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Spain: From Recovery to Resilience

Banco de España-IMF High-Level Seminar

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Ladies and Gentlemen,

Let me welcome you to this Banco de España and International Monetary Fund joint conference devoted to the recent evolution of the Spanish economy in the Euro-Zone and European Union context.

I would like to thank the International Monetary Fund, represented here today by David Lipton, First Deputy Managing Director, Poul Thomsen, Director of the European Department and Andrea Schaechter, Mission Chief for Spain, for their proposal to organise this conference. The Banco de España was more than pleased to accept, considering it to be very timely and of great interest.

As to the title of the conference: "Spain: From Recovery to Resilience", allow me, before going forward, a candid clarification: I can assure you that it is far from our intent to suggest any pessimistic forecast or premonition. The title refers to our economy's resilience in the face of a hypothetical cyclical downturn which, needless to say, we hope will be later rather than sooner.

In 2017 Spain's economic recovery maintained the strong growth path of previous years, exceeding expectations for the fourth year in a row. In particular, GDP grew by 3.1%, meaning that the economy has grown above 3% for the third consecutive year. Strong domestic and external demand pushed GDP up, and the economy has proved quite resilient to uncertainty shocks. The positive behaviour of the economy contributed to and, in turn, was stimulated by the correction of the macro-financial imbalances accumulated during the pre-crisis and crisis periods. Such corrections were particularly significant as regards private sector deleveraging, the reduction of unemployment, the progressive absorption of disequilibria in the housing market, and the balancing of the external accounts, not least due to significant gains in competitiveness.

Looking forward, nonetheless, a number of questions remain open. Will this process continue at such a strong pace? Under which conditions would the recovery turn into a sustained and prolonged expansion? Which are the main vulnerabilities and weaknesses that policy-makers should tackle in order to raise potential growth and the well-being of the population? Is the Spanish economy, within the EU framework, well equipped to cope with the next cyclical downturn? Is the euro area as a whole well prepared?

The programme of this conference approaches these questions, trying to identify some answers. The discussion is organised around four main topics: how to lower fiscal vulnerabilities; which are the main challenges for the Spanish labour market to function properly; how to raise medium-term growth; how to advance in the euro area architecture.

Lowering fiscal vulnerabilities

The first session of this conference deals with the policy priorities for addressing medium-term fiscal challenges in Spain. The panellists are going to explore options to bring down the high level of public debt and to handle rising pressures from ageing population. The session will also discuss how to improve the fiscal governance framework to support the achievement of fiscal objectives in the medium term, both at the national and European

Union levels. These are crucial issues, and their discussion in this Conference is fully warranted.

Let me briefly share with you some thoughts on how we see at the Banco de España the key challenges for the Spanish economy that arise from the domain of public finances.

The economic and social impact of the recent crisis has been deep and painful in many aspects, including in the case of public finances. During the past decade, public authorities in Spain had to deal with the challenge of keeping welfare state services functioning, while, at the same time, delivering the necessary fiscal adjustment that could ensure the long-term sustainability of public finances. Between 2011 and 2017, the public deficit-to-GDP ratio was significantly cut, from a peak of 9% in 2011, excluding financial sector assistance, to 3.1% last year. In that process, public expenditure was reduced, as a proportion of output, by more than 3.5 percentage points (pp).

Notwithstanding this effort, the historically very high debt-to-GDP ratio of the Spanish General Government sector, currently around 98% of GDP, poses specific risks for economic growth. Economic literature finds evidence that maintaining a very high public debt-to-GDP ratio over a prolonged period tends to hamper economic growth, becoming a source of economic vulnerability, which, in addition, reduces the stabilising capacity of the public budget. Simulations by Banco de España staff show that, under plausible assumptions, the deleveraging process of the public sector towards levels considered safer will be very gradual in Spain, and in developed economies in general, possibly taking up to several decades to reach the reference value of the 60% debt-to-GDP ratio.

Therefore, continuing with the ongoing fiscal consolidation process to ensure exit from the Excessive Deficit Procedure (EDP) must be a priority. The Spanish Public Administration has been subject to this procedure since 2009, under the corrective arm of the Stability and Growth Pact (SGP). In 2016, the EU Council updated the conditions under which the EDP exit would take place, and set 2018 as a deadline. In particular, the Council requires the public deficit to reach 2.2% of GDP this year and to achieve an accumulated structural effort over the period 2016-2018 of 0.6 pp of GDP. While it is very likely that the General Government deficit will be below 3% in 2018, achieving the required structural effort will call for further fiscal adjustments. In fact, according to the European Commission, the structural component of the public deficit in Spain is still very high, at around 3 % of GDP this year, in fact, the largest of the euro area members.

In addition, public finances will have to face the challenge posed by ageing population.

In the Spanish case, the pension system reforms introduced in recent years have addressed this challenge by, among other measures, putting back the retirement age, introducing a sustainability factor linking the initial pension to the increase in life expectancy and setting in place a new mechanism making the annual rise in pensions conditional upon the system's revenue and expenditure being balanced, with ceilings and floors duly in place. On the estimates available, in benign macroeconomic scenarios, these reforms would be successful in countering the effect of the expected increase in the so called dependency ratio, the ratio of the population aged over 65 to the working-age population, on pension spending and, therefore, would contribute to restoring the system's long-term sustainability.

