BANCO DE ESPAÑA
Eurosistema

**19.04.2016**

# The challenges of the Spanish economy

"XXIII Encuentro del Sector Financiero"


Luis M. Linde
Governor

## Introduction

Let me begin by thanking Deloitte, Sociedad de Tasación and ABC for their kind invitation to deliver the closing address of this first session of the XXIII Financial Sector Meeting, devoted to analysing the challenge of profitability in an environment which is most definitely uncertain.

I would like to address the situation of the Spanish economy and its main challenges.

The recovery of the Spanish economy over the past three years has been one of the highlights of recent developments in the euro area. To explain it, we must consider both structural or more durable factors, and temporary ones, some of which have been given by the international context.

The structural factors relate to the still-incomplete correction of the main imbalances built up during the last cyclical upturn and during the crisis, but also to the improved financial landscape.

The job creation observed since 2013 has been a significant prop for demand and, by sustaining household disposable income, for the improvement in confidence.

In the course of 2015 there was further progress in the ongoing deleveraging of households and firms, and Spain posted an external surplus or net lending, based largely on the gains in competitiveness achieved since the onset of the crisis.

These developments took place against the background of the normalisation of financial conditions. Contributing to this process were the domestic reforms applied and the ECB's monetary policy measures, together with progress in EMU governance arrangements.

In the case of monetary policy, the ECB's deployment of a raft of non-standard measures favourably impacted financing conditions, reducing financial fragmentation in the euro area and prompting a pick-up in bank lending. In turn, on the back of expectations of a recovery in the US economy, the euro area monetary policy enabled a substantial depreciation of the euro in the first half of 2015, which helped European – and Spanish – exporters to increase their relative weight in international markets.

Adding to these factors underpinning the recovery in activity and employment were the marked decline in oil prices and fiscal policy, which joined monetary policy in its expansionary stance, in contrast to its restrictiveness in previous years.

Our recovery can hardly continue to be based, to the same extent as in 2015, on these expansionary factors. The mix of stimuli, both from demand-side policies (monetary policy and fiscal policy) and from the fall in oil prices since 2014, is going to have less of an impact on growth. Fiscal policy will have to be restrictive again until the process of fiscal consolidation is complete. And, as to the exchange rate of the euro, the most prudent assumption would be that it will not be a significant additional stimulus but rather approximately neutral, at least during 2016.

On the international front, global and European GDP growth forecasts have been revised downwards in recent months. To mention what appear to have been the most important factors, this has been due to the decline in activity in some of the main emerging economies and to the sluggishness of world trade.

As a result, for this year and for next year too, we should expect more moderate growth in the Spanish economy than in 2015. Indeed, the latest projections published by the Banco de España and by various analysts and international institutions are along these lines, with GDP growth rates of 2.7% in 2016 and 2.3% in 2017.

This lower growth will come about when we are still far from having sufficiently corrected the serious imbalances that built up in the expansion and in the early years of the crisis. These may be listed under four headings: the labour market; fiscal consolidation and public debt; private debt and dependence on external funding; and productivity.

Let us look more closely at each of these four aspects.

## 1 The reduction in unemployment

Firstly, unemployment. The main challenge facing the Spanish economy is to reduce the unemployment rate, which stood at the end of last year at almost 21%, 6 pp down from its peak at the start of 2013, but still far above the average for the European Union and the level in almost every other euro area country.

But the problem is not just the high volume of unemployment; it is also the high proportion of long-term unemployment (defined as the number of people out of work for over a year). Our rate of long-term unemployment has scarcely dipped from its 2014 peak, which means that it is currently three times as high as in 2008. If we only consider persons unemployed for over two years, the rate has increased by 44% in 2015, to four times the level in 2008.

These levels of unemployment and long-term unemployment indicate the difficulty our economy has in matching supply and demand in the labour market and have, among others, two consequences that should not be overlooked: they generate inequality (unemployment has been and is in Spain, unquestionably, the driving force of greater inequality); and they pose difficulties for the public pension system, because the financing of the unfunded system obviously depends crucially on employment.

