Luis M Linde: Brief review of recent developments in the Spanish economy

Testimony by Mr Luis M Linde, Governor of the Bank of Spain, before the Senate Budget Committee in connection with the draft State Budget for 2013, Madrid, 21 November 2012.

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Ladies and gentlemen,

This is the first time I am following the tradition of the Governor of the Banco de España in giving testimony to this House as part of the debate on the State Budget. It is a pleasure to do so.

The Budget is being debated this year in a national and international economic context beset by difficulties. Consequently, before analysing fundamental aspects of the Budget, I think it is appropriate to briefly review some of the most significant recent developments in the Spanish economy. I will confine my comments to those developments I consider most important for the debate on this draft law.

The international setting and the euro area

In the current circumstances, marked by the need to complete a series of difficult adjustments, the Spanish economy's ability to recover is heavily conditioned by the fragile external setting. On the most recent projections of the main international organisations and most private analysts, the euro area's gross domestic product – and, therefore, the imports of our main economic partners – will hardly grow next year. The outlook for the other developed economies is not much more favourable and, indeed, the available projections for the emerging economies, which in recent years have been the main driver of global economic growth, also show a weakening of activity.

The difficulties of definitively restoring confidence in the soundness of the Monetary Union continue to weigh on the lack of momentum in the euro area. It is widely accepted that the problems continuing to affect sovereign debt markets in the area and limiting its ability to recover ultimately stem from the slowness shown by certain economies in adapting to the new reality of belonging to a monetary union and from certain weaknesses in the original design of European governance.

Since the tensions emerged, significant progress has been made in what could to some extent be considered the first phase of reform of the euro: warranting a mention here, in any event, are the strengthening of the Stability and Growth Pact, the Excessive Imbalances Procedure and the European Semester. At the same time, however, the scope and depth of the crisis have shown the need for a more far-reaching review, whose ultimate aim must be to achieve a "genuine economic and monetary union". The Summit of Heads of State or Government of the euro area in June this year marked the beginning of the second phase of reform, which rests on three basic pillars: the banking union, further fiscal integration and greater economic policy coordination.

As to the ECB, it has contributed to providing stability to the euro area both through its more conventional remit, i.e. setting interest rates, and through its less conventional facet, namely supplying exceptional amounts of liquidity through unorthodox channels. But the roots of the current crisis in the euro area are not of a monetary nature and, consequently, monetary policy alone cannot resolve those problems. Monetary policy can, however, provide more time for the remedies aimed at resolving the underlying problems to be effective.

On 2 August the Governing Council of the ECB adopted a new non-conventional measure: the so-called Outright Monetary Transactions. This programme of purchasing government debt on secondary markets, subject to compliance with certain macroeconomic conditions, aims to repair the monetary policy transmission mechanism, thus ensuring that the effects of the expansionary conventional measures adopted from the onset of the crisis reach European households and firms alike, irrespective of their country of residence.

This ECB decision has had a stabilising effect on markets and eased the pressure on the Spanish economy, although financial conditions remain very tight and uncertainty continues to weigh on households' and firms' spending and investment decisions.

As stated, euro area measures should contribute to restoring the transmission channels of monetary policy and, thereby, reduce financial tensions. They should also help to sever the problematic public finances/banking system feedback loop, a vicious circle which contributes to prolonging the climate of uncertainty and makes it difficult to resolve the problems facing the euro area. Nevertheless, it should not be forgotten that the scope of these actions is limited and that definitively overcoming the crisis in Spain will depend on the progress achieved in other domains, including those which depend on our own economic policy.

The Spanish economy

The challenges facing the Spanish economy are well-known: reducing its high dependence on external financing, sustainably correcting the budget imbalance and strengthening the drivers of medium- and long-term growth through substantial and lasting improvements in competitiveness. Naturally, completing the clean-up and restructuring of the banking system is also a key factor in this strategy, and I will briefly refer to this later on.

