

1 OVERVIEW

1 Introduction

In 2008 the world economy underwent momentous changes which brought to an end the longest uninterrupted growth period since the 1960s. The turmoil on international financial markets present since the summer of 2007 turned in the closing months of the year into a deep global financial crisis, giving rise to an economic recession that has now extended to all the main economies.

The ratcheting up of the financial crisis in September 2008 heightened the process of deleveraging in which the financial system was immersed, while exacerbating its effects on real activity. The crisis spread to the emerging economies – which had until then shown signs of some resilience – and led some countries to post very negative GDP growth rates in 2008 Q4 and 2009 Q1.

The paralysis of demand prompted a drastic turnaround in inflation worldwide during the year. Until the summer, inflation had been running very high as a result of the notable rises in oil, food and other non-energy commodity prices. However, as the growing weakness of the world economy contracted the demand for oil and commodities, their prices moved sharply down and affected both actual inflation rates and inflation expectations, which fell notably against a recessionary global background.

The economic authorities reacted forcefully to this combination of adverse factors with the aim of supporting the financial system, safeguarding its workings and stimulating the economy. Governments devised financial system support plans and adopted relatively ambitious fiscal impulse packages. Central banks, for their part, altered the stance and operational framework of their monetary policies during the year to adapt them to the change in the global scenario. Following the heightening and globalisation of the financial crisis, monetary policy responses became more uniformly expansionary. Sizeable cuts were made to official rates, which fell in some cases to all-time lows, while policies geared to the abundant provision of liquidity took on a key role.

In the Spanish economy, the shocks induced by the serious global economic and financial crisis superimposed themselves on the process of domestic adjustment which had begun previously (as a result of the imbalances built up during the previous long, intense expansion), and which was being driven, above all, by the correction of the excesses in the real estate sector and of the high levels of private-sector debt. The combination of both made for a severe increase in uncertainty, a precipitous decline in confidence, a notable tightening of the conditions of access to financing and a considerable erosion of private-sector wealth. The contractionary forces behind this process pushed the Spanish economy into a sharp recession, in parallel with the global recessionary trends. Despite the change in monetary policy stance and the expansionary measures adopted, the Spanish economy showed a continuous loss of momentum, which became more accentuated in the second half of the year when, for the first time since 1993, two consecutive quarters of falls in GDP were recorded. As a result, the year closed with a 0.7% year-on-year decline in output. This recessionary pattern became more visible in 2009 Q1, with a 3% fall in GDP compared with the same period a year earlier according to the data released as this Report was going to press. The information available for Q2 appears to point to less intense contractionary trends, as is proving the case worldwide.

The inflationary outlook changed drastically during the year, in line with worldwide developments and with the sudden weakening of demand. After having increased significantly in the first half of the year, the CPI growth rate declined rapidly, reflecting the effect of the correction of oil and other commodity prices, and of the diminished momentum of spending, which led the inflation differential with the euro area to turn negative from December, for the first time since the euro area was created. The external deficit also turned around and began to narrow fairly sharply. The processes brought on by the strong adjustment of domestic spending are thus prompting a relatively swift re-absorption of some of the imbalances pending correction, although they are doing so by means of bringing activity grinding sharply to a halt, with high costs in terms – above all – of falling employment and rising unemployment.

This chapter analyses the current situation of the Spanish economy against the backdrop of the global economic and financial crisis. It sets out the economic policy challenges posed and the steps needed to mitigate the contractionary forces and forge a prompt recovery on balanced and sustainable foundations. Chapter 2, from a more analytical and selective perspective, details some of the aspects of the impact of the global crisis on the adjustment of the Spanish economy, paying particular attention to the implications for the determinants of job creation.

2 The world economy amid the international financial crisis

A year of momentous change for the world economy, in which the longest period of uninterrupted growth since the 1960s was cut short.

Undoubtedly, 2008 was a year of momentous changes for the world economy. The risks identified in 2007 materialised, full-blown, and the longest uninterrupted period of growth since the 1960s was cut short. The financial turmoil accompanying us since summer 2007 turned in the closing months of last year into a deep-seated and global financial crisis, entailing an economic recession which has now extended practically to all the main economies, including the euro area. Faced with this combination of adverse factors, economic authorities reacted forcefully, practically simultaneously and, to some extent, concertedly, with the aim of supporting the financial system, safeguarding the flow of credit to the economy, restoring confidence and sustaining aggregate demand. However, the feedback loop between financial and real-sector recessionary forces have shaped an economic and financial situation of extreme fragility and one auguring a very negative outlook for 2009.

2.1 THE GLOBAL FINANCIAL CRISIS

The international financial system underwent its most difficult time in several generations

In 2008 the international financial system underwent its most difficult time in several generations. The benign and relatively unvolatile macroeconomic context marking the world economy in the years immediately prior to the start of the crisis in August 2007 had given rise to a situation of underpricing of risk. And, driven by low real interest rates in historical terms and extraordinarily dynamic credit, real and financial asset prices stood at historically high levels. The degree of leverage obtained by the financial system was also high, as was the private-sector non-financial debt in some countries.

In these circumstances, the change in the real estate cycle in the United States, around whose mortgage market a web of complex mechanisms for transferring risks from loan-originating institutions to other agents had been woven, paved the way in the opening months of 2007 for an increase in subprime mortgage defaults, which would ultimately act as the trigger for the current global financial crisis. The scope for contagion of the financial turmoil that began in the summer of 2007 was soon apparent, despite its relatively local source. The sharp reassessment of risk against a background of high leverage triggered a drastic reduction in liquidity on money markets, amplified by the complexity of some of the instruments at the epicentre of the turmoil (structured products) and by the opacity with which risks were distributed through the so-called originate-to-distribute model, the expansion of which had spurred the extraordinary buoyancy of credit in the previous years. However, few could then have predicted the range of institutions, assets, markets and economies which would ultimately be affected.

In the first half of the year the financial turmoil spread, compromising the solvency of some systemically important institutions

The heightening of the crisis in September accelerated the deleveraging of the financial system and increased the risks of a severe contraction in credit

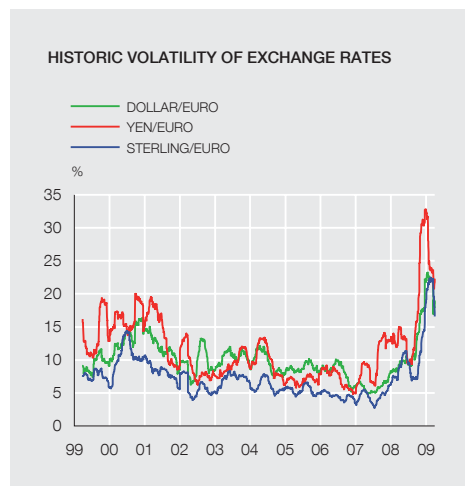
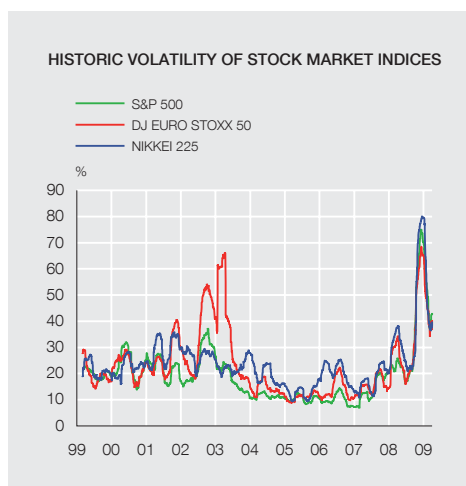
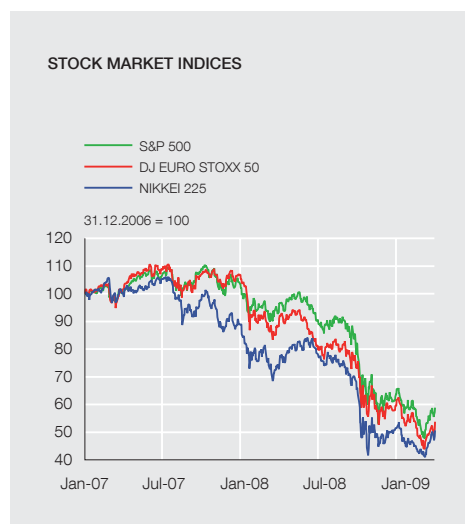
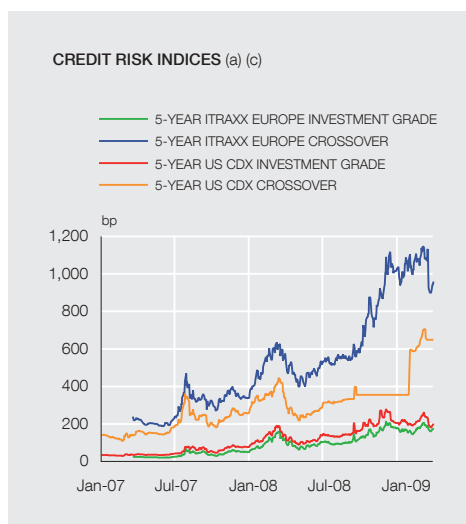
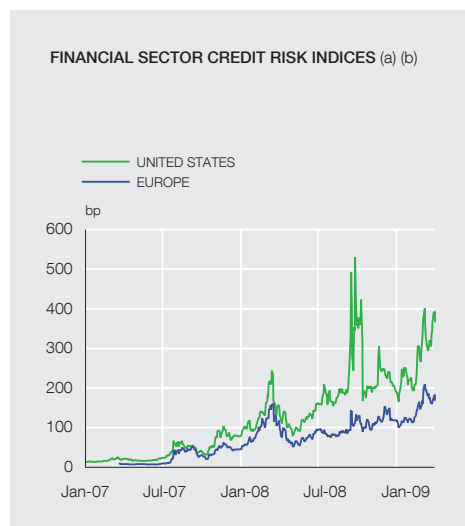
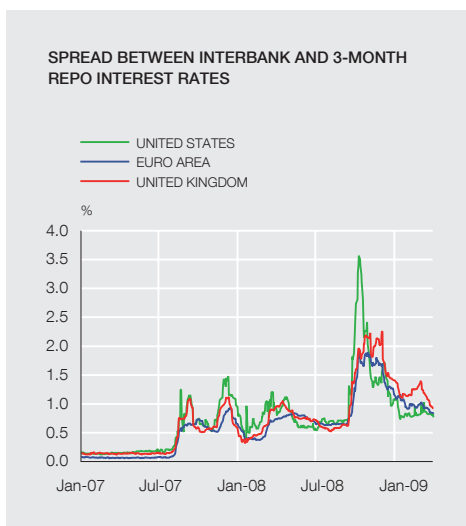
The initial turmoil progressively fed through to other assets, markets and economies, becoming what is currently a global financial crisis

In the first half of 2008, the financial market turmoil and dysfunctions persisted and spread, compromising the solvency of some systemic institutions. During this period, central banks increased the supply of liquidity on interbank markets and governments conducted selective bail-outs of ailing systemic institutions. Such was the case of the investment bank Bear Stearns which, thanks to the support of the Federal Reserve, was purchased by JP Morgan Chase in March. In September, following the placing under control of Freddie Mac and Fannie Mae (agencies which play a key role in the US mortgage market), the bankruptcy of the investment bank Lehman Brothers and the bail-out of the insurer AIG, the financial markets entered a global crisis which placed the system on the verge of collapse and which impacted with force the European banks directly involved in the distribution of risks originating in the United States.

The heightening of the financial crisis in September gave rise to a period marked by the quickening of the deleveraging process which the financial system is undergoing and which entails the risk of a sharp contraction in credit. The great uncertainty and volatility overshadowing markets (see Chart 1.1) were most visibly reflected on stock markets, which from mid-September 2008 to March 2009 fell by around 30% in the main economies, and on certain foreign exchange markets. Further, there was a marked increase in credit risk premia and, despite the easing of monetary policies, a notable tightening of credit standards.

Many factors contributed to the spread and heightening of the crisis. The loss of confidence in the pricing of the assets initially affected (some of great complexity) and the opacity of the resulting losses promptly turned into uncertainty over the financial position of those financial institutions that were holding such assets on their balance sheets or which were exposed through credit lines to off-balance sheet vehicles, giving rise to a significant increase in counterparty risk. With access to the wholesale funding markets closed except for the very short-dated terms, and with financial institutions obliged to increase their solvency ratios in a setting of high risk aversion which was far from conducive to the raising of private capital, banks were caught up in a disorderly process of deleveraging through asset liquidation. In turn, the massive sale of assets at bargain prices on relatively illiquid markets led to fresh losses and prompted negative externalities for other financial institutions not initially exposed to the assets affected at the outset; but such institutions also entered a vicious circle of losses due to the depreciation of assets on their balance sheets, worsening solvency ratios and asset liquidation.

