

Luis M Linde: Performance of and outlook for the Spanish economy

Testimony by Mr Luis M Linde, Governor of the Bank of Spain, before the Senate in connection with the draft State budget for 2016, Madrid, 23 September 2015.

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Ladies and gentlemen,

In my appearance today, as part of the process of discussion and approval of the budget in the Senate, I will focus on analysing the performance of, and outlook for, the Spanish economy and on the role of the State budget for 2016, following approval of the draft law by the government on 31 July, and the role of the Budget Plan for 2016, submitted to the Council of Ministers on 11 September.

The external setting of the Spanish economy

Heightened uncertainty is presently the most noteworthy feature of the external setting of the Spanish economy.

The recovery in the advanced economies and the return to normal on the international financial markets have been affected by the consequences of the global economic slowdown, as a result of the downturn in some emerging economies, particularly China, and especially in light of the difficulties involved in assessing its real magnitude in the medium term.

The risk that the figures that are now emerging might herald a sharp correction in the imbalances that built up in the Chinese economy during the lengthy period of strong growth is having a negative impact on world trade, oil prices and the stock markets and foreign exchange markets. It is also very probably having an effect on the timing of the Federal Reserve's decision to raise its key policy rates.

A more positive development, however, is the approval and start-up of the Third Bailout Programme for Greece, which has mitigated another key source of uncertainty for both the European and the Spanish economy.

In the euro area, GDP rose by 0.4% in Q2. This is lower than the Q1 figure (0.5%) and it is also lower than most forecasts of public and private sector analysts. Along the same lines, on 3 September the European Central Bank (ECB) revised down slightly its growth projections for the euro area, for both 2015 and 2016, to 1.4% and 1.7%, respectively. These figures continue, in any event, to be more positive than those expected at the end of last year.

The inflation projections were also revised down, to 0.1% for 2015 and 1.1% for 2016. Inflation is, therefore, expected to continue to rise, in 2017 also, but at a slower pace, remaining still some distance from the price stability target of 2%.

On 3 September the ECB reiterated that it was willing and able, if need be, to adopt a more expansionary monetary policy stance. The various measures taken, including in particular the purchases of government debt securities, have allowed a more uniform transmission of expansionary momentum to the euro area countries. This benefits, in particular, the countries such as Spain that were hardest hit by the fragmentation of European financial markets.

The financing conditions of the Spanish economy have improved significantly. Lending is slowly but gradually returning to normal, as households and firms undertake the necessary deleveraging and new financing flows towards those that are in the best position to take on new investment and spending projects. As the cost of these new funds is lower, this also

reinforces the fiscal consolidation process and helps improve the balance of payments position.

Performance of and outlook for the Spanish economy

Compared with the weakening in the euro area, GDP in Spain grew by 1% in Q2, slightly above the growth rate for the opening months of the year. This figure confirms the recovery in the Spanish economy, the progress made in the correction of imbalances and the improvement in financing conditions for households and firms.

GDP growth in Q2 continued to be based on highly robust domestic demand, with some quickening among the components most closely linked to private demand (household consumption and investment in capital goods and housing). However, net external demand made a slightly negative contribution, as has been the case almost continuously since the start of the recovery, owing to the strong import momentum.

The latest indicators, for Q3, suggest that this growth trajectory will hold in the second half of the year, in keeping with the Banco de España's pre-summer projection of GDP growth of slightly over 3% in 2015. For 2016 the estimate was marginally lower (2.7%), on the back of a degree of weakening in some of the factors that have driven growth this year, stemming in the main from the drop in oil prices and the depreciation of the euro.

As I indicated earlier, the outlook for the external setting has deteriorated and there is heightened uncertainty and volatility in the financial markets. It is too soon to assess the scale of these developments and their possible impact on the growth prospects for the Spanish economy. In any event, the downside risks have increased, making it even more important to maintain the policies that have permitted economic recovery, job creation and the correction of imbalances.

Spain's higher growth will come from the strong rate of expansion of national demand. It is to be hoped that higher household disposable income, together with the foreseeable improvement in credit conditions, will continue to boost consumption and prompt a recovery in housing investment. In turn, strong final demand and a gradual return to normal in financial conditions will continue to have a positive impact on investment.

