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Challenges for the Spanish economy. Productivity and the business sector
Annual assembly of the Instituto de la Empresa Familiar

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Governor

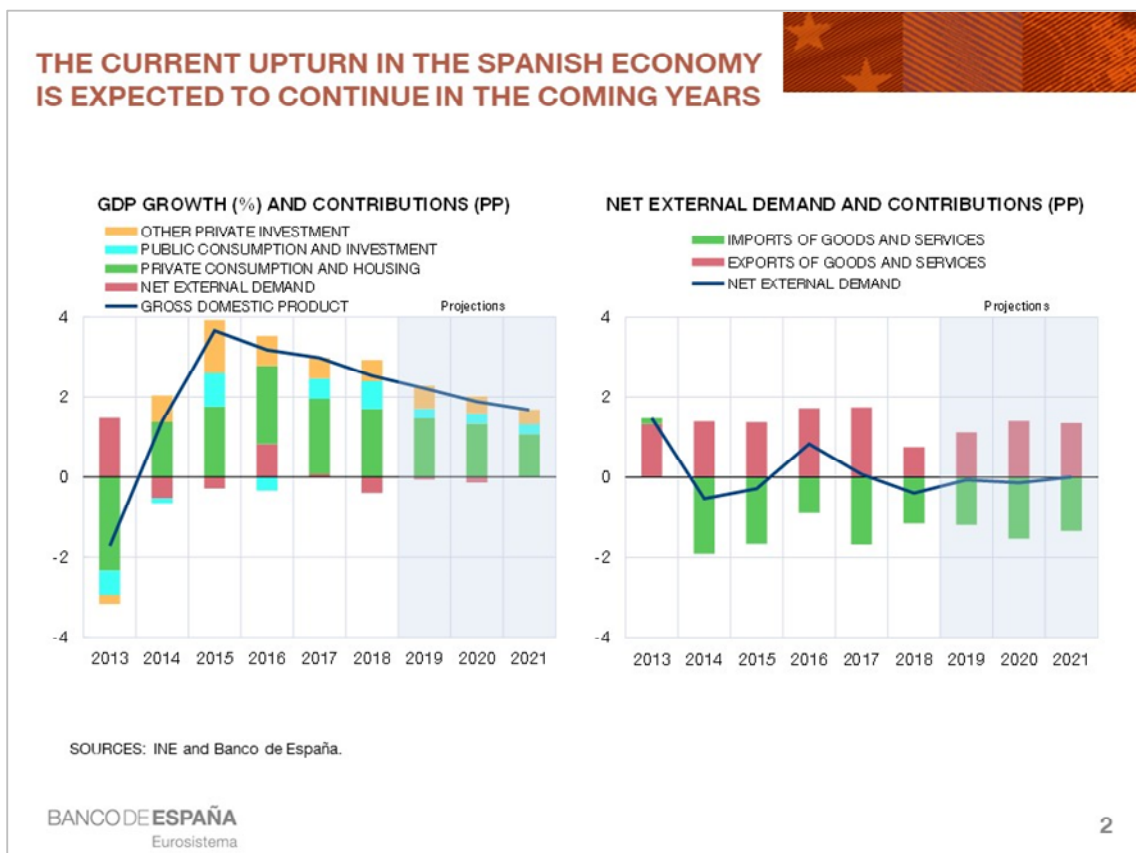
Good morning. Let me begin by thanking the Instituto de la Empresa Familiar (IEF) for their kind invitation to take part in their annual assembly.

Throughout its 25-year history, the IEF has not only played a crucial role in disseminating studies on the reality of and the challenges facing family businesses in our country, but has also fostered debate on many economic aspects of general interest. One recent example is its interesting publication on dual training on its website.¹

In my address today I shall, after briefly describing the current economic setting, mainly analyse the principal challenges facing our economy. I will particularly focus on productivity, the main determinant of economic growth in the long run.

In Spain's case, productivity dynamics have been particularly poor in recent decades. Improving them with a view to the future is, therefore, a prerequisite for achieving sustainable and balanced growth.

The economic situation



After averaging growth of around 3% in the three years from 2015 to 2017, the pace of the Spanish economy eased somewhat last year to annual growth of 2.6%.

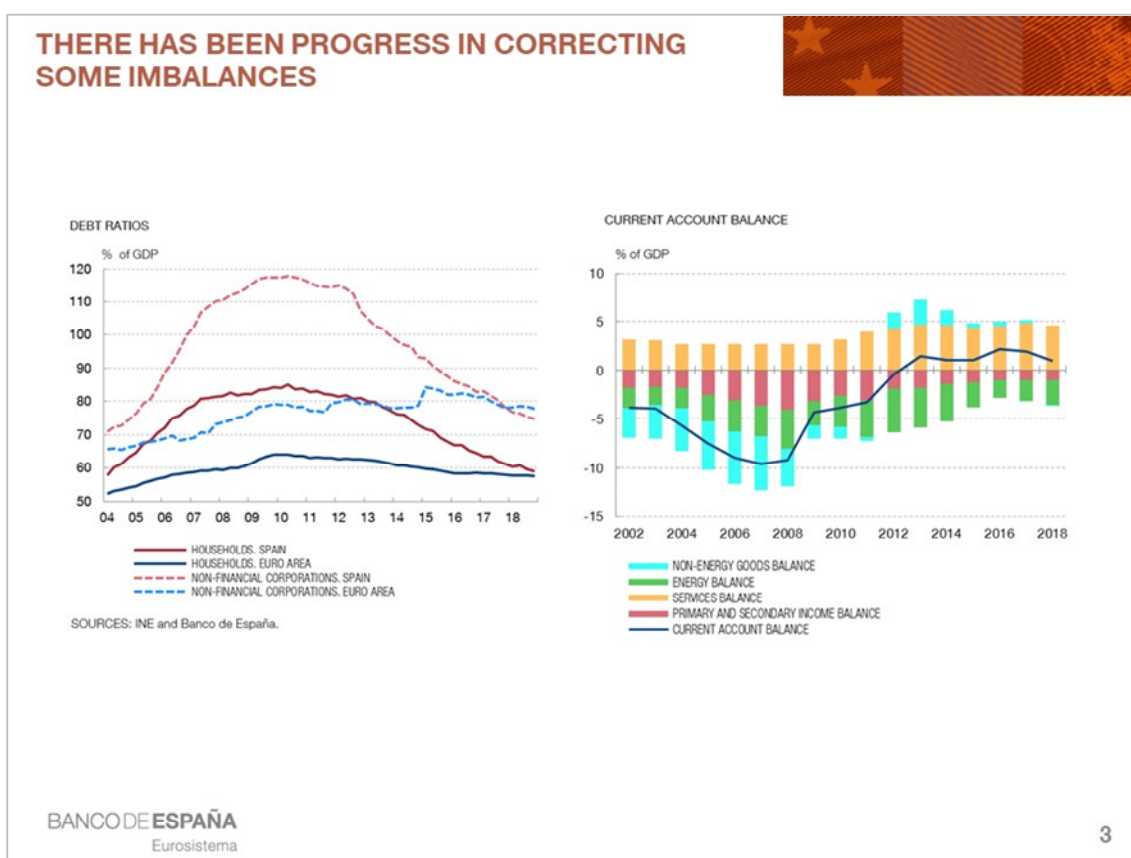
¹ See the study by Instituto de Empresa Familiar (2018) "Orientación profesional y formación dual. Hacia un modelo integrado para el empleo juvenil".

