

20.06.2017

**Testimony by the Governor of the Banco de España before the
Parliamentary Committee on Economic Affairs and Competitiveness**

Luis M. Linde
Governor

Ladies and gentlemen,

I appear before this Committee on the occasion of the presentation of the Banco de España Annual Report for 2016.

I would like to begin by reviewing the most notable features of the current Spanish economic upswing, which began almost four years ago. I will then go on to describe the more immediate prospects for the Spanish economy, with reference to the Macroeconomic Projections Report published by the Bank on 13 June, and I will mention the main risks surrounding this outlook. Finally, I intend to address the main challenges for Spanish economic policy over a longer time horizon and to conclude with a brief reference to the challenges for the European project.

The factors underlying the firming of the Spanish economic recovery

According to the estimates available, Spanish GDP should have regained its pre-crisis level during the current quarter, after growing in 2015 and 2016 at a rate of 3.2%, which was notably higher than the rates recorded in the other main euro area economies and, in both years, higher than initially forecast.

As regards the labour market situation, one of the main causes for concern for our economy and society, positive employment growth data are being recorded, which are also exceeding expectations. However, we are still far from achieving the employment levels prevailing before the crisis, given the enormous impact that it had on our labour market.

Unlike in previous upturns, the growth of activity and employment is proving to be compatible with the ongoing correction of the economy's imbalances. The more balanced and sustainable nature of the current recovery is closely related to the factors that have made it possible, some of which should be considered temporary while others may have a more persistent impact.

I would like to refer to two central issues to explain this more balanced growth: the improvement in competitiveness and the normalisation of financial conditions.

Competitiveness improvements

One of the most important changes in the functioning of the Spanish economy since the crisis has been the recovery in external competitiveness.

Cost and price adjustments have stimulated exports and have also enabled our productive sectors to compete better in their domestic markets with imports. This has led to an increase in the demand for resources, driving business investment decisions and encouraging job creation. The increase in employment, favoured by moderate wage growth, has led to a significant recovery in household consumption.

Unlike in previous upswings, the moderate growth of prices and costs is helping to ensure that the increase in economic activity is not achieved at the expense of a deterioration in the external balance. In fact, in 2016 the Spanish economy recorded a current account surplus of close to 2% of GDP and the external balance is expected to perform positively over the medium term, although probably less so than during the last two years.

The normalisation of financial conditions

The recovery in economic activity and competitiveness is also related to the decline in financing costs.

Since the most acute phases of financial stress in the second half of 2011 and in the first half of 2012, there has been a gradual normalisation of the financing costs of firms and households, with less divergence from the interest rates paid by economic agents in other Eurosystem countries.

The decline in the cost of financing has stimulated business investment and helped to enhance household spending possibilities, with a positive impact on economic activity. The normalisation of financial conditions has also extended to the level of household and business debt, which has fallen significantly in recent years, in relative terms.

In keeping with this reduction in private sector debt, aggregate bank lending continues to decline, although at increasingly slower rates. This is the case, in particular, of lending to households and non-financial corporations that do not belong to the construction and property development sector.

The outlook for the Spanish economy over the next few years

According to the latest economic projections published by the Banco de España, the upswing is expected to continue until 2019, although activity will tend to slow on account of, among other factors, the less expansionary fiscal policy stance and steady or rising prices for oil and other commodities, which are expected, in any event, to be higher than over the last two years.

With regard to the composition of spending, the less expansionary fiscal policy stance and the squeeze on the income of resident agents, resulting from the rise in inflation associated with the increase in energy prices since early 2016, will somewhat reduce the growth of private domestic demand. Net external demand will continue to make a small positive contribution, against a background in which exports are expected to remain dynamic while imports remain relatively weak.

The risks surrounding the central scenario

The favourable outlook for economic activity I have described is subject to risks originating essentially in the external environment.

First, although there has been an improvement in the outlook for world activity and trade, it has been accompanied by an increase in global uncertainty stemming from the greater strength of restrictive positions on trade, migratory movements and international policy coordination, in the area of financial regulation, for example.

Second, we should not forget that, despite the significant progress made in deleveraging in recent years, our level of debt is still high. Moreover, the progress made in reducing the level of debt has not been uniform. While general government debt is still close to its recent high levels (on which I will have more to say later), private sector deleveraging has been very significant.