In the area of foreign trade, the latest projections pointed to a practically neutral contribution from net external demand in 2015 and 2016. Exports were expected to move upwards, driven by the progressive recovery of foreign markets in 2016 and by the effects of exchange rate depreciation heightening the gains in competitiveness built up over the last few years. Imports were projected to remain buoyant, in line with final demand. The data on foreign trade transactions for the first half are in line with this forecast made in June.

Until June the balance of payments performed more strongly than last year. In the first six months the current account balance reached a surplus of 0.6% of GDP compared with a deficit of 0.1% last year. The bulk of this improvement derived from the smaller energy deficit due to cheaper imports, and from the smaller income deficit. By contrast, the non-energy goods surplus has continued to shrink due to the greater vigour of our imports of this type of goods.

The dynamism of imports stems in part from the momentum of domestic spending. It should be kept in mind that gains and losses in competitiveness manifest themselves not only in export capacity, but also in competition in the domestic market between national production and imports. The vigour with which imports are reacting to the upsurge in demand signals the need to maintain and further pursue the improvements in competitiveness.

The recovery of output has been accompanied by the somewhat more expansionary behaviour of employment than might be expected from historical patterns. Both the second-quarter Spanish Labour Force Survey figures and the Quarterly National Accounts estimates released at the end of August reflect high employment growth rates in the first half of the year (3% year-on-year; around half a million new jobs). The most recent data on Social Security registrations,

i.e. those for July and August, show a certain moderation in the rate of job creation in this period, albeit still in a positive vein.

Labour costs continued to moderate in the first half of the year, reflecting the greater flexibility with which firms can adjust their labour conditions to the macroeconomic environment. If the trend prevailing in the past year and a half continues, the rise in employment may put the unemployment rate at around 20% in 2016 Q4.

In the realm of inflation, the recent energy price falls have interrupted the course of recovery of the CPI. After posting positive year-on-year rates in June and July, for the first time in nearly a year, the overall price index slipped back (by -0.4%) in August.

It is important, however, to emphasise the temporary nature of this new bout of disinflation, linked to the recent oil price fall in the international markets. In fact, the rate of change of the CPI excluding energy increased by 0.9% in August, growing slightly faster than in July, while the indicator which excludes unprocessed food as well, so-called "core inflation", grew by 0.7%. The latest data have not invalidated the outlook for gradual recovery of inflation reflected in the most recent forecasts.

Budgetary policy in 2016

As I have said in previous appearances before the Senate, the primary objective of budgetary policy is to ensure that the recovery is underpinned by lasting stability. In particular, it is indispensable to persevere with the strategy of fiscal consolidation leading to the stabilisation and subsequent reduction of the public debt ratio.

The improvement in the cyclical conditions envisaged in the macroeconomic scenario used to prepare the draft Budget has a positive effect on public finances owing to increased tax collection, a further drop in unemployment benefits and a progressive reduction of the average interest rates paid on public debt. All this means that the budgetary policy measures to meet the budget deficit targets are less costly.

Specifically, the draft State budget envisages economic growth of 3.0% for 2016, slightly below the 3.3% projected for 2015, with growth of domestic demand and a progressive recovery of inflation rates which would lead to an increase in nominal GDP of nearly 4%.

Against this background, the overall general government deficit for the coming year will foreseeably stand below 3%, the ceiling established in the Stability and Growth Pact, while the public debt/GDP ratio will decrease for the first time since 2007.

The State and Social Security budget under discussion here is the first element of this budgetary strategy. However, a few days ago the general government budget plan for 2016 was released. It includes the local and regional government projections, so it allows the fiscal policy analysis for the coming year to be completed.

This Budget Plan is crucial, not only because these regional and local governments are now together responsible for more than 40% of overall general government expenditure, but also because their initiatives are essential for implementing fiscal consolidation. In fact, the regional governments will have to bear almost half of the reduction of the government deficit envisaged for 2015 and 2016 (which amounts to 3 pp of GDP in cumulative terms for general government overall), by moderating their deficits by 1 pp of GDP in 2015 and by 0.4 pp in 2016.