On the latest Banco de España macroeconomic projections released on 20 March, the current upturn is forecast to continue over the coming years.

These economic projections are expected to be underpinned by the continuation of the factors that have sustained growth since the start of the recovery. These include, in particular, the gains in competitiveness achieved since the onset of the crisis, the strengthening of the financial situation of firms, households and financial institutions, and the accommodative monetary policy stance. And we should add, in the short term, the prolongation of the slightly expansionary stance of budgetary policy.

This combination of factors would enable the economy to continue growing at a pace greater than its potential rate, which would support the continuing absorption of the high unemployment generated during the crisis.

Among these factors I would like to stress the role played by competitive gains and the improved financial position of households and firms. Both have helped make the Spanish economy more resilient.



Indeed, throughout the recovery, thanks to cumulative gains in competitiveness, the positive developments in our export markets were conducive to the internationalisation of Spanish companies. That in turn boosted business investment and employment and, through this latter variable, consumption.

As a result, the Spanish economy has managed recurrently to post external surpluses during the upturn, which was somewhat unusual in previous recoveries. This would indicate that at

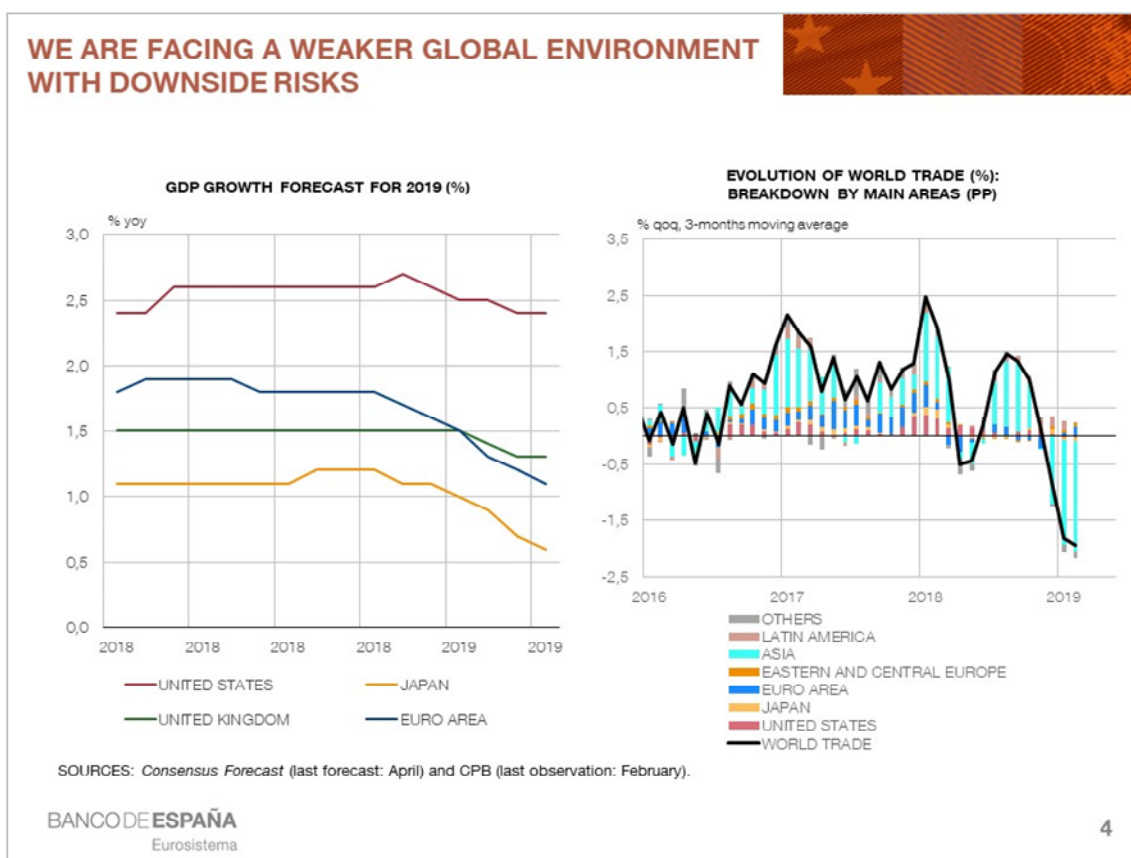
least some of the correction of the external adjustment is of a structural nature, and associated with the aforementioned cumulative gains in competitiveness and with the increased geographical diversification of exports and of the number of firms selling their products regularly to the rest of the world.

Also worthy of mention is the notable deleveraging by the non-financial private sector, at a very advanced stage in the case both of non-financial corporations and of households. In the case of non-financial corporations, for example, the debt-to-GDP ratio, after falling more than 40 percentage points (pp) from its peak, stands below the average for euro area firms.

Significantly, too, there has been intense recapitalisation and restructuring in the banking sector. In particular, since December 2013 non-performing loans have fallen by over €122 billion, accounting for 64.5% of the total. Yet as I shall explain, the sector continues to face a very complex environment demanding high adaptability.

Under the projected baseline scenario for growth of the Spanish economy, however, the Banco de España expects a gradual slowdown in the rate of change of GDP to figures more closely in line with its potential growth. On our estimates, that would be around 1.5%.

