

FOREWORD BY THE GOVERNOR

Luis M. Linde

The Spanish economy is immersed in a phase of recovery which began in mid-2013 and which has marked the end of a long and deep-seated recession. Economic activity progressively gained in momentum during 2013, taking the form of positive growth figures as from the third quarter. The latest data indicate this trajectory has strengthened in 2014 to date. The change has also been discernible in the labour market. There, the long phase of job destruction gave way to modest net job creation in the final stretch of 2013, which has continued into 2014, meaning that the critical job creation threshold has been breached. Despite this gradual improvement, the unemployment rate ended the year at a still unacceptably high level.

As the analysis in the *Annual Report* shows, the change in course in the Spanish economy has come about as a result of a combination of external and domestic factors.

Among the external factors, the rise in global activity and trade in the second half of 2013 and the return by the euro area to a path of economic growth shaped an environment conducive to exports, lower uncertainty and restored confidence. These impulses were strengthened by the headway made in the construction of the European Banking Union, which has contributed to easing tensions on the area's financial markets. Acting along these same lines has been the progress in fiscal consolidation and structural reform in the euro area countries subject to the greatest pressures. Naturally, there is still work to do and the challenges ahead remain significant, as was manifest in the annual review by the European Commission of the area's main macroeconomic imbalances.

The monetary policy of the ECB has contributed most significantly to shaping a more favourable environment. The strongly expansionary stance adopted since the onset of the crisis has helped ease the serious financial tensions and has improved financing conditions, although significant fragmentation and heterogeneity persist and are hampering the transmission of monetary impulses to all regions and industries. In any event, the ECB's actions are providing the vital leeway needed so that fiscal consolidation and the structural reforms may yield their full benefits and thus smooth the way for our economy and that of the rest of the area to resume growth and job creation.

Notwithstanding, the Spanish economy could not have entered a phase of recovery had it not progressed, as it has done, in the correction of imbalances and in the design and implementation of the reform programme. The year 2013 saw significant advances in fiscal consolidation, in gains in competitiveness and in the restructuring of the banking system. The result has been the normalisation of the external funding flows the Spanish economy needs for sustained growth.

As regards public finances, the deficit fell in 2013 to 6.6% of GDP, despite the cyclical weakness and the increase in interest payments; the adjustment was, therefore, the outcome of a considerable structural effort. But the task ahead remains significant and is burdened by Spain's high public debt/GDP ratio.

Turning to competitiveness, the ongoing moderation in labour costs and prices allowed further gains during the year. The adjustment of goods and services prices relative to the rest of the world is exerting a very favourable effect on our foreign trade. The year ended

with our first current-account surplus in the euro era, although the still-high external debt is a reminder of the need to persevere with and build on our efforts to date.

There was decisive progress in the restructuring, recapitalisation and clean-up of our banking system. The financial assistance programme agreed with the European authorities in 2012 for the recapitalisation of part of the system ultimately amounted to €41 billion and was successfully concluded in January 2014. Other strictly private-sector actions should be included in the overall recapitalisation drive, including most notably the burden-sharing exercises involving hybrid capital and subordinated debt instruments. Micro-prudential regulation and supervision frameworks were also overhauled, both to allay the risk of future crises and to better protect taxpayers from their adverse effects. Significant challenges remain, but the system is now more favourably placed to be able to properly finance the economic recovery.

There was also progress in 2013 in the necessary deleveraging of the private sector. This year, Chapter 2 of the *Annual Report* — the special-focus chapter — analyses this subject in depth. Deleveraging still rests on the contraction of aggregate credit, but signs of improvement are beginning to be discernible. Thus, since mid-2013, credit to non-financial corporations has continued to shrink, but at progressively lower rates. And this turnaround has also begun to be seen in the case of households since early 2014. The more disaggregated analyses show that this behaviour is proving compatible with a change in the mix of credit flows towards those companies that are better placed to channel available funds to growth- and employment-boosting investments.

Despite the progress in the restructuring of the Spanish economy, entrenching the recovery will face formidable challenges as a result of the far-reaching effects of the crisis. Unemployment and the debt of the resident sectors are of a major scale and their absorption will take considerable time. Economic policy must push through further improvements in competitiveness and reallocate resources to sectors with higher growth potential, while paving the way for public- and private-sector deleveraging. And this in an environment in which the low euro area-wide inflation rate and the appreciation of the euro make for added difficulty in proceeding with the adjustments still to be made.

The headroom for implementing expansionary domestic policies is limited. Monetary policy is already deploying considerable impulses at the European level, so the challenge is to boost their transmission to Spanish households and firms. Fiscal conduct should be governed by the priority need for further headway in consolidation and in lowering public debt. Achieving this, in line with European commitments, is pivotal to maintaining investor confidence and ensuring the external financing of the economy. The medium-term targets set on the road towards budgetary stability must help anchor agents' expectations on public finances and provide for the implementation of the measures needed. Likewise, the composition of the fiscal adjustment should seek to soften the short-term contractionary effect on activity and improve growth potential. The tax reform the Government plans to unveil in the second half of this year should seek to redress the problems beleaguering taxation in Spain, namely low revenue-raising capacity and a bias towards indirect taxation and social security contributions, since this is more harmful for competitiveness and employment. We can count, in any event, on the benefits for the sustainability of public finances stemming from the pensions reform.

The *Annual Report* highlights the important role structural reforms have to play in seeing through the remaining adjustments, minimising their costs and restoring the economy's

growth capacity. The reform-induced increase in the cyclical sensitivity of prices is prompting a correction of the competitive lag built up during the last expansionary cycle, while greater labour market flexibility has been conducive to wage moderation which, in turn, is supporting job creation. A change can also be seen in the role played by past inflation in determining costs and incomes. This is an important change as regards adaptation to EMU membership requirements. It has been boosted by various initiatives and will be reinforced by the new legislation on the deindexation of the economy. It is essential that the reforms in product markets (the respective laws on entrepreneurs, single market guarantee and insolvency, among others), designed to increase competition and improve efficiency, are implemented speedily and ambitiously.

Perseverance with this economic policy approach will help set an increasingly firm path of recovery in place, paving the way for essential reduction in the high level of unemployment, which is the most burdensome legacy of the crisis and the main economic and social problem our country faces.

