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**Testimony by the Governor of the Banco de España, Luis M. Linde,
before the Senate Budgetary Committee in connection with the
Draft State Budget for 2015**

Senate

Luis M. Linde

Governor

Ladies and gentlemen,

In my appearance today before this Chamber as part of the discussion of the State Budget for 2015, I will focus, as usual, on analysing the developments in, the outlook for and the challenges facing the Spanish economy. On this occasion, I am speaking just two weeks after the start-up of the Single Supervisory Mechanism, so I will also refer to the progress of the Banking Union.

The euro area economy

The Spanish economy is currently in a less favourable external environment than had been anticipated a year ago. In recent months, growth forecasts for the global economy for 2014 and 2015 have been revised downwards, and the loss of momentum of the recovery is more marked in the European countries which, as we all know, are our main trading and financial partners.

Euro area GDP flatlined in the second quarter of this year and the information received since has led international organisations and private analysts to revise their medium-term growth forecasts downwards. At present, the scenario considered most likely is one of weak GDP growth rates, which will be uneven from one country to another and prone to possible downscaling.

The behaviour of prices in the euro area is also a cause for concern. Against a fragile macroeconomic background, as at present, very low inflation rates entail a danger that consumer and business expectations will stand excessively below the ECB's medium-term price stability objective of 2% for the euro area as a whole.

Contrary to the downside risks surrounding the growth projections for the international economy as a whole, those for inflation are more mixed and have given rise to different responses by various central banks. The US Federal Reserve and the Bank of England have begun to withdraw some of the exceptionally expansionary non-conventional measures they introduced at the height of the crisis. Conversely, the European Central Bank has gone in the opposite direction, deepening the expansionary stance of its monetary policy.

The euro area monetary policy stance has taken the form of a series of measures adopted, in the main, at the June and September meetings of the ECB Governing Council, where conventional action has been combined with other exceptional and non-conventional measures.

Among the conventional measures, official interest rates have once again been cut. The main refinancing operations rate currently stands at an all-time historical and technical low of 0.05%. The deposit facility rate moved into negative territory in June and was further lowered in September to -0.20%, thus increasing the cost for banks of holding immobilised surplus liquid balances in their accounts with the Eurosystem.

This policy has been complemented by three new extraordinary tools, designed to promote the more efficient and uniform transmission of expansionary monetary impulses and to foment a greater expansion of lending in the area.

First, a new long-term refinancing facility has been set in place. Last September, the first of these fund-injection operations was carried out, and they will be extended to June 2016. These operations may have a maturity of up to 4 years and are carried out at a very attractive cost for banks: only 10 bp above the main refinancing operations rate, which is currently equivalent to a rate of 0.15%.

So that these new long-term injections may translate into an increase in lending to the private sector, access to the funds has been tied both to the outstanding balances and to the flows of the credit extended by banks to households and firms.

The ECB has also launched two new asset purchase programmes. The first, which is already under way, involves the acquisition of bonds issued by banks and backed by specific items on their balance sheets. This is the case, for example, of the various types of covered bonds traded in Spain.

The second programme, which will be operational in the coming weeks, envisages the acquisition of securities derived from the securitisation of loans to households and firms. This programme will contribute to reinvigorating a market which has been greatly affected by the financial strains caused by the crisis but which, once suitably redirected and stripped of its toxic components highlighted by the crisis, should play a key role in the financing of the private sector, particularly in the case of small enterprises, whose direct access to the capital markets is very limited.

In addition to these measures, I would also like to recall that the ECB remains, with the unanimous support of its Governing Council, committed to resorting, as and when necessary, to additional measures.

The Spanish economy

In contrast to the progressive weakening of the euro area, the recovery in the Spanish economy has remained firm. The year-on-year rate of change in GDP in the third quarter rose to 1.6%, and might draw close to 2% in the final stretch of the year, at which rate it might hold on average in 2015. Naturally, this forecast is conditional upon the risks I shall refer to not materialising.

Figures for the labour market have also trended favourably, showing net job creation since the second half of last year, which has prompted a 2 pp decline in the unemployment rate over the past 12 months to 23.7% of the labour force. Of course, this remains an unacceptable level that reflects the most serious imbalance in our economy, the correction of which must be the chief objective of our economic policy.

Reactivating national demand has taken on a decisive role in the recovery, enabling the re-balancing of the internal and external components of expenditure. This change in the dynamics of domestic expenditure compared with events during the crisis years is in

response to a series of factors, including most notably the growing normalisation of financial conditions, headway in the construction of the Banking Union, favourable developments in the labour market and the unquestionable improvement in confidence.

Against this backdrop, both private consumption and business investment have regained momentum, underpinned by the improvement in the financial environment. Mention should also be made of the role being played by investment in construction, which might begin to turn around in 2015 or 2016. Recent developments in house prices are along the same lines, although certain caveats should be voiced: for the first time in six years, growth rates in the aggregate domestic indices of real estate prices are close to zero, or slightly positive, although significant differences across regions remain.

