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Testimony by the Governor of the Banco de España, Luis M. Linde, before the Senate in connection with the draft State Budget for 2014

Ladies and gentlemen,

When I appeared before this Senate last year, the Spanish economy was undergoing a phase of great difficulty and uncertainty. Developments since then show it has notably improved and, at present, it may be beginning to emerge from the second recession of this prolonged crisis. In any event, prudence advises avoiding any complacency since the risks have not disappeared and the momentum for a sustained recovery is still weak.

The euro area and Spanish economies

Several reasons explain the change in the Spanish economic situation in recent months. Firstly, the international economic setting has improved, despite the uncertainty over the behaviour of the emerging economies. This improvement has, above all, affected the United States, Japan and, most importantly from the standpoint of the Spanish economy, the euro area.

In the third quarter of this year euro area GDP posted limited growth, of 0.1 pp in quarter-on-quarter terms, following its dynamic performance in the second quarter, with 0.3 pp of growth, which surprised most analysts and ended six consecutive quarters of contraction. Since then, the indicators have broadly tended to entrench expectations that output will continue to increase at positive rates in the immediate future; into the medium term, however, forecasts anticipate very moderate growth rates, which will be insufficient to allow a rapid reduction in euro area unemployment levels, which remain very high.

The positive effects that the turn for the better in the external environment have had on the Spanish economy have been reinforced by the headway in the economic governance of the euro, enabling the serious confidence crisis that gripped the Monetary Union in 2012 to be overcome.

Admittedly, though, the degree of fragmentation persisting in euro area financial markets is still high and is not allowing monetary impulses to be transmitted efficiently to all countries in the area. Indeed, the Spanish economy as a whole – households, firms, credit institutions and general government – continues to face financing costs which, though they have moderated, remain excessive when taking into account the strongly expansionary stance of the ECB's monetary policy.

In this respect we may recall that at the start of this month the ECB decided once again to cut its official interest rates, which are now at an all-time low. In combination with the continuation of the unlimited liquidity-providing policy it has maintained since the start of the crisis, the successive cuts in official rates have led money market interest rates to extremely low levels. The expansionary monetary policy stance was strengthened by the announcement that the ECB expects official interest rates to remain at or below the new level for a prolonged period.

Along with these external factors, the Spanish economy has also benefited from other developments that have helped temper the contractionary pressures on demand and activity during this year.

Household spending began 2013 weighed down by the impact of the decline in employment on income from work and by the debt-reduction process. However, as the year unfolded, improved confidence and the somewhat less unfavourable state of the labour market have meant that private consumption has begun to pick up.

Further, according to the available indicators, investment in equipment has posted increases in the first nine months of the year. In a setting in which sluggish domestic demand, ongoing corporate deleveraging and the restrictions on access to financing continue to check investment, this improvement stems, above all, from the strong pace of goods and services exports, which would have led to greater investment activity by exporting firms.

Moreover, construction, as a whole, has continued shrinking, owing to the adjustment in residential investment and in public works. General government consumption spending has also carried on falling. As a result, national demand has continued to decline, albeit at a progressively slacker pace.

The positive contribution of the external sector to activity has increased in 2013. That reflects the strong dynamism of exports, driven in recent months by the improvement in Spanish competitiveness and the buoyancy of the euro area markets; but it is also indicative of the weakness of domestic expenditure, giving rise to the contractionary behaviour of imports.

As a consequence of these developments, Spain will show a net lending position against the rest of the world of around 2% of GDP, an unprecedented and record figure in recent decades.

Over the past months, inflation, proxied by the CPI, has been declining notably, essentially as a result of the tapering off of the effects of the VAT increase over more than a year back. Thus, in October, the CPI fell by 0.1%. Foreseeably, however, positive though moderate rates of change will resume in the coming months, therefore proving compatible with the necessary continuation of the ongoing improvement in competitiveness our economy requires.

For 2014, a central scenario has been outlined in which the factors that have been affecting domestic demand progressively slacken. It is projected that the processes of adjustment in the economy, and most particularly the redressing of private-sector debt and the ongoing fiscal consolidation, will continue to influence the pace of recovery of demand and activity; but, at the same time, the reduction in uncertainty and the culmination of the restructuring of credit institutions, along with their improved results, will lay the foundations for improving financial conditions for the resident sectors.

This outlook of progressive re-balancing of the external and domestic components of demand is not free from uncertainty. In particular, while the likelihood of fresh bouts of instability in the euro area has lessened significantly, this cannot be ruled out completely in the future. Moreover, should growth in certain emerging regions be checked more sharply than is currently projected, this might have consequences for Spanish exports, which in recent years have been increasingly underpinned by these markets. In this respect, the potential reduction in the degree of monetary expansion in the United States might significantly affect the emerging countries, in their capital movements and in their exchange rates, most particularly Latin America.

