Luis de Guindos: Euro area and Spain - current status and challenges ahead

Remarks by Mr Luis de Guindos, Vice-President of the European Central Bank, at the 1st Edition of the Prize José Echegaray of elEconomista, Madrid, 15 October 2018.

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Despite the recent slow-down, economic growth in the euro area remains solid and broad-based, as confirmed by the latest data. Real GDP has expanded for 21 consecutive quarters, growing 0.4% quarter-on-quarter during the second quarter of 2018.

In the first half of 2018, growth weakened from the very high rates of last year, reflecting lower exports. In the coming period, however, we expect the economy to continue to grow at a pace above its potential. In fact, the duration and amplitude of the current expansion is still below historical averages, having lasted no more than five years and with real GDP now 10% above the trough in the first quarter of 2013.[1] By comparison, on average, growth phases in the past lasted seven and a half years from trough to peak, with GDP increasing by 21% over the same period.

While risks to growth have remained broadly balanced, those related to global factors, including the threat of increased global protectionism, rising oil prices and emerging market vulnerabilities, **have become more prominent.** Volatility in sovereign debt markets and the rise in populism add to overall uncertainty.

The ongoing expansion has led to strong employment gains. Since the beginning of the recovery, the number of people employed in the euro area has risen by 9.2 million. Euro area unemployment declined to 8.1% in August, its lowest level in almost ten years.

Consumer spending is being driven by steady growth in households' real disposable income. Strong labour markets – with increasing job creation and rising wages – boost household income and, in turn, consumer spending.

The investment outlook remains solid on the back of robust demand, improving profitability and favourable financing conditions. Since the end of 2014, bank lending rates in the euro area have declined significantly, by around 130 basis points for non-financial corporations and by around 110 basis points for households. Lending rates on very small loans, which can be used as a proxy for loans to small and medium-sized enterprises (SMEs), have fallen by more than 210 basis points. This is encouraging, as SMEs provide two-thirds of total private sector employment in the euro area.

Overall, the underlying strength of domestic activity in the euro area continues to support a sustained adjustment in inflation. According to the flash estimates, HICP inflation increased to 2.1% in September, from 2.0% in August. On the basis of the latest oil futures prices, headline inflation is expected to hover around the current level for the rest of the year. Our most recent projections foresee annual headline inflation at 1.7% in 2018 and in each of the two subsequent years. The stable path of inflation conceals a decline in the contribution of the energy component, as the impact of the past oil price hike fades, offset by a gradual increase in underlying inflation.

Although measures of underlying inflation remain generally muted, they have been increasing from earlier lows. Tighter labour markets and the emergence of wage pressures are expected to continue to bolster underlying inflation.

Given the underlying strength of the economy, we are confident that the sustained convergence of inflation to our aim will proceed even after a gradual winding-down of our net asset purchases. At the same time, an ample degree of monetary accommodation will still be necessary to ensure a durable convergence of inflation over the medium term.

Against this background, we have reduced our net asset purchases to €15 billion as of this month, and we continue to anticipate that net purchases will terminate by the end of the year. But in order to ensure that sufficient monetary policy stimulus continues to support the further build-up of headline inflation that we see in our projections, the Governing Council decided:

- to enhance our forward guidance on the likely future path of our policy interest rates, expressing our expectation that they will remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure the continued convergence of inflation towards our aim;
- and to re-assert our intention to continue to re-invest the principal payments from maturing securities in our portfolio for an extended period of time after the end of our net asset purchases, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

These measures will continue to provide the necessary degree of monetary policy accommodation to bring inflation back towards a level that is below, but close to, 2%.

Let me now turn to the Spanish economy.

Following the severe recession in 2008-09 and 2012-13, Spain's economic recovery has been strong, with five years of growth since 2013. During this time, the economy has expanded by an estimated 14% and the level of GDP is now above its pre-crisis peak.

This strong recovery reflects substantial policy efforts at both national and European level, particularly the reforms initiated at the height of the sovereign debt crisis.

Under the EU financial assistance programme, numerous measures and reforms were undertaken to strengthen the banking system. These included the stress testing and recapitalisation of troubled banks; the identification of troubled real estate assets and their transfer to SAREB (Spain's "bad bank"); and the reform of the savings banks. At the same time, actions and reforms at European level, including monetary policy (longer-term refinancing operations, LTROs, asset purchase programme, APP) and the move towards banking union, have ensured liquidity and strengthened confidence in Europe's monetary and financial system.

Financial reforms were accompanied by a series of reforms to labour and product markets and to the public sector. The 2012 labour market reform gave priority to collective bargaining agreements at firm level over those at sectoral or regional level. Reforms to product markets, including the law on market unity, have sought to reduce regulatory obstacles to firms' growth, although implementation has been challenging.

