

## **Luis M Linde: Exiting the economic crisis**

Speech by Mr Luis M Linde, Governor of the Bank of Spain, at a conference at the Colegio de Ingenieros de Caminos, Canales y Puertos, (School of Civil Engineers), Madrid, 18 February 2014.

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Let me first thank the School of Civil Engineers, their Governing Board and its President for inviting me to participate in this conference.

Civil engineers are one of the most prestigious professional groups in our country, and their contribution over many years to the development of our economy and society has been most important. Currently, they are moreover participating decisively in the expansion abroad of our construction and engineering companies, raising them to the ranks of the international first division.

In my address today I shall discuss our view at the Banco de España of recent developments in the Spanish economy and the prospects open to us to emerge from the crisis that began seven years back.

I shall begin by recalling the severity of this crisis, moving next to discussing the discernible signs of recovery. Finally, I shall refer to the complexity of the current situation and the challenges ahead for us.

The crisis has been of a depth and seriousness unprecedented in our economic history. Since 2007, the level of Spanish GDP has fallen by seven percentage points; that said, perhaps the most representative measure of the severity of the crisis has been the labour market, with unemployment falling by 19% and a major increase in the unemployment rate, which affected 26% of the labour force at the close of 2013.

The crisis has moreover entailed a substantial readjustment in the composition of GDP, with a strong decline in national demand, broadly across all its different components, but a fall of even greater depth in investment in construction. Late last year, the cumulative decline in investment in construction was 50% compared with its level in the pre-crisis years. Adding to the collapse in residential investment from 2010, following the onset of the public spending adjustment plans, was the decline in non-residential construction, where civil engineering is to be found.

Naturally, the external environment has played a major role in the origins and unfolding of our crisis.

The contraction in world trade during the 2009 recession strongly affected our exports. However, as from 2011, net external demand has been markedly buoyant, mitigating the contractionary effect of the fall in domestic demand on activity, and it has provided for the correction of some of the macroeconomic imbalances I shall refer to.

Further, the climate of uncertainty which took hold on international financial markets and the subsequent fall-off in financing flows had a more marked impact on those economies, such as Spain, which are more reliant on external saving.

Nor can we forget that the 2009 recession also disclosed a series of weaknesses in the institutional arrangements for the euro. Membership of the Economic and Monetary Union provides for extra stability and resilience. Unsurprisingly, then, at the height of the crisis when the very survival of the monetary union and the euro were in doubt, the wave of mistrust affected us most forcefully.

That said, strictly domestic factors played a substantial role in the source and development of the crisis in our economy. This was because unsustainable imbalances built up, even in the absence of an international crisis, and our vulnerability to external shocks thereby increased.

I shall now briefly review some of these imbalances.

During the prolonged expansionary phase before the crisis broke, heavy losses in competitiveness built up as a result of the growing divergence of our prices and costs relative to those of the euro area countries, with which the exchange rate had been set at the onset of monetary union. This was the outcome of the continuous pressure exerted by domestic spending on plant capacity, driven by very loose financial conditions, whose expansionary effects were not countered by a more restrictive economic policy stance, most specifically in respect of budgetary policy or supply-side policies.

The financial counterpart of this excess spending was the accumulation by Spanish households and firms of excessive debt. This over-indebtedness was moreover accompanied by a strong bias towards the construction and real estate development sector and, inevitably in an economy as strongly banked as Spain, this also led to excessive growth in bank lending and excesses in banks' risk concentration.

The relative ease with which these debts built up and their subsequent effects on activity, employment and financial stability were not, in any event, an exclusively Spanish phenomenon. Indeed, these and other similar developments have given rise to widespread initiatives at the international level to strengthen the economic policy tool box, with a new instrument – namely macroprudential supervision – being incorporated to head off this type of situation.

In any event, the losses in competitiveness and excessive debt led to a large-scale imbalance in our foreign trade, resulting in a deficit of 10% of GDP in 2007 and requiring the resort to large volumes of external saving to ensure trade financing.

But other elements of fragility emerged with the crisis. The worsening macroeconomic scenario and, in particular, the collapse in employment had a most adverse influence on public finances. The characteristics of labour market regulation meant that the effects of the adjustment to the sudden change in the business cycle fell basically on employment, and hardly on wage conditions or on greater hiring flexibility. In turn, the marked deterioration in public finances revealed weaknesses in the institutional workings of the public sector; in particular, the insufficiency of the disciplinary framework in place to ensure compliance with budget targets.

Overall, the high dependence of the Spanish economy on financing from the rest of the world, the duration and scale of job destruction and the size of the budgetary deterioration contributed to notably compounding the intensity of the effects of the economic crisis in Spain.

Fortunately, since the second half of 2013 our economy has initiated a phase of recovery, one no doubt very gradual but which has enabled it to emerge from the downturn that took hold in early 2011. In recent quarters, domestic demand has begun to rise, underpinned by some recovery in household consumption and investment in equipment, while the declines in investment in construction continued to lessen. Furthermore, the positive contribution of external demand began to lose momentum, marking the start of the rebalancing of both expenditure components.

The labour market performance has also been a pleasant surprise since mid-2013, with increasingly lower rates of decline in employment, which turned positive at the close of 2013 for the first time since 2008. Wage moderation, stimulated by the effect of the labour reform, is beginning to make itself felt in employment. And this against a background of price stability, which contributes to easing the pressure on spending exerted by the slow recovery in household and corporate income.

As at the very source of the crisis, it is possible in this incipient change in trend to identify certain impulses originating beyond our borders, while others are generated at home.