This gradual easing in growth reflects the progressive exhaustion of some of the above-mentioned factors, such as the expansionary demand policies and, in particular, monetary policy.



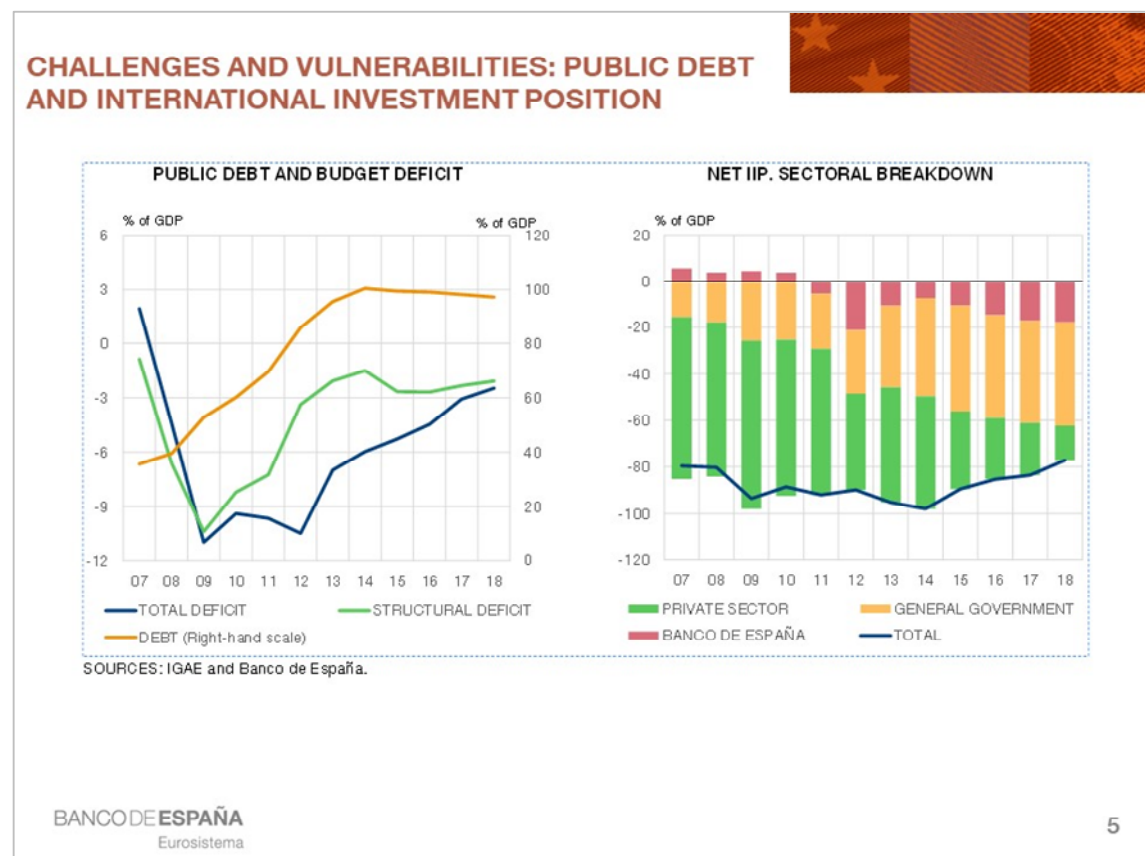
This scenario of gradual deceleration is, moreover, part of a complex and uncertain global context. Here there are doubts about the intensity and the pace of growth in the global

economy, especially in the euro area, which is Spain's main export market. Moreover, the risks associated with a no-deal Brexit persist, and the emergence of fresh protectionist tensions hampering the recovery in global trade cannot be ruled out.

Domestically, doubts prevail over the future course of economic policies, in relation both to budgetary policy and structural reforms. We must wait until a government emerges from the results of the latest general elections.

The challenges and vulnerabilities of the economy

Beyond its expected course in the short and medium term, the Spanish economy continues to face significant challenges and vulnerabilities. Headway in correcting these is needed in order to shore up the economy's long-term growth capacity. Most notably, I would stress here high public and external debt, progressive population ageing, the high unemployment rate, the strengthening of the banking system and, as I said in my introduction, low productivity.



Let us take first high public debt. This stood at end-2018 at around 97% of GDP, over 60 pp up on 2007, and is one of the main vulnerabilities that arose in the wake of the crisis. Also, the budget deficit is still high (2.5% of GDP in 2018) and, on available estimates, still has a significant structural component into which no inroads had practically been made in the past four years.

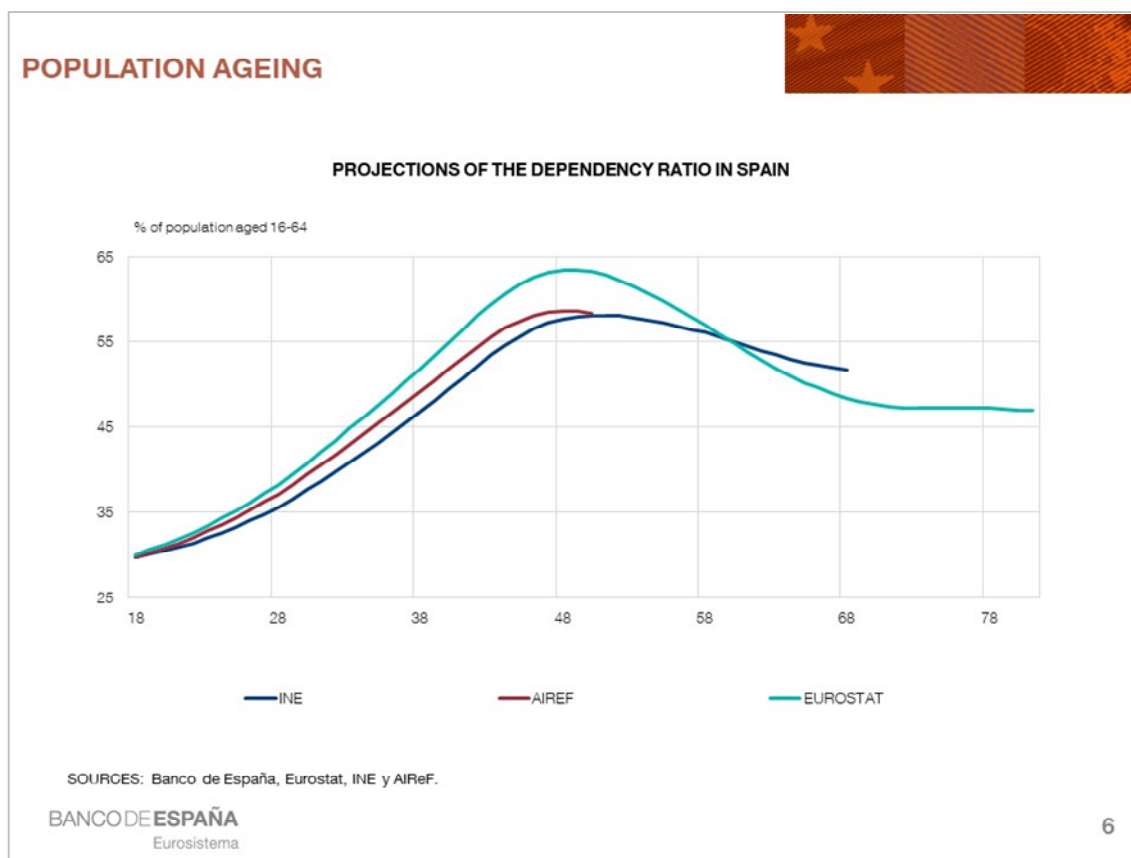
Eliminating this vulnerability of the economy requires resuming the budgetary consolidation process. Cutting the deficit and public debt would, moreover, give fiscal policy greater leeway for countercyclical action in the face of any future negative shocks.