Since the crisis began, spending by private agents has been constrained by the need to reduce the high levels of debt built up during the expansion that ran to 2008. Recently, there has been progress in private sector deleveraging, while the attendant restrictive effects on spending are being mitigated by a shift in lending flows towards more creditworthy agents and, in particular, towards companies better placed to commit to new investment projects.

In recent years, goods and services exports have been the engine of our economic activity, against a background of marked weakness of domestic private expenditure and contained imports from the rest of the world. During 2014, foreign trade flows have undergone changes of some scale, as a result of the loss of steam in our export markets (in the emerging economies and, since the spring, in the euro area alike) and the acceleration in imports as the recovery progressively took hold. As a result, the contribution of the external sector to GDP has declined appreciably and the pace of adjustment of the external imbalance has been less rapid than expected.

Conceivably, some of these developments are temporary and will be reversed, in part, in the coming months. Moreover, the depreciating trend of the euro may help improve the external balance in the near future. However, the weakness of the euro area, along with the high sensitivity of our imports to changes in final demand, highlight the need to further improve the competitiveness of our economy.

As regards inflation, the Spanish economy is currently posting very low rates. This partly reflects temporary factors, but also structural factors that account for the subdued tone of core inflation. Inflation rates have been trending downwards for months throughout Europe, and Spain is one of the euro area countries that has moved most markedly in this direction.

We can argue about the advantages and disadvantages of a price situation such as that described. Without forgetting the difficulties that a prolonged period of low inflation entails for reducing debt ratios and for price-competitiveness, it is important not to lose sight of the fact that the adjustment witnessed in Spanish relative prices and costs vis-à-vis the euro area has been crucial to explaining the sound performance of the external sector, whose contribution continues to be vital for the recovery.

Overall, the outlook for the Spanish economy remains favourable, although not free from risks. Spain has so far shown resilience in the face of the worsening international setting. But this should not lead us to believe that the loss of momentum in our external markets, and in particular in the euro area, may be fully averted. In addition, at home, the need to see through both private- and public-sector deleveraging might detract from the recovery capacity of domestic expenditure.

The State Budget for 2015

The Draft State and Social Security Budget currently under discussion is framed in a macroeconomic setting in which real GDP would increase by 2% in 2015, as a result of the fresh momentum of national demand, which would contribute 1.8%, and of a small rise in the contribution of net external demand, to 0.2% of GDP. The process of job creation would firm, reaching a growth rate of over 1%, and taking the unemployment rate down to around 23% in annual average terms. The GDP deflator would increase by 0.7%, whereby the rise in nominal GDP would be around 2.6% compared with the potentially meagre end-2014 figure of 1%.

Overall, these forecasts coincide with those on which analysts concur, although the latter generally involve a somewhat lesser fiscal effort than envisaged in the Draft Budget. The macroeconomic setting accompanying the Draft Budget is subject to downside risks, owing to the uncertainty surrounding international and, in particular, European economic developments.

It is against this macroeconomic and financial background that the Draft State and Social Security Budget for 2015 was unveiled in late September.

Before continuing, I should point out that, along with the Draft Budget, the Budgetary Plan for 2015 was presented in October. The Banco de España considers that the preparation and publication of this Plan is a most valuable step forward for the control and transparency of our public finances.

The Budgetary Plan for 2015 includes information on the budgetary planning of the regional and local governments, and it thus offers a view of overall general government conduct. The Budgetary Plan is important because it fills a substantial information gap: the lack of integrated information relating to all general government activity at a time at which a new budgetary cycle is beginning. Given that its publication marks the main change since my appearance in Parliament in October, I shall now focus on its content.

Budgetary programming foresees, firstly, fulfilment of the budget deficit target for 2014, at 5.5% of GDP. To August, the central government, Social Security and regional government budget outturn evidenced a deficit of 4.3% of GDP, a 0.3 pp improvement on the same period the previous year. To meet the deficit target requires an improvement of 0.8 pp of GDP over the year as a whole; accordingly, the increase in revenue and/or the containment of spending in the final four months of the year will need to be greater than that recorded between January and August. This greater effort should be concentrated at the regional government level where, on the information available, the risks of slippage are located.

For 2015, the Budgetary Plan sets a budget deficit target of 4.2% of GDP, 1.3 pp of GDP below that for 2014. In terms of the different agents, the reduction in net borrowing would amount to 1 pp of GDP in the case of central government and the Social Security system, while the regional governments should adjust their fiscal imbalance by 0.3 pp of GDP and local governments should run a balanced budget.

In 2015, the improvement in the cyclical position and the reduction in government debt yields will contribute to enhancing public finances. On the estimates available, meeting the deficit target for the coming year will require a budgetary adjustment drive, measured by the change in the primary structural balance, that is appreciably less than that made in previous years. Overall, what we have is a more favourable macroeconomic scenario for the adjustment than that in place in 2012 and 2013.

In terms of composition, under the Budgetary Programme the brunt of the adjustment is borne by government spending, since, as a proportion of GDP, it will be reduced by nearly 1 pp, basically due to cuts in government consumption. Notable among the other expenditure items is that pensions rise by 0.25% as a result of application of the indexation formula included in the reform approved in December 2013.