The former include most notably the pick-up in the world economy since last summer. The turnaround has chiefly been based on the better performance of the advanced economies, including the European countries, which remain our main trade partners. Conversely, the emerging economies are losing some of their momentum. Indeed, investors and analysts have shifted their chief concerns in recent months towards this group of economies.

The incipient recovery in Spain is also benefiting from the easing of financial tensions in European markets. In particular, measures by the European Central Bank and the headway made in correcting the weaknesses detected in the governance of the euro, and in creating a banking union within the area, have contributed to improving the financing conditions of the Spanish economy. That said, the cost our households and firms still have to pay for their credit remains overly high for the accommodative stance of monetary policy, revealing that it is not yet appropriate to talk about the full normalisation of the single monetary policy transmission process in the euro area.

Undoubtedly, however, domestic impulses are playing a decisive role in improving perceptions of the Spanish economy, and in laying the foundations for a sustained path of recovery. These include most notably the progress in correcting imbalances and in adopting reforms in different areas.

As regards imbalances, the most visible achievement has been in restoring competitiveness and in correcting the balance of payments deficit. The adjustment of costs and relative prices, albeit with some delay compared with what would have been desirable, has ultimately placed the Spanish economy in a much more competitive position. The reduction in unit labour costs has allowed virtually all of the losses in competitiveness that had built up in the first ten years of the euro to be absorbed. The process has not, however, been free from difficulties, since it was initially based, as I stated earlier, almost exclusively on job destruction. From 2010, the contribution of the adjustment in wages progressively became more prominent, a trajectory which stepped up following the 2012 labour market reform.

The gains in competitiveness and Spanish firms' greater export-gear thrust are providing for the growing penetration of our products in foreign markets, against a background of increased geographical diversification and higher goods and services exports. The marked decline in imports during these years also reflects the gains in competitiveness, although the weakness of domestic demand has likewise helped contain purchases from the rest of the world. Set against these developments, the least favourable aspect of our foreign trade continues to be the high dependence on imported energy.

As a result of the foregoing, our economy posted – for the first time since 1997 – a balance of payments surplus, i.e. net external lending, of 1.5% of GDP. This trajectory will foreseeably continue over the coming years, meaning that Spain's high level of foreign debt will be declining.

On the fiscal front, there has been an intensive drive to correct the budget deficit, as indicated by the significant reduction in the structural general government deficit since 2009. The increased transparency and the strengthening of the fiscal framework further to the approval of the Law on Budgetary Stability and Financial Sustainability in 2012 assist the different tiers of government –central, regional and local – in meeting the budget targets. In turn, the reform of the pensions system is a necessary step for ensuring the sustainability of public finances in the medium term. Despite these achievements, the rising course of the public debt/GDP ratio has not yet been halted and is a reminder of the scale of the fiscal effort still required.

There has also been progress in private-sector deleveraging. The sluggishness of household and corporate income is slowing the process, as a result of which the weight of the adjustment is falling on the contraction in lending extended to these sectors.

That said, this contraction in credit may be and indeed is proving compatible with its appropriate restructuring. The analysis of the Banco de España suggests that, even in years

as difficult as the past two, the proportion of firms that have not seen a fall-off in their bank loans has been significant, around 30%. And more significantly, those that have not seen their credit decline are, precisely, those firms which, in general, were departing from a sounder position of debt and profitability.

As the recovery takes root, this positive restructuring of credit will foreseeably step up, and lending at the aggregate level may also be expected to normalise. It will be then that the process of clean-up, recapitalisation and restructuring of the Spanish banking system will be in a position to yield its full benefits. Once the problems of oversizing and risk concentration are overcome, our banking system will be better placed to meet the solvent demand for credit that will emerge with the economic recovery.

So far I have talked about the main aspects of the ongoing re-balancing of the Spanish economy and the factors underlying the path of recovery. Allow me to conclude with some thoughts on the complexity of the current economic juncture and the challenges that must be overcome to ensure that the incipient recovery leads to an increase in our long-term growth capacity.

The most likely outlook for recovery in the coming months involves relatively moderate growth in activity. Foreseeably, domestic demand will continue to gain in weight, albeit moving on a very gradual course of recovery, in line with what is forecast for its attendant determinants. Investment in construction will join this recovery, albeit taking into account its somewhat more negative position at the start of this year, lagging the other domestic demand components. External demand, meanwhile, will maintain its positive contribution to GDP, but with lower contributions than during the crisis years.

Several risk factors cloud this central scenario of recovery. First, the growth outlook for the euro area continues to point to moderate increases in activity in the coming quarters, likewise subject to downside risks.

Moreover, further headway in fiscal consolidation will be inevitable, which does not allow expansionary budgetary policies to be applied in the short term. In these circumstances, it is of great importance that any tax reform should prove conducive to economic efficiency and growth.

With regard to private debt, credit may not be expected to recover at the aggregate level until economic growth has done so. Meanwhile, the necessary deleveraging should continue to be compatible with the positive restructuring of credit, as attested to by the latest developments.

In conclusion, I would say that economists and, even more so, those of us who work in the monetary and financial field, tend to focus on the short or very short term. But I would like to close my address with a reflection on the medium and long term.

The twin engines of economic growth are demographic growth and increased productivity. Our worrying population trend responds to complex economic, social and cultural factors that cannot be rapidly changed. But that does not mean that action should not be taken, as far as possible, to improve this trend.

Productivity growth is directly related to capital formation, which is in turn connected to saving. Accordingly, any policy wishing to be effective in enhancing productivity must be underpinned by incentives to save and the lifting of any related institutional obstacles, something which is also connected to the reforms that boost competitiveness and legal certainty. Spain must persist with reform policy geared to these objectives.

Thank you.