The Spanish economy has rebalanced as far as "flow" variables are concerned, while "stock" imbalances are gradually correcting.

Banks' asset quality and solvency has substantially improved, as reflected in higher capital ratios and a steadily declining ratio of non-performing loans (NPLs). The NPL ratio of Spanish banks has more than halved from 13.6% in 2013 to 6.4% now and continues to fall steadily. The banking sector has been able to finance growth with new loans while steadily deleveraging as legacy loans mature.

Private sector debt has fallen considerably. Deleveraging of firms and households is well under way, with debt having declined by almost one-third since 2012. At the same time, the public debt-to-GDP ratio, while remaining very high at almost 100%, has stabilised. The public deficit ratio came down from double-digit levels at the peak of the crisis to 3.1% in 2017.

More than two million jobs have been created since the end of 2013 and the unemployment rate has fallen from a peak of more than 26% to 15%. Throughout the recovery, the pace of employment growth has broadly matched that of GDP growth, generating around half a million jobs each year. In a context of subdued wage growth and low inflation, employment growth has supported disposable income and a recovery in consumer spending, which is now close to its pre-crisis level.

Export performance has substantially improved, helping to reduce external debt. The current account deficit of almost 10% of GDP before the financial crisis turned into a surplus in 2012 and has remained positive throughout the recovery. The number of exporting firms has grown and exports now go to more destinations than in pre-crisis times.

Finally, wage moderation and low inflation are supporting competitiveness. In fact, the Spanish economy recovered the competitiveness lost in the decade prior to the financial crisis.

However, the recovery of the Spanish economy may have passed its cyclical peak and downside risks have emerged. While still growing at a reasonable pace, the rate of economic expansion has slowed gradually in recent quarters. Real GDP growth has decelerated in 2018 compared with the growth we have seen since the second half of 2014. This slowdown mainly reflects weakness in net trade. Looking forward, global protectionism and weakening conditions in emerging markets represent further downside risks to growth. Internally, the present low savings rate of Spanish households and the need to restore savings in the near term, points to moderation in consumption going forward.

Let me point to the three main challenges that the Spanish economy is facing at present, in my view. The first relates to the process of fiscal consolidation. While well advanced, it is still incomplete. The government deficit ratio is still the highest in the EU and it needs to be further reduced to bring the government debt ratio on to a downward path. In fact, adequate buffers need to be rebuilt now, in times of solid growth and favourable financing conditions. This would enable fiscal policy to support the economy in the event of any future shock.

Secondly, unemployment remains very high, as does the share of temporary employment. Spain’s unemployment rate remains well above pre-crisis levels and is roughly the double of the euro area rate. This situation calls for further reforms to address the duality of the labour market and more effective active labour market policies to re-integrate young people and the long-term unemployed.

Finally, productivity remains low and needs to be raised to maintain economic growth and enable sustainable wage growth. Productivity gaps between regions and between large and small firms point to regulatory fragmentation which still needs to be addressed. To enhance productivity, measures to increase the scale of small firms in the SME sector, which tend to be smaller than in peer countries, need to be pursued. More attention needs to be placed on the education system and professional training to enhance human capital and reduce skills mismatches. Finally, greater investment in R&D and innovation by Spanish firms would enhance their competitiveness and contribute to generate more growth through higher value added.

Only by raising productivity and correcting macroeconomic imbalances can the long-term growth potential of the Spanish economy rise. This is a condition to place Spain on a solid growth path, increase employment and raise wages to finally leave behind the financial crisis that erupted ten years ago.

Let me conclude. The importance of increasing long-term growth potential is true for Spain as it is for the whole euro area.

At the same time, I cannot emphasise enough that a robust euro area economy has to rely on sound economic governance. Solidifying the institutional architecture of EMU is essential at this juncture in order to foster cohesive economic performance without fragmentation or excessive imbalances.

Reforms at the national and EU level are needed to uphold a stable financial system and a resilient monetary union. A common stabilisation function, which − in the spirit of a true counter-cyclical fiscal policy instrument – would maintain convergence in the event of large shocks, is an overriding priority. Completing the banking union with the establishment of a European Deposit Insurance Scheme, its third pillar, and firm moves towards capital markets union, promoting deep and liquid bond and equity markets in Europe, are necessary reforms of the financial sector. Attaining these goals is essential to safeguard financial stability, foster further integration and support economic growth and well-being of European citizens.

Thank you for your attention.

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[1] See also Camba-Mendez, G. and Forsells, M., "The recent slowdown in euro area output growth reflects both cyclical and temporary factors", *Economic Bulletin*, Issue 4, ECB, 2018.