But, without further increases in the system's revenue the adjustment mechanism would operate chiefly through reductions in average pensions relative to the average wage, i.e. via a reduction in the public pension replacement rate, thus, raising the issue of the "social sustainability" of the adjustment mechanism.

Beyond specific proposals, what remains crucial is that any reform strategy should be transparent, increases the link between intertemporal contributions and benefits of the system and is anchored in an adjustment mechanism that guarantees its financial balance.

In this context, a medium-term fiscal programme is needed to complete successfully the fiscal consolidation process. This programme should detail the legislative initiatives needed to achieve the targets and include a prudent medium-term macroeconomic and fiscal revenues forecast. To achieve this goal without hampering long-term economic growth, the composition of the fiscal adjustment is very relevant. Moreover, the combination of this consolidation efforts with other structural reforms on which I will focus later might be crucial in order to smooth and reduce the public finances adjustment needs.

In addition, given the high degree of decentralisation of public spending in Spain, all government decision centres must contribute to this effort. To this end, it is crucial to provide efficient mechanisms to finance the different competences, permitting citizens to identify the bodies responsible for implementing the different public policies.

On a related matter, let me mention that the adequate access to external financing by regional governments – be it by credit provided by financial institutions or through the capital markets – is of particular importance to avoid a pro-cyclical stance in the provision of the public services, and guarantee market pressure geared towards fiscal discipline. Currently, an exceptional mechanism is in place, namely the "Fondo de Liquidez Autonómica", whereby the central government provides funds to most regions, in the form of bilateral loans, in exchange for a heightened control over their fiscal policies. However, in the current favourable macroeconomic and financial context, regions should regain market access.

Challenges of the Spanish labour market

The second session of the Conference is devoted to the challenges facing the Spanish labour market.

During the last three years, the annual growth rate of employment has been 3.0%. In the last five years, the unemployment rate decreased to 16.5% at the end of 2017, more than 10 pp below its peak at the beginning of 2013.

Despite these positive developments, unemployment is still at unacceptably high levels, in fact, the second highest in the euro area after Greece. The high incidence of long-term unemployment, which now stands above 50%, is signalling the risks of hysteresis in the labour market, which would make the reduction of the unemployment rate to pre-crisis levels more difficult.

From a longer perspective, the Spanish economy also faces three important challenges.

First, even at the height of the last expansion in 2006, Spain had an unemployment rate of 8.2% which was far off the best performers at that time. Second, during recent decades, the segmentation of the Spanish labour market has been very marked, with a temporary rate exceeding 25%, 10 pp above euro area averages, which contributes to exacerbating the volatility of employment and reducing productivity growth. Third, the Spanish economy should be ready to accommodate the worldwide process of automation of certain tasks, especially in a context in which the incidence of low-skills unemployment is high and the labour market is not flexible enough.

The analysis of the Banco de España suggests that the higher possibilities for firms, in the presence of adverse shocks, to adjust wages and, in particular, hours worked, which were introduced through the 2012 labour market reform, led to a significant slowdown in job destruction flows, despite the adverse economic situation in 2012 and 2013. Apparently, however, the reform has not been able to change either the structure of the collective bargaining system or the acute segmentation of the working population. These two features of the Spanish labour market have been at the core of the high volatility of employment and the high level of unemployment and, therefore, should be at the core of the reform agenda in this area.

Raising medium-term growth prospects

The third session will be devoted to the general question of how to improve medium-term growth prospects. Spain's potential output growth is estimated to be somewhat below 1.5% over the following decade, a level much lower than that of 3% before the crisis.

Among the most important structural factors limiting Spanish growth prospects are ageing of the population, a lower contribution of the participation rate now that many women have already been incorporated into the labour force, and a lower contribution of the stock of capital following the high growth recorded in the previous upturn. These factors are common to most developed countries.

Hence, the growth of the Spanish economy will essentially rely on its capacity to raise low productivity growth.

Spain has a significant productivity gap with the euro area and recent research has related this gap to an inefficient reallocation of resources towards less productive firms during the expansionary period. However, since 2008 there has been an improvement in the reallocation of resources, especially due to the disappearance of many unproductive firms. But business mark-ups stand at relatively high and rising levels. This could indicate a persistent lack of competition in some markets, with adverse implications in terms of competitiveness, for instance, those regulations that distort the cost of production among firms or affect incentives to grow, such as market barriers due to the heterogeneity of regulations across regions.

More generally, the Spanish economy continues to exhibit a low productivity level in terms of the average firm, something that can be perhaps explained through different combinations of inadequate managerial skills and educational attainment of workers, as well as a relatively low a degree of technological capitalisation. Hence, it is important to pass reforms aiming at reducing the rate of early school dropouts and to foster the relationship between firms and both the vocational training and university systems. These, together with a new well-designed and effective system of incentives to suppport innovation in the private sector are prerequisites for enhancing the Spanish economy's stock of technological capital and its capacity to innovate.

