

Luis M Linde: The exit from the crisis and the firming of the recovery in the euro area and in Spain

Speech by Mr Luis M Linde, Governor of the Bank of Spain, at the Círculo de Economía, Barcelona, 13 November 2013.

* * *

Let me begin by conveying my sincere thanks to the Círculo de Economía and to its Chairman – who is unable to accompany us – for the invitation to join you today. It offers me the opportunity to share with you some thoughts on the major issue our economy faces: the exit from the crisis and the conditions under which a recovery may firm.

More than five years back now, the Lehman Brothers bankruptcy triggered the most serious international economic crisis since the Second World War. It has severely affected growth and employment in the advanced economies and, among these, the European countries. At certain junctures, most particularly in summer last year, monetary union and the very process of European integration were subjected to serious tensions.

But the latest economic indicators point to an incipient pick-up in activity in the euro area, and most international agencies and private analysts forecast a firming of economic growth over the next two years.

To assess the scope of this turnaround, we should recall what were the underlying weaknesses over this long phase of crisis and recession.

In the euro area, the crisis has most acutely affected those countries whose economies evidenced greater dependency on external funding (i.e. those running bigger current-account deficits) and less flexible economic structures. Most of these countries had not sufficiently adapted their institutional frameworks and economic policies to the membership requirements of a monetary union, in which exchange rate devaluation is no longer available to bring about rapid adjustments in competitiveness, and in which the basic parameters of monetary policy have ceased to be set independently by the authorities of each Member State.

Having entrusted themselves to the macroeconomic stability provided by monetary union membership and scarcely pressured by markets that remained indifferent, for some time, to the problems being incubated, some of these economies built up significant imbalances, failing to undertake the reforms needed to withstand the shocks that could seriously affect them.

The institutional arrangements designed 20 years ago in Maastricht did not have the wherewithal to prevent and, where appropriate, correct this lack of adaptation of national policies to the requirements of a monetary union; and nor did they have the mechanisms to manage the far-reaching and protracted crisis we have experienced.

These shortcomings have translated into losses in well-being for the public at large. The impact in terms of output and employment has been enormous. On the projections available, the euro area will not regain the level of GDP existing at the start of 2008 until 2015, at the earliest. And in terms of employment, the gap will take even longer to close.

Despite recent positive indicators, the current situation continues to pose challenges of the highest order to both European and national economic authorities. But it should be acknowledged that they have undertaken what are, in many cases, politically difficult and technically complex reforms. Irrespective of the identifiable aspects of these reforms that could be improved, they have prevented the situation from worsening considerably and have laid the foundations for the incipient recovery we are witnessing today.

In this respect, let me begin by mentioning the role of the European Central Bank which, in my opinion, has successfully lived up to its responsibilities.

From the onset of the crisis, the ECB applied a series of measures with a three-pronged aim: to relax the monetary policy stance in order to accommodate it to the cyclical circumstances of the economy; to prevent liquidity tensions from triggering bouts of instability that would have compounded the loss of output and employment; and, at the height of the tensions, to dispel the risk of the euro area potentially breaking up, a risk that was very real in 2012.

The monetary policy measures adopted involved both conventional actions and exceptional measures, tailored to the circumstances experienced over the course of the crisis.

As regards conventional measures, the ECB has progressively cut official interest rates, placing them at an all-time low 400 bp below the September 2008 levels. As you know, the latest cut was just a week ago. Further, like the Federal Reserve and the Bank of England, it has pursued a very expansionary liquidity-provision policy, which can be measured by the sizeable increase of over 50% in its balance sheet since 2008.

Among the extraordinary measures, I would highlight the long-term (as long as three years) refinancing operations; the extension of the list of assets accepted as collateral for the loans made to banks; and the launch of asset purchase programmes, such as the Securities Market Programme, the two Covered Bonds Purchase Programmes (including Spain's) and the announcement, in August 2012, of the Outright Monetary Transactions programme. More recently, in July this year, a policy of forward guidance has been adopted, involving the more accurate communication of the projected behaviour of official interest rates in the future.

Yet we should remember that the capacity of monetary policy to resolve the problems at the root of this crisis is very limited. What it can do, and is doing, is making time so that other players who do have the proper tools to resolve the problems can adopt the measures needed, and so that such measures may take effect.