These trends called into question the long-term viability of business models which, supported in some cases by looser regulations, had shown great dynamism in recent years and had developed a web of complex interconnections in the financial sector. Firstly, the vulnerability of those banks (the major investment banks in particular) that had depended excessively on the capital markets to fund with short-term debt the – often aggressive – expansion of their balance sheets was highlighted. Also, the losses incurred by the monoline insurance companies, which had backed in recent years the issues of some of the instruments at the heart of the credit problem, called into question their solvency, undermining the very basis on which their business was founded. Finally, hedge funds, whose high returns were based on the possibility of making investments financed largely through resort to credit, experienced significant disinvestment. In any event, set against the high integration of and complex interconnections between financial institutions, the initial turmoil progressively fed through to other assets, markets and economies – including the emerging countries, which initially showed some resilience – to become what is today a global financial crisis without parallel in the past 70 years.

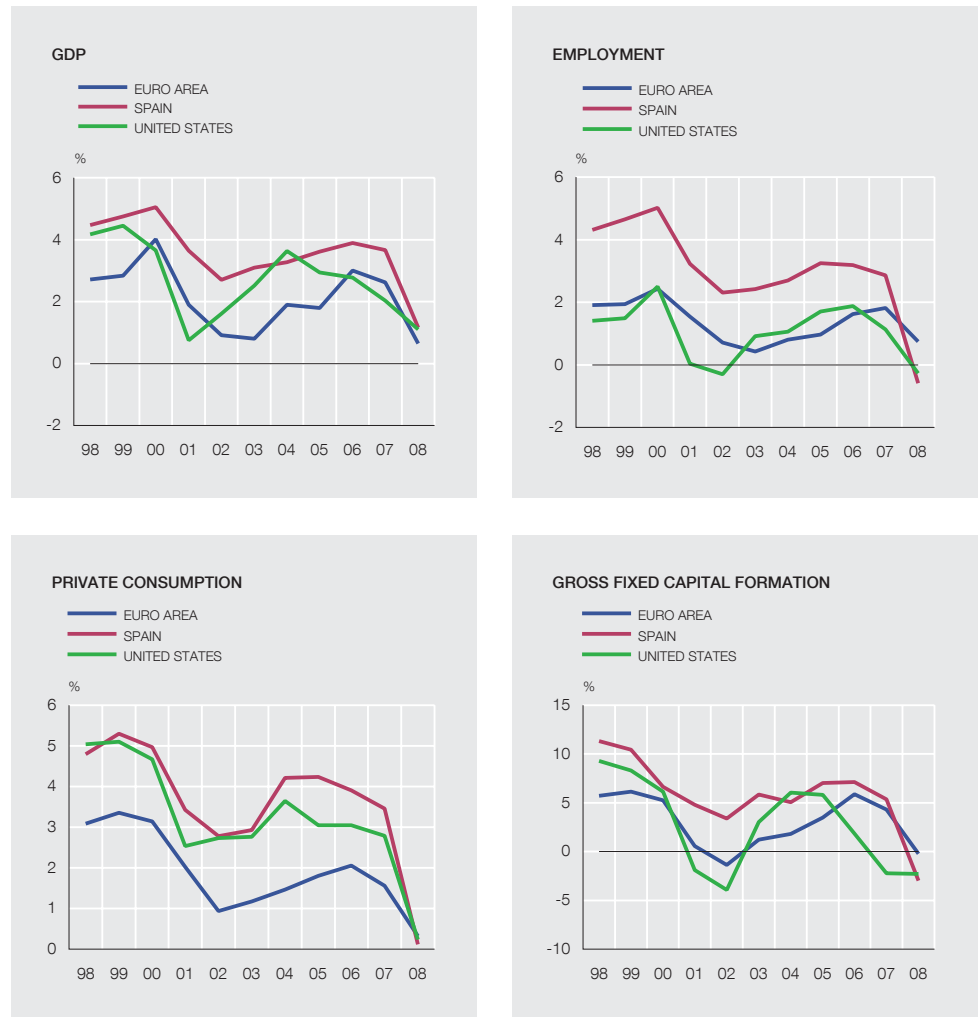


SOURCES: Banco de España, Bloomberg and Datastream.

- a. Prepared on the basis of CDS premia
- b. For the United States, the average of the major banks' CDS spreads. For Europe, the iTraxx financial index.
- c. Investment grade indicates that the index includes the debt of institutions with a rating of BBB or higher for Standard & Poor's and Fitch. Institutions with a poorer rating are included in the crossover index.

GDP, PRIVATE CONSUMPTION, EMPLOYMENT AND GROSS FIXED CAPITAL FORMATION
Rates of change

CHART 1.2



SOURCES: Eurostat and national statistics.

The effects of the crisis on the real economy have become patent in the situation of global economic recession

In late 2008 and early 2009, the effects of the financial crisis on the real economy have been patent, giving rise to a recession which has now reached practically all the main economies. This has meant that the focus has shifted towards a new feedback loop, this time from the real to the financial sector.

2.2 THE ECONOMIC CRISIS

The economic situation deteriorated progressively throughout the year

The loss of momentum in world growth dating back to mid-2007 continued in 2008. For the year as a whole, GDP grew by around 3%, down from 5.2% a year earlier. The economic situation deteriorated progressively throughout the year, and was reflected in successive downward revisions of growth and inflation forecasts by public and private organisations. Nonetheless, from Q3 the slowdown intensified sharply and some countries posted very negative growth rates in Q4 and in 2009 Q1 (see Chart 1.2). The latest information, however, suggests the intensity of the contraction is easing.

In the first half of the year, activity in the developed countries began to be affected

In the first half of the year, activity in the developed countries began to be affected by the impact of the high commodity prices prevailing and by the financial turmoil passing through to aggregate demand via various channels. Firstly, household and corporate spending decisions progressively adapted to the much more restrictive financial conditions in place,

reflected in both higher interest rates and risk premia, and in the lesser availability of credit. Further, the reduction in the price of financial and real estate assets generated a significant negative wealth effect which, along with the fall in confidence (which prompted a deferral of consumption and investment decisions), entailed a clear slowdown in aggregate demand during the year. The emerging countries, however, continued to post high growth rates, which sustained to some extent the external demand of the advanced economies and curbed the intensity of the adjustment of activity to the new macroeconomic scenario.

The persistence and spread of the financial problems meant that towards the end of the summer the world economy was already showing unequivocal signs of intense and widespread weakness

Towards the autumn, however, the persistence and worsening of the financial problems meant that the world economy was already showing unequivocal signs of intense and widespread weakness, across both industries and regions. These signs were most patent in the marked deterioration in the global trade indicators. The relative resilience which, to differing degrees, the emerging economies had shown came to an end, and most – including China – underwent a sharp deceleration, though they still maintained positive growth rates. The correction was also evident in the financial indicators, and the economic outlook turned markedly gloomy. Some of the emerging countries with greater vulnerabilities went into crisis, requiring the activation of multilateral resolution mechanisms.

There was also a drastic turnaround in inflation during the year

Inflation also underwent a significant turnaround during the year. Until the summer, as a result of the notable increases in oil, food and other non-energy commodity prices, very high figures were recorded. However, as the growing weakness of the world economy reduced the demand for oil and commodities, their prices moved sharply downwards and affected both actual inflation rates and inflation expectations, which fell notably.

The euro area was intensely affected by global developments and the decline in external demand

Despite a relatively favourable starting situation, the euro area did not remain immune to global developments and to the decline in external demand. Although the real effects of the financial turmoil were perceived with some delay, they were quite clear in the second half of the year. As a result, 2008 ended with the euro area economy in deep recession, with the level of GDP in Q4 1.5% down on the same period a year earlier. Inflation, which was running at around 4% in mid-2008, slowed markedly in the closing months of the year and early 2009, owing largely to the fall in commodity prices but also to the notable weakening of domestic demand. The sharp change in outlook after the summer dispelled all fears that had arisen in the previous months over inflation expectations becoming unanchored, in a setting in which inflation had posted rates unknown since the start of EMU and in which wage demands, after several years of containment, had risen owing to labour market tightness.

During the year central banks modified the stance and operational framework of their monetary policies to adapt them to the change in global scenario

During the year central banks progressively adapted their monetary policy stance to the changing global scenario, which became increasingly complex. The heterogeneity of monetary policy responses in the first half of 2008 was the outcome of discrepancies in the cyclical position and outlook of each economy, and of structural differences in transmission mechanisms. These factors meant that differing assessments were made of the balance of risks to attaining objectives. The Federal Reserve continued during these months on the road on which it had embarked on 2007, aggressively cutting interest rates, while many of the emerging economies tightened their monetary policy. In the euro area, the ECB Governing Council faced a particularly complex situation in which some change in the dynamism of demand was discernible, but with the indicators of capacity utilisation not falling back and with wages growing at a very high rate. Accordingly, the ECB decided in July to raise its key rate by 0.25 pp, with the aim of preventing the risks identified to the goal of maintaining price stability in the medium term from materialising.

The change in economic outlook further to the worsening of the financial crisis in September made for greater uniformity in monetary policy responses

The radical change in economic outlook following the intensification and globalisation of the financial crisis in September tended to make for uniformity in the direction of monetary policy responses. With inflationary risks dispelled from the policy-relevant horizon, central banks coincided in giving priority to preventing the process of disinflation into which developed economies were moving from translating into inflation rates persistently below target, or in some areas into deflation. This was against a background in which the sharp contraction of aggregate demand and the marked deterioration in economic prospects threatened to feed back into the financial crisis. In a practically unprecedented and concerted move, the central banks of the main world economies cut interest rates by 50 bp in early October, and followed this up with fresh cuts in the final months of 2008 and in early 2009. In the case of the euro area, the total reduction in interest rates amounted to 325 bp, placing the main refinancing operations rate at 1% in May 2009, a level not seen since the start of EMU. These reductions saw, in several cases, the room for manoeuvre available under conventional monetary policy measures exhausted. And in a setting in which distortions in significant segments of the transmission mechanism persisted, this led to a shift in emphasis towards broadening the range of measures aimed at reinforcing the pass-through of the cut in interest rates to agents' financial costs and to making agents' access to financing easier, through the expansion of the central bank balance sheet or the change in the composition of its assets.

Liquidity provision by central banks reached extraordinary volumes

Central bank liquidity provision policies have also become exceptionally prominent since the outbreak of the financial tension in August 2007. The unfolding of the crisis during 2008 – whose effects, once again, were felt with particular virulence on the interbank markets, which ceased to function as efficient liquidity distribution mechanisms – posed major challenges to which the central banks responded in an innovative fashion, increasing the supply of liquidity in order to meet the system's gross needs directly. On the basis of the respective operational frameworks in place, innovations entailed an increase in the number of institutions with access to central bank financing, the broadening of the range of acceptable collateral for monetary policy operations and the lengthening of the terms at which liquidity was supplied to the market.

Governments, too, responded forcefully to the intensification of the financial crisis

Governments also responded forcefully to the intensification of the financial crisis. In the first half of the year, measures had focused on the selective bail-out of ailing systemic banks, supplementing the actions of central banks to prevent liquidity problems in the banking sector from becoming solvency problems. However, the risks of financial collapse and the increasingly evident and heightened prospect of global recession led from September to the widespread approval of plans to support the financial sector and to boost aggregate demand via fiscal stimulus. The breadth of the measures adopted and the volume of resources mobilised were on an unprecedented scale, although they evidenced a wide variety of approaches derived from differences in starting positions and in the various ways in which real and financial tensions were manifest. Box 1.1 sets out in a detailed though summarised fashion the main economic policy guidelines adopted to combat the crisis in the main regions.

2.3 OUTLOOK AND CHALLENGES

The envisaged horizon for 2009 points to a contraction of the world economy, with a deep-seated recession in the developed economies

The economic outlook for 2009 points to a contraction of the world economy and a deep-seated recession in the developed economies, in a setting in which the downside risks remain considerable. The latest IMF forecasts suggest world growth in 2009 will fall in annual average terms to a slightly negative rate, a situation not seen since the Second World War, and that this rate will be very negative in the case of the developed economies, including the euro area. It is likely in the developed world that the rate of inflation, reflecting cheaper commodities, will fall back to very moderate or even negative levels during the year and that the unfavourable economic situation will translate into downside risks to inflation and, in those cases in which medium-term expectations are insufficiently anchored, to the emergence of deflation risks. The

Since the onset of the global financial crisis in the summer of 2007, major economic policy interventions have been necessary. At first, efforts focused on alleviating the liquidity problems facing the financial system and on bailing out institutions whose collapse could signify systemic risk. Nevertheless, the rapid deterioration of the financial situation and its impact on economic activity as from September 2008 led to a redoubling of economic policy responses. The governments of the main economies approved ambitious financial support programmes and discretionary fiscal packages, and central banks deployed broader measures. Refuelling and heightening the problems were the uncertainty over the volume and distribution of the high losses expected on banks' balance sheets, the restrictions on funding markets and the spread and intensification of the economic slowdown. This situation, which is not yet over, has required successive and ever-greater public intervention measures worldwide. In turn, the high degree of interconnectedness of the world's economies, and the global nature of the crisis, were conducive to a certain degree of international coordination, especially in the financial sphere.