In any event, it should be taken into account that the early submission of the Budget Plan for 2016 means that it does not include information on the essential outlines of the regional and local government budgets, which makes it difficult to evaluate. Allow me to underline the importance and also the complexity of preparing this document in an environment as decentralised as that existing in Spain. Its content should permit an analysis of the compatibility of the fiscal targets set and the budgets of the different levels of government; this entails significant challenges in terms of accounting and aggregation.

The starting point for the 2016 fiscal consolidation strategy is, firstly, the assumption that the government deficit target for 2015 will be met, which requires a reduction of 1.6 pp of GDP with respect to the deficit observed in 2014. The available information on the budget outturn to date in National Accounts terms shows that, on data to May, the consolidated aggregate of central government, regional government and Social Security recorded a deficit of 2.2% of GDP, close to 0.2 pp of GDP lower than the figure recorded in the same period of the previous year. In relation to this information, it should be noted that the Social Security surplus decreased by 0.2 pp of GDP, compared with the required improvement of 0.5 pp, and the regional government deficit narrowed by 0.1 pp of GDP, compared with the reduction of 1 pp envisaged for the whole year. In consequence, in order to meet the general government deficit target for the year, the increase in revenue and/or the containment of spending in the remainder of the year will need to be greater than that observed in the early months of the year.

The main changes in the State and Social Security Budget for 2016 are, on the revenue side, the application of the second phase of the tax reform designed in 2014 and, on the expenditure side, still in the context of observing the spending ceiling, certain expansionary measures such as the approval of a wage increase of 1% for public employees, payment of the second part of the salary payment eliminated in 2012, and the general increase in the average staff replacement rate to 50%. The 2016 Budget Plan presents an estimate of the impact of these measures on regional and local governments, which are the levels of government that manage the most labour-intensive public services. Noteworthy in the area of Social Security is the revaluation of pensions by 0.25%, in accordance with the application of the new revaluation index.

In light of the macroeconomic developments envisaged and the above-mentioned measures, the 2016 Budget Plan anticipates growth of around 4.5% in overall general government revenue, which is slightly higher than projected nominal GDP. This would take the public revenue/GDP ratio to 38% in 2016, compared with 37.8% estimated for 2015.

On the expenditure side, the State spending ceiling, the improvement in the economic situation and the application of the above-mentioned measures to overall general government would – according to the estimations of the 2016 Budget Plan – give rise to a decrease of 1.4 pp in the public expenditure/GDP ratio. The decline, as a percentage of GDP, in government consumption, social transfers and the interest burden is particularly noteworthy.

As a result of the interplay between these fiscal targets and the macroeconomic setting described above, the budgetary policy stance can be described as practically neutral, if the estimations of the change in the primary structural balance included in the 2016 Budget Plan are taken into consideration. Clearly, if any of the risks to growth I mentioned earlier were to materialise, or financing costs were to increase, it would be more difficult to meet the government deficit commitments, and this must continue to be the main aim of Spanish budgetary policy. The enhanced credibility of Spanish economic policy in recent years is a result of the achievements in the area of fiscal consolidation; to maintain this credibility we need to continue and complete the process of correcting the fiscal imbalances.

Conclusions

The Spanish economy has made visible progress in the correction of the external imbalance, the deleveraging of households and firms, the redressing of fiscal balances towards levels more compatible with the sustainability of public finances and the restructuring and consolidation of the banking sector. Unemployment has also begun to decrease significantly.

The reforms undertaken within Spain, along with the headway made in furthering economic and monetary union and the ECB's highly expansionary monetary policy, have proven key to restoring confidence. However, the legacy of the crisis, eight years after its onset, is still burdensome as shown by the high levels of unemployment and foreign debt.

In this setting, the main risk is that of doubts arising over the continuity of the macroeconomic, fiscal and financial re-balancing drive. Such doubts could prompt a deterioration of confidence and a fresh tightening of financing conditions which is highly significant for a country like Spain with a very high net debtor position, that is, ongoing net borrowing.

Undoubtedly, therefore, in order to avoid reversals in the achievements attained, it is necessary to persevere with competitiveness-enhancing and fiscal consolidation policies, which provide the foundations for confidence, economic growth and job creation.

Thank you for your attention.