Meeting the guidelines of the preventative arm of the European Stability and Growth Pact should show the temporary fiscal consolidation path to follow in the future after having managed last year to cut the budget deficit to below 3%.

At the same time, a review of the composition of public spending and revenue might also contribute decisively to improving the economy's potential growth. There is room both to increase the efficiency of public spending and steer its composition towards those items exerting greater influence on the accumulation of physical, technological and human capital, and to re-define the structure of the tax basket in order to make it more conducive to growth. The presence of high tax benefits in our tax system, arising from numerous exemptions, allowances and special low rates, which generate substantial revenue-related losses and distort the efficiency and fairness of the tax system, is a good example of the headroom existing here.

Secondly, despite the notable correction to date, the negative net international investment position is still at 77.1% of GDP. And the nation's gross debt amounts to 166.7% of GDP, only slightly below the peak seen during the crisis.

To bring down the debt vis-à-vis the rest of the world, Spain will have to run external surpluses over an extended period of time. And that, in turn, requires maintaining the gains in competitiveness, which throughout the recovery have been based on the moderation of labour and financial costs, and which, hereafter, should rest to a greater extent on increases in productivity.



Thirdly, population ageing is one of the main medium- and long-term challenges facing developed economies. Illustrating this phenomenon is the substantial increase foreseen in the dependency ratio (percentage of the over-66s relative to the population aged 16-66). Even in the most optimistic demographic projections, this ratio will exceed 50% in Spain by the mid-21st century, far exceeding its current level of 25%.

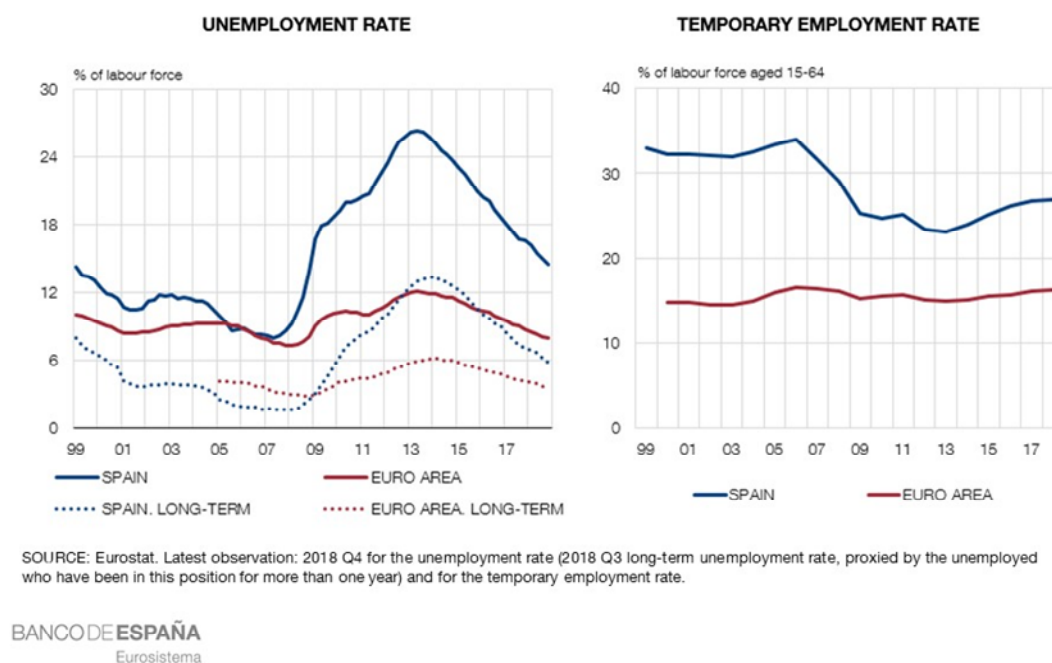
Population ageing will have – and is already having – a significant impact on public finances. The latest estimates anticipate a substantial increase in public spending on pensions, health and long-term care.

In the case of the pension system, the 2011 and 2013 reforms included certain adjustment elements that would enable the effect of the expected increase in the dependency ratio in the long term to be offset significantly. This would, above all, be through a likewise significant reduction in the pension replacement rate (defined as the ratio of the average pension to the average wage or average productivity in the economy). The latest implemented measures have put back the application of the sustainability factor to 2023, and have reintroduced an annual revaluation system for pensions indexed to the CPI. Against this background, ensuring the financial sustainability of the public pension system and safeguarding inter-generational equity will require additional measures, on both the revenue and expenditure sides.

Nor must we forget that population ageing has significant consequences not only for public finances, but also for aggregate supply and demand in the economy.

Foreseeably, demographic changes will affect consumption and saving patterns and tend to reduce productivity growth. This is why I must stress that addressing the population challenge calls for the adoption of a multidisciplinary strategy. Among other aspects, this strategy must encourage the participation of older workers, tailor migratory policy to labour market needs and boost the birth rate. In this scenario, education and vocational training policies are crucial.

