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The Spanish economy: transformation and challenges

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Let me thank the Governing Board of Spain Investors Day and its chairman, Benito Berceruelo, for their kind invitation to speak here today, together with the Minister of Foreign Affairs, at the gala dinner of this 9th edition of Spain Investors Day. I am convinced that, as on previous occasions, the meeting will be a success.

I will be focusing on the situation of the Spanish economy and on its banking sector. Along with a brief description of the current conjunctural setting, marked by a more complex and uncertain international economic environment, I would like to summarise some of the improvements observed in the Spanish economy in recent years, in the wake of the latest and acute crisis we experienced. I shall, moreover set out various challenges and vulnerabilities which, in my opinion, need to be properly and resolutely addressed. The aim thereby would be, first, to shore up the potential growth of our economy in the long term and, further, to adapt our financial system to the new regulatory demands and to the new competitive and technological setting.

Let us take the economic situation first. After growth equal to or higher than 3% over the three years spanning 2015 to 2017, and which eased somewhat last year to around 2.5%, the latest macroeconomic projections of the Banco de España, published last December, envisage the continuation in the coming years of above-potential economic growth, enabling the still-high level of unemployment to continue to be absorbed.

However, the rate of expansion of GDP is expected to slow gradually in the coming years. This easing in growth essentially reflects the progressive exhaustion of the positive effect of various exogenous factors that have been operating in recent years, such as the expansionary demand-side policies (monetary policy, in particular) and strong world growth, which has already shown signs of dwindling to some extent in 2018.

Beyond this baseline scenario, the downside risks to growth have been increasing. These risks, whose source is essentially external, include a possible resurgence of financial strains associated with the US economic policy mix and its potential effects on the more vulnerable emerging economies, and a hypothetical escalation in protectionist measures, which might affect the vibrancy of trade and global activity. In the European arena, the political vagaries in some European countries (particularly in Italy) and the uncertainty over the outcome of Brexit entail additional sources of risk. In Spain, the current parliamentary fragmentation also adds uncertainty over the future course of our economic policies.

Against this background, it should be stressed that notable headway has been made in recent years in correcting some of the imbalances that had built up in the Spanish economy during the expansion prior to the crisis. Contributing factors here, in addition to the more temporary factors I have just mentioned, were certain structural reforms introduced during the crisis.

Of note, first, is the intense deleveraging, carried out by households and non-financial corporations. Specifically, the corporate debt/GDP ratio has fallen by 42 percentage points (pp) from mid-2010, when it peaked, to 2018 Q3, meaning that this indicator now stands some 2 pp below the related figure for the euro area. In the case of households, the process has been slower (partly on account of the greater average life of the debt incurred), but also very significant. Over the same period, households' debt ratio fell by 25 pp and its level is but 3 pp above the related euro area figure. Accordingly, in both cases, the deleveraging process is at a very advanced stage, although some heterogeneity is evident. In particular, in the two sectors, certain agents continue to face situations of high financial pressure as a result of debt incurred.

In parallel, the banking sector has been subject to an intense process of clean-up, recapitalisation and restructuring. And in the past four and a half years its basic parameters – such as asset quality and profitability and solvency levels – have improved notably. From December 2013 to September 2018, non-performing loans have declined by more than €120 billion and foreclosures have contracted by €20 billion. Likewise, the return on equity has returned to positive territory above the euro area average since the 2012 collapse, when it stood at -25%. The total capital ratio, meanwhile, has increased by 1.7 pp in the past four years, whereas the leverage and liquidity ratios are above the European average. The recent European Banking Authority and Banco de España stress tests reveal that Spanish banks' resilience to adverse scenarios is considerable.

The Spanish economy's external balance has also undergone an intense adjustment process. Just before the start of the crisis in 2007, the Spanish economy posted an external deficit of 9.6% of GDP, one of the highest figures among the advanced economies. As a result of the deep-seated recession prompted by the crisis, but also of the structural adjustment carried out since, the Spanish economy has recorded current external surpluses in the past five years, which even exceeded 2% of GDP in the 2015-2017 period, despite the strong pick-up in domestic demand during those years.

