Luis M Linde: Overview of the Spanish economy against the background of the euro crisis

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 2014, Madrid, 4 October 2013.

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My first appearance as Governor of the Banco de España before this Committee was last year, amid a very difficult situation for the Spanish economy and a serious euro crisis. Since then, fortunately, the situation has improved and the most serious uncertainties surrounding the future of the common currency have been dispelled.

Allow me to begin by stressing the importance that strengthening the Economic and Monetary Union and Spain's participation in it has for our economy and for the well-being of Spanish society.

The difficulties we are facing should not mask the benefits the Spanish economy has reaped from its participation in the European project and in its most significant institution in terms of integration, namely monetary union. It is worth citing some figures.

In the 1986–1990 period, Spanish per capita GDP stood at 78% of the average of the countries then comprising the European Union. In the 2007–2012 period, despite the severity of the crisis in Spain, the percentage figure relative to the same group of countries, which are the richest in the Union, was at 93%. And if we focus on infrastructure, which is so important for any country's growth potential, the last 20 years have seen the weight of investment in infrastructure in Spain far exceed the European Union average. Specifically, over the past two decades, the weight of public investment in GDP in Spain has held, year by year, at 1.25 pp above the European Union average. That has allowed almost full convergence in terms of our public capital endowment, in proportion to our population, with the core European countries.

From this standpoint, which we should not lose sight of, I shall refer to the economic and financial situation in Europe and to recent developments in the Spanish economy, with particular reference to economic policies and to the draft budget for 2014. To conclude I have some comments, which I feel bound to make, on the headway in our bank restructuring.

The euro area

For some months, the economic and financial situation in Europe has shown some improvement, against an international background marked by signs of recovery in the United States and Japan, and by some loss of momentum in the emerging economies, most particularly China.

Following six consecutive quarters of contraction, euro area GDP growth has moved back into positive territory. Underpinning this change in sign is a pick-up in internal demand, which has added to the progress in net exports. The growth of 0.3 pp in euro area GDP in the second quarter of 2013 has, naturally, been a positive surprise and plots a favourable course for the Spanish economy. But its duration and intensity are by no means assured. Indeed, recently revised medium-term forecasts for the euro area as a whole continue to augur very moderate GDP growth rates and overly high unemployment levels.

In the financial domain, the degree of market fragmentation is lessening considerably, but is still not fully compatible with the normal functioning of a monetary union and with efficient monetary policy transmission. The cost at which households, credit institutions and the different levels of government can currently finance themselves in the countries subject to most tension is still above what the ECB monetary policy stance would warrant.

The ECB has in fact continued to reinforce its expansionary monetary policy stance throughout the year, both through conventional conduct and through non-conventional or extraordinary measures.

In May there was a fresh cut in official interest rates which, along with the maintenance of the unlimited liquidity provision policy, is serving to set money market interest rates at extremely low levels.

In July the ECB Governing Council decided to take a further step in its strategy of reinforcing its expansionary monetary policy stance with the use of a new instrument, known in the parlance as "forward guidance". Thus, after the May cut in rates, in July the ECB announced that the Governing Council expected rates to remain at the new level, or at a lower level, for a protracted period.

In any event, the contribution monetary policy can make to resolving the problems at the root of the crisis is limited, and can hardly go beyond providing the time needed for other economic policies to bear fruit, policies that do have the wherewithal to curb these problems. For full normalisation of the area to come about, Member States must successfully see through the adjustments to their domestic economic policies to adapt them to what a monetary union requires to function.

From this perspective, I believe we should assess the progress made towards banking union in Europe. In the coming days, the European Union Council will approve the legislation to underpin the creation of the Single Supervisory Mechanism (SSM). That will formally set in train the process that will culminate in the assumption, by the ECB, of microprudential supervision in the euro area in autumn next year.

There is virtual consensus around the conviction that the banking union will be a decisive instrument for breaking the loop between banking risks and sovereign risks, enabling the degree of financial fragmentation still prevailing in the area to be reduced and, we trust, ultimately eliminated. But to harness the full potential of the banking union, it is important to ensure the quality of the bank review exercises to be conducted before the ECB assumes its new supervisory responsibilities.

