# Luis M Linde: The international economic environment and Spain's economy

Testimony by Mr Luis M Linde, Governor of the Bank of Spain, before the Parliamentary Budget Committee in connection with the draft State Budget for 2013, Madrid, 4 October 2012.

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Ladies and gentlemen,

The appearance by the Governor of the Banco de España before this Committee at the start of the annual debate on the State Budget is a tradition I am most pleased to embrace. I shall try to be as clear and direct as possible on those issues I consider most important.

The Draft State Budget Law for 2013 is being presented against a background of singular difficulty for the Spanish economy.

I intend, first, to discuss the international economic context, in particular in the euro area; second, to look at recent developments in the Spanish economy, with particular reference to competitiveness and fiscal consolidation; and finally, to analyse the key features of the draft Law.

Without overstaying my welcome, I shall, before ending my address, briefly discuss the clean-up and restructuring programme for our banking system which, as you know, took a significant step forward on 28 September with the publication of the evaluations of the whole of the Spanish banking system. If you wish, we can go into greater detail on this matter in the round of questions, given its importance for restoring confidence in our economy, in activity and in employment, and, in short, for the implementation of the Budget for 2013.

## The international context

The international context is a primary factor of difficulty. The latest analyses and projections show signs of weakness, which can be explained to some extent by the difficulties the European economies are facing in overcoming a sovereign debt crisis that has now lasted for more than two years. While the growth forecast for the world economy as a whole in 2012 stood at around 4% a year back, this has now dipped to around 3%. The forecast for the United States has improved, but that for the euro area as a whole has fallen from growth of 1.1% a year ago to a decline of 0.4%. And the growth forecast for the emerging economies has edged down from above 6% to around 5%.

The forecasts for 2013 have also been lowered, especially for the euro area as a whole. The sluggishness of the international economy and, in particular, of the euro area is bearing down on our ability to recover.

## Euro area governance

I would therefore find it useful to start with a comment on euro area governance and its problems.

In my appearance before the Economic Affairs Committee last July, I addressed the source of the sovereign debt crisis in Europe and the main reasons for its depth and development. I believe I should reiterate that, to overcome the crisis, a new version of Monetary Union governance will be needed.

There have so far been two different stages in the reform of European governance. In the first, efforts focused on remedying the shortcomings detected in macroeconomic and financial policy oversight and coordination, and on the creation of financial assistance mechanisms. In the second stage, following the June 2012 Summit of euro area Heads of

State or Government, a banking union, greater fiscal integration and a common economic policy framework were proposed.

Here you may recall that the European Commission communicated its plans for the banking union to the Parliament and the Council on 12 September, with a legislative proposal to give form to the first of the three pillars which would underpin such a union: a common supervisory mechanism for which ultimate responsibility would be centralised at the European Central Bank, while there would be scope for some degree of decentralisation, enabling the knowledge and experience of national supervisors to be harnessed.

The move is just a preliminary one and should be viewed with caution, since in order to complete the banking union an integrated bank crisis management mechanism and a common deposit guarantee scheme will be needed. This will not be possible without progress towards a fiscal union, an area that obviously poses most significant political difficulties.

Along these same lines, I believe we should welcome the European Central Bank Governing Council's decision on 2 August to set in train the so-called Outright Monetary Transactions. This comprises a programme to purchase public debt on secondary markets, subject to compliance with specific conditions, as part of the financial support programmes of the European Financial Stability Facility and its successor, the European Stability Mechanism.

Since the start of this crisis the ECB has adopted a series of conventional (short- and medium-term liquidity provision, changes in the deposit rate) and non-conventional measures (long-term liquidity provision, debt purchases) aimed at preserving the sound functioning of monetary policy, which is tantamount to saying the transmission of the policy rates the ECB wishes to maintain at all maturities. These measures have also been useful in buying time for governments to correct the macroeconomic imbalances and the shortcomings in the institutional design of the euro which are, in part, at the source of the current fragility. The Outright Monetary Transactions are a further example of this type of non-conventional measure.

The new initiative is aimed at making sovereign debt markets work normally again, as their yields bear indirectly, but significantly, on households' and firms' financing costs. The aim is fully compatible with the ECB's mandate, as the President of this institution has stressed on various occasions.

Evidently, the announcement of this programme has had a stabilising effect. But given the nature of the problems at the source and in the development of this sovereign debt crisis, the role that any ECB decision may play in resolving it can hardly go beyond mitigating the risks of serious accidents and of providing more time so that the decisions that must be taken in areas other than the ECB may come to fruition.