Our labour market arrangements have traditionally – and by “traditionally” I mean over decades – suffered from two serious and chronic problems: first, the mismatch, in many cases, between companies’ working and wage conditions and their particular competitive, technical and commercial conditions; and, second, the highly marked duality between the conditions of temporary employment and of what we call “permanent” employment.

The setting of working and wage conditions having regard to general or sectoral criteria, without taking into account the specific situation of each company, has been one of the main causes of our structural imbalance in terms of employment, and one of the factors that explains why Spain has always, even at times of greater economic activity and higher growth, had a far higher unemployment rate than the euro area, and indeed the European Union, as a whole. It will not be possible to reduce our structural unemployment rate in a collective bargaining framework that does not take into account productive, commercial and cost conditions, that is to say each firm's conditions of competitiveness.

The duality of our labour market – whose adverse effects on productivity, on decisions regarding investment in human capital and on collective bargaining itself nobody denies – cannot be scaled back if there continues to be a major imbalance between the labour costs (including firing costs) of permanent jobs and of temporary ones. Moreover, it is unlikely that we can manage to reduce duality and, in turn, to increase total employment – which must be the main priority – simply by raising the labour costs of temporary employment.

## 2 The reduction of public debt

Our second challenge is to contain the growth of public debt and, then, to reduce its volume.

Taking the budget deficit observed in 2015, of 5% of GDP, the Spanish general government sector has reduced the scale of this imbalance by more than 6 pp, from its peak in 2009. However, on the latest European Commission estimates, the structural budget deficit, i.e. the non-cyclically adjusted deficit, was over 2.5% of GDP, while the public debt/GDP ratio was 99.2% in 2015, having stabilised relative to a year earlier but more than 60 pp of GDP above its 2007 level.

Such a high volume of public debt evidently entails considerable refinancing requirements on the capital markets. That heightens the vulnerability of our economy, as was patently clear during the euro area sovereign debt crisis from 2010. Every year, our general government sector must obtain funds equivalent to more than 20% of our GDP, involving major dependence on the markets and on expectations about our economic and political situation.

But the problems posed by such a high level of public debt, even under expectations of its gradual reduction, are not confined to the consequent dependence on the capital markets.

A high level of public debt, even in the current environment of low or very low interest rates, involves debt service with considerable interest payments. To offset this expense and obtain an equilibrium or surplus that allows debt to be contained and reduced, significant primary surpluses must be run; but this may affect activity and employment if, for example, fiscal policy involves taxation levels or specific taxes that adversely affect growth, or lower levels of productive spending. Moreover, a high level of public debt reduces the ability of fiscal policy to play a countercyclical role, which is a particularly valuable lever to have in a monetary union, where exchange rate adjustments vis-à-vis other members of the union cannot be made.

It is vital to see through fiscal consolidation in order to preserve the gains in credibility already achieved, ensuring the fulfilment of fiscal targets by all tiers of government and the application of the mechanisms of the Budgetary Stability Law. From a medium and long-term perspective, budgetary and fiscal consolidation requires taking into account other factors, including the composition of the adjustment, in an attempt to pave the way for a greater contribution of public finances to growth, making headway in the rationalisation and efficiency of spending and, also, of the tax basket.

We must also take into account the impact of population ageing on public finances, in particular through spending on pensions. The reforms since 2011 to the public pension system (the progressive raising of the retirement age; the definition of a sustainability factor linking the initial pension to changes in life expectancy; the introduction of a new pension indexation system; and the segregation from the system of specific non-contributory pensions that should be financed through general taxes and not through social security contributions) have been in the right direction as far as the sustainability of the system is concerned.

Apart from these reforms, there are insurance and saving mechanisms that can help supplement the unfunded pension system. But, as I said earlier, a key factor for the public pension system is the buoyancy of employment. It is in this nexus between employment, pensions and public finances where, I believe, the "hard core" of the difficulties facing our economy in the years ahead is concentrated.

## 3 The reduction in private debt and in the net external debit position

The third challenge facing the Spanish economy is high private debt and the heavy dependency on external financing.