But the banking union will not reach its full potential if progress is not made in the design of its other component parts, most notably a single resolution mechanism and fund, i.e. a harmonised or common procedure for the treatment of bank crises.

Spain

I shall now turn to the situation of our economy.

The Spanish economy is showing signs of improvement, although the momentum for a sustained recovery remains weak. During the current year the rate of contraction of economic activity has eased, posting a quarter-on-quarter decline of only 0.1 pp in the second quarter. The as yet incomplete data for the third quarter suggest that this improvement has continued in recent months, meaning activity in Spain may have ceased to fall in the July-September period and may have even posted a slight increase, following two years of continuous declines.

I thus believe it is not unwarranted to state that the Spanish economy appears to be overcoming the second recession of this protracted crisis.

Several factors lie behind this change. Undoubtedly, the pick-up in euro area activity has contributed, along with a highly favourable tourist season. But the sound course of exports, and to non-euro area destinations moreover, indicates that the most notable gains in competitiveness are contributing considerably to this improvement.

The labour market figures for the past two quarters offer positive signs. They indicate that the pace of job destruction has been curbed along with a fall of 1 pp in the unemployment rate, which still stands at slightly over 26% of the labour force. The greater momentum of hiring habitually seen in the summer months and the decline in the labour force have influenced these developments; but they no doubt also reflect a favourable reaction by employment to the adjustment under way in labour costs.

As the Banco de España has previously indicated and reiterated just a few days ago, evaluating the results of the labour reform approved last year requires prudence for two key reasons: it is a structural reform, whose effects, in any event, can only be felt in the medium and long term; and it was implemented amid a full-blown recession. That said, the analysis that can now be conducted shows better results – a lower fall in employment and greater wage restraint – than those indicated by forecasting models. As previously stated in other parliamentary appearances, I believe the reform was vital, that it has been correctly oriented and, most essentially, that practically all experts and international organisations had been stressing its necessity for several years. I believe its effects will be positive and that this will be clearly perceived once activity begins to pick up.

Comparing the present situation with that a year ago, there has evidently been notable progress in restoring confidence in the Spanish economy. The growing normalisation of external funding flows and the fall in the sovereign risk premium clearly illustrate this. However, the pass-through of this improvement in overall financing conditions is still proving limited, whereby the financial restrictions continue to weigh down most significantly on private-sector spending and investment decisions in Spain.

All told, the slowing trend in inflation has continued over recent quarters and further headway has been made in correcting the main imbalances.

The increases in the annual rate of the consumer price index in the first half of this year have slackened as the effects of the tax rises and increases in administered prices from July to September last year have been stripped out. According to the flash estimate, the CPI rate stood at 0.3% in September. It is therefore likely that its annual rate of change will stand below 1% in December. Running such a moderate inflation rate evidently contributes to alleviating the impact of weak incomes on households' and firms' purchasing capacity. The legislation on the deindexation of the economy will be a valuable instrument for entrenching this trajectory.

But the clearest example of the marked re-balancing the Spanish economy is undergoing is the elimination of the external deficit. In 2013 to date, we have achieved a net financing position with the external sector, a trend which will foreseeably continue and become more accentuated over the rest of the year, to the point of placing the overall balance of payments on current and capital account for the whole of 2013 at over 2% of GDP. Nonetheless, the accumulation of major external deficits between 2007 and 2011 (amounting, over these five years, to €328 billion, 32% of our GDP in 2012) has led to a high debit international investment position, and years will be needed to reasonably reduce our dependence on external saving.

Private-sector deleveraging continues to progress, although the unfavourable course of income is checking the speed of the process. It is moreover likely that debt/income re-balancing will prolong the contraction of credit at the aggregate level, although we may expect its impact to be increasingly less. This is compatible with a reallocation of funds towards the more productive agents with healthier financial positions. In any event, measures are needed aimed at reallocating funds towards firms with greater potential in terms of activity and employment and with financing difficulties, a situation particularly prevalent among small and medium-sized enterprises.

Fiscal consolidation

Let me now address the public finances situation.