UNEMPLOYMENT RATE AND TEMPORARY EMPLOYMENT RATIO



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Fourthly, the unemployment rate remains very high (14.7% in 2019 Q1), despite the fact that almost 2.5 million jobs have been created since the onset of the recovery. Moreover, around 45% of the unemployed have been looking for a job for a year or more.

Improving the employability of the most vulnerable groups – namely youths and elderly workers, in particular the least skilled – is essential to reduce this scourge and thus help correct the strong rise in wage inequality that stemmed from the crisis. In this respect, it would be desirable to increase the human capital of the least skilled unemployed and to align job training measures to employers' demands.

These measures should be structured to fit others aimed at reducing the high temporary employment ratio, in light of its negative influence on human capital accumulation – to which I shall refer later – and, once again, on inequality.

Indeed, despite trending more favourably over the past year, the temporary employment ratio stood in 2019 Q1 at almost 26%, far above that in other European countries. Reducing it will necessarily involve raising the attractiveness of permanent hiring for firms.

Finally, let us turn to the banking sector. Major challenges, in many cases shared with other European banking systems, remain outstanding, despite the progress made in recent years.

For one thing, the Spanish banking sector should speed up the reduction of its non-earning assets, since these bear down not only on its profitability but also on its capacity to allocate resources efficiently.

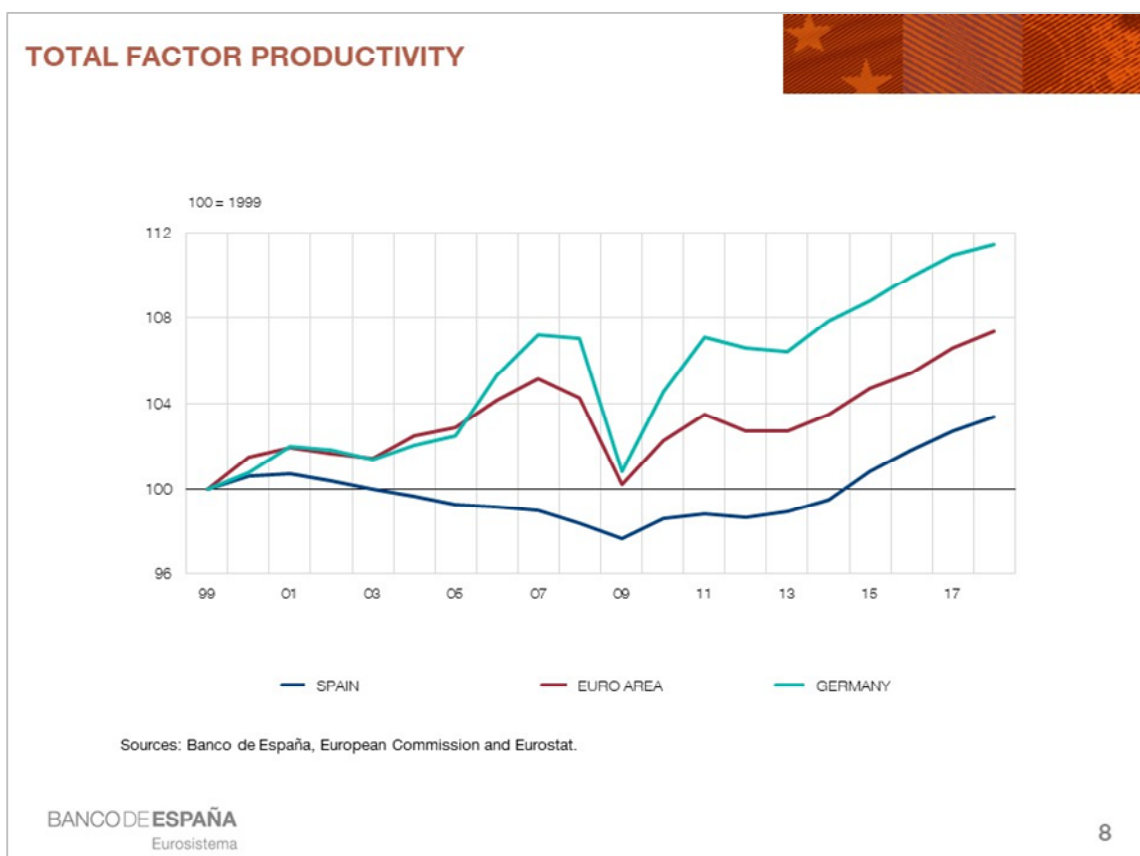
Next, in addition to enhancing the quality of their assets, Spanish institutions should strengthen their capital and the liabilities susceptible to be used in the event of bail-ins in order to face on the best footing the regulatory challenges still pending.

As in other countries, the new technological environment poses a challenge. But it is also an opportunity for the financial system, which the Spanish banking sector should harness.

Finally, financial institutions should seek to enhance their reputation. This challenge should not be neglected if they are to successfully tackle an environment like the current one, which is becoming more competitive as new agents emerge (e.g. the so-called fintech).