The monetary authorities, who met the high demand for short-term funding from mid-2007, continued to extend their liquidity provision mechanisms in 2008 and, in some cases, to cut interest rates. But the events of September 2008 triggered a ratcheting up of the monetary policy response: central banks made substantial interest rate cuts and took unprecedented concerted measures (relating to rate cuts and to the extension of foreign currency funding agreements), they increased the flexibility of the ordinary framework for liquidity provision and they started to use non-conventional tools. Thus, many central banks introduced specific facilities for the purchase and exchange of assets, with a broad range of objectives: to provide institutions with quality collateral, to bolster financial markets facing difficulties and to encourage the flow of credit to certain sectors. All these operations led to substantial growth in central bank balance sheets (see Panels 1 and 2).

In light of the serious refinancing and recapitalisation problems emerging in the banking system from October 2008, governments designed a rapid-response strategy to support the financial system under a framework of common principles agreed by the Heads of State and of Governments in the case of the EU, and, on a global scale, within the G20. The key aim behind these plans was to restore confidence. Accordingly, the limits on deposit guarantee systems were raised, to halt the threat of declining confidence among deposit-holders, and bank debt issues were backed by State guarantees, to safeguard financial institutions' funding (with public funds also provided through loans and purchases of high-quality assets). Moreover, to shore up their balance sheets, in various countries banks received injections of public capital (to the extent that some banks were effectively nationalised), whilst in others the authorities purchased low-quality assets from the banks. In addition to raising the creditworthiness of the institutions concerned, these asset purchases should help limit the uncertainty surrounding their value which has been a key aspect of the present crisis. Indeed, more recently a second raft of measures has included various asset protection schemes for financial institutions.

Against the backdrop of these support programmes – which remain in force – bail-outs of institutions that might signify systemic risk have continued, especially in the United States and in Europe. Work has also continued on the reform of the global financial system, fostered at the international level by the Financial Stability Forum and the G20, and within the EU by the ECOFIN.

The financial support packages have been particularly significant in the developed countries (see Panel 3). In terms of maximum allocations, the funds earmarked for capital injections represent more than 5% of GDP in the United States, and approximately 3% of GDP in the euro area, with a higher relative weight – 4%-6% of GDP – in some of the smaller European countries (for example, Austria, Belgium, Ireland and the Netherlands). The highest bank debt guarantees are to be found in the United Kingdom, the United States, the Netherlands and Switzerland, in all cases in excess of 30% of GDP, and in Ireland, where the exceptional circumstances seen in September 2008 obliged the government to guarantee the liabilities of the country's six largest banks, signifying more than 200% of GDP. The measures involving the purchase and exchange of assets and direct financing represent more than 10% of GDP in the United Kingdom and in France, in the latter via a new, partly State-held agency funded by means of State-backed issues. In Spain, the urgent economic and fiscal measures approved in October 2008 envisage a maximum allocation of approximately 5% of GDP for purchase of high-quality assets on financial institutions' balance sheets and guarantees for debt issues equivalent to 9% of GDP.

The spread and intensification of the crisis also warranted the adoption of a wide range of discretionary economic stimulus policies, especially measures to increase public expenditure and, in particular, public investment. In addition, most countries launched aid packages for the groups and sectors hardest hit by the crisis, including small and medium-sized enterprises, the construction and automobile industries, and the export industry in the case of the emerging economies. Overall, the IMF estimates that fiscal stimulus measures in the biggest economies will amount to more than 4% of GDP between 2008 and 2010¹, albeit with significant differences from country to country. The stimulus packages announced in the United States since February 2008 and the more recent initiatives launched in Japan are noteworthy, each at a cost of approximately 5% of GDP up to 2010. In China, where the economy is more shielded from the direct impact of the financial turmoil but more exposed to the decline in world trade, additional expenditure of approximately 6% of GDP has been earmarked in the period 2009-2010. In the EU, fiscal incentives were established in the European Economic Recovery Plan approved in December 2008, with an overall impact of 1.5% of GDP. In the euro area, discretionary measures amount to 2% of GDP in the period 2008-2010, with lower figures for France and Italy and higher figures (more than 3% of GDP) for Spain and Germany. Lastly the emerging G20 economies have also made significant fiscal efforts, on a similar scale to those of the developed countries.

1. See "Update on fiscal stimulus and financial sector measures", April 2009.

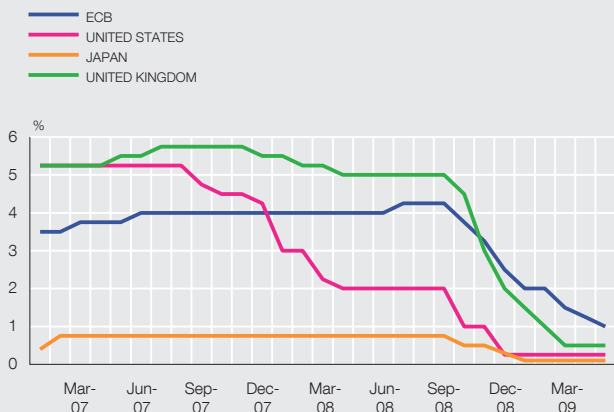
A simulation exercise² shows that these measures would have an impact of 0.3 pp – 0.5 pp on GDP growth in the euro area, with a slightly higher impact in Spain. In the United States the impact would be much higher (around 2 pp). In any case, the effect of the discretionary measures should be assessed jointly with the fiscal impulse deriving from the automatic stabilisers, which is higher in the European economies owing to the greater progressivity of their tax systems and the size of their social protection systems.

The present economic and financial crisis poses a challenge to economic authorities worldwide. In 2008, unprecedented changes were made in economic policy conduct to halt the dramatic deterioration in the financial system and in economic activity. How effective these policies prove will hinge largely on their impact on agents' confidence and on the financial system, and on maintaining

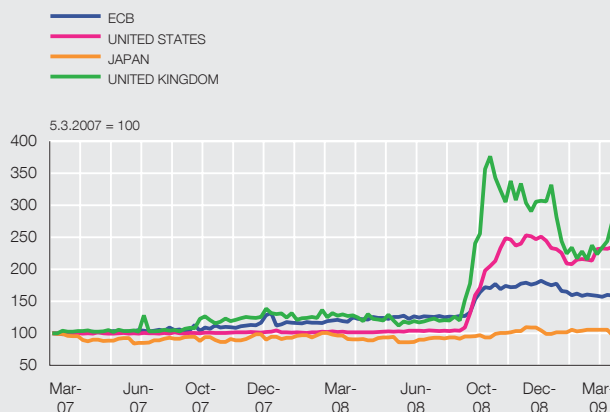
a certain degree of concerted action worldwide. Moreover, although many of the measures are temporary and, in the case of those directed at the financial sector, the sums provided are still short of the total funds committed and are, in many cases, return-bearing investments, they will have a considerable impact on public finances, particularly in the developed countries. Accordingly, continued confidence in budgetary stability in the medium term will be essential, to minimise the risk that higher interest rates and prospective tax increases may detract from the efficiency of the economic expansion measures.

2. Using the NIGEM global econometric model to make comparable simulations between countries, considering only the measures taken as from November 2008.

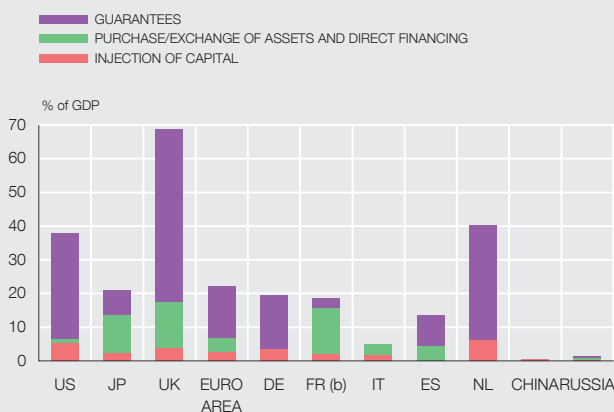
1 OFFICIAL INTEREST RATES



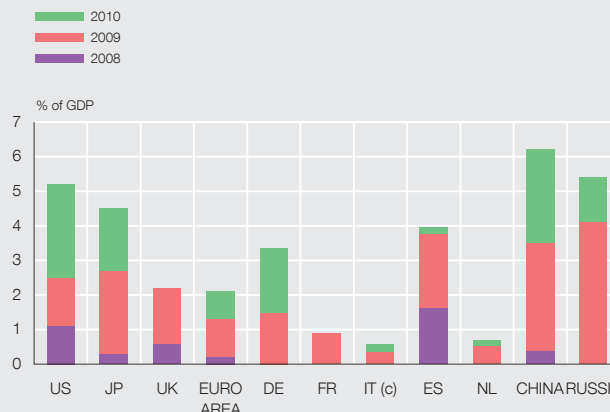
2 CENTRAL BANK BALANCE SHEETS



3 GOVERNMENT MEASURES TO SUPPORT THE FINANCIAL SYSTEM (a)



4 DISCRETIONARY FISCAL STIMULUS MEASURES



SOURCES: ECB, Datastream, IMF and Banco de España.

a. Maximum amounts committed in plan announcements and in rescue action.
 b. A partly State-held agency (SFEF) was set up, the issues of which are guaranteed by the State and which lends to banks. In France the guarantees exclude those provided for Dexia.
 c. The budgetary impact in Italy will be significantly lower because it is financed via taxes.

forecasts available also point to a central scenario in which activity would begin to recover gradually towards late 2009 or in 2010, according to the region involved, assisted by the resolute monetary and fiscal policy action and the financial sector support measures, and, in some economies, by the restoring to health of the starting position. However, the current economic situation is the outcome of intense and global shocks, of a financial origin, that have exposed serious vulnerabilities in the balance sheets of financial institutions, companies and, in some cases, households, the absorption of which may prove slower than these central scenarios currently envisage.

The effectiveness of economic policy responses will determine the prospects of recovery

In any event, the prospects of recovery hinge enormously on the effectiveness of the responses adopted by governments and central banks. The exceptional measures urgently applied in all economic policy areas have been intended to resolve the most pressing challenges of the financial crisis and to prevent the deterioration in activity from feeding back into the crisis. The fact that these policies are moving into uncharted territory means the significant uncertainty over their ultimate effectiveness has not abated.

Correctly calibrating public intervention is exceptionally complicated...

Gauging public intervention correctly is essential, but its calibration and its necessary insertion in a medium-term outlook that recognises the exceptionality of the circumstances and envisages a path of return to a situation of greater normality both prove exceptionally complicated. In terms of government financial sector support measures and fiscal policies, the need for action that helps resolve the still-latent uncertainty over the long-term solvency of financial institutions and to appropriately stimulate aggregate demand may clash at some point with the need to ensure the sustainability of public finances in the medium term. The solvency problems in some segments of the financial sector must not feed through and become a problem in the form of a build-up in risks in the public sector that ultimately raises long-term interest rates. In the euro area, this is a relevant concern in some cases in light of the developments in sovereign spreads. Also, the global nature of the shocks affecting the economy require cross-country cooperation and some coordination – particularly at EU level – not only in the responses to the crisis, but also in exit strategies once normality begins to return to the economy.

... but it is crucial for intervention not to distort competition...

To properly bound the perimeter of public intervention is another difficult task. Support measures to certain financial sector segments, and fiscal support in some cases to specific economic sectors particularly afflicted by the crisis, pose the problem of their potential effect on the areas that remain outside the realm of public intervention. For example, guarantees extended to debt issued by certain banks have had the desired effect of reducing the risk of such banks, but in turn they have a bearing on the financing of other banks and non-financial corporations, which see their borrowing costs rise. Further, public injections of capital and the extension of backing to the financial systems of some countries expose the financial systems of those others (e.g. the emerging economies) that have less leeway as regards the credibility of their public finances. On designing measures in the various economic policy areas, it is vital to try and avoid unwanted collateral effects, in particular on competition.