### The Spanish economy

Let me now turn to the key features of our current economic situation.

The Spanish economy has been greatly affected by the financial tensions in the euro area, which emerged with the outbreak of the international financial crisis in 2007–2008, and the public finances problems of several euro area members, beginning with Greece. In our case, the crisis reached us and, in turn, we contributed to its unfolding as a result of the doubts over the sustainability of our public finances, our poor growth expectations and the scale of our foreign debt, which essentially built up during the real estate boom.

Economic policy has striven to overcome various factors of vulnerability in a very adverse macroeconomic setting. The results of the reforms undertaken are still incipient, and we must persevere with this strategy, which is the only realistic way of resuming sustained growth.

As recent events in Europe show, there are feedback loops from public finances and their problems to the banking system and its problems, and from the latter to activity and employment. In turn, job creation and growth are essential ingredients for progress on fiscal consolidation. Accordingly, economic policy-making should continue to be structured around two main goals: promoting competitiveness and growth, and restoring the sustainability of public finances. I shall briefly refer to these two major issues before analysing the Budget for 2013.

## Competitiveness and employment

First, let us look at developments in employment and competitiveness, two closely interconnected problems.

In terms of economy-wide unit labour costs, the cumulative loss to 2008 in respect of the 1998 level stood at 18%. In industry, and measuring competitiveness always in terms of unit labour costs, it was almost 30%. Naturally, labour costs are not the only explanation for the increase in unemployment, but they have undoubtedly been a major factor. That there were serious failings in the regulation of our labour market is something that practically all international economic organisations have been pointing out for years. The reform of our labour legislation was unavoidable.

The changes made are essentially geared to increasing the flexibility of our labour market: the priority of firm-level agreements, limits on the so-called “ultra-activity” of agreements, new regulations governing dismissal for objective reasons and greater facilities for maintaining wage restraint at companies in difficulty are all elements of change aimed at preventing dismissals and higher unemployment from being the only option for many companies to stay in business.

The macroeconomic projections accompanying the Budget for 2013 include the stabilising of our unemployment rate at around 25% of the labour force, a rate double the average for the European Union countries. This rate of unemployment is, quite simply, dramatic. Hence the enormous importance of economic recovery and of greater labour market flexibility: these two variables complement one another, and without both operating simultaneously, net job creation will not be possible.

## Fiscal consolidation

I shall now move on to public finances and to the nature of the fiscal drive needed.

In 2007 Spain posted a budget surplus of close to 2% of GDP and a public debt/GDP ratio of 37%, then one of the lowest among the euro area members. However, this apparently healthy state of affairs concealed a precarious situation owing to the presence of high tax revenue that had a significant temporary component tied to the major expansion of the construction and real estate sector, and to unsustainable spending dynamics.

Indeed, the end of this expansion uncovered the risks latent in that situation. Almost half of the deterioration of more than 13 pp of GDP over only two years from 2007 to 2009 – a turnaround in public finances unprecedented in Spanish economic history – was due to the fall in revenue, largely associated with the disappearance of the aforementioned extraordinary revenue. Meantime, public spending climbed significantly, largely as a result of the increase in unemployment benefits and in the interest burden, but also as a result of spending on pensions and on government consumption. A further expression of the rapid deterioration in the deficit was the most substantial rise in public debt as a proportion of GDP.

The first conclusion that may be drawn from this analysis, and one which is very relevant for understanding our present difficulties, is that the budget deficit arising with the crisis was eminently structural. That is to say, it was not only due to the downward cycle, or to the temporary discretionary measures with no lasting effect on public finances. In any event, the outcome has been that the public debt/GDP ratio has not stopped growing since 2007, and we will end the current year 2012 with a level close to 85%: i.e. an increase of almost 50 pp of GDP over a period of only five years, which in itself is an indicator of the seriousness of our crisis.

Reducing the budget deficit from its 2009 peak is proving anything but easy. Indeed, the correction made in 2010 and 2011 was very scant, and was of course less than that initially planned and desired. The budgetary adjustment is being made in highly adverse economic and financial circumstances, compounded by the impact in the short run of the austerity measures on economic activity. Moreover, stabilising the proportion of debt to GDP, which is a key figure for restoring market confidence, is all the more difficult against a backdrop of meagre growth or recession and of high interest rates on public debt.