Significant steps have been taken in addressing these challenges. Nonetheless, the ongoing adjustment of the Spanish economy is at a delicate juncture, since there are no perceptible improvements in activity and job creation because many of the measures taken are structural and will take some time to work fully through. The growth outlook for the coming quarters is still not favourable, as shown by the forecasts released by different organisations in the past few weeks, which point to a fresh contraction of activity in 2013. However, the adjustment undertaken is essential in laying the groundwork for a new phase of economic growth which will allow a substantial and lasting reduction in the unemployment rate. The resumption of growth of the Spanish economy will depend above all on our perseverance in pushing through the reforms.

As I mentioned in my address to the Spanish Parliamentary Budget Committee, and as I believe bears repeating here, economic policy has to continue striving towards two main goals: promoting competitiveness and growth, and restoring the sustainability of public finances. I will focus particularly on this second stage of the adjustment.

Fiscal consolidation

In the present circumstances, ensuring the credibility of the process of fiscal consolidation is a priority. After the heavy slippage in the deficit in 2011, it is crucial to dispel doubts as to the capacity to control the upward path of public debt. Credibility is the main alleviating factor to mitigate the contractionary impact, in the short run, of the necessary adjustment measures.

For the consolidation to be credible, the expenditure-reducing and revenue-enhancing measures have to be well-designed and consistent with our chosen path; in addition, experience indicates that to prevent slippage, it is advisable to work with a highly conservative projection of public revenue. When forecasting revenue, underestimates are more acceptable than overestimates. Also, adequate early warning tools are required to detect in advance any possible deviations and to make, where necessary, the required corrections in time. The Budgetary Stability Law provides an appropriate tool for controlling expenditure. In the area of credibility, it is highly advisable to define a multi-year budgetary time horizon which offers certainty to agents and, moreover, to deploy fiscal measures which combine actions with a short-term impact and others acting on the sustainability of public finances in the medium term, impinging, among others, on those expenditure items most affected by population ageing.

Regional government finances

Let me begin my analysis of the 2013 State budget by looking at regional government finances.

Spain is today a country characterised by strongly decentralised public expenditure. On 2011 figures, central government accounted for 22% of total expenditure, social security for 32%, regional government for 34% and local government 12%. Thus, 46% of public expenditure was by regional and local government. With this structure of public expenditure, the setting of budgetary objectives for the various political and administrative tiers, on one hand, and the monitoring of their fulfilment, on the other, are two sides of the same coin. Both are fundamental in building the credibility of budgetary policy.

Let me mention here what I consider to be an extremely significant advance. At the end of October the Ministry of Financial Affairs and Public Administration began to publish for the first time, as a result of the commitments made under the Stability Law, monthly data on the regional government budget outturns. As these figures become available regularly, in accordance with the related Law, the task of monitoring regional government expenditure will be made immensely easier. This is fundamental for the timely detection of any slippage from stated budgetary objectives and for standing ready to respond appropriately. It should also be noted that in the past few weeks a good number of regional governments announced their budgets for 2013, although it is still early to make a full diagnosis of overall regional government expenditure.

These developments remedy some of the weaknesses in the information available for assessing the budgetary adjustment scheduled for 2013. Even so, the fact that the presentation of the various budget documents by the various governments is not formally coordinated makes the work of analysts harder, given that, obviously, what matters from the macroeconomic standpoint or for the analysis of public finances is general government as a whole.

The State and Social Security Budget for 2013

Let me now turn to the essential features of the State and Social Security Budget for 2013, beginning with a reference to the budget outturn in 2012.

The budget deficit is being reduced this year in very adverse economic and financial circumstances. Indeed, as a result of the risks of possible slippage, a series of supplementary fiscal measures were adopted for the 2012 Budget. Their effects have begun to be perceived only in the second half of the year. Notwithstanding, on the information available, the possibility of slippage can still not be ruled out. Meeting the target will depend on the numerous tax measures taking effect in the last quarter of the year ultimately yielding the expected returns, and on that offsetting the growth of debt service payments, unemployment benefits and pensions. Given the importance of meeting the deficit target in 2012, it should be foreseen that possible slippage in certain items may be offset with possible adjustments to others.

