-year in 2013.

In 2013 Spanish banks persisted in their efforts to increase efficiency, readjusting their operating capacity by pruning staff and branch numbers in their business in Spain, which, compared with the highs in mid-2008, were down by around 20% and 25%, respectively.

In an environment characterised by persisting downward pressure on earnings from factors such as weaker lending, low interest rates and still-high provisioning needs, banks have to persevere in reducing their operating costs and improving their efficiency.

### **Conservation of banks' capital**

In 2013 the banking sector strengthened its solvency. The aggregate core capital of all deposit institutions stood at 11.5% at the end of that year, up somewhat more than 2 pp on end-2012.

From a medium- and long-term standpoint, the banking sector has to maintain its capital conservation policies.

The economic recovery is still incipient and some fragmentation persists in the euro area financial markets. Moreover, the new solvency legislation which came into force in Europe last January implementing the requirements of the Basel III Accord, but whose application has yet to be completed, calls for, inter alia, higher levels and quality of capital. The Banco de España, recognising that it is desirable to conserve capital and strengthen solvency levels, last February renewed its recommendation that banks should limit their dividend payout policies.

### **Challenges facing the Spanish economy and the role of economic policy**

I shall conclude with some thoughts on the challenges facing the Spanish economy and the role of economic policy.

Our economy is currently setting its growth on a firm footing. However, the effects of the crisis in terms of unemployment and indebtedness of the resident sectors have been sizeable and their absorption will require time.

The improvements in competitiveness and the reduction of private-sector debt must continue. And this in an environment of low inflation in the euro area and of high euro exchange rates, which poses an additional difficulty.

In the area of national policies, the leeway for applying demand-side policies is scant. In this respect, let me discuss in more detail the challenges ahead for fiscal policy.

### **Fiscal policy challenges**

As I have already indicated, progress in the correction of European fiscal imbalances has been significant. The data for 2013 show, however, that six years after the economic crisis began, ten countries in the European Union countries had budget deficits of over 3% of GDP and public debt levels stand at record highs in many member countries. Having now emerged from the phase of financial and banking instability, the need for fiscal consolidation will continue to condition economic policy in Europe over the coming years, although the adjustments planned are on a lesser scale than those already implemented.

In the case of Spain, the consolidation drive still ahead remains substantial. According to the latest Stability Programme Update, the planned reduction in the budget deficit between 2014 and 2017 is 5.5 pp of GDP, and rises to 6.4 pp of GDP in terms of decreasing the primary deficit.

Completing the fiscal consolidation process must remain an overriding priority of Spain's economic policy. This effort is necessary to maintain the confidence of economic agents, to continue to advance in the normalisation of financing and to restore the room for manoeuvre in budget policy.

Meeting targets is crucial first for containing and, subsequently, reducing the public debt/GDP ratio. It will be difficult to curb the rising trend of public debt now the latter has reached high levels and the outlook for economic growth and inflation is moderate.

If the interest on the debt is higher than the nominal growth rate of the economy, the public debt/GDP ratio grows inertially, even when public revenue and spending are balanced. This effect stems from the pressure generated by the interest burden, arising from high debt which cannot be countered by growth in real GDP and changes in inflation. In this situation, then, in order to avoid an increase in debt, it is not enough to attain an overall balanced budget (that is, net of the interest burden); rather, sizeable primary surpluses must be achieved and maintained, which is particularly difficult in a setting of low growth and low inflation. Furthermore, the short-term negative effects on economic growth of the fiscal adjustment should be considered, which contributes to the above-mentioned inertial increase in debt.

Against the backdrop of a brighter economic outlook, it is to be expected that, unlike in recent years, the reduction of the budget deficit will foreseeably be boosted by a more positive performance of tax revenue and a decrease in those expenses more closely linked to the economic cycle, particularly unemployment benefits. The efforts to contain spending should desirably be accompanied by public spending and revenue arrangements which help to ensure that the public sector makes a better contribution to economic activity and to achieve a lasting adjustment.

As for public spending, various actions have already been undertaken in the area of public employment in the health and education sectors, as well as in reforming local government administration and streamlining the public sector, among others, which should continue to generate savings over the coming years. In line with the recommendations of the European Council, this process would gain in depth and consistency if it were accompanied by a public spending assessment and review. Given the degree of decentralisation in Spain, such an exercise requires the active collaboration of the regional governments.

Of the various public expenditure items, spending on pensions is particularly important given its high share and the challenges faced in relation to its sustainability in the medium term.

Progress in this area has been significant as a result of the various reforms approved. In particular, in 2011 the retirement age and the period for calculating the regulatory base were increased, and in 2013 the so-called "sustainability" factor was defined and the revaluation index of pensions was introduced. These measures will help to ease the pressure in the medium term arising from population ageing. The next step should be to develop the mechanisms to increase saving for retirement so that in the future this may complement defined-benefit public pensions.

Turning to public revenue, according to the findings of the Committee of Experts – which delivered its report in March 2014 – and the recommendations of international agencies, a reform is needed to redress the problems which have become visible during the crisis. These problems include most notably the low revenue-raising capacity of the tax system, the high legal rates of taxation alongside low effective rates of taxation due to the proliferation of tax benefits, and a bias towards a more distortional system of taxation for economic growth and employment, namely, that levied on labour and capital.

Given this diagnosis, the proposals of the Committee of Experts and international agencies coincide as to the need to increase the weight of indirect taxation to permit a reduction in the taxation of labour, particularly social security contributions, and also a lowering of the taxation of capital income. Additionally, the Committee suggests that tax rebates, reductions

and allowances be eliminated and that progress be made towards greater neutrality across savings instruments. These recommendations underline that it is important that any future changes to taxation, in addition to improving efficiency, should not jeopardise the fiscal consolidation required.

### **Medium-term economic growth**

The fiscal consolidation process has been accompanied by a series of reforms whose effects are becoming discernible or will be perceived shortly. The increased sensitivity of prices to the economic cycle has prompted a correction of the competitiveness gap of the Spanish economy, while the more flexible labour framework has undoubtedly been conducive to wage moderation. A change is also perceptible in the role of past inflation in the process of determining costs and income. This change will be bolstered by the implementation of the legislation on the deindexation of the economy.

The effects in terms of job creation are more tentative, yet promising. Foreseeably, as a result of the more flexible labour framework, employment will grow at rates which, while moderate, are relatively high in relation to the growth in GDP.

Undertaking reforms to increase competition is also unavoidable. Progress in this area has also been significant: we may recall the laws on entrepreneurs, single market guarantee and insolvency. However, it must be acknowledged that in some cases their actual implementation is encountering difficulties or has been delayed.

Thank you.