... and for governments not to succumb to the temptations of protectionism

Above all, it is vital not to succumb to the temptations of protectionism. The financial sector support programmes are of a national scope and designed with the aim of restoring the flow of credit to national agents. This poses a whole series of challenges for financial market integration – in Europe in particular – and the future of international banking, as is the case of countries with a banking system comprising subsidiaries and branches of foreign parents. Likewise, there are incentives for national fiscal plans to prevent, in some cases with administrative measures, the leakage of fiscal impulses abroad and to protect certain economic sectors from international competition. This is an extraordinarily complex matter. But history has taught us that protectionist measures are a sure-fire recipe for disaster. Here, too, some coor-

dination of responses both at the international level and, in particular, at the level of the EU is needed, owing to the potential consequences for the single market.

Beyond the most immediate challenges, it is vital to tackle the appropriate reforms in the area of macrofinancial policies

It now seems clear that the prolonged period of stable and non-inflationary growth in the global economy in recent years led important lessons from the past to be forgotten. The financial crisis that began in the summer of 2007 and the deep-seated economic recession it has entailed are a powerful reminder of the enormous costs that financial instability inflicts on society and of the fact that the vulnerabilities that lead to this arise precisely in boom periods, characterised by excessive optimism. As well as boldly facing up to the most immediate challenges, it is vital that the pertinent reforms in the area of macrofinancial policies should be tackled in parallel with the dual aim of restoring confidence and rebuilding sounder foundations with which to underpin the recovery. Appropriate regulation and supervision are the first and main line of defence against financial instability, as has been particularly stressed in the agreements reached at the G20 meeting on 2 April in London. Regulation and supervision need to be reinforced with a view to limiting the intrinsic procyclicality of the financial system and to increasing resilience in the face of systemic risks, while preserving the benefits of innovation. Reforms in this area should most particularly include the extension of the regulation perimeter to systemic institutions that have been left outside the regulatory framework, and the review of the incentives for financial institutions and investors. But recent experience also casts greater light on the link between financial stability and macroeconomic policies – particularly monetary policy – and strengthens the argument that such policies should act pre-emptively in the face of medium- and long-term risks associated with the emergence of imbalances, frequently connected to excessive debt and to unsustainable asset price dynamics.

3 Developments in the Spanish economy in an international context of crisis

3.1 THE EXTERNAL DETERMINANTS OF THE ADJUSTMENT OF THE SPANISH ECONOMY

The international financial crisis, which superimposed itself on the adjustment that the Spanish economy had begun, ...

Developments in the Spanish economy during 2008 were governed by the worsening of the international financial crisis and the progressive weakening of the world economy. Both shocks superimposed themselves on the domestic adjustment that had begun previously, driven by the correction of the real estate sector and the high level of private-sector debt, and both have ultimately taken a leading role in the unfolding of the crisis. Although the channels through which the financial and real crisis spread were similar to those described in the previous section at the international level (tightening of financing conditions, crisis of confidence, fall in wealth, decline in trade flows), the pass-through to the Spanish economy of the shocks evidenced specific differences. In its initial stages, the virtually non-existent direct and indirect exposure of Spanish credit institutions to US subprime mortgages, along with Spanish banks' favourable financial situation, lessened the impact of the shocks on their balance sheet position. Also contributing to this was the long average life of outstanding debt, which meant that short-term funding requirements were moderate. However, the clogging up of wholesale funding markets increasingly affected Spanish intermediaries owing to their high dependence on external saving, and they had to react by replacing long-term securities issues with short-term instruments and by raising funds on interbank markets, including resort to the Eurosystem.

led to a tightening of financing conditions, ...

The resort to these temporary solutions in the face of the closure of wholesale markets was limited. In turn, the growing feedback loop between the financial tensions and the weakness of the real economy gave rise to further impacts on banks, the effects of which were much more difficult to avoid. In particular, perception of the risk associated with credit operations increased substantially, in a setting in which default ratios, which had started from very low levels, were growing rapidly. Indeed, in the other resident sectors segment (households, companies and financial institutions other than those of the credit system) this ratio stood at 3.4% at the end of 2008, compared with 0.9% one year earlier. In step with the habitual procyclical behaviour of credit supply, intermediaries progressively tightened credit standards in light of the deterioration in the macroeconomic outlook in general and in the outlook for certain indus-

		2003	2004	2005	2006	2007	2008
DEMAND AND OUTPUT (b)	GDP	3.1	3.3	3.6	3.9	3.7	1.2
	Private consumption	2.9	4.2	4.2	3.9	3.5	0.1
	Government consumption	4.8	6.3	5.5	4.6	4.9	5.3
	Gross capital formation	5.2	5.2	6.5	7.7	5.0	-2.8
	Equipment investment	4.1	5.1	9.2	10.2	10.0	-1.1
	Construction investment	6.2	5.4	6.1	5.9	3.8	-5.3
	<i>Housing</i>	9.3	5.9	6.1	6.0	3.8	-10.9
	<i>Other construction</i>	3.5	5.0	6.2	5.7	3.9	0.9
	Exports of goods and services	3.7	4.2	2.5	6.7	4.9	0.7
	Imports of goods and services	6.2	9.6	7.7	10.3	6.2	-2.5
EMPLOYMENT, WAGES, COSTS AND PRICES (c)	Total employment	2.4	2.7	3.2	3.2	2.9	-0.6
	Employed labour force (d)	60.8	62.0	64.3	65.7	66.6	65.3
	Unemployment rate	11.5	11.0	9.2	8.5	8.3	11.3
	Compensation per employee	3.6	3.0	3.7	3.9	3.7	5.3
	Unit labour costs	2.9	2.4	3.3	3.2	2.9	3.4
	GDP deflator	4.1	4.0	4.3	4.0	3.2	3.0
	Consumer price index (12-month % change)	2.6	3.2	3.7	2.7	4.2	1.4
	Consumer price index (annual average)	3.0	3.0	3.4	3.5	2.8	4.1
	Consumer price differential with the euro area (HICP)	1.0	0.9	1.2	1.4	0.7	0.9
SAVING, INVESTMENT AND FINANCIAL BALANCE (e)	Resident sectors: saving (f)	24.5	23.5	22.9	22.6	21.6	20.5
	<i>General government</i> (f)	3.3	3.1	4.5	5.7	6.1	0.1
	Resident sectors: investment	27.4	28.3	29.5	31.0	31.2	29.6
	<i>General government</i>	3.5	3.4	3.6	3.6	3.9	3.9
	Resident sectors: domestic net lending (+) or net borrowing (-)	-2.9	-4.8	-6.5	-8.4	-9.7	-9.1
	<i>General government</i>	-0.2	-0.4	1.0	2.0	2.2	-3.8
	General government gross debt	48.7	46.2	43.0	39.6	36.2	39.5
MONETARY AND FINANCIAL INDICATORS (g)	ECB main refinancing rate	2.3	2.0	2.0	2.8	3.9	3.9
	Ten-year government bond yield	4.1	4.1	3.4	3.8	4.3	4.4
	Synthetic bank lending rate	4.4	4.0	3.8	4.6	5.7	6.2
	Madrid Stock Exchange General Index (DEC 1985 = 100)	706.4	863.3	1,066.1	1,344.0	1,637.0	1,263.1
	Dollar/euro exchange rate	1.1	1.2	1.2	1.3	1.4	1.5
	Nominal effective exchange rate vis-à-vis developed countries (h)	100.0	100.7	100.8	101.1	102.3	104.1
	Real effective exchange rate vis-à-vis developed countries (i)	104.2	106.7	109.1	111.8	114.4	117.2
	Real effective exchange rate vis-à-vis the euro area (i)	103.7	105.4	107.7	110.3	111.6	112.1
	Cash and cash equivalents	12.0	11.3	14.4	11.5	-2.9	-3.2
	Liquid assets (j)	8.8	5.8	11.2	8.2	8.9	11.0
	Households: total financing	19.1	20.2	20.9	19.6	12.5	4.4
	Non-financial corporations: total financing	13.4	13.2	21.4	27.9	17.7	7.3

SOURCES: INE, Intervención General del Estado, AMECO and Banco de España.

a. The National Accounts data are calculated on the basis of base year 2000.

b. Volume indices. Rates of change.

c. Rates of change, except the unemployment rate, which is presented as a level.

d. Employed labour force (16-64).

e. Levels as percentages of GDP.

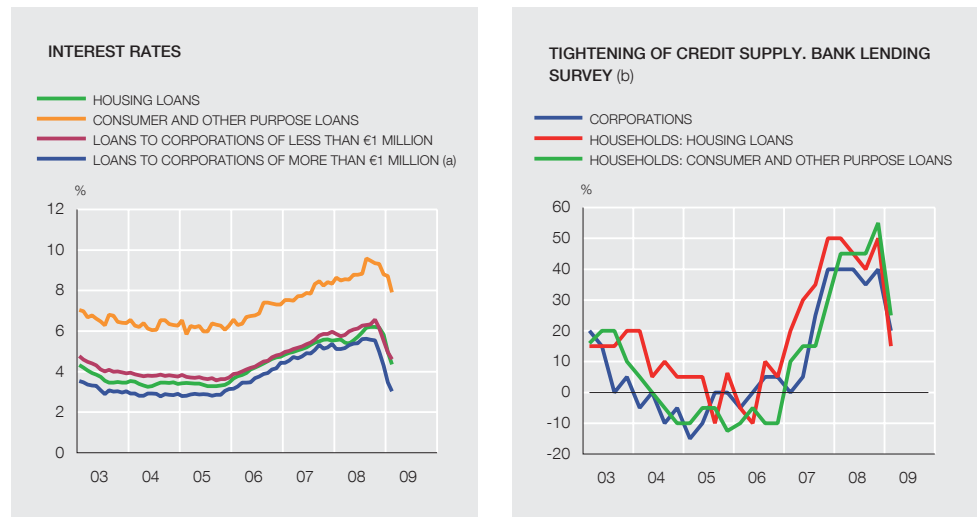
f. Includes net capital transfers received.

g. Annual average levels for the Stock Exchange General Index, interest rates and exchange rates, and rates of change for financial assets and liabilities.

h. 1999 Q1 = 100.

i. 1999 Q1 = 100.

j. Includes cash equivalents, other bank liabilities and money-market funds.



SOURCE: Banco de España.

a. The interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of these expenses.
 b. Indicator = % of institutions that signal a considerable tightening × 1 + % of institutions that signal some tightening × ½ - % of institutions that signal some easing × ½ - % of institutions that signal a considerable easing × 1.

tries (such as the real estate sector) in particular. Also contributing to this were market demands concerning the capital ratios required of banks and the greater difficulties in obtaining funds on international markets, although according to what may be inferred from the replies to the Bank Lending Survey, these last two factors played a less significant role.

The tightening of financing conditions also operated through the dearer cost of funds, since the notable increase in interbank rates fed through to lending interest rates (see Chart 1.3). Further, in some cases (as, in particular, in lending to SMEs and to households for purposes other than house purchase), the spreads over interbank yields widened. The cost of companies' own funds also increased. The remaining credit conditions other than price also became more rigorous. The average term of transactions shortened and the guarantees required increased. However, in the second half of the year, the significant cuts in intervention rates began to feed through to the costs of private-sector financing, a trend which became more pronounced during the opening months of 2009.

... a deterioration in agents' confidence

The financial crisis and its impact on the real economy have also given rise to a progressive and generalised deterioration in agents' confidence and a notable increase in uncertainty over the economic outlook. While this is a global phenomenon, it was initially somewhat more acute in countries such as Spain, whose business cycle is more closely linked to the real estate sector and is more dependent on external financing. The confidence crisis and uncertainty contributed to discouraging spending by agents beyond what might be warranted by the domestic adjustment or the rebalancing of private-sector balance sheet positions. Generally, the loss in confidence has proven one of the facets of the crisis that is posing the biggest challenges to economic policy.

... a decline in household wealth, prompting a slowdown in credit and a fall-off in domestic demand,...

The international financial crisis has unfavourably impacted Spanish household wealth. The value of financial assets fell by around 12%, essentially as a result of the decline in stock market prices.

As regards the real estate component, although the indicators habitually used to measure it showed that it scarcely altered in 2008 in nominal terms, since the decline in property prices (3.2%, on data from the Spanish Ministry of Housing) was more or less offset by a similar increase in the stock of housing, it is very likely that these figures underestimate the decline during this period. Set against low activity in the real estate market, the stock of housing held by households may have grown less than what the information on housing starts infers, while under the current conditions the statistic published by the Ministry of Housing foreseeably reflects with some delay the actual course of changes in valuations. Under these circumstances, the INE price indicator on second-hand housing, which shows a decline of 10.7% over the past year, may be more representative. Considering both factors, the loss in real estate wealth recorded last year might be somewhat more than 8%.