Yet these contractionary forces can be mitigated if credibility in the process of fiscal consolidation can be attained. From this standpoint, following the heavy slippage in the deficit in 2011, the target of 6.3% of GDP for this year and the fiscal adjustment path to which we have committed to 2014 should be the means by which the doubts of the European authorities and the markets are dispelled.

The information currently available (on central government figures to August) indicates that there are risks of slippage from the target set for 2012. Given the importance of achieving the target, additional measures under the Budgetary Stability Law should be considered that provide for the target to be met. I have some points to make in this connection.

First, most of the slippage seen has originated from adverse developments in public revenue, partly deriving from the very nature of the adjustment under way in the Spanish economy. The fact that, at present, the only source of improvement in economic activity is the external sector (neither higher exports nor lower imports generate, per se, increases in tax revenue) means that the prospect of buoyant public revenue is scant, and is compounded by the intensity of the real estate adjustment. Against this background, maintaining a prudent projection of public revenue is essential.

Second, instruments are needed that enable early detection of potential slippage in revenue and expenditure during the fiscal year. The new Stability Law demands significant improvements in the transparency of general government conduct, particularly in relation to the budget outturn figures for regional and local government, which should be released with the same periodicity, degree of detail, lag and ready accessibility as central government data.

Third, the mechanisms enabling the prompt correction of any potential slippage must be reinforced. Once again, the Stability Law includes new instruments, such as the automatic adjustment of regional government spending in specific cases of non-compliance, the possibility of establishing sanctions and also of central government imposing adjustment measures. These new provisions may be effective in ensuring discipline, a matter that is all the more important following the extraordinary measures adopted by the State to offer liquidity support to regional and local government, such funds being conditional upon compliance with adjustment plans.

And, fourth, the reinforcement of the credibility of the fiscal consolidation process takes on great importance in the current situation of the sovereign debt crisis. It may be of help here to establish a medium-term budgetary horizon providing sufficient details of the expected trend of public revenue and spending and the assumptions on which they are based, and on the contents of the planned measures and the expected effect they will have. That would all contribute to reducing economic agents' uncertainty and would help identify the problems ahead in the medium term.

In the fiscal consolidation process, the long-term perspective is fundamental. Over this horizon, it is well known that the biggest challenge to public finances stems from the pressure that population ageing will exert on specific expenditure items, particularly pensions spending. Following the Social Security reform approved in July 2011, a specific definition is now needed of the so-called “sustainability factor”, which should result in an automatic adjustment of the system’s parameters if imbalances are detected in the long run.

### The 2013 budget

Before moving on to the Budget for 2013, I would like to specify the framework for debate of the draft legislation.

Spain is a very decentralised country in terms of public spending, more so than certain countries with a federal political structure. Currently, almost half the consolidated public spending in Spain, i.e. net of transfers between general government sectors, is by regional and local government.

Based on figures for 2011, central government was responsible for only 22% of total public spending; regional government for 34%; local government for 12%; and the Social Security system for 32%. That is to say, overall central government and social security spending in 2011 accounted for only 54% of the total, while that of regional and local government amounted to 46%. The picture given by the State and Social Security Budget is thus necessarily incomplete in respect of overall general government spending.

Admittedly, prior to the presentation of the State Budget, Parliament and the Senate have approved the budget targets, both for overall general government and for each of its sub-sectors, on the proposal of the Government and following a report by the Fiscal and Financial Policy Council and the Local Government National Board. Yet clearly the budgets of each regional government and each municipality are approved separately, there being no document containing information on all of them, together with that on the State and Social Security Budget. Hence, although we do have ex-post information that enables the public spending outcomes and outturn for the four major spending groups – central, regional and local government, and the Social Security system – to be analysed, we do not have an ex-ante or prior document that provides a detailed analysis of budgetary projections for overall general government and its compatibility with the objectives set.

It should be recalled, however, that the new Budgetary Stability Law introduced substantial improvements in this respect. Specifically, it stipulates that, before 1 October each year, regional and local government shall submit information on the essential items contained in their forthcoming budgets to the Ministry of Finance and General Government. Then, before 15 October, the Ministry of Finance and General Government will release a report on the alignment of this budgetary information with the stability objectives, in such a way that the Ministry may make recommendations should it perceive slippage. And, finally, before 1 April the following year, the Minister of Finance and General Government has to submit a report to the Government on the degree of fulfilment by all tiers of government of the objectives in the initial budget. I consider that these reports should in fact offer this complete picture of the budgetary projection that we are today lacking.