The general government deficit target for 2013, at 6.5% of GDP, entails a reduction of almost 5 pp from its 2009 of 11.2% of GDP. The reduction is difficult because it is taking place in a highly adverse macroeconomic setting, therefore equating to a real adjustment on a much greater scale, as indicated by the decline in the cumulative structural primary deficit in this period, which can be estimated at around 7 pp of GDP.

Progress here has called for the adoption of numerous measures, both on the revenue and expenditure sides.

On the revenue side, it has been sought to offset the effects on tax receipts of the collapse in the real estate sector, and of the weakening of tax bases. To this end, there have been rises in practically all taxes. On the expenditure side, measures have been aimed at correcting the unsustainable dynamics that had begun to take root in the pre-crisis phase and at compensating for the strong upward pressure that the crisis exerted on all items, such as the higher interest burden and unemployment benefits.

Fiscal consolidation has also been pursued through far-reaching changes to our budgetary framework, with the constitutional reform and the approval of new budgetary stability legislation, which have made for great progress in transparency and have broadened the range of instruments available to strengthen public spending discipline.

Slippage in the budget deficit targets set between 2009 and 2011 affected the credibility of the adjustment process. The greater degree of success in meeting targets last year gave rise to unquestionable benefits in terms of restored credibility. That has contributed to easing the pressure on the risk premium and smoothed the way for agreements in Europe, under the Stability and Growth Pact and the Excessive Deficit Procedure. The European authorities agreed last July to allow a milder fiscal adjustment path for Spain, in particular for 2013 and 2014, which is more consistent with the current macroeconomic conditions and those that will prevail in the coming years.

For this improved credibility to take root, the deficit targets must be met. Information on the budget outturn in 2013 is still limited. In the first half of the year, the deficit improved relative to the same period a year earlier (without considering the impact of the assistance to the financial sector which, as is known, does not count for these purposes). The budget outturn in the second half of the year must, therefore, be very strict at all levels of government if slippage is to be avoided at the end of the year. While there are risks, I trust we can meet the target this year of cutting the deficit to 6.5%.

The headway in budgetary consolidation should not mask the fact that the effort needed to ensure Spanish public finances are redressed is still most considerable. Let us not forget the distance still existing between the present situation and the requirement set in the Stability Pact and in the new Budgetary Stability Law for the medium term, which is to have a structural balance in equilibrium. Closing this gap will require further adjustments that will never prove easy because restoring growth will be a gradual process.

We must also be mindful of the problems posed by the dynamics of the public debt/GDP ratio and its perspectives in the short term. So far, and as is usual in the initial phases of fiscal consolidation processes, this ratio has continued growing, with a forecast for 2014 of 98.9% of GDP. Reversing this trajectory is vital for ensuring the future sustainability of public finances, but it will require running primary surpluses for a prolonged period; naturally, the sooner we achieve sustained economic growth, the smoother this adjustment process will be.

To tackle these challenges, institutional developments geared to ensuring budgetary rigour must be pursued. The independent fiscal responsibility authority, which will foreseeably start up in 2014, must reinforce the quality and independence of budgetary programming. Here I would like to mention the planned review of regional government financing arrangements and the creation of the committee of experts for the reform of the tax system, who are expected to submit their report in the coming months.

As for the public pension system, I shall reiterate what I said before the Economic Affairs Committee last June on the presentation of the *Annual Report* of the Banco de España.

The public pension system is a fundamental factor of economic and social stability and it is in everybody's interest to address the risks of shortfalls arising as a result of demographic developments. The sustainability of the pension system – i.e. certainty as to the ability to fund it appropriately – is essential for giving stability to public finances and for the credibility of any programme to consolidate total public spending.

For the system to be sustainable, it must find a way to accommodate its key elements, namely the retirement age, the means of calculating pensions and the so-called "sustainability factor". I hope and trust that political forces will continue working on this delicate and very important matter, in the spirit of the Toledo Pact agreed almost 20 years ago, and which has repeatedly been supported by our parliamentary institutions.

The major budgetary figures and the macroeconomic aggregates for 2014

The 2014 Budget is the first to be drawn up following the entry into force of the latest European budgetary governance reform, which introduces into countries' budgetary procedures an assessment by the European Commission of draft general government budgets.