Overall, the declines in the value of the household financial position generated a wealth effect that contributed to the contraction in consumption and in investment in housing. The increase in borrowing costs and the deterioration in expectations of future income and of appreciation of real estate and financial assets checked corporate and household demand for borrowed funds. This development, along with the decline in the supply of funds, translated into a strong slowdown in credit to these sectors, with the year-on-year growth rate falling from 16% to somewhat less than 6%. However, this figure was still above the nominal increase in GDP at the close of the year. In 2009 to date, the pace of bank financing has continued to moderate, reaching a year-on-year rate of expansion of around 3% in April, according to the figures released as this Report was going to press.

... and the disappearance of the external supports which, under other circumstances, would have cushioned the decline in domestic spending

As is occurring in most countries, one propagation channel which has been increasing in significance as the financial crisis has become more pronounced and as its effects pass through to activity is the one through which trade flows run. In this respect, the progressive weakening in world economic activity over the course of 2008 affected the foreign demand for Spanish products, more sharply so as the year unfolded, although the high import content of exports and of the other components of final demand softened this effect on growth.

In sum, the scale and persistence of the global financial crisis and its impact on the world economy have radically transformed the environment in which households and firms make and commit their spending plans. Compared with the previous long expansionary phase, lending standards tightened notably, sizeable declines in private-sector wealth built up, there was a considerable weakening in the external environment, and all this against a backdrop of diminished confidence and growing uncertainty. The combination of all these factors on an economy which had already initiated a process of adjustment, in response to the imbalances that had built up, intensified the ongoing weakening in activity and activated the aforementioned feedback loops between the financial and real sectors.

3.2 FROM ADJUSTMENT TO RECESSION

These contractionary forces compounded the severity of the adjustment and led to a recession in the second half of 2008 ...

The Spanish economy showed an ongoing loss in momentum which became accentuated in the second half of the year, when GDP posted a decline in its quarter-on-quarter growth rate for two consecutive quarters (for the first time since 1993), as a result of which it ended the year with a fall of 0.7% in terms of its year-on-year rate. This recessionary pattern became more visible in 2009 Q1, with a year-on-year decline of 3% in GDP according to the data released as this Report was going to press. The information available for Q2 points to a contraction in activity, albeit at a less sharp rate.

In 2007, activity in the Spanish economy began to slow, leading to negative year-on-year rates of expansion in output being recorded from 2008 Q4. This box compares the current recession in Spain with that occurring in other economic regions and with other similar episodes in the Spanish economy in the period from 1970 to the present day.

The identification of business cycles is not exempt from ambiguity, and several alternative methods can be used. For the identification of recessionary cycles, this box uses a procedure based on deviations by GDP in respect of its trend. The periods in which the positive deviation attains its highest value are the cyclical peaks (which do not necessarily match the moment in the cycle in which the year-on-year rate reaches its highest value). Under this procedure, the peak of the current cycle was in 2008 Q1, both in Spain and in the euro area and in the United States, which gives some idea of the high cyclical synchrony between the three economies.¹ Chart 1 depicts the year-on-year growth rates for GDP in the quarters subsequent to the peak in Spain, the euro area and the United States, where the figures observed have been lengthened in the first case with the projections path plotted by the Banco de España for its March 2009 *Spanish economic projections report*, and, in the remaining two cases, with the *Consensus Forecasts* projections for the same month. According to these projections, the trough for the year-on-year rate is expected to be reached in 2009 Q2 in the euro area and in the United States, and in Q3 in Spain. Thus, according to the *Projections Report*, six quarters would pass by from the peak of the current cycle to the minimum year-on-year growth rate. Given that the year-on-year rates reflect with something of a lag the changes in the quarter-on-quarter rates, the troughs in terms of the latter would be reached somewhat earlier. Furthermore, the recovery of the Spanish economy is expected to be less intense, particularly when compared with the United States.

In addition to the current recessionary cycle, the Spanish economy has recorded two others since 1970 whose previous peaks are dated in 1974 Q1 and in 1991 Q4 (see Chart 2). As can be seen, the trough of the year-on-year growth rates in the two previous recessionary cycles was reached, as is projected for the current cycle, six quarters after the peak, i.e. in 1975 Q3 and in 1993 Q2, respec-

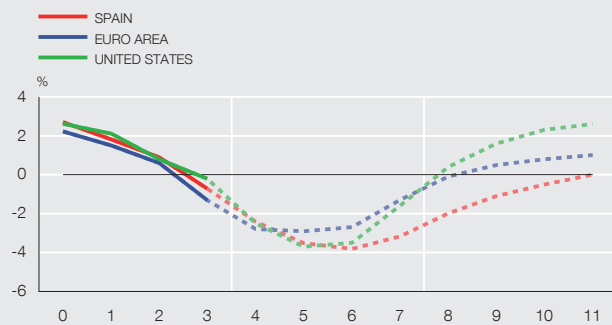
tively. Among the three episodes considered, that most distant in time was characterised by GDP growth rates that were substantially higher throughout the deceleration phase, meaning that GDP scarcely contracted.

Compared with the recession in the 1990s, the current recession departs from a year-on-year growth rate that is similar in respect of the cyclical peak. However, in the three subsequent quarters for which there are figures, the slowdown has been more pronounced in the current episode, with this difference set to intensify – according to the Banco de España projections – in the coming quarters, meaning the trough would be lower and the subsequent recovery milder. All the components of private national demand help explain the greater intensity of the slowdown in output in the current cycle in the three quarters observed since the peak. Nonetheless, mention may be made of the more unfavourable behaviour of private consumption, and especially of residential investment, immersed in a far-reaching period of adjustment following its prolonged boom (see Chart 3). As a result, it is household – as opposed to business – spending that would account for a greater extent for the fact that the current recession is proving more severe. The worse behaviour of household spending compared with the previous cycle is closely related, among other factors, to the adverse impact of the greater intensity of job destruction on household incomes and on their future expectations (see Chart 4).

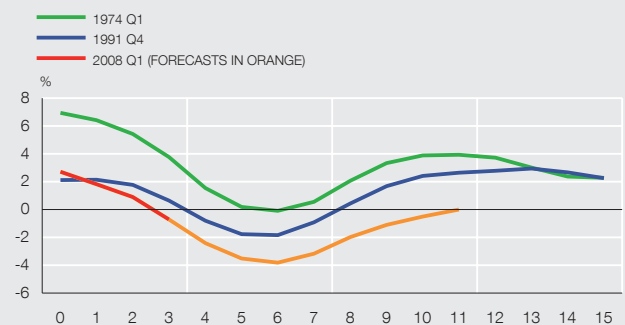
Following the initial, relative resilience of exports (see Charts 5 and 6), the current cycle is being characterised by a much more pronounced deterioration in this demand component, as a result of the strong fall-off in world trade. Thus, while between 1991 and 1993 the growth rate of Spain's export markets fell by 4 pp, the related decline between 2007 and 2009 is expected to be almost 15 pp. Further, in the previous cycle the contribution of exports in helping exit the recession was very high, owing to the gain in competitiveness arising from the devaluations of the peseta. On this occasion, since Spain's euro area membership will not allow for gains in competitiveness of a similar magnitude and speed, the pick-up in exports will have to reside on the recovery of our foreign markets and on containment of the growth of costs and margins. In any event, since imports, in step with the greater sluggishness of final demand, are slipping in the current cycle at notably higher rates than those previously observed, the external sector is making a considerably higher net contribution to sustaining activity.

1. In the United States, where cycles are officially dated, the start of the recession is set at December 2007.

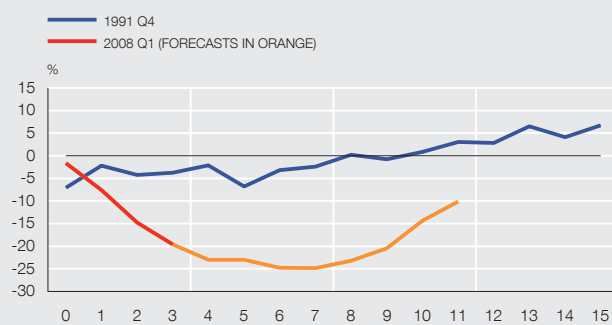
1 COMPARISON OF THE CURRENT CYCLE (PEAK 2008 Q1)
(Forecasts in broken line)



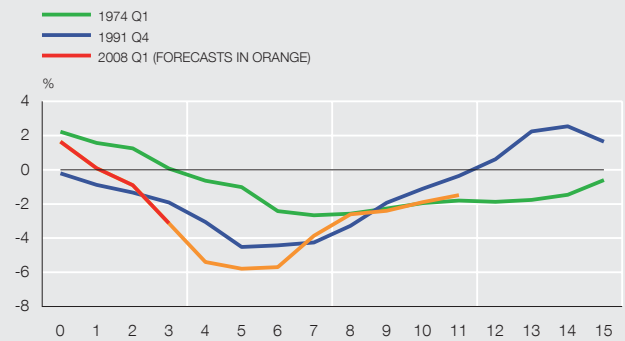
2 RECENT CYCLES IN SPAIN: GDP



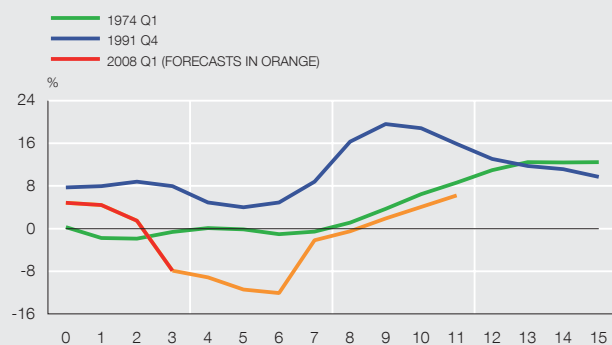
3 RECENT CYCLES IN SPAIN: RESIDENTIAL INVESTMENT



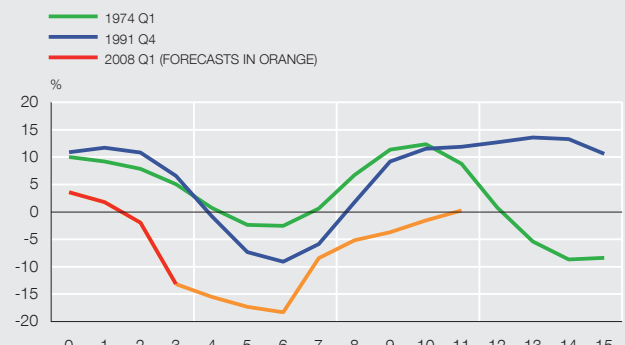
4 RECENT CYCLES IN SPAIN: EMPLOYMENT



5 RECENT CYCLES IN SPAIN: EXPORTS OF GOODS AND SERVICES



6 RECENT CYCLES IN SPAIN: IMPORTS OF GOODS AND SERVICES



SOURCES: INE, Consensus Forecasts and Banco de España.

... as a result of the weakening in national demand, since the contribution of external demand was positive

The average increase in output over the course of 2008 – which amounted to 1.2%, against 3.7% in 2007 – marked a path of rapid deceleration and a deepening of the change in the role played by national demand and net external demand in spending, initiated in the second half of 2006. In this respect, national demand contracted during the year, posting a 2.8% decline in its year-on-year rate in Q4, while net external demand showed a pronounced increase, with a contribution of 2.3 pp to GDP growth in the same quarter, thereby softening the contractionary effect of national demand on GDP. Significantly, set against the progressive weakening in the world economy, the improvement in the contribution of the external sector was due to the notable slowdown in imports.

The collapse in spending had very negative repercussions for activity and employment, which began to fall for the first time since 1994

Household spending underwent a very severe adjustment. The sharp check in consumption and the recovery in the saving ratio were a reflection of the strong deterioration in confidence

Residential investment fell markedly and the adjustment of housing prices and of the real estate sector became sharper

Households' net borrowing declined substantially and their debt ratio began to turn down as from October

Business investment collapsed in the closing months of the year...