External surpluses, which have been relatively unusual in previous recovery phases in the Spanish economy, have been assisted, among other factors, by the gains in competitiveness arising from the containment of labour and financial costs. Such gains have enabled companies to compete internationally on a better footing and to increase their exports. In particular, Spanish unit labour costs relative to the rest of the euro area fell by 14% from 2008 to 2018, thereby offsetting practically all the losses in competitiveness, measured by this indicator, built up during the previous expansion. This has been conducive both to across-the-board gains in share in international markets and to greater geographical diversification towards markets with high growth potential. As a result, goods exports rose from accounting, in real terms, for 19% of GDP in 2009 to 28% in 2018; exporting firms as a proportion of total Spanish companies grew sharply as from 2009; and the number of regular exporting firms has increased in the past five years by 31%, with a notable increase in destinations such as Asia and North America.

Likewise of note is that this period of growth has been accompanied by significantly buoyant investment in equipment. Specifically, from 2013 to 2018, this aggregate increased in real terms by almost 34%, compared with the cumulative 14.4% increase in GDP over the same period. Hence, the weight of this component in GDP stood in 2018 above 10%, the highest figure for the past three decades. Further, this improvement in productive investment has been across the board in terms of productive branches, and notably sharper than that recorded in the euro area as a whole, a development closely linked to the competitive gains and to the intensification of Spanish firms' export orientation in recent years to which I referred.

The other investment component, that linked to construction, has undergone a most significant adjustment in the past decade. This means that, in 2018, following several years of recovery, this GDP component was still at around 16% of its pre-crisis level. The downscaling of investment in housing entailed a decline in its weight in GDP to levels close to 5% in 2018, in line with Spain's peers, compared with 12% pre-crisis. The reduction in housing investment activity came about in parallel with a decline in house prices which, despite the growth observed in recent years, remain in real terms some 32% below the nationwide levels observed in 2007, albeit with some cross-regional dispersion. All these developments better position this sector to support economic growth, as indeed has been the case in 2018. The weight of non-residential construction, for its part, has also diminished considerably, largely reflecting the impact of the reduction in public-sector investment spending.

Beyond these improvements, as I stated in my introduction the Spanish economy remains prone to certain vulnerabilities and faces significant challenges, which I shall now set out.

First, despite the notable above-mentioned reduction in private debt in recent years, on the latest available data for 2018 Q3 the negative net International Investment Position (IIP) of the Spanish economy stood at 81% of GDP, and that of gross external debt at 168% of GDP, levels that are high in relation to other advanced economies and which mark a factor of vulnerability for the economy as a whole. The reduction in the IIP to less vulnerable levels will require running current account surpluses for a prolonged period. The continuation and deepening of the gains in the economy's competitiveness posted in recent years should, along with healthier public finances, contribute to entrenching a sustained path of external surpluses.

Closely related to the foregoing point, the second factor of vulnerability of the Spanish economy is that arising from the imbalance in public finances. The sectoral breakdown of the net IIP shows how, since the onset of the crisis, the general government's net liability position has increased notably, with the liabilities position of the monetary financial institutions and the rest of the resident sectors declining. Despite the considerable reduction in the budget deficit relative to GDP from its peak of 11% in 2009 to 23.1% in 2017, Spanish public finances continued to evidence a high level of structural deficit (estimated by the European Commission to be 3% of GDP, the highest in the euro area) and of public debt, which currently stands at around 98% of GDP. Against this backdrop, it is worth bearing in mind that maintaining a very high level of public debt over a prolonged period may not only hamper economic growth but also lessen the stabilising capacity of fiscal policy in the face of future recessions.

Spain must therefore harness the current, favourable economic setting by launching a medium-term programme to reduce the vulnerabilities of its public finances and thus generate budgetary room for manoeuvre, enabling it to face future crises. Reducing fiscal imbalances should be compatible with an improvement in the quality of public finances, as should too the combination of a fiscal consolidation drive with other structural reforms, which I shall later mention.

Indeed, improving the parameters that depict the public finances position is particularly necessary in our country, given the major challenges that population ageing poses in the medium and long term. The latest estimates augur a significant increase in public spending on pensions, health and long-term care as a result of the significant increase in the dependency ratio (measured as the percentage of over-65s relative to the working-age population), which is expected to practically double in the coming decades, according to the various demographic projections available.