The Spanish economy's net external debit position stood at around 93% of GDP at end-2015, far above the level in other euro area or developed countries in a debit position, not to mention core Monetary Union economies such as Germany, Belgium and the Netherlands, which run an external credit position.

Our private debt has improved – that is to say it has declined – in recent years, and we are now closer to the average for the euro area countries as a whole. Yet even so, despite the emergence in the past three years of a substantial external surplus, our external debt is a factor of vulnerability that cannot be underestimated because, excluding the Banco de España, public and private and bank and non-bank debt refinancing requirements exceed 45% of our GDP each year. Of this volume, around 60% relates to liabilities incurred by financial institutions, slightly more than 20% to general government and marginally less than 20% to non-financial corporations. Given this heavy financial dependence on the external sector, a downturn in the economic growth outlook might have a considerable effect on the terms of such financing and on the effort required to meet the foreign obligations incurred.

Improving our external position hinges largely on our competitiveness, that is to say on our productivity. Allow me to elaborate on this point.

## 4 The improvement in productivity

In the long run, economic growth is essentially determined by gains in productivity. In our case, total productivity – the variable that seeks to approximate the level of efficiency of the economy and which depends, among other factors, on the effects of technological improvements and on the efficiency of the institutions and the regulations in place within an economy – worsened significantly during the years of expansion prior to the crisis, posting slightly negative rates as from 2000. Despite some improvement as from 2008, linked to the disappearance of unproductive firms, Spain continues to post significantly lower productivity growth than the average for the developed economies.

There are simplistic analyses that would seek to explain these developments by resorting to singular and even anecdotal macroeconomic aspects; but the factors that appear to lie behind our mediocre productivity performance are varied and complex. Apart from the fact that Spain has significantly lower levels of technological capital than other developed countries, factors are often cited such as the high costs and administrative obstacles facing business start-ups, the low level of competition in certain sectors and the small size of our companies. Low productivity can also be related to some of the labour market aspects I referred to earlier, such as the disconnection between remuneration conditions and the specific situation of each firm, and labour market duality, which hamper the reallocation of resources across companies and human capital accumulation decisions.

**Conclusions**

To conclude, allow me first to refer to the situation of the euro area, and then to the Spanish economy, on the road to recovery from the crisis.

The euro area faces a complex macroeconomic scenario, marked by an outlook of moderate growth and very low inflation, recently compounded by uncertainties such as those arising from the assimilation of migrant flows and the referendum on the United Kingdom's continued membership of the EU.

The ECB's monetary policy is providing considerable stimulus through the easing of financing conditions, but it is necessary for other policies to accompany monetary policy if we wish to anchor the recovery and improve the medium-term outlook. In this respect, the fiscal policy of the member countries and of the EU as a whole should use the room for manoeuvre allowed under the Stability and Growth Pact to promote activity and, in parallel, the structural reforms aimed at improving our economies' potential should be deepened.

Turning to the Spanish economy, it has in the past three years moved back onto a path of economic growth, showing greater dynamism than in most of the EU countries. But it has not managed to overcome the imbalances I talked about earlier to the extent necessary.

Spain still has an unemployment rate of over 20% and a very high proportion of very long-term employment; we have financing maturities arising from our external debt that each year exceed 45% of our GDP; and our long-term demographic outlook threatens the sustainability of our public pension system.

A country with such challenges should not and actually – given our euro area membership and the background of market globalisation – cannot pursue any economic policy avenue other than one which, firstly, provides for and boosts higher employment growth or, on the other side of the same coin, brings about swifter and more sustainable gains in our productivity and competitiveness; and, secondly, helps curb the growth of our public and private debt with a view to subsequently reducing it.

In economic policy, hits and misses only become clearly manifest after some time. Just like big vessels which, owing to their great inertia, can only change course or speed slowly, an economy such as ours also moves with considerable inertia: correcting mistakes takes time and, almost always, entails losses in income and well-being, and social instability.

Our experience – both in the pre-crisis expansionary phase while the imbalances were accumulating and during their correction and the recovery of growth – should help us avoid errors, persevere with reforms to safeguard and enhance our competitiveness, and fulfil our public finance commitments in the European Union.

Thank you.