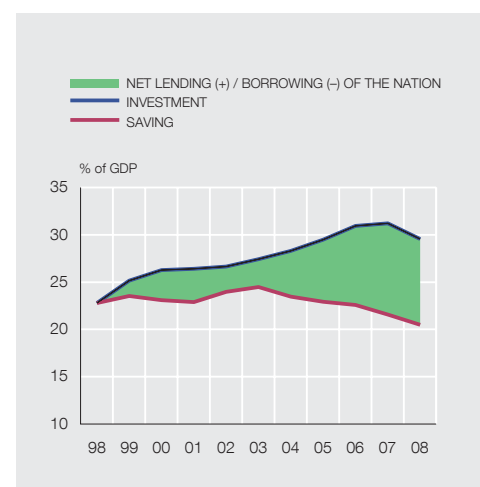
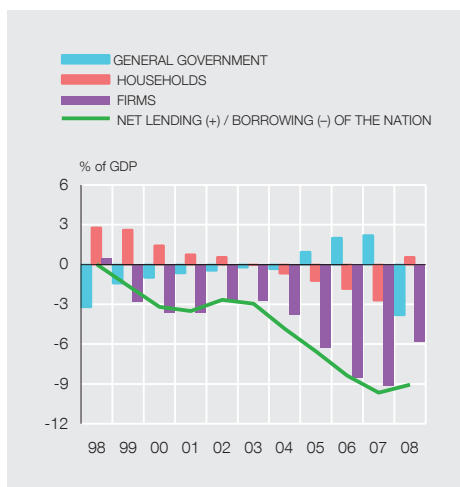
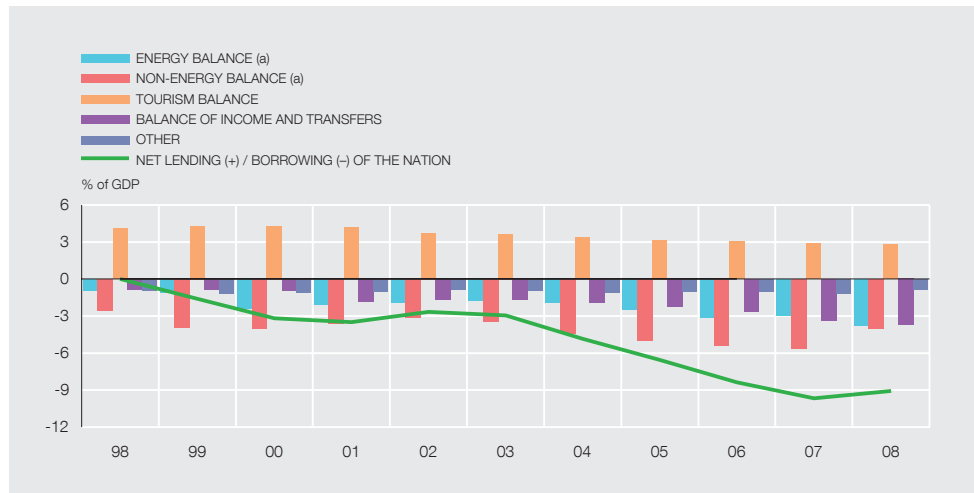
On the supply side, the collapse in activity bore most unfavourably on employment, which increased moderately in the first half of the year and fell in the second half (for the first time since 1994). This was as the process of job destruction in the construction industry stepped up and progressively spread to other productive branches, to the point of recording a 3% decline in Q4.

In response to these circumstances, household expenditure underwent a very severe adjustment. Affecting it were the aforementioned contractionary factors, compounded by a particularly determinant factor in the form of the decline in employment (Box 1.2 offers more detailed information on the differential nature of this cycle in Spain). Household consumption was abruptly curtailed during the year, as a result of which it was the domestic demand component that most contributed to the slowdown in GDP in 2008. And this despite the fact that household disposable income rose, reflecting the expansionary impact of the fiscal measures adopted, which are described elsewhere in this report, and the marked fall in inflation in the second half of the year. Conversely, the tightening of financing conditions and the worsening in the labour market tended to lessen the contribution of these sources of income, and the loss of value in wealth acted in the same direction. The deterioration in consumer confidence and work prospects played a key role in the weakening in household consumption, as corroborated by the sharp recovery in the saving ratio, which rose to 13% of disposable income, following five years of consecutive falls.

Residential investment showed a marked reduction, which gained in intensity over the course of the year, posting a decline of 20% in Q4. Real estate supply reacted sharply to the fall in residential demand, the expression of which was a substantial cut in the number of housing starts, which was 40% less on average than in 2007. Despite the intensity of this correction, the stock of unsold property continued to increase, since the houses started at the height of the expansion in the residential sector, around 2006, were progressively completed during the course of 2008. The surplus supply accumulated contributed to intensifying the slowing course of house prices, which began to fall in the second half of the year, after having increased strongly in prior years. That generated further expectations of declines and inhibited residential demand. Under these circumstances, the real estate sector embarked on a far-reaching restructuring process during 2008, contributing decisively to the collapse in activity and employment, which generated very powerful contractionary effects on the rest of the economy.

The rise in the saving ratio and the reduction in residential investment led to a strong decline in household net borrowing, meaning that over the year as a whole households generated net lending for an amount equivalent to 0.6% of GDP. The slowdown in household debt steepened in the wake of the tightening of bank lending conditions and began to be reflected in a slight reduction in the debt ratio, as from the final quarter. However, this did not translate into a decline in the associated interest burden, owing to the increase in the average cost of liabilities over the year as a whole.

Business investment was more resilient in the first half of the year, but collapsed in the final months owing to the unfavourable course of demand, the sharp deterioration in expectations and heightening financial tension. This latter factor is adversely affecting the financing conditions for new investment projects, as bank lending standards have tightened and there are difficulties in raising resources through this channel, especially following the events in financial markets in the last quarter. The decline in productive investment led to a sharp reduction in net borrowing. In step with this, borrowing by businesses slowed notably in 2008 across the board but particularly sharply in real estate services and con-



SOURCES: INE, Customs and Banco de España.

a. The energy balance and non-energy balance are estimates by the Banco de España drawing on Customs data.

... and the external sector contributed to sustaining activity...

As indicated, the external sector cushioned the adjustment of domestic demand, against a background in which the contribution of external demand contributed positively to sustaining activity with growing intensity over the year, despite the fall-off in exports.

... and the nation's net borrowing fell during 2008

Against this, a correction of the nation's net borrowing began in the second half of 2008, underpinned by the narrowing of the deficit on goods and services. The reduction in the trade imbalance was particularly sharp in the closing months of the year, when the decline in the non-energy balance steepened and the energy balance began to fall, reflecting the decline in oil prices initiated during the summer (see Chart 1.4). As a result, and on Balance of Payments data, the economy's net borrowing declined in 2008, for the first time since 2002, to a ratio of 7.9% of GDP in Q4, 1.5 pp down on the same period in 2007 (for the year as a whole, the decline was smaller, at 0.6 pp, to 9.1% of GDP). The correction in the nation's net borrowing

has become more marked in 2009 to date, evidencing the depth of the contraction in domestic demand.

From the viewpoint of saving and investment decisions, the improvements in net borrowing reveals a reduction in the weight of investment in GDP that is higher than that recorded by the saving ratio. From the standpoint of the sectors' net debt, the reason lay in the significant correction in the net borrowing of non-financial corporations and households, in the latter case reaching a surplus position for the first time since 2002. Conversely, there was a drastic change in the public sector surplus position of recent years; it moved from a situation of net lending of 2.2% of GDP in 2007 to net borrowing of 3.8% in 2008, a reversal of 6 pp of GDP in only one year. The significance and scope of this reversal will be discussed later.

The weakening in activity spread to all productive branches...

On the supply side, the weakening in activity fed through to all the productive branches, although particularly sharply to construction and industry, which both showed declines in value added, earlier and more acutely in the former case. Market services showed greater resilience in the first half of the year, but could not remain immune to the widespread climate of deterioration; accordingly, at the end of the year they were running at a positive but very moderate rate of increase. Indeed, only non-market services sustained levels of activity similar to previous years.

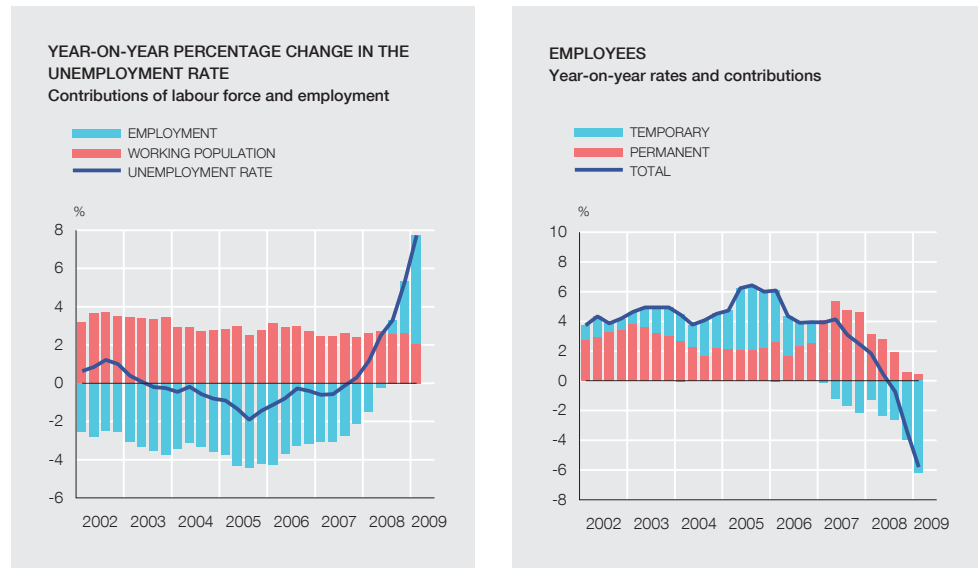
... and resulted in net job destruction as from the summer

As a result, the process of employment generation came to a halt after the summer (following 14 years of uninterrupted job creation), giving way to a marked decline in employment in the closing months which has run into the opening months of 2009 (employment, on EPA figures, fell at a year-on-year rate of 6.4% in 2009 Q1). Overall, the adjustment in employment was greater than that in value added, whereby apparent labour productivity recovered, once again showing a countercyclical pattern of behaviour, unlike the pattern prevailing in most economies. Yet this behaviour reflects significant composition effects and scant genuine gains in efficiency. By productive branch, the decline in employment in construction had already begun in 2007, while it started in the industrial branches in the second half of 2008. At the same time, employment weakened progressively in market services.

As had occurred in previous downturns, the adjustment in employment fell mainly on temporary workers (prompting a 3 pp decline in the ratio of temporary to total employees to 25.4% in 2009 Q1), the young and the least skilled. The labour market deterioration is thus one of the most powerful channels through which the contractionary impulses besetting the economy are spreading.

Despite the labour market deterioration, the labour supply continued increasing, meaning the unemployment rate climbed rapidly...

Despite the cyclical downturn, the labour supply continued increasing in 2008, at a similar rate of intensity to that observed during the boom years. Supply was driven by the increase in female participation, although the growth rate of the population began to slacken after a decade of continuous rises, since a significant slowdown was seen in the pace of migrant inflows. The far-reaching deterioration of the labour market, both in terms of speed of adjustment and of scale, against this background of dynamic working population growth, had a most adverse impact on unemployment. Consequently, the unemployment rate rose most significantly to a level of 17.4% in 2009 Q1, compared with the historical low of 8% in the summer of 2007 (see Chart 1.5). Joblessness affected above all the young and the less skilled, the unemployment rate for whom exceeded 20%. Long-term unemployment also began to rise in this period and, should it continue, it might ultimately affect the structural component of unemployment.



SOURCES: INE and Banco de España.

a. The EPA (Spanish Labour Force Survey) series are linked on the basis of the 2005 Q1 control survey.

... and labour costs rose significantly, showing scant sensitivity to the worse cyclical conditions

Despite the weakening in activity, labour costs showed considerable inertia. Wage settlements under collective bargaining agreements stood at 3.6%, 0.5 pp up on 2007, in response to the poorer performance of inflation in the first half of the year. This greater wage pressure was amplified by the effect of the wage indexation clauses, the activation of which in 2008 marked an increase of somewhat over 1 pp on collectively bargained wage rates. Both compensation per employee (5.3%) and unit labour costs (3.3%) showed growth higher than in previous years and above that of our trading partners.

