

Luis M Linde: An outlook on the Spanish economy

Speech by Mr Luis M Linde, Governor of the Bank of Spain, at the Official Monetary and Financial Institutions Forum (OMFIF), London, 9 February 2016.

* * *

I would like to thank OMFIF and Mr. David Marsh for the invitation to participate in this Forum, an initiative that favours public and private sector interactions and the exchange of views on topics of common interest.

According to the title of my intervention, I will comment on the current situation of the Spanish economy, with a special focus on developments in employment, the external sector and fiscal adjustment. I shall continue with a brief review of some of the reforms undertaken that have laid the foundations underpinning the recovery. I will continue with some references to the situation of the banking sector and the challenges it is confronted with; and I will conclude with some comments on the growth perspectives of the Spanish economy.

Current performance of the Spanish economy

The current performance of the Spanish economy shows robust growth, employment creation and a surplus in the external balance. The simultaneous occurrence of these three positive developments has not been very usual in recent decades in the Spanish economy. We should also mention the ongoing deleveraging process, which should be considered necessary and positive.

The recovery of the Spanish economy started in the second half of 2013, following the severe contraction that took place in the preceding years. According to the estimates of GDP growth for the fourth quarter, the economic expansion extended into the final part of 2015, setting the rate of growth at 3.2% for the whole year. Spain thus recorded the strongest economic growth amongst the main economies in the euro area.

Certainly, these developments were supported by some tailwinds, whose impact on growth rates is expected to decay over time. I refer here to the fall in oil prices, the depreciation of the euro and the easing in financing conditions. But, quite obviously, these factors were also present in other economies which posted significantly lower growth rates. This underlines the fact that elements of a more permanent nature lie behind the recent performance of the Spanish economy, these elements being linked to the correction of the previous imbalances and the reforms that have been undertaken.

Concerning prices, the latest estimate for the harmonized price index in Spain was moderately negative in January (minus 0.4%), due to a decline in energy prices, and it is expected to remain in negative territory for the coming months. The indicator that excludes energy prices went up moderately in the course of last year, in line with the reduction in the degree of slack of the economy.

In the euro area, overall prices showed an increase of 0.4% in January, that is, 0.8 pp above the rate recorded in Spain. Thus, the Spanish economy continues to gain competitiveness vis à vis the euro area. That said, low inflation in the eurozone adds some additional pressure on the adjustments of the Spanish economy.

The recovery of activity has proceeded alongside significant employment creation. Employment grew at an annual rate of 3.2% in January. Social security affiliates have increased by more than half a million people in 2015, a figure closely in line with the latest numbers provided by the labour statistics. The unemployment rate stood at 20.9% at the end of last year, 2.8 percentage points lower than a year earlier and 5.4 percentage points below the peak at the beginning of 2013, but this is still a very high figure comparing it with Europe or the Eurozone.

The favourable dynamics of the labour market since the start of the recovery can be explained, at least partially, by the process of wage moderation which, in turn, is associated with the effects of the 2012 labour market reform.

Balance of payments

The performance of the external sector in recent years has been remarkable. In terms of the current account balance, Spain has successfully addressed deficits around 10% of GDP at the beginning of the international financial crisis turning them around to surpluses above 1% of GDP since 2014. Exports of goods and services have been a key driver of these developments, with sales abroad growing well in excess of export markets themselves. This vigorous behaviour of exports is strongly related to the improvement in cost competitiveness and to the need for Spanish firms to search for new markets abroad, all of which has resulted in a significant increase in the diversification of export markets.

Deleverage

Corporate and households debt has followed a downward path since mid-2010, when it reached its highest levels in terms of GDP. The deleveraging process is now quite advanced.

In September 2015 (latest available data), the ratio of debt to GDP for corporates (excluding intercompany loans) stood at 88%, and for households at 69%, 30 and 16 p.p. below the peak levels of 2010. As a result, the gap with the EMU average has been reduced from its peak of 37 percentage points (p.p.) to 10 p.p. for non-financial corporations, and from 20 to 10 p.p. for families.