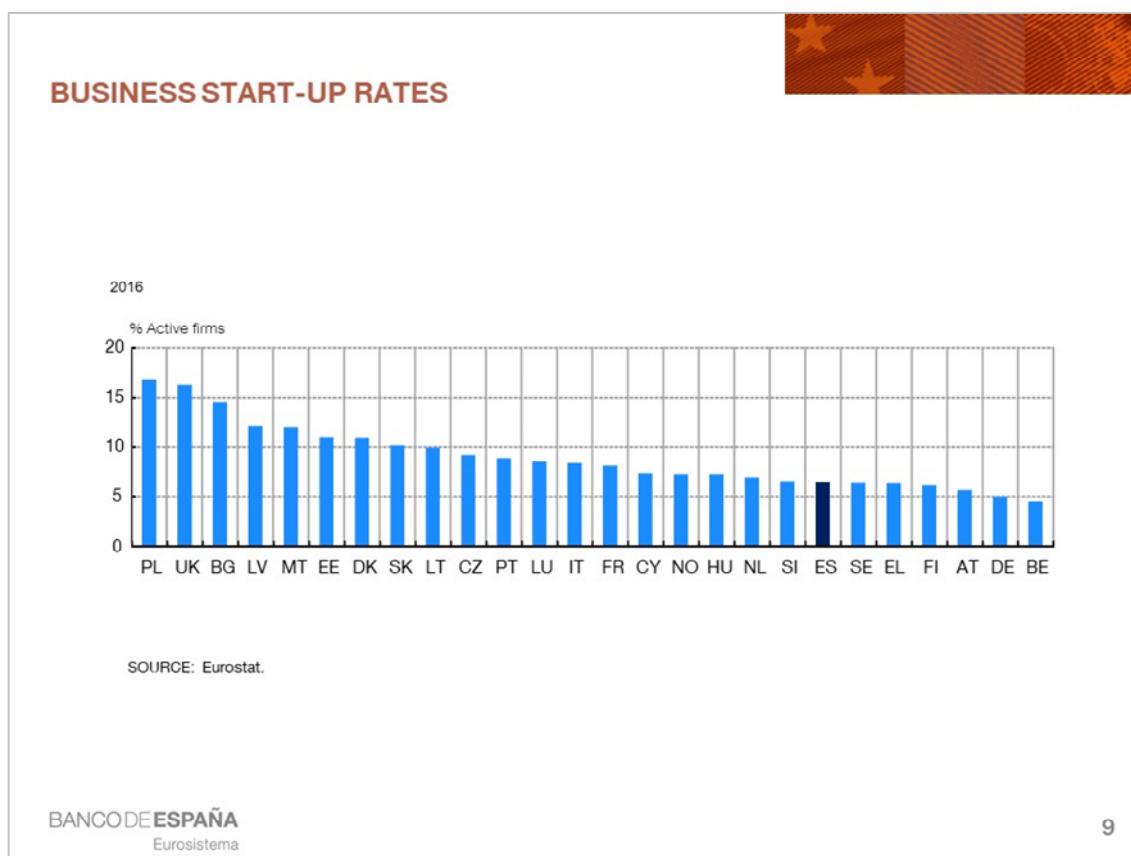
In an economy like Spain's, where the banking sector continues to mediate most financial flows, overcoming these challenges is crucial if deposit institutions are to continue contributing to economic growth.

The productivity challenge



In recent decades the increase in total factor productivity (TFP), which measures the efficiency with which productive factors are used, has been notably meagre in Spain. Indeed, TFP posted negative growth rates for much of the 2000s. In Spain, it has averaged growth over the past 20 years of approximately 0.2%, 0.2 pp less than the euro area average, according to European Commission estimates.

Such poor productivity has a cost in terms of wealth. A simple calculation helps illustrate the fact that, if Spanish TFP had performed like that of the euro area, income per employee would today in Spain be almost 90% of the euro area average, as opposed to its current level of 83%.



The latest economic literature stresses the role of business dynamism in productivity. Specifically, innovative business start-ups and the destruction of relatively unproductive firms are at the root of productivity gains.

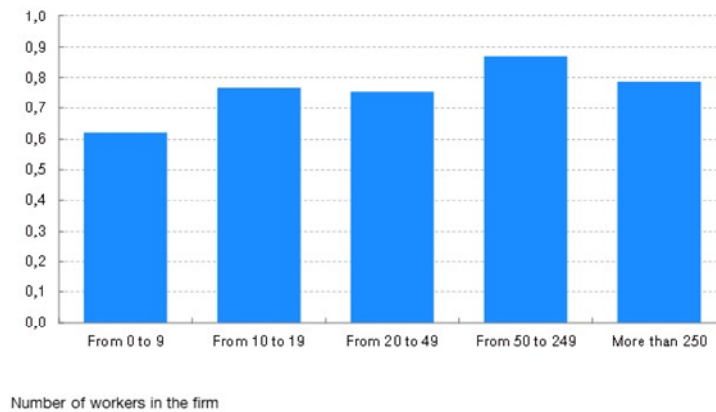
On Eurostat data, the pattern of business start-ups in Spain prior to the crisis was relatively similar to other advanced economies, and the destruction of firms somewhat lower.

Yet during the crisis the rate of business start-ups underwent a sharper fall than that observed in other economies, while destruction increased, being concentrated moreover in the least productive companies.

Since 2013 the business sector has proven somewhat more dynamic. That said, the pick-up in business start-ups is moving slowly, as it is in other European economies such as Germany and France.² This environment of diminished business dynamism in net terms might be associated with an increase in the market power of certain big firms in some sectors.

² See Chapter 4, "Business dynamics in Spain: characteristics, determinants and implications", *Annual Report 2015*, Banco de España.

RELATIVE PRODUCTIVITY BY COMPANY SIZE (a)



SOURCE: Eurostat.

a. Relative productivity of Spanish firms and the average of France, Germany and Italy (average=1). Year of estimation: 2016.

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Additionally, business dynamics in Spain show two anomalies compared with other countries: 1) the productivity of business start-ups is lower; and 2) companies that increase their size are not necessarily the most productive.

As occurs in other countries, new Spanish firms are small in size and show lower productivity levels than the average for their sector. This suggests the existence of a learning curve that new firms must follow if they are to converge towards average efficiency. In Spain's case, however, the evidence available suggests that the productivity gap between new firms and existing ones is greater than that in other European countries.

The relatively low level of new firms' productivity adversely affects both their survival - Spanish firms' probability of survival after three years is low when compared with other countries - and their ability to grow.

There is also evidence that, in Spain, the correlation between growth and productivity is not particularly high. In other words, the most productive firms do not always increase their market share.

The outcome of these two phenomena is that the Spanish economy has a business sector in which the predominant pattern is one of a large number of small-sized and relatively unproductive firms alongside a relatively small group of large, better positioned corporations, but which also show somewhat lower productivity than their European counterparts.

Specifically, the relative productivity of small Spanish firms is 40% lower than that of German, French and Italian companies. This difference progressively diminishes as the

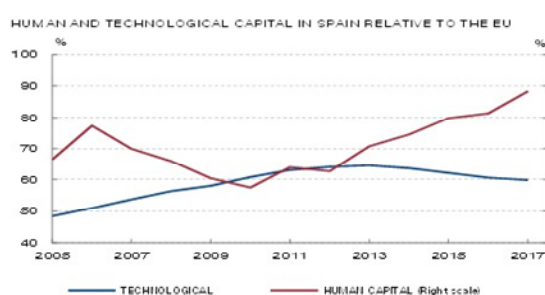
productivity of large companies is analysed; in any event, however, the negative difference never falls below 10%.