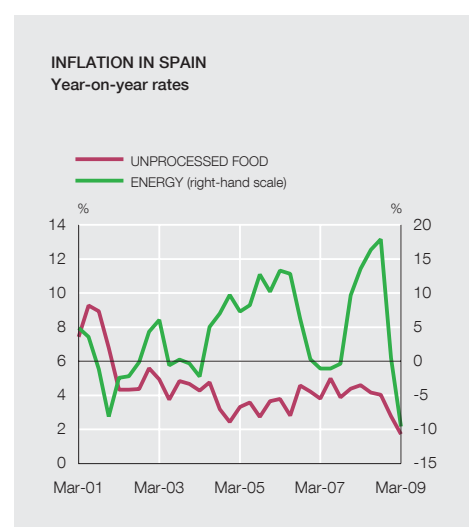
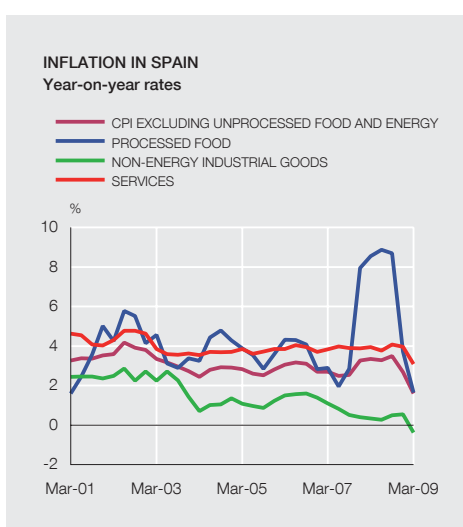
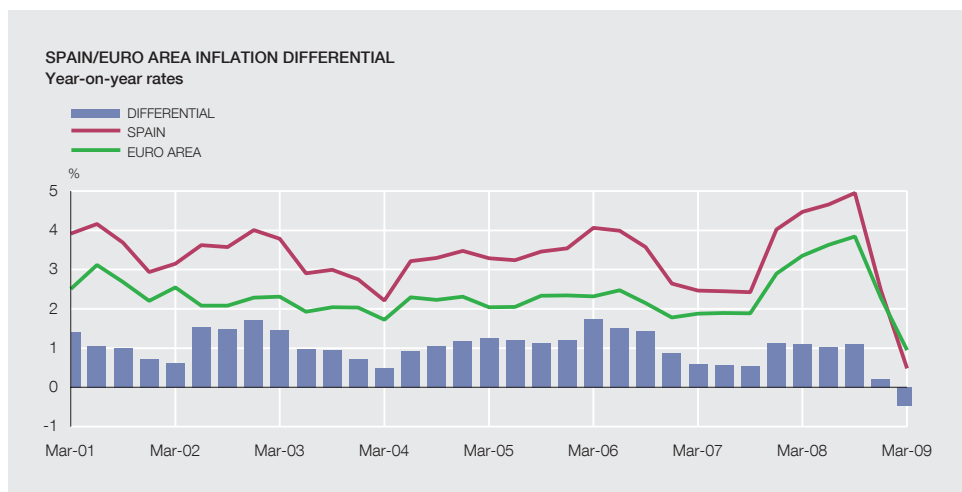
Inflation posted successive falls from the summer onwards, evidencing negative differentials with the euro area from December, which had not occurred since the start of EMU

Inflation underwent a sharp turnaround during the year. For the year as a whole, the CPI stood at 4.1%, peaking at 5.3% in July, in the face of the sharp increase in oil and other commodity prices (see Chart 1.6). Thereafter, however, its growth rate fell swiftly, reaching a negative rate of -0.8% in May, according to the HICP flash estimate, which was released as this Report was going to press. This reflected the effect of the correction in oil and other commodity prices, but also the sluggishness of demand, as shown by the decline in the prices of non-energy industrial goods and the slowdown in services price increases, departing from their historical path, which had indicated their scant sensitivity to changes in cycle. The reduction in inflation was sharper in Spain than in the euro area in the closing months of 2008, whereby the inflation differential in terms of the HICP turned negative from December. This development is indicative of the severity of the contraction, although it may also reflect greater price flexibility that would help activate the improvements in competitiveness needed to underpin the recovery. The strong reduction in inflation provides, in any event, a reference that should be conducive to a substantial easing in negotiated wage rates in the direction required by the cost adjustments needed to promote job creation.

4 Economic policies, outlook and challenges

Economic policies progressively adapted to the change in cyclical position during the year...

Economic policies progressively adapted to the change in cyclical position during the year. On the fiscal policy front, the State Budget for 2008 had been designed with a markedly expansionary bias, as detailed in chapter 5 of this *Annual Report*. This was reinforced with the adoption in April of a series of fiscal stimulus measures, essentially tax-based and general in nature, and designed in the main to remain in place. The abrupt halt in activity also activated the automatic stabilisers, which exerted their effects throughout the year through the usual channels



SOURCE: Eurostat.

(an increase in unemployment benefits and a decline in tax revenue), lessening the impact of the progressive weakening of growth on household disposable income.

... and received a further impulse in the closing months of the year, with policies geared to stimulating demand and supporting the financial system

Subsequently, given the exacerbation of financial tensions in the closing months of 2008 and the rapid deterioration in activity, the government likewise adopted policies geared to stimulating demand and supporting the financial system that were along the lines of those implemented at the international level. In the financial arena, and within the common framework of coordinated action at the European level, measures were implemented to restore confidence, to offer means of providing liquidity at maturities longer than those envisaged in monetary policy operations and to restore funding channels on the wholesale markets. To this end, the limit of the deposit guarantee fund was raised in October, a fund for the acquisition of financial assets funded by the Treasury was created and the granting of public guarantees to banks' bond issues was approved. The possibility was also considered that the State might acquire equity securities, if it were judged necessary at some point to resort to this instrument to capitalise banks.

Another batch of measures was aimed at smoothing access to credit for specific sectors or agents that are particularly vulnerable to the financial tensions, such as SMEs, and to soften the impact of the crisis on indebted households in particularly difficult circumstances, through

the deferral of a portion of their loan instalment payments. These measures have been carried out through the extension and creation of new ICO credit lines.

Approval was also given in November to the creation of a State Fund for Local Investment and of a Special State Fund for the Reinvigoration of the Economy and Employment, for a cumulative amount equivalent to 1% of GDP. In line with the guidelines of the European Economic Recovery Plan, what is involved here is a transitory fiscal measure aimed at boosting public investment at the municipal level and in strategic industries.

Foreseeably, the effects of the measures will unfold over the course of this year...

The raft of measures available is, therefore, very extensive, and the resulting expansionary effects will foreseeably unfold over the course of this year. The sizable cuts in interest rates by the ECB since October – the transmission of which is being reinforced by the changes introduced in its operational framework (see Box 4.2) – will act along these same lines, and have been reflected in subsequent reductions in the 12-month EURIBOR of somewhat more than 3 pp. The lower interest rates have already begun to feed through to private-sector borrowing costs and to the average cost of outstanding loans. Foreseeably, too, as a result of the prevalence of floating-rate loans, this feed-through will take place relatively swiftly, freeing up private-sector resources that will bolster the impulse stemming from the reduction in oil prices and from the decline in inflation.

...although the macroeconomic projections available point to a deepening of the current recession in 2009, with significant depressive effects on the inflation rate

The macroeconomic projections available, though subject to an exceptionally high degree of uncertainty, point to a deepening of the recession in Spain in 2009, which might lead GDP to contract by around 3%. Foreseeably, however, the intensity of the contractionary effects will progressively diminish during the year, being gradually offset by the impact of the economic stimulus policies implemented and by the plans to provide public backing to the financial system, whereby the contraction should have slackened by 2010.

To restore confidence and for spending plans to be reactivated, the imbalances built up must be reabsorbed

To restore the appropriate foundations for recovering confidence and rekindling spending plans, the imbalances built up during the long expansionary phase must be redressed and reabsorbed. To do this, soundness must be restored to the private-sector financial position and there must be an effective improvement in competitiveness and in labour market conditions. The financial system, for its part, must face the challenges to its stability and efficiency posed by the new scenario brought about by the financial crisis and the deterioration in the macroeconomic conditions in which it has to operate.

The soundness of the financial system is an advantage that must be preserved

The stability of the financial system is a vital asset for ensuring credit flows and embarking on a recovery, and it must be preserved and strengthened. The financial sector performs a crucially important transversal task for market economies in terms of the selection of productive projects and of the redistribution of risks among the individuals best able to bear them. And here the experience, reputation and confidence of intermediaries are fundamental factors. Accordingly, when the crisis turning point is reached, the momentum of the economy will depend greatly on the soundness and efficiency of the financial system, which will provide the capacity for effective intermediation and provide the credit flows that underpin household and corporate spending decisions.

The effectiveness of demand-side policies depends on their design being appropriate

In the current circumstances, the scale of the global recession and the unfavourable outlook concerning its duration warrant the implementation of expansionary demand-side policies, monetary and fiscal alike. However, their effectiveness hinges crucially on their being designed appropriately. In the fiscal policy realm, the magnitude of the impulses should bear in mind the starting position of public finances and, above all, their sustainability in the medium term. Hence, the expansionary policies applied must be temporary and medium-term-oriented, en-

visaging a return to stability once the economy moves on to a normal footing. Likewise, it is important that the measures are geared to the agents most affected by the crisis, to those on whose income the expansionary impact may be greater, and that they contribute to improving the quality of public finances and the economy's efficiency (for greater details on the pros and cons of discretionary fiscal policy in times of crisis, see Box 1.3).

In Spain, the fiscal position is strongly governed by the scale of the fiscal impulse already under way and by its high budgetary impact...

Bearing in mind the foregoing, it is essential to take into account the scale of the fiscal drive made, along with its budgetary impact. It should be noted that when the adjustment began, the Spanish economy was starting from a relatively healthy budgetary position, which gave fiscal policy some leeway to act in a countercyclical fashion without endangering budgetary stability. During 2008, however, the impact of the automatic stabilisers – of a much greater magnitude than initially foreseen given the greater severity of the crisis – was compounded by the loss of tax revenue-raising capacity, prompted by the substantial correction in the real estate sector, and by the numerous discretionary measures adopted. The outcome was a significant deterioration in the fiscal position, with a deficit standing at 3.8% of GDP compared with a surplus of 2.2% of GDP the previous year, and an increase in the public debt ratio to 39.4% of GDP, triggering an excessive deficit procedure in keeping with the requirements of the Stability and Growth Pact. Having regard to the macroeconomic projections published by the Banco de España in early April, this deterioration in the fiscal position will run throughout 2009 and 2010, with a further increase in the deficit, which might rise to over 8% of GDP in both years, under the assumption of the measures already agreed being implemented without changes. Against this background, it is foreseen that the public debt ratio will increase very rapidly, whereby it might be at a level close to 60% in 2010, more than 20 pp above the low reached in 2007.

... which highlights the limits on the room for manoeuvre of fiscal policy and the need to avoid measures that may endanger budgetary stability in the medium term

This highlights the limits on the room for manoeuvre of fiscal policy – above all if the measures adopted need time for their effects to unfold – and the importance of holding to a path of budgetary consolidation in the medium term. That way, when more favourable macroeconomic conditions begin to settle, the position of public finances is not a drag on the recovery.

It is therefore necessary to avoid measures that may call into question the commitment to budgetary stability in the medium term, which might have adverse repercussions in terms of the cost of raising resources, of confidence and of generating expectations of tax rises that might ultimately sterilise the expansionary effects of the measures adopted. While the relative level of public debt is still below the EU average, the high increase foreseen in the coming years is worrying for three reasons: the difficulty its reversal would entail; the influence it may exert on the costs of financing the economy (since risk premia appear to have become more sensitive, among other factors, to the perception of the sustainability of public finances); and, in sum, because maintaining low public debt ratios is crucial for being better placed to withstand the future increase in pension spending, projected to be one of the highest in the EU.

In this connection, the framework of the Stability Pact and the budgetary stability laws remain appropriate, and stemming from this are substantial consolidation requirements which stave off the risk of the budget deficit running out of control and which mark the path for its future reduction. Against this backdrop, it is a priority to define a credible strategy for ensuring compliance with the requirements laid down by the laws on budgetary stability and the medium-term limits and objectives of the Stability and Growth Pact. In this respect, when an excessive deficit was reported in Spain, the European Council recommended its correction following a schedule that would allow it to be reduced to 3% in 2012. Lastly, the collaboration of regional and local government continues to be crucial. Accordingly, the regional government financing arrangements that arise following the review currently under

As a stabilisation tool in the face of economic crisis, discretionary fiscal policy has acquired significant importance in the past year. Practically all the EU countries and the main OECD economies have submitted more or less ambitious fiscal packages to stimulate demand over the 2008-2010 period. The characteristics of the packages differ greatly in terms of their composition, incorporating measures on the revenue side through cuts in the rates of specific taxes or through tax incentives, and/or increases in current spending and in public investment. Furthermore, their budgetary cost also varies greatly; it is relatively low in some cases, such as in France and Italy, and very high in others, such as in Spain and the United States (see Box 1.1). Beyond a description of the fiscal package is adopted, it is crucial to analyse the role that expansionary fiscal policy discretionary measures may play in the current economic circumstances. In this respect, a review of the specialist literature suggests various aspects to bear in mind when assessing the timeliness, design and effectiveness of discretionary fiscal policies.