The draft State Budget for 2013 sets an overall general government deficit target, in National Accounts terms, of 4.5% of GDP, in line with European commitments. That is down from 6.3% envisaged for 2012, excluding from that figure the impact of the measures to support banks which must be recorded this year (amounting to around 1 pp of GDP). The Budget envisages that the public debt ratio will increase from 85% of GDP in 2012 (including €30 billion of FROB debt due to the drawdown in December of the credit line agreed with the European authorities) to 91% of GDP in 2013.

The fiscal effort these targets entail is highly ambitious (around 2 pp in terms of the cyclically adjusted primary deficit), in a setting which will remain difficult. The macroeconomic scenario accompanying the budget envisages that GDP in real terms will contract 0.5%, as a result of the 2.8% fall in national demand which would be partly offset by a 2.3 pp contribution by the external sector. The main difference between this macroeconomic setting and that of the IMF or the European Commission is the lower decline in gross capital formation projected in the budget.

Achievement of the targets set for 2013 may be jeopardised if tax receipts are affected by lower economic activity. Expenditure in the State and Social Security Budget is dominated by the interest on government debt, spending on contributory pensions and unemployment benefits. The sharp rise in these items reflects the increase in debt and the higher cost of new issues, demographic trends and the unfavourable performance of the labour market. To offset this expansionary trajectory, the Budget adopts an austere stance on other expenditure items, in particular the remuneration of public employees and real investment.

Lastly, I must mention that the Budget for 2013 saw the culmination of one of the most important agreements of the Toledo Pact, namely the separation of the Social Security System's funding sources: on one hand, contributory pensions, funded solely by social contributions and, on the other, non-contributory supplements and non-contributory pensions, funded by taxes. This separation, which began to be applied in 2002, will finally be completed in 2013.

The bank restructuring process

Finally, I would like to comment on the bank restructuring process under way further to the agreement entered into with the European authorities last July.

Bank restructuring is progressing as scheduled. In June the evaluation exercise was completed, enabling an estimate of the capital needs for the whole system to be made, and confirming that they were clearly below €100 billion; at the end of August the Royal Decree-Law on credit institution restructuring and resolution was approved, constituting a new code in this area; at the end of September the exercise was completed, enabling the capital needs for each of the banks participating in the exercise, which accounted for 90% of the Spanish banking system, to be determined; and, last Thursday, the Decree which will regulate the activity of the Asset Management Company for Assets Arising from Bank Restructuring (SAREB) was approved, another key step in the implementation of the programme agreed with the European Commission.

The analysis concluded in September enabled the classification of banks for restructuring purposes to be confirmed. Previously, the banks without additional capital needs had already been determined (Group 0) as had the banks controlled by the FROB (Group 1), to use the terminology of the Memorandum of Understanding; this classification was completed, dividing the other banks with capital needs into: a) those with plans to achieve the capital levels required using their own means; and b) those which will require State aid to do so. The latter were requested to provide restructuring plans which are currently being studied.

At the end of this month, it is planned to approve the restructuring plans of the banks in Group 1 (those controlled by the FROB), and those of Group 2 (the other banks which will require State aid) will foreseeably be approved before year-end. The restructuring plans envisage the transfer of assets to the asset management company, which will become operational in December, and the recapitalisation of banks which need it. Each bank will have a schedule for implementing the measures that it must adopt, and these are expected to be completed in the first quarter of 2013.

Conclusions

The State Budget for 2013 represents a substantial effort in terms of austerity. The intended fiscal adjustment is certainly very ambitious, given the ongoing recessionary setting for public finances next year. Central government efforts would be insufficient if not accompanied too by the adjustment to which regional and local government have committed.

From the macroeconomic standpoint, some data show progress is being made in rebalancing the Spanish economy. The bulk of the correction has already been made by the current account and it is close to balance in 2012 which, foreseeably, will enable it to run a surplus in 2013. Similarly, we can see improvements in the competitiveness of the Spanish economy both with regard to labour cost indicators and productivity. We forecast that in 2014, and measured by unit labour costs, Spain will have recovered practically all of the competitiveness lost between 1998 and 2008.

The correction of imbalances will be essential for regaining market confidence. And here, both budget policy and further structural reforms will be a pivotal contributing factor. The year 2013 poses considerable challenges and difficulties. If we manage to overcome them, they will put us on the path of economic growth and job creation.