I would further remind you that the Government has announced the creation in 2013 of an Independent Fiscal Authority to ensure compliance with budgetary regulations. This type of institution has proven useful in other developed countries in enhancing budgetary policy credibility. It is, however, crucial that such an institution should enjoy a degree of independence, effective responsibilities and resources in line with best international practices.

I will now discuss the essential features of the State and Social Security budget for 2013.

### Macroeconomic setting and fiscal deficit

The draft State Budget for 2013 is part of a macroeconomic setting in which real GDP is estimated to decrease by 0.5% as a result of a negative rate of change in national demand of 2.8%, which would be partially offset by a 2.3 pp contribution from the external sector.

This projection of a 0.5% decline in GDP in 2013 is clearly optimistic compared with the fall of around 1.5% currently projected by most international organisations and analysts.

That said, I would like to make two observations. Firstly, if indeed the fall in activity in 2013 is closer to 1.5% than 0.5%, the foreseeable impact on the deficit can be estimated at 0.3 pp of GDP. This deviation is substantial, but it would be possible to correct it during the year. Secondly, all projections of changes in activity should be viewed with caution and with some distance. The history of forecasting errors and corrections to all manner of projections – including those of international institutions, large investment banks, government and, of course, the Banco de España – would fill many pages. In short, while considering that the rate of change in GDP for 2013 contained in the Budget is certainly optimistic, I would like to add that I do not think it is a serious difference or that it should detract credibility from the fiscal consolidation exercise undertaken in 2013.

The Budget proposes an overall general government budget deficit target, in National Accounts terms of 4.5% of GDP, down from 6.3% projected for 2012, excluding from this year the impact of the support measures for financial institutions. The target for 2013 is in line with our European commitments and will require a reduction in the primary deficit of almost 2.5 pp of GDP.

In terms of the different agents, a deficit target, in National Accounts terms, of 3.8% of GDP is proposed for central government and the Social Security system, compared with a deficit of 4.5% of GDP projected in 2012, which would represent an improvement of 0.7 pp of GDP, similar to that projected for the regional governments, which should reduce their deficit from 1.5% in 2012 to 0.7% in 2013. The adjustment would be completed with the projected reduction of 0.3 pp in local government to reach a balanced budget in 2013.

### Revenue

On the revenue side, this budget tightens the fiscal pressure both in terms of direct and indirect taxation, with a range of new measures. Furthermore, it should be recalled that, in 2013, the measures approved in 2012 in relation to higher personal income tax rates, the increase in the rate on income from fee-earning activities, changes to corporate income tax and the rise in VAT rates will still have a significant impact.

Despite the background of recession, the tax take is projected to increase overall by 3.7%. The net effect of all the tax regulation measures with an impact in 2013 is estimated to be approximately €7.2 billion. Net of this impact, revenue would fall by 0.5%.

As for the Social Security Budget, the 1 pp reduction planned last July is postponed or ruled out, and a 1.1% fall is projected in 2013 in total social security contributions compared with the initial budget for 2012.

The projected tax revenue for 2013 is subject to downside risks because it is based on the assumption that the revenue targets for 2012 will be achieved. However, on the information currently available, it cannot be ruled out that revenue performs worse than expected in 2012. If this risk materialises and is not countered by appropriate action in the remainder of the year, that would make it difficult to achieve the targets set for 2013, compounding the possible effects of a bigger decline in GDP than that assumed in the budgetary programming.

### Expenditure

On the expenditure side, the weight of three items should first be underlined: Social Security system contributory pensions, unemployment benefits and the interest on government debt. In 2012, these three items are equivalent to 20% of GDP and will account for approximately 36% of total public spending. In 2013, these percentages will foreseeably increase significantly.

Noteworthy among the measures considered on the expenditure side are: the freezing of civil servants' and public-sector employees' salaries, although they will recover their December extra payroll, which, together with not filling vacancies, will result in a very low increase in personnel costs in relation to serving employees of around 0.1%. Real investments are reduced by 46%, whereas the interest burden increases by more than €12 billion.