The timeliness of discretionary policy measures should be analysed in conjunction with the countercyclical impacts that fiscal policy automatically provides in the economy, i.e. with the role of the automatic stabilisers. The transfer of income from the public sector to the rest of the economy through this channel is not in response to any discretionary action by governments and, therefore, is not affected by the lags in the implementation of fiscal policy which affect discretionary policies. In this respect, the fiscal stimulus provided by the automatic stabilisers is higher in the EU than in the United States, given the more progressive tax systems and the social protection policies in place. The automatic flow of income from the public sector towards households and firms caused by a deterioration of 1% in the growth rate of GDP is estimated at 0.5 pp of GDP in the case of the euro area aggregate, at 0.43 in the case of Spain, and at between 0.25 and 0.34 pp in the case of the United States.¹

While there is some consensus that discretionary fiscal policy, if implemented without significant delays, may exert positive effects on the economy in the short term², it is also pointed out that the greater or lesser effectiveness of discretionary policies depends on a series of factors. One fundamental aspect is the composition of the fiscal impulse, given that, despite the enormous heterogeneity present in the findings of empirical studies, there appears to be evidence that, in the very short term, increases in public spending in the form of, for example, temporary purchases of goods and services show greater multipliers than tax cuts, since a significant portion of the latter tends to be saved. However, if the aim were to affect economic growth in the medium term, tax cuts and productive public investment – with their added effects on productivity – would provide better tools than an increase in spending (either current or capital) geared merely to the short term. Hence, the mix of short and medium-term tools should take into account the expected duration of the situation of

economic weakness.

It should further be stressed that the findings described referred to normal periods, while in the current situation marked by loss of financial wealth and high uncertainty, even the short-term multipliers might be below their average historical values. Along these same lines, another important factor for the effectiveness of fiscal stimulus measures is that they are aimed at groups who are in fact more likely to spend. In the current situation, the loss of disposable income due to the rise in unemployment and the prevailing degree of financial restriction have raised the proportion of households and firms facing difficulty in financing themselves in the credit markets.³ Accordingly, the discretionary measures aimed at these groups would be more likely to be effective, whether implemented through direct income transfers or whether involving the bearing of risks by the public sector, in the form of credit backing and guarantees for households and firms. Nonetheless, the measures aimed at specific groups should be designed with care, given that they have the potential to distort free market mechanisms and the optimal allocation of productive resources among alternative economic activities.

The academic literature also points out that the effectiveness of discretionary measures depends on how they are communicated to the public and, therefore, how they affect expectations. If fiscal packages are announced clearly and credibly, and include a medium-term consolidation strategy, they can increase their effectiveness. If, on the other hand, they consist of series of one-off measures or ones that are difficult for the public to understand, they may contribute to raising overall uncertainty in the economy and to ultimately exerting adverse effects on activity.⁴

Fiscal policy effectiveness further depends on the monetary and financial conditions in place. In this respect, in a low-inflation, low-growth environment in which monetary policy has an expansionary stance consistent with maintaining expectations of price stability, the potential upward effects that fiscal policy may exert on interest rates prove more limited, with the subsequent crowding out of private-sector activity.

In any event, it cannot be ruled out that expansionary fiscal policy may prompt an increase in sovereign risk premia, thereby hampering the financing of private investment. The risks concerning premia are related to the perception that economic agents have of the sustainability of public finances in the medium term. There is evidence that for levels of public debt that are high, or that are deteriorating rapidly, the values of the fiscal multipliers are low, and may even be negative if economic agents raise their savings rates to cushion themselves from the medium-term risks that may be posed by potential problems of solvency or sharp hikes in taxes in the future to balance public finances. These mechanisms may operate with great virulence in small

1. See N. Girouard and C. André (2005), *Measuring Cyclically-Adjusted Budget Balances for OECD Countries*, OECD Working Paper no. 434. 2. A representative paper here is that of R. Perotti (2007), *In search of the transmission mechanism of fiscal policy*, NBER Working Paper 13143.

3. See A. Tagkalakis (2008), *The effects of fiscal policy on consumption in recessions and expansions*, in *Journal of Public Economics*, vol. 92, pp. 1486-1508. 4. For an illustration of this, see T.H. Hoon and E.S. Phelps (2008), *Future fiscal and budgetary shocks*, *Journal of Economic Theory*, 143, pp. 499-518.

and very open economies that are sensitive to potential spillover effects between economies, particularly in cases in which the level of foreign debt is high. In this respect, government-co-ordinated fiscal policy action would be more effective. Furthermore, many of the papers available on the effectiveness of discretionary fiscal policy tend to find more significant effects of temporary as opposed to permanent measures on economic activity, especially as regards public spending, given that such measures do not affect the medium-term fiscal position.

Given the diversity of measures included in the different countries' fiscal stimulus packages (see Box 1.2), it is difficult to make a broad

assessment of their potential impact, in light of the determinants discussed in the foregoing paragraphs. In any event, there appears to be a general tendency, as the crisis unfolds, to improve the quality of the measures relative to their effectiveness, e.g. in terms of their temporary nature and of their bias towards items with theoretically higher multipliers, such as public investment. Nonetheless, it should be borne in mind that the fact that a certain discretionary response may be appropriate at one point in time does not mean that discretionary fiscal impulses may be unlimited, since the room for manoeuvre available may be running out owing to the large scale of the funds committed, both in the strictly fiscal area and in the financial realm.

discussion should set the appropriate incentives for the disciplined behaviour of these governments.

All told, the intensity of the recovery and of long-term growth are conditional upon the necessary adjustments being made to sustain growth potential...

Beyond the major challenges posed by addressing and resolving the economic and financial situation, it should be borne in mind that the intensity of the recovery and the capacity for long-term growth are conditional upon the necessary adjustments being made. That raises significant challenges for economic policy, in a situation in which it is not possible to resort to exchange rate adjustments to restore competitiveness and in which there is a risk that contractionary trends may ultimately diminish the possibility of expanding output potential.

The risks that the lesser use of productive factors during the adjustment phase may ultimately generate permanent effects on output potential stem from various sources. On one hand, it will prove difficult for productive investment to offset the sharp correction residential investment is undergoing, a correction which is in any event necessary after the excesses accumulated over the past decade. On the other, there is a risk that the sharp increase in joblessness will instil a high degree of persistence in unemployment, as occurred in the past. If this were the case, there would be a notable reduction in labour utilisation, while the labour supply would foreseeably tend to slow, as the impulses derived from women joining the labour market and from migrant inflows eased, which might have durable effects on growth potential. Compounding this are the difficulties of boosting the pick-up in total factor productivity.

...which requires the adoption of structural reforms aimed at containing the employment adjustment, increasing productivity and promoting the channelling of investment towards more productive sectors

To avert these risks, demand-side policies are insufficient. What are needed are structural reforms aimed at containing the intensity and persistence of the employment adjustment, increasing productivity and promoting the channelling of investment towards more productive sectors with greater potential for growth. In the labour market, the scale of the reaction by employment to the change in cyclical conditions highlights the presence of rigidities which emerge with intensity in downturns and intensify contractionary trends. To correct these features, there is a pressing need for reforms that allow wages to react to a greater extent to changes in cyclical conditions and that prevent the cyclical adjustment from resting excessively on employment. As is analysed in greater detail in Chapter 2, that requires a change in collective bargaining arrangements and in employment protection legislation, providing for new hires in this contractionary phase and allowing, once demand picks up, the resumption of an employment generation path on sounder foundations that is consistent with more intensive and efficient labour utilisation.

Persistent unemployment must be avoided through improvements to market intermediation services and training systems for the unemployed...

At the same time, efforts should be made to prevent the strong increase in unemployment from leading to situations of persistence that might hamper recovery. In this connection, it is essential to continue improving active employment policies – in terms both of job-search systems and of matching the training of the unemployed to the job skills in demand – and to strengthen their coordination with the unemployment benefits system. In this respect, public employment services must be improved, in particular concerning market intermediation services, involving private placement agencies and ensuring greater coordination among the regional governments. That would allow for a more widespread sharing of information on vacancies and job offers, it would improve the mechanisms for monitoring the degree of activism in job-search and it would enable training plans to be designed on bases better tailored to actual demand.

Further, guidance and training for the unemployed should be improved, in particular for those groups that are at particular risk of being excluded from the labour market. This is because the rise in unemployment is most acutely affecting the lesser-skilled and workers in construction, a branch that is scarcely likely to regain the employment levels of recent years.

... and regional mobility for the unemployed must be provided for, which may partly be done through a reform of the rental market

Another constraint on placing the unemployed is the limited regional mobility of workers, motivated in part by the scant wage differentials across regions, though also by the under-developed rental market. Here, a reform of the rental market might prove appropriate in the current circumstances, in that it would provide an outlet for the stock of unsold housing, facilitating the demand for lodgement at a time when housing affordability is difficult and, moreover, it will promote regional mobility of workers. In this respect, two aspects of the current legislation merit particular attention. First, the effectiveness of the various measures that have been adopted to improve legal security for owners should be guaranteed. Further, certain aspects of the current legislation should be made more flexible, such as those relating to contract duration. In addition, the funds assigned to public programmes for owner-occupied subsidised housing should be redirected to developing a sufficiently extensive stock of rental housing. Headway also needs to be made towards a more neutral and balanced tax treatment of owner-occupied housing, in which connection possible future measures have recently been announced.

Also, however, the quality of human capital and of technological capital should be enhanced...

Also, however, as indicated earlier, the change in productive pattern needed to resume high potential growth rates requires investment be encouraged in sectors other than construction and an increase in productivity. To do this, human and technological capital should be enhanced, competition increased and the environment in which companies pursue their activity improved.

In the case of human capital, the increase in the labour force's level of educational attainment in the second half of the 20th century has been checked over the past decade, meaning that the proportion of youths who have not attained an advanced secondary level of education has stagnated at a very high level (close to 40%, compared with 26% in the euro area), with adverse repercussions in terms of the lower increases in aggregate productivity.

Other factors have tended to lessen advances in the quality of human capital. First, as a result of the pattern of specialisation followed by the Spanish economy in the recent period, the demand for skilled labour has grown less than the supply thereof, prompting a mismatch that has tended to reduce the individual incentive to continue studying. In this respect, support must be given to the innovation drive needed to boost the demand for skilled labour and to adapt study programmes at the most advanced levels to business demands. Also, the effect that the collective bargaining system may have had on the rigidity of relative wages should not be underestimated, as should neither the fact that the recent minimum wage increases may

have led to an artificial wage squeeze. While these policies may respond to social goals in the public interest, the cost entailed in terms of fewer incentives to attain greater levels of educational attainment should be assessed. Nor does labour market segmentation encourage youths to extend their training, since too often this effort culminates in their joining the labour market as a temporary hire. The headroom for improving continuous training is also most considerable.

Turning to technological capital, the level of expenditure on both R + D and on information and communications technologies (ICT) remains significantly lower in Spain than in other EU countries. While in recent years considerable effort has been expended by the public sector in this area, drawing the private sector in its wake to some extent, significant favourable effects have not yet been perceived. Moreover, in Spain's case the bulk of private investment in R + D continues to be concentrated in few industries, although the problem of low investment is extensive to all sectors.

... and the competitive environment in which companies take their decisions improved, through the liberalisation of the services sector...

To improve competition and sectoral liberalisation, priority attention should be focused on the services sector, as it accounts for a very high percentage of value added and employment in the economy, albeit still lower than that observed in more developed economies. Further, the sector encompasses the most dynamic activities, those that lead the employment generation process and in which the new forms of labour relations can best be found. The growing interaction between industry and services has tended to raise the influence of the latter on international competitiveness and on trading results.

In this respect, the transposition of the Services Directive should play a crucial role in the liberalisation of the sector. The approval by the Council of Ministers of the laws now in the initial stages of transposition should help reduce the administrative burden on companies, lowering their costs and enhancing their competitiveness. As the Spanish productive structure is characterised by the small size of its firms, the impact of this measure will be greater than in the rest of the euro area. This should likewise contribute to significantly lowering the obstacles to business start-ups imposed by the current legislation and the overlapping of State, regional and local government rules. Deeper liberalisation is also called for in the case of professional services, which are characterised by their high value added and which, in some cases, also have very high export potential.

Within the services industry, retail trade plays a crucial role given that its activity involves placing a large part of consumer goods at the disposal of consumers. This sector is characterised in Spain by very extensive regional government regulation, with evidence that the heavier regulation in some regions has been associated with higher inflation and with lower employment in the sector. In particular, the entry barriers in place may be particularly inhibiting competition.

... and of the network industries

Although liberalisation of the network industries has been relatively deep in recent years, some shortcomings persist. Evidence of this has been the still-low growth of productivity in some of these branches. In the energy sector, the rise in oil prices in the first half of 2008 had particularly adverse consequences for the Spanish economy, owing to its greater dependence on this energy source and to the greater intensity in its use in productive processes. That calls for these biases to be corrected, in line with the progress other industrialised countries have made in this area. Turning to the electricity sector, prices remain distorted, while international interconnections continue to be insufficient. In the telecommunications market, the market share of the former monopoly is still very high, both in fixed telephony and, above all, in Internet access, which might be restricting the degree of actual competition.