In Spain's case, this reform will lead to the availability of a single document drawing together the main budgetary items of all levels of government, i.e. one that includes the regional governments. In a country as decentralised in terms of public spending as Spain, as decentralised or more so than other countries with a federal political structure, the preparation of this documentation is a fundamental requirement for the appropriate assessment of budgetary forecasts. According to the agenda set, this document will be available, at the European level, in the coming days. I shall therefore refer solely to the State and Social Security budgets.

The draft State budget for 2014 is set against a macroeconomic background in which real GDP is forecast to grow by 0.7%. This macroeconomic scenario, whose central forecast is export growth above 6%, is prudent and in keeping with the forecasts of most national and international agencies. It outlines a gradual recovery in activity and employment in a setting in which the ongoing budgetary adjustment and the deleveraging of households and firms will continue, and in which the competitiveness regained in 2012 and 2013 will not be lost.

In step with our European commitments, an overall general government budget deficit target, in National Accounts terms, has been set at 5.8% of GDP, against the figure of 6.5% forecast for 2013. In terms of the different agents, a National Accounts deficit target of 3.7% of GDP has been set for central government, against 3.8% in 2013, and in the case of the social security system and the regional governments the figures mark an improvement of 0.3 pp of GDP, taking the respective deficits to 1.1% and 1%. Local governments should maintain in 2014 the balanced budget already forecast for 2013.

As in previous years, three expenditure items – the public debt interest burden, pensions and unemployment benefits – will continue to condition budgetary programming. Indeed, while in the initial consolidated State budget for 2013 these three items accounted for around 18.2% of GDP, in 2014 they are expected to represent around 18.5% of GDP and close to 55% of total consolidated public spending. The budgetary adjustment will therefore continue to focus on government consumption, for which a real-terms reduction of 2.9% is projected in 2014 for overall general government, based partly on the civil servant wage freeze and on the extension of austerity policies in relation to public-sector employment; and, moreover, on the reduction in public investment. A further expenditure-containing factor will stem from the envisaged revision of pensions, set at 0.25%, in line with the floor established in the draft law defining the sustainability factor.

How do these figures compare with those for the euro area as a whole? In terms of GDP, the weight of unemployment benefits continues to stand far above the euro area average, as a result of our high unemployment. Interest payments on debt in Spain are also expected to exceed the euro area average, while spending on pensions would continue to be below the average, given that demographic developments in our country remain more favourable.

On the revenue side, a 2.4% increase in total tax receipts (including the share of regional and local government) is forecast, with very few tax changes. These are concentrated in the broadening of corporate income tax bases approved last June. In the case of personal income tax and VAT receipts, increases of 1.7% and 2.7% are projected. As to social security contributions, the main regulatory change consists of a 5% increase in the maximum contribution bases.

Progress in the reform of the banking system

Before concluding, I shall briefly mention the progress in the reform and strengthening of our banking system. This task is at the heart of the responsibilities and concerns of the Banco de España, and, as we all know, it has required a most considerable contribution of public funds.

At present we are at a most advanced phase in the ongoing recapitalisation and restructuring of our banking sector.

As you know, the starting point was in 2009, when the FROB (the Fund for the Orderly Restructuring of the Banking Sector) was created, and the process moved up a gear in 2011 further to Royal Decree-Law 2/2011 on the strengthening of the financial system, which raised capital requirements. But the decisive steps were taken in 2012, with Royal Decree Laws 2/2012 and 18/2012 on the clean-up of the financial system, the Memorandum of Understanding agreed in July with the European Commission, and the financial support facility of up to €100 billion annexed to this agreement; and, finally, Law 9/2012 on the restructuring and resolution of credit institutions.

Against this background, each bank's capital needs were identified on the basis of a rigorous stress test and, in accordance with the European authorities, restructuring or orderly resolution plans were drawn up and approved for those banks requiring them.

In 2012, backed by public financial assistance, the institutions classified under “group 1” of the Memorandum of Understanding were recapitalised, and their problem construction and real estate development-related assets were transferred to SAREB (the asset management company for assets arising from bank restructuring).