The other European economic authorities, starting with the Commission, have – in close collaboration with national governments – taken significant steps towards correcting the weaknesses exposed in the euro's institutional arrangements.

Thus, a permanent mechanism, the European Stability Mechanism, has been set up, with the capacity to provide funds to the Member States deprived of access to the capital markets. And an ambitious reform of overall economic governance has been launched, strengthening the mechanisms to align national economic policies with the aims of the Union as a whole and designing a plan to move towards a deeper and sounder union in four stages: banking union, economic union, fiscal union and, finally, political union.

Highly significant progress has already been made in the first of these four areas. In November next year the new Single Supervisory Mechanism will begin to operate within the ECB, and it should be complemented by a single bank resolution system and, later, a Single Resolution Authority and a Common Resolution Fund although, as is known, these latter steps pose complex legal and political problems that might delay their effective start-up.

National governments, too, have reacted within their remit. On one hand, to contain the worsening of public finances, one of the main imbalances underlying the European strand of the crisis. And on the other, to make markets more flexible and to promote investment, growth and employment.

Since late last year the quantitative and, above all, the qualitative indicators have improved markedly. In the second quarter this year, there was a year-on-year increase of 0.3% in euro area GDP. This positive figure has put an end to six consecutive quarters of contraction. The rise in output has been across the board, spanning both domestic and external demand.

Looking ahead, the estimates available indicate that GDP in the euro area will grow once more in the third and fourth quarters of the year, albeit at moderate rates, underpinned by the improved international setting and by an accommodative monetary policy, both of which

factors are potentially conducive to exports and investment. A pick-up in private consumption is also expected, owing to the rise in household disposable income, but not so in government consumption, which will remain affected by fiscal adjustment processes.

It should be stressed that the continuing looseness of monetary policy is fully compatible with the projection that, in the medium term, inflation will hold substantially below the ECB objective of 2%, while in the long run expectations remain anchored at this level.

Naturally, the exit by the euro area from this phase of very low interest rates and abundant liquidity, as from the time at which the start of the recovery and the resumption of growth are considered to be entrenched, will pose problems for the ECB's monetary policy, as they have already begun to do so for the Federal Reserve. But, as matters currently stand, this is not yet our problem.

All told, this more favourable baseline scenario for the euro area, if it is to materialise, requires the economic authorities to persevere with the policies that have contributed to stabilisation and to what appears to be the onset of the recovery.

The banking union should contribute to breaking the still-prevalent link between banking and sovereign risks, a link that largely explains the persistence of an appreciable degree of European money and financial market fragmentation. This is incompatible with the normal functioning of the monetary union and prevents the loose single monetary policy stance from being transmitted uniformly to households and firms throughout the area.

I shall now move on to the ***Spanish economy***.

In Spain, our experience since the outbreak of the crisis has been extremely difficult. We have witnessed a double-dip recession, something unprecedented in our economic history over the last half-century.

Adjustments were needed to overcome the serious real and financial imbalances – namely the budget deficit, private and public debt, the external imbalance and unsustainable activity in the construction sector – which began to build up in 2002-2003, during the period of real negative interest rates in the United States and in the EU. And matters worsened with the international financial crisis and the confidence crisis in the euro area, the latter driven by the public finances crisis in several countries, Spain among them.

Three figures suffice to illustrate the severity of the crisis in Spain: in 2013 our GDP will be 7–8% below the cyclical peak (marked by the second quarter of 2008); national demand will be 16% lower; and employment 20% down.

But we are correcting these imbalances. Headway is most visible in our improved competitiveness, and more incipient in the recomposition of the contribution of domestic demand to activity, or in the reallocation of productive and financial resources towards industries with higher growth potential.

The Spanish economy grew slightly in the third quarter – the first rise in output since the opening quarter of 2011 – amid a somewhat more favourable external setting, and with financial tensions lifting and confidence indicators improving. As in the rest of the euro area, the coming quarters will foreseeably see a prolongation of the path of gradual recovery, which is expected in its initial phases to continue to be driven by the external sector.

In recent quarters, net external demand has played a key role in sustaining activity, owing to the sound export performance, the weakness of imports and the highly favourable tourism figures.

Moreover, the decline in private domestic demand is being checked as a result of the rise in investment in equipment and of the stabilising of private consumption.

