

FOREWORD BY THE GOVERNOR

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For the first time since the start of the crisis, GDP and employment grew significantly in Spain in 2014, outstripping the figures for the euro area as a whole. This dynamism has taken root during the opening months of 2015, and forecasts by both the Banco de España and other private-sector and institutional analysts point to the prolongation of this pattern in the short and medium run. This scenario reflects the firming of a sustained recovery, leaving behind the most severe recession in Spain's recent economic history.

The analysis of the factors behind the recovery in the Spanish economy and of the challenges posed in entrenching this trajectory constitutes the core of this *Annual Report*.

The growth of activity and employment in 2014 and in 2015 to date is underpinned especially by the progress in the ongoing correction of the macroeconomic imbalances built up in the Spanish economy during its last upturn, against the background of the improvement in some of its external conditioning factors.

The growing dynamism of GDP in Spain is in contrast to the loss of momentum the global economy – and most particularly the euro area – experienced in 2014. On this occasion, moreover, the weakness of activity in the euro area did not only affect the most vulnerable economies, but was also visible in others such as Germany and France.

The fall in oil prices, on the contrary, contributed to increasing Spanish household purchasing power and to lowering firms' output costs, with their exports outside the euro area also benefiting from the progressive depreciation of the euro. But the most significant and lasting positive impulses stemmed from the increasingly expansionary stance of the Eurosystem's monetary policy and from the milestone marked by the start-up of the Banking Union. Against the backdrop of the normalisation of the area's financial markets, the effects were felt with greater intensity in the economies, such as Spain, which had been most severely affected by the fragmentation prompted by the crisis of the euro. In the original Spanish version of this Report, Chapter 2 analyses in detail the behaviour of the single monetary policy and its divergence from that implemented by the US Federal Reserve and the Bank of England.

The recovery is underpinned above all by the support provided by the progress in macroeconomic re-balancing and the reforms implemented, which have placed the Spanish economy in a healthier and more competitive position. That has provided not only for more buoyant activity but also for the more intensive pass-through of activity to job creation.

The dynamism of employment was one of the highlights of 2014, reflecting, inter alia, the effects of the reforms made since 2012. Set against the reduction in the working population, there has been a significant decline in numbers unemployed and in the unemployment rate, a rate which nevertheless remains at an unacceptably high level.

The competitive adjustment of the Spanish economy based on internal devaluation also continued in 2014. Despite the lesser tempo of the increase in productivity, labour costs moved further along a path of moderation which, in recent years, is proving greater than what the behaviour of their determinants might have inferred. The improvement in competitiveness has been extensive to a broad range of price indices. Given their relevance, the dynamics of

price and cost formation in Spain and the challenges posed by a low-inflation environment are addressed in Chapter 4 of this Report.

For the third year running, the Spanish economy generated a net lending position vis-à-vis the external sector. The scale of this net lending was, however, less than that of the previous year. The reduction in the sizeable net debtor International Investment Position (IIP) is, in any event, proving very gradual.

The adjustment of the housebuilding sector appears to have been completed in 2014, following a drastic reduction in its contribution to GDP and a severe correction of prices. Its recovering trajectory is surrounded by some uncertainty given the high volume of unsold houses and the particular geographical distribution involved, and the doubts over the incidence of demographic developments on the potential demand for housing.

Turning to public finances, the general government deficit met its established target for the third year running. The public debt/GDP ratio also trended in line with the official target, although it posted a further increase, thereby highlighting the importance of promptly achieving, as planned, stabilisation that paves the way for its progressive reduction.

Conversely, Spanish households and firms substantially reduced their debt ratios. Although the process continues to rest on the fall-off in bank lending, last year saw a significant easing in this variable and, from a more disaggregated perspective, there were signs pointing to a reallocation of new flows towards firms better placed to invest and hire. A chapter in the original Spanish version of the Report is dedicated to analysing this trajectory of progressive normalisation and its implications for the economic recovery.

To conclude the review of domestic adjustment processes, I should also highlight the fact that the effectiveness of the clean-up, restructuring and recapitalisation of our banking system was substantially vindicated by the ECB's publication in October 2014 of the results of the comprehensive assessment of significant euro area credit institutions, which was conducted as part of the groundwork for the entry into force of the Single Supervisory Mechanism.

While all these advances have been substantive, the adjustment and re-balancing of the Spanish economy is not yet over. Economic policies continue to face major challenges to overcome the consequences of the crisis and achieve sustained economic growth.

As regards strictly national policies, and in particular fiscal policy, co-responsibility in the fulfilment of objectives by the different tiers of government (central, regional and local) remains a necessity. The Budgetary Stability Law provides the tools for this and the recently created Independent Authority for Fiscal Responsibility can contribute to making them effective. Also, in the event of contingencies that were to make it necessary to reinforce the fiscal consolidation plan, it would seem reasonable to review in depth the different public spending items and to identify those exerting most of an impact on growth. On the revenue side, the relative weight of indirect tax and the rationalisation of the extensive range of deductions, rebates and reductions that erode tax-raising capacity should be prioritised, as proposed by international experts and agencies.

With regard to pensions, the reform adopted in 2013 will contribute to making the growth of public spending associated with population ageing sustainable. But to avoid uncertainty and false expectations, the new system must be implemented transparently, in keeping

with the legal provisions laid down. And there is also a pressing need to promote insurance and saving mechanisms that help supplement the unfunded public pension system.

In the labour market, the challenges continue to be to reduce unemployment and raise productivity. In this connection it is vital to maintain reform momentum. The possible avenues for progress include improving the effectiveness of active policies, enhancing the role of firm-level negotiations under collective bargaining and, with regard to employment contracts, increasing the incentives for stable employment, narrowing the gap between the termination conditions for the different forms of hiring arrangements and promoting greater continuity among such forms.

It is also important to maintain and reinforce the structural policies aimed at lowering the obstacles that prevent productive resources from being channelled to those companies and sectors showing greater growth potential. Given the major implications both in the short term and, especially, in the long run, Chapter 3 of the *Annual Report* in its English-language version is dedicated to analysing this subject. The main obstacles identified relate to regulatory problems, too-small average company size, limited regional and sectoral labour mobility, a degree of educational mismatch between labour supply and demand, and limited innovative capacity. The amount of ambition deployed to overcome these limitations will determine the speed and consistency of the process of convergence of the Spanish economy towards the standards of well-being in the core EU countries.