In any event, the net external debt of the economy as a whole remains very high. Reducing this debt will require running persistent external surpluses, which would be difficult in a setting of contracting international trade or rising interest rates.

Insofar as maintaining balanced economic growth is concerned, the low profitability of Spanish deposit institutions is certainly a problem. This phenomenon, also observed in other European banking systems, is related to the pressure that the low interest rate environment exerts on the net interest margin, but also to the still-high level of unproductive assets, limited turnover and the competitive environment, in which a growing number of institutions from outside the financial sector are increasingly active in offering services traditionally provided by banks.

Challenges for sustained economic growth in Spain in the long term

Taking into account these short and medium-term prospects, I will now refer to the challenges facing the Spanish economy in the longer term. Our report refers to four priorities: combating the effects of population ageing, tackling long-term unemployment, increasing productivity growth and reducing public debt.

The consequences of population ageing

As in other European countries, we are witnessing a process of strong population ageing, a phenomenon with profound implications in various areas. This development, which has been under way for several decades already, has accelerated as a result of the impact of the crisis on births and migratory flows. People over the age of 65, who in 1970 made up less than 10% of the population, currently account for 21% and, according to INE projections, will represent more than a quarter of the Spanish population within 15 years.

Currently, two types of adverse effects of this phenomenon on economic growth can be identified.

First, population ageing is leading to a reduction in the number of persons prepared to work or seek employment.

Second, indirect negative effects of population ageing on productivity, saving and investment decisions and innovation can be identified.

As a result, ageing poses enormous challenges for fiscal policy, since a smaller labour force, that is possibly on average less productive, will have to support the vital needs of a growing number of dependent persons.

In fact, the scope and consequences of population ageing form the backdrop to the other long-term challenges facing the Spanish economy.

Towards a greater use of the labour factor

The formulas to combat the effects of demographic developments involve the search for means to achieve a greater use of the labour factor and higher productivity growth.

Despite the recovery, employment still stands below its pre-crisis level. The unemployment rate in the first quarter of 2017 was 18.8%, far higher than in the other euro area countries,

with the exception of Greece. This high unemployment is concentrated in groups that include those with the lowest skills and the young (with ages ranging from 16 to 29), those whom the economic recovery has reached with least intensity, since they continue to have unemployment rates in excess of 30%.

Remaining unemployed over a very long period of time reduces the skills that individuals had acquired from their previous work experience, which in turn compounds the difficulties of obtaining a new job. Getting these people back to work must be one of our main economic policy priorities; it is also worth noting that changes in the degree of income inequality in our country are very closely related to the unemployment level.

Productivity growth

Another key way to counter the adverse effects of population ageing on economic growth is to promote productivity. I should like to highlight three significant areas for improvement.

Firstly, increasing productivity requires continuous efforts to improve the educational system and to promote the accumulation of technological capital. The shortcomings in our educational system are illustrated, for example, by the fact that the percentage of the population aged 25-34 with a level of educational attainment below that of full secondary education stands in Spain at 35%, more than twice the average of the EU countries. When designing any educational reform, promoting skills linked to the new technologies should be a priority objective.

Secondly, promoting competition in certain markets for goods and services used as inputs in other productive processes would contribute to reducing the gap between Spanish firms' average productivity growth and that observed in other developed countries. Specifically, it would be worth reviewing some of the regulatory elements in place in certain network industries, such as telecommunications, transport and energy, and professional services.

Finally, there are aspects of labour market regulation that have a bearing on weak productivity growth. The tying of firm-level wage increases to productivity is still very limited. For instance, the figures available indicate that fewer than 6% of workers are covered by firm-level agreements.

In addition, the fact that employees with temporary contracts continue to bear the brunt of adjustments to negative shocks raises the volatility of employment and discourages the formation of human capital. Lessening the differences between the different types of contract, which would be negative if it were a disincentive to the demand for labour as a whole, would contribute to promoting productivity gains and reducing inequality.

The challenge of reducing public debt

I shall now address the high level of public debt, one of the most notorious legacies of the crisis.

After increasing by more than 60 percentage points relative to its pre-crisis level, the public debt/GDP ratio has stabilised at around 100% of GDP, against a background in which our budget deficit level remains high when compared with other euro area countries.