Which factors account for these dynamics?

According to the economic literature, the various factors that may influence an economy's productivity growth include most notably the human capital available, the capacity to innovate, access to and allocation of funding, market regulation and the degree of sectoral competition.^{3 4}

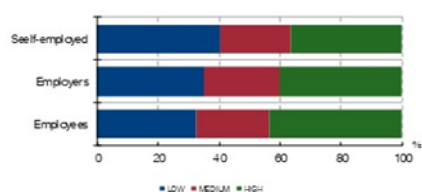
Human and technological capital

HUMAN AND TECHNOLOGICAL CAPITAL

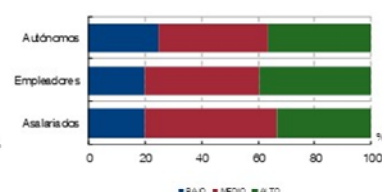


SOURCE: Structural Indicators Banco de España.

SPAIN 2017: DISTRIBUTION BY EDUCATIONAL ATTAINMENT



EURO AREA 2017: DISTRIBUTION BY EDUCATIONAL ATTAINMENT



SOURCE: Eurostat.

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Turning to human capital, let me first stress the gradual improvement in the Spanish population's level of educational attainment in recent decades. There will have been further progress in recent years owing to the extension of the formative period for youths during the crisis. Hence, 24% of those aged 60-64 did not complete what now constitutes the first cycle of secondary education, while among those aged 25-29 this figure has dropped to 6%.

³ See Syverson C. (2011): "What determines productivity", *Journal of Economic Literature*, 49 (2), pp. 326-365.

⁴ See Chapter 3 "Growth and reallocation of resources in the Spanish economy", *Annual Report 2014*, Banco de España, and Chapter 2 "Financing and investment decisions of Spanish non-financial corporations", *Annual Report 2016*, Banco de España.

Despite these positive developments, the Spanish education system has still to face significant challenges. These include most notably the high early school dropout rate (18.3% among those aged 18-24) and the poor performance of our pupils in standardised exams at the international level, indicative of low educational quality compared with that of other developed countries.

The evidence available shows that these poor results have not only to do with students' relative knowledge, but also with their non-cognitive skills (such as the desire to innovate, self-control and the ability to concentrate).⁵

In light of this evidence, adding to which is the need to address issues such as globalisation and digitalisation, we should reconsider the institutional design of the Spanish education system, learning methods and the content of the educational curriculum.

Spanish entrepreneurs also show some disadvantages in their levels of human capital relative to what is seen in other leading economies. For example, according to Eurostat figures, the level of educational attainment of the self-employed is lower than the euro area average. Specifically, in Spain 40.5% of the self-employed and 35.1% of employers have a low educational level, compared with 24.8% and 20.1%, respectively, for their European counterparts.

Moreover, managing a company requires certain skills – interaction, strategic, operational and control abilities – that also appear to be comparatively lower in Spain than in countries such as Germany, the United Kingdom, France and Italy.

In any event, the indicators available on business management should be viewed with caution. It is not clear they distinguish appropriately between entrepreneurial capabilities per se, as opposed to structural problems arising from an institutional framework that constrains the capacity to organise firms' productive resources. For instance, excessive Spanish labour market segmentation does not facilitate on-the-job training of either temporary or permanent workers. Thus, on top of improving entrepreneurial and employee capabilities, doing away with the excessive duality of employment contracts is fundamental for raising productivity.

To conclude my thoughts on the importance of human capital, allow me to refer also to the need to improve the relationship between general government and the firm in two spheres: that of vocational training and that of innovation.

On vocational training, it is essential that firms should be involved in the guidance of youths seeking their first job. But it is likewise necessary that the Administration should evaluate and adjust the vocational training system as business needs evolve.

Recently there has been much discussion of the virtues of dual vocational training, based on the positive results in other countries. But it is difficult to define how best to transfer a system such as Germany's, with a high prevalence of large industrial corporations, to Spain's very different business sector.

⁵ See G. Zamarro, C. Hitt and I. Méndez (2016) "When Students Don't Care: Reexamining International Differences in Achievement and Non-Cognitive Skills" EDRE Working Papers No. 2016-18.

The first papers to have evaluated this experience in Spain do not offer conclusive findings. And that underscores the challenge of adapting another country's successful model to our circumstances.⁶ It is therefore important to conduct pilot programmes enabling us to determine which design is most suitable for us.

Also, in addition to improving employee training, it is important that such training should be in an innovative environment. In this respect, investment in R+D activities in Spain is still very low in the public and private domains alike (0.8% and 1.4% of GDP, respectively, in 2016), which places Spain at levels 25% and 50% below the European average. As a result, the technological capital gap with the European Union has continued to widen.

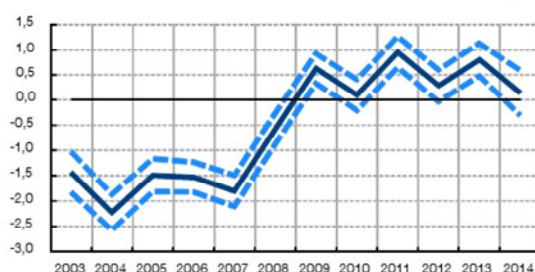
Here several measures, among others, would be advisable: to evaluate the possibility of increasing the public funds allocated to the area of innovation; to change research promotion and career arrangements to facilitate the entry and development of new high-potential researchers; to restructure in their entirety public organisations that pursue innovation in order to harness synergies where they may be found; and to promote a sound evaluation system to determine the allocation of resources across centres.⁷

Business financing

BUSINESS FINANCING AND STRUCTURE OF GROSS CAPITAL FORMATION IN SPAIN



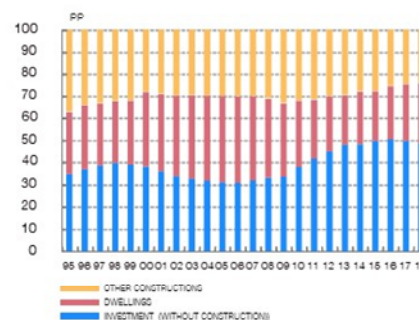
PRODUCTIVITY AND CREDIT ACCEPTANCE AT THE FIRM LEVEL (a)



SOURCE: Banco de España's Annual Report 2015, chapter IV.

a. A negative coefficient (positive) means a negative (positive) correlation between productivity and credit acceptance. Dashed lines are confidence intervals of the estimation.