So far, I have addressed a number of issues mostly from a national point of view. But, indeed, solving Spain's problems cannot be done in isolation from the euro area. At the same time, Spain can certainly contribute to move ahead some of the reforms needed in the euro zone.

Euro area economic situation and avenues for reform

A decade after the recession that followed the global financial crisis, the economic recovery is well underway. The euro area is experiencing robust and widespread growth, and a number of risks have receded. Economic sentiment has reached levels close to all-time highs.

However, the robust economic recovery has not yet translated into stronger price dynamics. Several arguments have been put forward to explain that.

Firstly, there is evidence that labour market slack may be larger than standard unemployment indicators suggest, owing to the existence of under-employment (i.e. those working fewer hours than they would like) and of a sector of the population classified as inactive because they are only marginally attached to the labour force. Secondly, the growing importance of global factors may come into play here, including spare capacity in other regions of the world, the prevalence of global value chains, and technological changes. And thirdly, and potentially more worrisome, the prolonged period of low inflation might have upset the way price expectations are formed, giving rise to persistent de-anchoring of medium and long-run expectations of inflation from central banks' targets.

In any event, the strong economic recovery underway in the euro area together with the ambitious package of expansionary policies put in place by the ECB provides for growing confidence that inflation will eventually converge to levels closer to our 2% reference.

Growth in the euro area has relied heavily on the ECB's very accommodative monetary policy. While the area's aggregate fiscal stance has ceased to be a drag on growth, we could benefit – in full respect of our rule-based fiscal framework – from a more growth-friendly composition of public finances, which would also support the necessary consolidation in Member states with higher debt levels.

But it is also essential to try to regain momentum in the structural reform agenda, in order to increase the resilience of national economies and foster productivity and potential growth.

The euro area governance reform agenda should not be let aside either. Progress in renewing the institutional architecture of EMU has been substantial, especially since 2012. At the height of the sovereign crisis, awareness of the vulnerabilities that were causing severe financial fragmentation and increasing risks of a break-up of the euro area generated the political consensus needed to establish permanent crisis-management mechanisms, strengthen fiscal and macroeconomic surveillance, and start developing a Banking Union.

Initially, reforms proceeded at a relatively rapid pace. At the beginning of 2012, two important treaties were signed: the European Stability Mechanism (ESM) Treaty and the Treaty on Stability, Coordination and Governance.

The agreement in mid-2012 to move towards the Banking Union led to the setting-up of two of its pillars: the Single Supervisory Mechanism (SSM), in 2014, and the Single Resolution Mechanism (SRM), in 2016. From those years we also saw: the Bank Recovery and Resolution Directive, which finally came into force in 2016, providing a comprehensive framework to deal with failing banks outside common mercantile insolvency proceedings; and the 2014 directive harmonising national deposit guarantee schemes.

Despite these improvements in the euro area's institutional framework, significant vulnerabilities still persist, both at the area level and in Member States. Additional steps would be required to ensure a more stable and stronger Monetary Union.

In order to overcome the current complacency arising from the more favourable economic and financial environment, the European Commission has put forward a number of initiatives aimed at advancing towards further economic integration.

Completing the Banking Union was, rightly, given top priority, and included the creation of a common backstop for the Single Resolution Fund and a common European Deposit Insurance Scheme (EDIS), although, in this latter case, in my opinion, to deactivate the perverse loop between sovereigns and banks a more ambitious approach than the one pursued by the Commission would perhaps be needed.

Also, a consensus is needed to move, in parallel, towards increasing private and public risk-sharing and reducing risks in bank balance sheets, stepping up efforts to lower the still-high levels of NPLs and diversify sovereign risk exposures. Current proposals to create Sovereign Bond-Backed Securities, by structuring asset pools into tranches with different risk levels, could potentially contribute to such diversification.

There are Commission´s proposals in other areas. Among them: the setting-up of an European Monetary Fund, which would take over the current functions of the European Stabilization Mechanism, eventually adding the role of common backstop for the Single Resolution Fund; the establishment of an European Minister of Finance, who would also be Vice-President of the European Commission and Chairman of the Eurogroup; and the creation of a common stabilisation tool for investment, which should not preclude the future development of a genuine European budgetary capacity for economic stabilisation purposes. Those are proposals that deserve careful consideration.

Moreover, the crisis has made it clear that the European budgetary framework is very complex, which highlights the need to simplify it. Recent proposals, which seek to reduce the current excessive number of rules, by focusing on the public debt to GDP ratio, as a medium-term anchor, and to the expenditure rule, as an operational tool, seem promising. In any event, reinforcing the oversight and control of fiscal rules is necessary to ensure their fulfilment. The aim should be that the budgetary governance framework is able to encourage countries to generate room for manoeuvre during expansionary phases, so that the stabilising capacity of fiscal policy may increase in the euro area, as a whole, at times of crisis.

Summing up: much work remains to be done in the coming months and years. We should make good use of the current benign environment to progress in our European integration agenda. Much is at stake, most notably keeping our achievements alive, preserving our political, economic and social model, and ensuring a pivotal role for a united Europe in an increasingly globalised world.