As regards the pension system, the 2011 and 2013 reforms included adjustments allowing the effect of the expected increase in the dependency ratio in the long term on total spending on the system to be offset. The latest legislative developments in this area, however, have softened the implementation of these mechanisms. As a result, ensuring the financial sustainability of the public pension system will require additional measures to be introduced, on either the revenue or expenditure side, so as to offset this added burden.

In any event, it is important to stress that facing the challenge of population ageing (which is not exclusive to Spain, but is proving particularly acute in our country) will call for the adoption of a multidisciplinary strategy to encourage the participation of elderly workers, to adapt migratory policy to the needs of the labour market and to boost the birth rate.

Despite strong job creation during the recovery, the unemployment rate remains very high, and its persistence (in particular among specific groups, such as the lesser skilled) raises the risk of it becoming structural. In this respect, the high skills mismatch between the employed and unemployed calls for active employment policies to boost the employability of each socio-demographic group, using those instruments which, further to appropriate assessment, have proven most effective.

Furthermore, the number of temporary employees as a proportion of total employees stands in excess of 27% and there is some evidence of new temporary contracts being of shorter duration in the recent period; in addition to the social difficulties that generates, human capital accumulation is also impaired. Reducing the incidence of temporary employment would call for boosting the attractiveness of permanent hires.

Thirdly, I wish to refer to productivity. The Spanish economy has continuously posted very weak figures for this variable in recent decades, and this has prevented a greater degree of real convergence with our European partners. Improving the dynamics of this variable is crucial for raising the economy's potential growth in the long term, and the well-being of our citizens. That requires measures in various areas. In addition to the above-mentioned labour market reforms, human and technological capital improvements must also be made. In this connection, it is essential to improve the quality of the education system, adapting it to the challenges posed by globalisation, technological progress and the automation of tasks. Moreover, the presence of high and persistent profit margins in some sectors advises lowering the potential barriers to competition in such sectors. It would also be worth mitigating the effects of those factors that prevent growth of the most productive firms (chiefly, the regulatory thresholds linked to size).

Finally, despite the progress made in recent years, the banking sector continues to face far-reaching challenges, largely shared with other European financial systems.

Spanish banks must firstly speed up the sale of their non-earning assets. These weigh down not only their profitability, but also their capacity to allocate resources to those economic activities that most contribute to growth. In addition, the reduction in non-earning assets originated before the European single supervisory and resolution mechanisms were established may bring us closer to culminating a Banking Union. Such a Union would then allow us to address the need to pool macrofinancial risks within the euro area and to strengthen its governance mechanisms. That would make the European financial system – and therefore the single currency – sounder and more resilient to future financial shocks.

Secondly, banks should strengthen their capital and the liabilities susceptible to be used in the event of bail-ins in order to face on an optimal footing the regulatory challenges still pending, particularly in respect of resolution. Thirdly, the financial sector should strive in particular to enhance its reputation and to introduce measures mitigating the risk of misconduct. Fourthly, banks should address the challenge of increasing their profitability, although this cannot be at the expense of an undue easing of lending standards. Finally, and clearly not least importantly, the new technological environment, while a major challenge for the sector (in particular because of the emergence of new competitors and services), is also an opportunity that Spanish banks should take advantage of.

Allow me to conclude by pointing out that, with a view to furthering the current growth phase and entrenching the Spanish economy's potential, it is essential in my opinion to harness the still-favourable cyclical juncture to create budgetary space ahead of future recessions and introduce reforms to take over from the expansionary demand-side policies of recent years. It is likewise vital to address the challenges the banking sector has still to face, such as the reduction in non-earning assets, the improvement of its capital structure and profitability, the strengthening of its reputation and the optimal harnessing of technological developments.

Finally, in order to endow the Economic and Monetary Union with greater stability and soundness ahead of future shocks, it is necessary to continue enhancing its design and governance as regards key aspects of the Banking Union and of the Capital Market Union, and the attendant implications for a future Fiscal Union. And with this final reminder of the importance of the European institutional framework for the economic future of our countries, it is an honour for me to give the floor to the Minister of Foreign Affairs, European Union and Cooperation, Mr Josep Borrell.

Thank you.