The Budgetary Plan envisages that the relative weight of revenue in GDP will increase by 0.4 pp, despite the fact that the phasing-in of the personal and corporate income tax reform is estimated to have a budgetary cost in 2015 of some 0.4 pp of GDP. The Budgetary Plan anticipates that the loss in tax takings associated with this reform will be offset by tax increases of the regional and local governments, the anti-fraud scheme of the Social Security system and a pick-up in tax revenue attributable to the economic recovery.

Meeting the spending targets will call for a very strict budget outturn by all levels of government, as well as the achievement of savings from the reforms approved, particularly by local government.

Finally, the Budget envisages a public debt ratio of 100.3% in 2015, up 2.7 pp of GDP on the projection for 2014. These figures illustrate the continuing importance the reduction of fiscal imbalances will have in the economic policy agenda for the coming years.

The European Banking Union

Allow me to conclude with a reference to the process of Banking Union in Europe.

As you know, on 4 November the first pillar of the Banking Union project, namely the Single Supervisory Mechanism, came into being.

The Single Supervisory Mechanism aims to harmonise banking supervision in the euro area so as, among other things, to sever the negative link between confidence in banks and doubts over the sustainability of public finances.

Intense work was needed to implement the new supervisory system. Milestones included the completion of the Single Supervisory Mechanism Regulation in October 2013; the

approval of another regulation assigning responsibilities to the European Central Bank and national authorities; and the drafting of a supervisory manual setting out the best supervisory practices of each country and implementing common procedures for all members of the system.

One of the main objectives of the new institutional design is to ensure that the ECB's supervisory functions do not clash with its monetary policy responsibilities. To this end, a new Supervisory Board was set up in the ECB to plan and conduct banking supervision. This Board will be responsible for making proposals on supervision to the Governing Council, which continues to be the highest decision-making body of the ECB in both monetary policy and supervision.

The start-up of the SSM constitutes an unprecedented transformation of the responsibilities of the participating national supervisory authorities, which naturally include the Banco de España.

The Single Supervisory Mechanism Regulation distinguishes two groups of banks.

First, the 120 banks considered to be significant, 15 of which are Spanish (although their number will drop to 14 when the acquisition of Catalunya Banc by BBVA is completed). They will be directly supervised by the ECB through so-called Joint Supervisory Teams made up of staff from the ECB and the national supervisors.

Second, the more than 3,000 less significant banks will continue to be the direct responsibility of national authorities, although the ECB will indirectly monitor their situation and the supervisory actions to which they are subject.

As a prior step to the creation of the SSM, a comprehensive assessment of the euro area's significant banks was conducted and the results were made public on 26 October.

This exercise consisted of two parts: an asset quality review and a stress test.

The assessment of asset quality involved an in-depth review of bank balance sheets as at end-2013. It was carried out with the assistance of the top audit firms.

The stress tests assessed the capacity of banks, in a three-year period from 2014 to 2016, to absorb losses under two hypothetical macroeconomic scenarios: a baseline, more likely one; and an adverse one, less likely but not impossible. This second phase of the exercise was basically carried out by the banks themselves.

Both phases were subject to strict quality assurance in which the national supervisory authorities, in our case the Banco de España, played a key role.

The exercise considered minimum capital thresholds which had to be exceeded in each of its parts: the asset quality assessment and the baseline and adverse scenarios of stress tests. Banks not exceeding any of these thresholds had to submit within two weeks a capital plan for remedying their capital shortfall within a period of six to nine months.

With the methodology used, 25 of the 130 banks assessed had a capital shortfall, which for the whole of Europe amounted to €24.6 billion. It should however be noted that, in anticipation of the exercise, many European credit institutions strengthened their solvency over the past year. Of the aforementioned 25 banks, 12 increased their capital sufficiently in 2014, so only 13 of them, with a capital shortfall of €9.5 billion, will have to take additional action to reinforce their solvency.

We consider the results of the Spanish banks to be positive. Only one bank was below the threshold in one of the parts of the exercise, specifically in the asset quality review. In this case the estimated shortfall was very small and, during 2014, the bank took measures to strengthen its capital by an amount well in excess of that needed to cover its shortfall. Taking into account these actions, at present all Spanish banks amply exceed the thresholds set in the exercise.

It should also be noted that Spanish banks were the ones that had to make the smallest adjustments as a result of the asset quality review: a total of only 0.14% of their risk-weighted assets.

In conclusion, the results of the comprehensive assessment show that the restructuring process undertaken in the Spanish financial system from 2012 has been successful and that our credit institutions face the future with healthy balance sheets and a sound solvency position.

Similarly, the structural reforms undertaken in recent years have played a crucial role in providing for a firm recovery and in correcting imbalances. It is imperative to stay the course and ensure sufficient growth to reduce the unemployment rate and anchor the economic underpinnings needed to sustain domestic and foreign demand.

Thank you.