The State Budget for 2014

It is against this macroeconomic background that the discussions on the draft Budget for 2014 are framed. I shall first refer to the forecasts for the end of the current budgetary year and the macroeconomic projections for the coming year.

As regards 2013, the revised figure for the overall general government balance, in National Accounts terms, has been released for the second quarter. It shows a deficit of 2.8% of GDP, excluding the effect of the public assistance to financial institutions, compared with the figure of 3% recorded in the same period a year earlier, marking an improvement of 0.2 pp of GDP. More updated figures (to August) have also been released for overall general government, excluding local government. The cumulative deficit to August is estimated to stand at 4.8% of GDP.

As indicated by the European Commission in its autumn projections and having regard to the budget outturn in the first half of 2013, meeting the budget deficit target of 6.5% is achievable. However, as the Commission has stressed, there are risks of slippage arising from the weakness shown by revenue, meaning that, to meet the target, revenue will have to pick up in the closing months of the year. The effort involved in the final stretch of the year in compensating for the recovery by civil servants of their extra payroll should also be recalled.

Let me now discuss the main items of the Budget for 2014.

Since my appearance in Parliament in early October, the overall information available on general government budgetary programming for 2014 has increased. This is most notably the case with the so-called 2014 Budgetary Plan, devised by the Government in compliance with its reporting obligations to the European Commission, derived from the legislative package on budgetary oversight approved last May.

The Plan includes information on overall general government revenue and expenditure for 2014, based on the draft budgets not only for central government and the social security system, as was habitually the case, but also for the regional governments. This information is necessary for making a proper assessment of the budget projection in Spain, given the high degree of decentralisation of our public sector: in 2012, central government was responsible for 27% of total consolidated public spending; the social security system for 32%; the regional governments for 30%; and local government for 11%.

As I indicated here a year ago, this Budget Plan marks an important step forward: over time, this document is destined to play a key role in the overall programming of total public spending, with the dual aim of making the budgets of the different tiers of government consistent and offering this information in an accessible and transparent fashion to the public at large, analysts and institutions.

The macroeconomic figures accompanying the 2014 Budget project real GDP growth of 0.7%, as a result of the positive 1.2 pp contribution of the external sector, offset in part by the negative contribution of national demand. These forecasts are prudent and in line with the above-mentioned central growth scenario and, broadly, with what may be inferred from the consensus reached by analysts.

The deficit targets for 2014 are well-known and match those approved by the European Council last July.

The overall general government deficit should stand at 5.8% of GDP, 0.7 pp down on the forecast for 2013. In terms of agents, an improvement of 0.3 pp of GDP is considered for social security funds and the regional governments, to 1.1% and 1%, respectively, while central government might post a deficit of 3.7% of GDP, compared with the figure of 3.8% projected for 2013; local government should run a balanced budget.

The target for 2014 entails an improvement in the general government structural balance of between 0.1 and 0.3 pp of GDP. Following the considerable adjustment made in the past two years, when the structural deficit was cut by 6 pp of GDP, the budgetary plans for 2014 are more conducive to the entrenchment of the recovery and compliance therewith will help maintain agents' confidence in fiscal consolidation.

On the expenditure side, three budgetary items – namely pensions, unemployment benefits and the burden of interest on public debt – will continue to influence budgetary programming, given that they account for almost 50% of total overall general government spending.

The adjustment is centred, in fact, on government consumption, with a projected reduction of 0.4 pp in total spending on general government employee compensation, owing to the wage freeze for civil servants and to the prolongation of the austerity policies governing public-sector employment; and of 0.3 pp in intermediate consumption, further to the maintenance of the restrictions on goods and services purchases at all levels of government.

The budgetary plan projects maintaining the weight of public investment as a percentage of GDP, following the cuts seen in recent years; that said, the cuts would be prolonged in the case of the State. Likewise, the envisaged revision of pensions is set at 0.25%, in line with the floor set in the draft law defining the sustainability factor.

As in previous years, the main challenges surrounding the budgetary projections arise from the course public revenue may take; despite the projected gradual recovery in activity and some re-balancing of the attendant growth factors, revenue will remain considerably influenced by the greater relative weight of exports and by the moderation of wage income, which will limit the response by public revenue to greater activity.

To conclude, I have a comment on public debt and its implications for the fiscal drive still to be made.

On official projections, the public debt/GDP ratio might rise to 98.9% in 2014 and stand above 100% in 2015, beginning to turn down in subsequent years.

Placing public debt below the ceilings set by the Stability and Growth Pact and the Stability Law will, in any event, require that high primary surpluses be maintained over a prolonged period of time. This is the indicator that best illustrates the scale of the challenges still ahead for us. It also highlights the importance of successfully seeing through fiscal consolidation and structural reform, so that the ongoing reduction in budgetary imbalances may combine with an improvement in our potential growth.

In my view, these should remain the priorities of economic policy if we intend the incipient recovery in our economy to strengthen and be sustainable over time.

Thank you.