In the Social Security system, spending on contributory pensions, sickness and other benefits will grow by slightly more than 5%, factoring in the raising of pensions by 1%. Foreseeably, however, spending on unemployment benefits will fall by slightly more than 6% due to the projected stability in unemployment figures and to regulatory amendments to the benefits system. Note, however, that changes in expenditure on social security pensions in 2013 will be affected by the revision that should be made, taking into account the inflation rate recorded to November 2012. Since an increase of 3.5% is projected and the corresponding adjustment payment could be around 2.5%, that would represent an increase in spending of approximately €3 billion in 2012, which would be consolidated in 2013 and in future years.

I should mention that, in the next budget, one of the most important agreements of the so-called Toledo Pact will finally be concluded, in connection with the separation of the system's sources of financing: on one hand, contributory pensions will be financed exclusively by contributions; and, on the other, the non-contributory top-ups and non-contributory pensions will be financed by taxes. This separation, which began to be applied in 2002, will be completed in 2013: and this is good news for the proper functioning of the system as a whole and for its future.

## Public debt

As I indicated above, from the beginning of the crisis in 2007 until the end of 2012, the ratio of our public debt – as defined in the Excessive Deficit Protocol – to GDP has increased by 50 pp. Undoubtedly, this is the highest increase over the shortest period in this ratio in Spain's economic history. The increase from 2011 to 2012 will amount to 16 pp of GDP, of which: 7 pp are explained by the deficit (4 pp by the primary balance and 3 pp by interest); nearly 1 pp is due to the fall in nominal GDP nominal, and 8 pp are attributable, essentially, to the financing of the Plan to Pay Suppliers and €30 billion of the amount estimated by the FROB to be drawn down from the European Financial Facility before year-end.

This ratio is projected to grow more moderately in 2013, from 85% to 91% of GDP, i.e. an increase of 6 pp compared with the 16 pp we will record in 2012, and will be almost exclusively due to the increase in the interest burden on public debt because, if the projections are fulfilled, the primary deficit will be 0.7% of GDP in 2013.

## Clean-up and restructuring of the banking system

I would not like to conclude without commenting, albeit very briefly, on the programme for the clean-up and restructuring of our banking system.

As you know, a further step has been taken with the publication of the estimates of capital needs, based on the stress tests performed by an independent appraiser, supported by audit firms and real estate appraisal companies under the supervision of the European Commission, the European Central Bank, the International Monetary Fund and with the participation of the Ministry for Economic Affairs and the Banco de España.

I will not repeat here the figures already published and explained and which were yesterday commented on by the Minister for Economic Affairs and Competitiveness before the Economic Affairs Committee.

However, I do want to say that the exercise performed is unprecedented in terms of its depth and detail, the severity of the macroeconomic assumptions accepted and the scrutiny to which it was subject throughout by experts from the institutions I have mentioned above.

But there is still some way to go in the clean-up and restructuring of our banking system. The Memorandum of Understanding signed last July sets out the steps now to be taken, which the Spanish authorities – and, rest assured, the Banco de España – will comply with as precisely as possible.

The restructuring or resolution plans for banks owned by the FROB must be approved before December 2012. Also, before November, we shall have at our disposal the recapitalisation plans of banks which cannot meet their capital shortfall without State aid, on the understanding that banks which are not considered viable will be resolved orderly in accordance with the terms of the corresponding resolution plan. Banks that can meet their capital shortfall without resorting to State aid will be required to implement their recapitalisation plans before June 2013.

The other key component of the Clean-up Programme is the Asset Management Company which should be operational at the beginning of 2013. It is key because it will permit the clean-up of the banks requiring State aid to be completed and will provide a suitable horizon for the management and sale of the mass of assets to be transferred.

## Conclusions

The Budget for 2013 involves a considerable drive in respect of fiscal adjustment. It attempts to bring about a correction in the primary deficit, net of interest on public debt of almost 2.5 pp of GDP. In the depth of a recession, that is very difficult, but necessary in order to meet the targets to which Spain is committed within the framework of the European Union and the euro area.

We have some data which, although not warranting excessive optimism, do indicate that an adjustment is being achieved. We are going to end 2012 with a current account almost in balance, and in 2013 it will probably run a surplus. The recession has a contributing factor, but not the only one. We also have a clear improvement in competitiveness based on changes in our labour costs and in productivity.

The most pressing problem facing the Spanish economy is to restore market confidence. There is no other way to achieve this than meeting the fiscal consolidation targets, completing the clean-up and restructuring of our banking system, continuing with the process of private and public deleveraging and moving ahead with the reforms undertaken to improve our competitiveness.

If we manage to make progress on those fronts in 2013, I am confident it will be possible to resume economic growth and to create net employment in 2014.