Since the start of the recovery, the reduction in the indebtedness of the private sector as a whole has not prevented new bank lending from flowing to borrowers with potential profitable projects and/or a good export performance. The share of companies whose credit stock has not declined has shown an increasing trend in the last two years and the rate of decline of NFC aggregate debt has moderated.

With regard to the public sector, the ratio of debt to GDP is expected to have stabilised *in 2015*, according to the official targets. Should that aim have been accomplished, the upward trend in public debt commencing 2008 would have been finally controlled after an increase of 60 points of GDP.

The basis of the recovery: the structural reforms

Now, I will briefly elaborate on the main reforms which have been the basis of our recovery.

These reforms have been oriented towards increasing the flexibility and competitiveness of the economy and addressing previous imbalances. For the sake of brevity, I will concentrate on the labor market reform, the reforms to ensure budgetary discipline and sustainability, and the reforms on the public pension system.

Labor market reform

The labour market reform has been key in the process of correcting the imbalances of the Spanish economy, where we can mention, first of all, the losses of competitiveness accumulated between 2002 and 2008 and very high unemployment.

The reform approved in 2012 made important changes in the institutional framework, including a reduction in the degree of centralisation of the collective bargaining system, an alleviation of dismissal costs and of the complexity of procedures, and a widening of hiring possibilities.

In a nutshell, the reform attempts to avoid repeating the previous pattern under which firms adjusted to an economic slowdown either by dismissing workers or by closing down, providing firms with increased flexibility to link wage negotiations to their particular economic conditions, and the possibility of opting-out from sectoral agreements, giving greater priority to firm-level ones.

Fiscal adjustment

The Spanish economy has made visible progress in the redressing of fiscal balances towards levels that are compatible with the sustainability of public finances. The adjustment has required strong measures both on the revenue and the expenditure sides.

From near double digit deficits in the early years of the current decade, the deficit was reduced to 5.9% of GDP in 2014. The commitments with the European authorities involve a further reduction of fiscal imbalances in 2015 and 2016. In this respect, public deficit targets are set to 4.2% and 2.8% for 2015 and 2016, respectively.

Despite the additional efforts shown in the most recent budgetary information (up to November 2015), the fulfilment of these targets is not without risks. To tackle these risks it will be important to ensure a strict implementation of the budget, both at the national and the regional levels and, if the need arises, to be ready to take the appropriate corrective measures within the framework of European Union fiscal governance.

But the challenges should not cloud the fiscal consolidation effort already made. This can be easily seen in the structural primary balance's evolution, which turned around from a deficit of 5.2% of GDP in 2010 to an estimated surplus of 0.6% of GDP for 2015, according to the latest European Commission figures. It is worth remembering that the bulk of this adjustment was made through a severe economic recession and under very stressed conditions in a fragmented Eurozone financial market.

Several legal reforms to ensure budgetary discipline and sustainability have contributed to these developments. Among those I would highlight the 2011 Constitutional reform which enshrined the principles of budgetary discipline and fiscal sustainability the maximum legal status; the 2012 Law on Budgetary Stability and Financial Sustainability which sets these principles in Spanish legislation; and the creation in 2013 of a new Independent Fiscal Responsibility Authority.

Pension reform

The recent pension reform aims at achieving financial sustainability of the Social Security System. It provides automatic mechanisms to absorb the challenges originated by the foreseen gradual ageing of the population and those from adverse developments in the economy.

The most important change has been the establishment of a new mechanism for calculating the annual revaluation of pensions and the introduction of the so-called "sustainability factor" **from 2019** onwards. The revaluation formula sets an annual pension increase based on the system's budget constraints, replacing the previous mechanism in which this increase was linked to changes in the CPI. The sustainability factor is an automatic mechanism linking the initial retirement pensions to life expectancy.

The Spanish financial system

Now, I will briefly comment on several issues relating to the current situation of the Spanish banking system.

After experiencing a severe crisis, far-reaching reforms have been implemented in the Spanish banking sector. These reforms can be summed up along three significant lines: an

intense restructuring process in terms of size and capacity; the sanitisation of bank balance sheets (recognition and treatment of bad assets); and the recapitalization of individual institutions and the entire system.