We need to consider the risks this situation poses. It is necessary to reduce general government debt both to lessen the vulnerability of public finances to any potential tightening in financing conditions and to restore scope for a fiscal policy response to any future adverse shocks. However, even in the current favourable environment of economic growth and low interest rates, the probability of the level of Spanish general government debt standing below the euro area reference level of 60% of GDP in the next decade is low.

Factors conducive to public sector deleveraging are higher economic growth in real terms, the prospect of higher inflation, limited interest rate movements and a reduction in the deficit. I shall focus on the last two factors: the interest burden and budgetary consolidation.

Evidently, a high level of public debt involves a likewise-high interest burden. While general government interest expenditure has eased owing to the effects of monetary policy, its level, at close to 3% of GDP, is above the average recorded since the launch of the single currency, in 1999. Moreover, the opportunity cost of this expenditure is very high: we might recall, for instance, that the volume of resources assigned at present by overall general government to nursery, primary and secondary education is similar to the cost of covering debt service.

Further, we should bear in mind that public debt financing conditions may become less favourable than at present. In this respect, given the high level of debt, an increase in interest rates may have a significant impact on interest expenditure, although this effect would take some time to become manifest, since the lengthy average term of maturity means that the pass-through of changes in interest rates to the cost of refinancing debt comes about gradually.

This situation means we must continue to rationalise public spending and make it more efficient, prioritising those items that have a greater potential for improving productivity and long-term growth. During the crisis, spending on public investment has halved, standing significantly below the average level for the euro area, and most likely even below – though this is not an easy calculation to make – the level needed to cover the depreciation of the existing stock of public capital.

Turning to revenues, consideration should be given to reviewing the composition of taxes which, once the desired level of public spending has been set, may enable the necessary takings to be raised in the most stable and efficient way possible. Compared with the European Union average, it is a fact that Spain stands out for the relatively low weight of its tax revenue as a proportion of GDP, this being attributable, in the comparison within the euro area, to the low relative weight of indirect taxation, particularly in the areas of environmental taxes and excise duties.

Finally, it may also be said that, from a medium and long-term perspective, population ageing exerts upward pressure on items such as healthcare, care for the elderly and, in particular, pensions.

In this latter case, the reforms introduced in recent years, such as raising the retirement age, the definition of a factor of sustainability linking the initial pension to the increase in life expectancy, and the new mechanism that makes the annual revision of pensions conditional upon balance between the system's revenue and expenses, with ceilings and floors, have

contributed to containing the increase in expenditure and to shoring up the long-term sustainability of the pensions system.

That said, in the absence of increased revenues, the adjustment mechanism would rest mainly on a reduction in the average pension relative to the average wage, which is known as the “replacement rate”. With a view to the future, it would be advisable to set an “objective replacement rate”, on the basis of which system revenues should be adjusted to ensure their sustainability. It would moreover be desirable if the reform strategy chosen were to lead to an increase in the system’s transparency and a stronger relationship between contributions and benefits, maintaining automatic adjustment mechanisms that ensure financial equilibrium.

Challenges for the European Union governance framework

I should like to conclude with a very brief reference to the risks arising in Europe and globally too from political positions and currents of opinion contrary to globalisation and free trade.

I need not stress that these movements are negative for our recovery prospects and, in general, for an economy such as Spain that is increasingly integrated into the global framework and which in recent years has notably improved its competitive capacity abroad. The United Kingdom’s departure from the European Union is, in my view, a negative phenomenon, although the results in recent European elections appear to indicate a brake on or at least a re-drawing of the lines marking these trends.

In any event, in the euro area – where our economy operates – it will be very important to maintain the goals of integration into the financial and banking area and to address the capital markets union project.

But it is important, too, that the achievement of a true economic union may go beyond the financial realm. Along these lines, our Annual Report refers to the discussion of possible ways forward towards a fiscal policy that includes common stabilisation elements within the euro area, in a setting, such as the present, in which the high levels of public debt restrict the budgetary room for manoeuvre in a good number of countries. Progress here would contribute to equipping fiscal policies within the area with greater strength and, therefore, to minimising the potential adverse repercussions – economic and social alike – of future crises.

Thank you for your attention.