GROSS FIXED CAPITAL INVESTMENT BY COMPONENTS



SOURCE: INE.

⁶ See Bentolila, S., A. Cabrales and M. Jansen (2018): "Market insertion of youth: Evidence from Madrid", Working Paper, forthcoming.

⁷ See the 2014 report "ERAC peer review of the Spanish research and innovation system", authorised by the European Commission.

The growth of firms is influenced by the availability of external financing to undertake new investment projects. In Spain's case, as is known, this financing is mainly through bank loans, especially at smaller-sized companies.

In the immediate run-up to the crisis, the standards governing this type of loan to firms were relatively lax. That made for abundant bank financing, which was particularly conducive to the creation and survival of numerous firms, many of them small in size.

However, the companies resorting in best conditions to such lending did not always evidence high productivity. Indeed, the buoyancy of loans extended to relatively unproductive firms in the years prior to the crisis made for the build-up of macrofinancial imbalances.

Conversely, in recent years, the allocation of lending appears to be proving more efficient. Specifically, funds tend to be earmarked for companies showing a comparatively more favourable economic and financial situation and that are more productive.⁸

However, this change in lending standards might be linked both to experience of the crisis and to financial regulation changes. In particular, the regulatory requirements applied to credit institutions have been significantly tightened with the aim, among others, of better aligning the level and quality of bank capital to the real risks assumed by banks.

Also, the weight of construction-related investment has diminished, partly as a result of the credit-allocation changes I have just referred to. Since 2013, in fact, investment in equipment and in intangible assets has gained weight relative to total investment (more than 4 pp) to the detriment of investment in real estate assets.

Beyond the changes in the supply of credit, this pattern will also have been influenced by certain far-reaching changes in the demand for real estate assets in recent years. In particular, there have been some housing-related fiscal and regulatory measures that have sought to reduce the traditional bias towards home ownership, such as the elimination of the house-purchase allowance under personal income tax.

It should also be borne in mind that Spain has been no exception regarding the overall tendency to increase the weight of investment in intangible assets derived largely from the expansion of digitalisation and technological development. This change causes difficulties when it comes to using the asset to be financed as collateral, which may lead to the disintermediation of business financing, in particular of large corporations. While this is a global phenomenon, its intensity has been somewhat more marked here, with Spain having traditionally been more highly banked than other developed economies.

Small and medium-sized enterprises cannot avoid this change, and they must be prepared to undertake the search for alternative means of financing. That will require headway in making their management more professional and in enhancing their transparency with a view to resorting to the financing offered on the capital markets.

⁸ See Chapter 2 "Financing and investment decisions of Spanish non-financial corporations", *Annual Report 2016*, Banco de España.

Regulatory framework

I would now like to focus on four regulatory challenges with the potential to distort our country's current regulatory framework: the enormous disparity of regulations at the municipal and regional levels; regulations that depend on firm-size; regulations that artificially distort the costs of different-sized firms; and certain shortcomings in the quality of the institutional framework.

Firstly, the disparity of regulations at the municipal and regional levels. The OECD published a report in 2015 showing the enormous dispersion of procedures needed in 19 Spanish cities in order, for example, to start a company, to apply for a building permit or to initiate a legal claim. In such a setting, the formalities needed to undertake investment projects proliferate, which hampers building up the business in alternative locations. This may be particularly relevant for certain sectors, such as professional, scientific and technical activities, training and wholesale and retail trade.

To correct these distortions, the Law to Ensure Market Unity was approved. This legislation only allows limits on an operator's freedom of establishment and movement when this is warranted by pressing reasons that are proportionate and in the general interest. Moreover, the legislation places at operators' disposal claim mechanisms under administrative law that are swifter, in principle, than the previous ordinary procedures.

Benefits have clearly arisen from the defence mechanisms for agents fomented by this Law. And thanks to the sectoral conferences being held as a result of the legislation, coordination between regions and municipalities is increasing so as to identify and, as far as possible, adopt best practices at the sectoral level.

Secondly, there are specific (tax or employment, for example) regulations in place intended to assist small and medium-sized enterprises, but which may actually discourage their growth. Indeed, there is evidence of an artificially high concentration of firms at sizes immediately prior to certain regulatory thresholds. That would denote the need to adapt existing regulations, so as to avoid these deterrents to business growth.⁹

Thirdly, while the foregoing types of regulation discourage company growth, there are other types of rules that may occasionally prevent such growth. This is because such rules artificially distort firms' costs, benefiting those already in place, and which are generally bigger, to the detriment of new firms, which are usually smaller.

The specific nature of these distortions is very varied. For instance, in relation to the labour market, the link between wages and the specific conditions of firms and employee productivity continues to be weak, despite the various labour market reforms. Further, the legislation on public procurement requires accreditation by tendering firms of a degree of solvency that is usually related to their turnover or their net worth and to public works executed in recent years. Start-ups have greater difficulty winning any tenders, irrespective of their productivity. But it is worth mentioning that the new public procurement legislation approved in 2018 made it possible for SMEs to tender by eliminating the accreditation of

⁹ See M. Almunia, and D. López-Rodríguez (2018): "Under the radar: The effects of monitoring firms on tax compliance", *American Economic Journal: Economic Policy*, 10 (1), pp. 1-38.

previous public works and reducing the number of years needed to demonstrate technical solvency.

Finally, the quality of the institutional framework has also proved significant when explaining cross-country productivity differences. In this respect, the indicators approximating the legal and administrative framework in which the public and private sectors interact show that Spain has ample room for improvement here. Further, according to different sources of statistical information, the Spanish legal system has efficiency indices below those of other comparable countries. That highlights the need to identify the factors behind these developments and redress them.

Conclusion

In conclusion, allow me to recall that, in a setting of limited potential growth, improving the economy's well-being turns on raising productivity. Indeed, set against the mere accumulation of production factors, increasing productivity is the sole mechanism that can generate sustained and stable economic growth in the long run. It is therefore crucial to make the structural reforms needed to improve productivity dynamics. Among other aspects, there is ample room to undertake reforms that reduce labour market duality, limit regulations impinging on competition and the allocation of resources, and eliminate the human and technological capital shortfall.

Thank you for your attention.