The levels of solvency of the Spanish banking system are currently well above regulatory minimums. The top quality capital ratio, namely Common Equity Tier 1 or CET1, of Spanish banking institutions stood last June at 12.4%; and the overall capital ratio was 14.3%, far exceeding the regulatory minimum levels.

Regarding domestic business, since early 2014, non-performing loans (NPLs) have continued to decline, in line with the pick-up in economic activity. The refinanced or restructured credit to the resident private sector has also been declining. This has enabled the NPL ratio to fall to 11.2%. Even so, for historical standards, the volume of NPLs and foreclosed assets on institutions' balance sheets still remains high.

Total consolidated profits of Spanish banks have continued the recovery initiated in 2013, with the return on equity (ROE) standing at 9.2% and the return on assets (ROA) at 0.63% in June 2015. The improvement was due both to an increase in net interest income – driven by positive developments in business earnings outside Spain from internationally diversified banks – and to the containment of certain costs which pushed down profits. These costs refer, **on the one hand**, to operating expenses (employees and offices restructuring), and, **on the other**, to the decline in asset impairments as a result of the provisioning efforts already made and the recovery of the economic activity.

I would note that the subsidiary model followed by the main Spanish banking groups for their international expansion, with high local autonomy, benefits from certain characteristics which, I dare to say, are not always well understood. To mention one of its main distinctive features: in this model, subsidiaries are autonomous in both capital and liquidity, therefore, limiting the contagion risk between the Group's units, while benefitting from revenues and risk diversification. It is well known by markets and supervisors that this model helped the Spanish banking sector and the Spanish economy through the financial crisis.

Banking business today has to face rapid technological change, new regulations, growing competitive pressure and low interest rates. These challenges are shared by many different banks throughout the world and, obviously, are not exclusive to the Spanish banking system. But now I will focus on the three main sources of pressure on the domestic income statement of Spanish banks.

In the current scenario of very low interest rates, the loan-deposit gap is at historically very narrow levels (around 1%). Where the interest rate spread is so tight, the sustainability of net interest income over time needs an adequate level of activity to offset, by volume, the scant contribution of price to the income statement. But this is not the case at present, as banking activity levels are still low, and precisely this is the second source of pressure on the income statement. The third one is the significant volume of non-productive assets (NPLs and foreclosures) remaining on banks' balance sheets although, as I mentioned earlier, the data shows a positive trend with a significant decline over the last two years.

In a period of far-reaching changes in the banking sector, it is important for banks to improve their efficiency, so as to remain viable competitors. Banks could do this through various means, for example redesigning their networks, redefining their capacity and efficiency, enhancing their geographical diversification, and increasing specialization in certain market segments. From this perspective, a number of analysts and market participants expect a greater degree of consolidation in the Spanish banking sector. The start-up of the Single Supervisory Mechanism and the gradual disappearance of barriers against banking integration at the European level facilitate a new operational framework for banks, when defining their strategies through the Eurozone and the area covered by the Single Supervisory Mechanism.

Conclusions: growth perspectives

Now, to conclude:

According to most analysts, public and private alike, the Spanish economy is expected to continue growing at sustained rates in the medium term. In particular, GDP might increase at a rate around 2.8% in 2016 according to the consensus. This figure is well above the estimated rate for the euro area average.

However, this central scenario is not free from risks.

The international environment has not only deteriorated recently, but it has also become more vulnerable due to the extent of the slowdown of the global economy -in particular, of some emerging economies, as far as they may affect world growth and international trade- and the evolution of commodity prices, in a context where there are doubts about the reaction of markets to the normalization of US monetary policy.

On the Spanish domestic political front, it is obvious that the uncertainty regarding the formation of a new government may affect investment and consumption decisions. So far, the impact on the Spanish financial markets has been limited. In any case, I take it for granted that any new government will show respect towards European Union commitments and the general framework of the European Union fiscal governance.

Thank you very much for your attention.