Into 2013, the “group 2” institutions subject to the exercise have been recapitalised, their troubled assets have been transferred to SAREB and the hybrid instrument management (burden-sharing) exercises have been conducted at all banks requiring them, except at one, where they began recently and will be concluded in the coming days.

The public financial assistance to financial institutions in various forms of capital, since May 2009, has risen to €61.37 billion, €38.83 billion of which were under the Financial Assistance Programme agreed with the European authorities. Verification by the international authorities of the fulfilment of the conditions agreed in the July 2012 Memorandum of Understanding, the last round of which concluded only a few days ago, confirms that the Memorandum and its deadlines have been strictly adhered to and that the main objective, the restructuring and recapitalisation of our banking system, has progressed satisfactorily.

As earlier stated, the Council of the European Union will shortly approve the Regulation governing the SSM, which will commence operating after a transitory period of one year. It is envisaged that more than 90% of the Spanish banking system, measured by volume of assets, will be supervised by the SSM.

Prior to the ECB effectively taking over supervisory responsibilities, a bank asset review and valuation is planned which will give rise to the requirement of a level of capital to be met by all banks subject to the review and, where necessary, to the setting up of additional coverage.

It is worth noting that our banks are starting from a very reasonable level, both from the perspective of the accounting classification of their assets, and from that of asset coverage and provisioning, the result of the review conducted last year under the stress tests and of the above-mentioned recapitalisation processes. Recently, banks' review of refinanced loans has also concluded, a process which contributes to shoring up their position ahead of the forthcoming evaluation of the quality of their assets.

Likewise, and once more with a view to reinforcing the solvency of our banking system, the Banco de España has recommended that banks moderate the distribution of dividends during 2013 and that, in any event, the cash dividends paid out should not exceed 25% of attributable consolidated profit. Naturally, all banks are following this recommendation.

The solvency position of Spanish banks has clearly improved in 2013. Average core capital in our banking system will stand at around 10.5% as at December 2013, more than 1 pp up on the same figure a year earlier.

Further, since the start of 2013 liquidity conditions at Spanish banks have improved, and there has been a re-balancing of their funding sources. This is the outcome of the diminished tensions on the sovereign debt markets and of improved confidence, along with the lesser fragmentation of euro area money and capital markets.

In this respect, retail deposits, which fell, especially in the summer months of 2012, have since been faring better. Since early 2013, they have been posting positive rates of change. The pick-up in deposits has seen the retail funding gap – i.e. the percentage of credit that banks cannot cover with deposits – narrow. That allows them to reduce the need to resort to less stable funding sources, such as the wholesale markets.

Against this backdrop, the resort to Eurosystem funding, though holding at still-high levels, has diminished most significantly from its peak last summer, registering a decline of 31% in the first eight months of 2013.

In terms of profitability, the exceptional drive by banks in 2012 to comply with provisioning requirements exerted a significant impact on their profit and loss accounts. Indeed, for the year as a whole, losses of over €40 billion were recorded. The first half of 2013 has marked a change in this tendency. Banks' consolidated profit rose to somewhat more than €8.2 billion, despite the fact that provisions continue to adversely affect profit and loss accounts in a period in which the proportion of non-performing assets remained high.

The signs of improvement in the sector are not free from risks. In a setting characterised by low economic growth, sluggish activity and relatively low interest rates, banking sector margins will continue to be subject to downward pressures. Foreseeably, moreover, doubtful assets will continue to increase in the short run, although their impact in terms of provisions will be less than in the recent past. Against this background, banks must persevere in their efforts to improve efficiency and contain operating costs. In particular, it is essential that banks subject to restructuring and recapitalisation plans strictly comply with the requirements established in those plans.

Conclusions

The difficulties the Spanish economy has been facing call for efforts to be made by all. The Budget you are to discuss is pivotal to the continuation of these efforts and to an exit from the crisis. The analysis I have attempted to convey seeks to show that these efforts are beginning to bear fruit in the gradual strengthening of the recovery. I believe if we manage to maintain the policy of expenditure control, structural reforms and the reinforcement of our financial system, the year 2014 may mark the start of the recovery in activity and employment.

Thank you for your attention.