The adjustment in competitiveness, in its various different strands, is playing a central role. In Spain, this has been done through what is known as “internal devaluation”, the direct containment of costs and margins, not through the nominal depreciation mechanism, which

was the normal device prior to our joining the monetary union. Internal devaluation is, evidently, more complicated and slower than nominal depreciation; but, in turn, the gains to be had are more durable.

In terms of competitiveness, progress since 2008 has been most significant. On Banco de España estimates, we will by early 2014 have regained, relative to the average of the euro area countries, all the competitiveness forgone from 2000 to 2008.

These gains in competitiveness have been underpinned, above all, by the moderation of wage costs, a trend to which the labour market reform approved in early 2012 has proven conducive in respect of collective bargaining. Along the same lines, inflation has been very contained since 2009, and this has naturally contributed to the recovery in competitiveness.

The export sector has shown great capacity and has notably increased its presence and sales both in the euro area and in other markets. Suffice it to say that this year, from January to August, the trade surplus, excluding energy, was almost double that of 2012, climbing from €12 billion to €24 billion.

These developments have been upheld by corporate restructuring that has enabled the average value exported per company and the export base to increase. The sustained increase in the number of exporting companies over the past five years is due mainly to the growing participation of SMEs.

Our trade balance with all regions has improved, with the exception of the oil-exporting countries. Spain is running a surplus both with the euro area and with the rest of the European Union. This has entailed a turnaround in our balance of payment on current account, and will lead in 2013 to a positive contribution of the external sector to GDP of around 2%, the best performance by this variable in recent decades.

Competitiveness and export capacity also depend on how productive resources are distributed across sectors and across companies within a single sector. One fundamental challenge the Spanish economy faces is to reallocate the surplus productive resources in non-tradeable sectors to others with higher growth and export potential.

At the aggregate level, 8% of the firms existing in 2007 have been destroyed in the 2007–2012 period, while in the construction sector this figure exceeds 30%. In the industrial and services sectors, and having due regard to their high heterogeneity, positive signs are discernible.

The sectoral reallocation is only just beginning and still has a long way to run. Economic policy has to contribute to completing this process by removing the obstacles associated with barriers to competition and the red tape hindering business start-ups. Some recent legislative initiatives which pursue these objectives are the law on business support measures, the law to ensure market unity and the future law on professional services and colleges. Market unity and legal certainty are absolutely necessary for sustained growth and job creation, and can and should be objectives shared by government at all levels.

Another task is that of completing the adjustment of Spanish corporate and household debt. This is progressing slowly because their income is weak and so the adjustment has to proceed mainly through the contraction of credit. Under these conditions, aggregate credit to the private sector will probably still take some time to achieve positive rates.

This situation at aggregate level can and should be compatible with differing behaviours of credit to firms and to households, so as to allow financial resources to flow to those sectors in a solid position to undertake viable spending, investment and hiring projects.

The results of preliminary analyses at the Banco de España indicate that such reallocation of financial resources is already taking place. However, there are still some frictions affecting most notably lending to SMEs, which as you know are particularly vulnerable to crises such as that we have witnessed.

Under its remit, the Banco de España has recently adopted specific measures addressing this sector, such as the redefinition of SME for the purposes of prudential regulation or the early application of the supporting factor for capital requirements associated with SME loans.

The Banco de España has also identified possible courses of action in other areas. A far-from-exhaustive list would include exploring ways of strengthening the role of the ICO, simplifying the current public framework of financial support to SMEs and, in the longer term, designing mechanisms to capture homogeneous high-quality information on the most significant aspects of SMEs' business to make it easier for them to access bank credit.

Conclusion

To conclude, the latest data on the euro area and on the Spanish economy give us a glimpse of a horizon in which the serious difficulties besetting us have been overcome. But the firming of the recovery and the absorption of the burdensome legacy of the crisis will require perseverance in the strategy adopted to complete and strengthen the design of Economic and Monetary Union and to lay sound foundations for sustained growth in all member countries.

In the arena of national policies, there is a risk that a degree of reform fatigue may emerge as the situation improves. On the contrary, the favourable effects now becoming apparent from the fiscal consolidation and structural reform measures should encourage us to maintain these policies.

Thank you.