

THE EXPERIENCE OF SPAIN WITH ADJUSTMENT IN THE EURO AREA

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OUTLINE

- 1. The expansion of the Spanish economy until 2007 and the cumulated imbalances.**
- 2. The crisis and the current period of adjustment.**
- 3. The desirable economic policy response.**

1. THE EXPANSION OF THE SPANISH ECONOMY UNTIL 2007 AND THE CUMULATED IMBALANCES



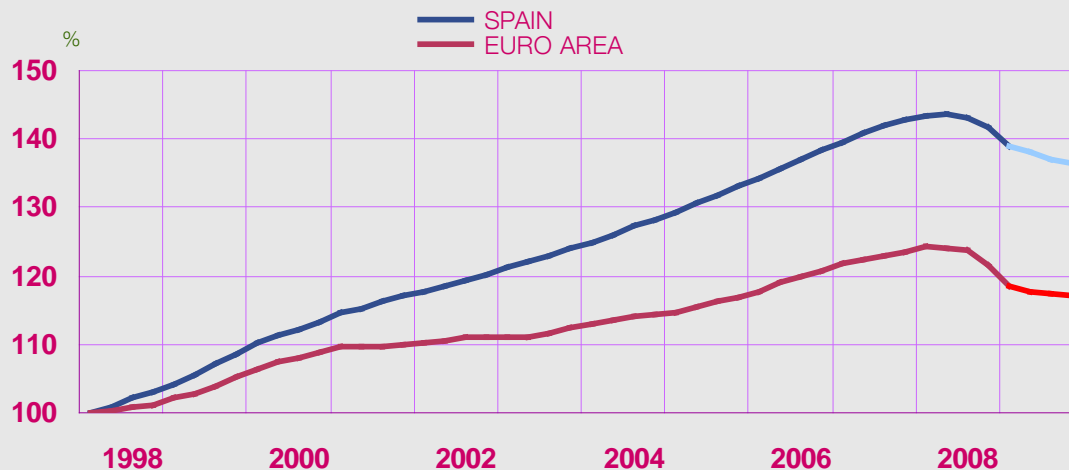
The Spanish economy expanded strongly in the first decade of EMU

Spanish real GDP increased more than 40% in the first ten years of EMU, almost twice as much as the euro area did.

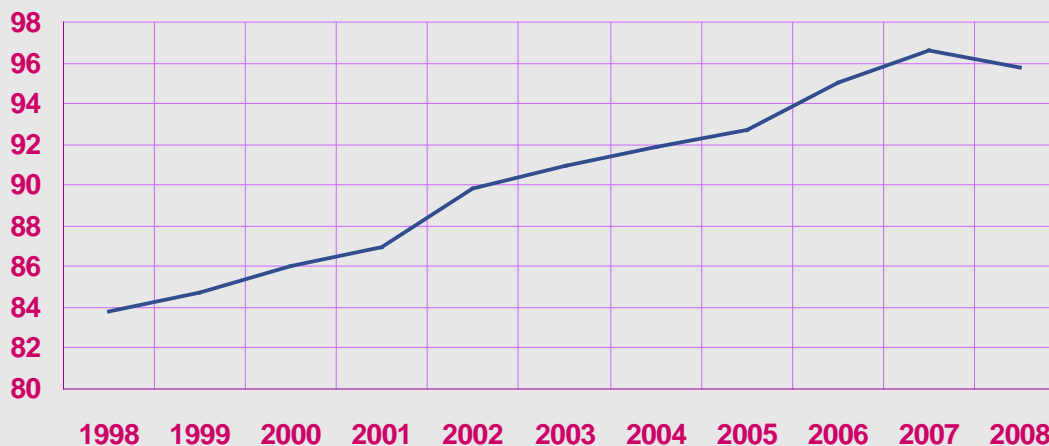
Average GDP growth rate was 3.6% from 1999 to 2007.

Real convergence advanced considerably in that decade. The gap with the euro area was trimmed to less than 4 pp in 2007.

GDP CUMULATIVE GROWTH (1998=100)



SPANISH GDP PER CAPITA AS % OF THE EURO AREA



Favourable financial conditions were key to explaining the strong increase in demand

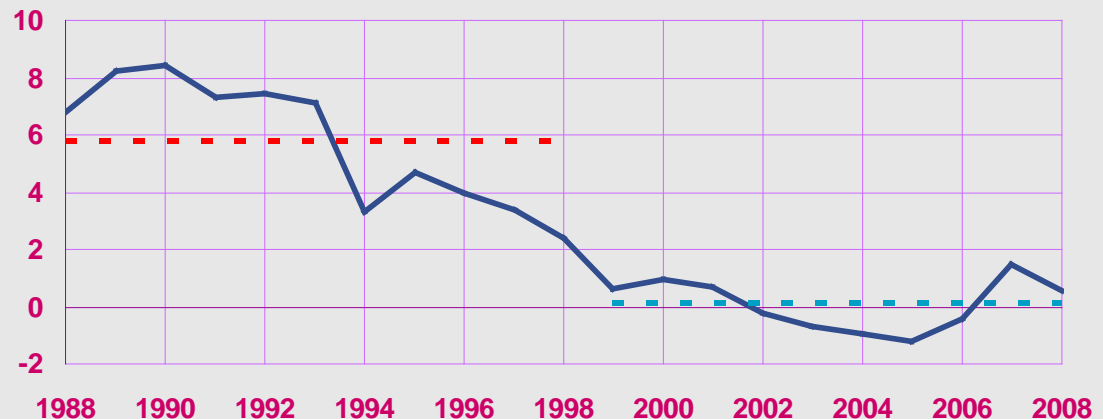


The framework of macroeconomic stability provided by EMU fostered demand.

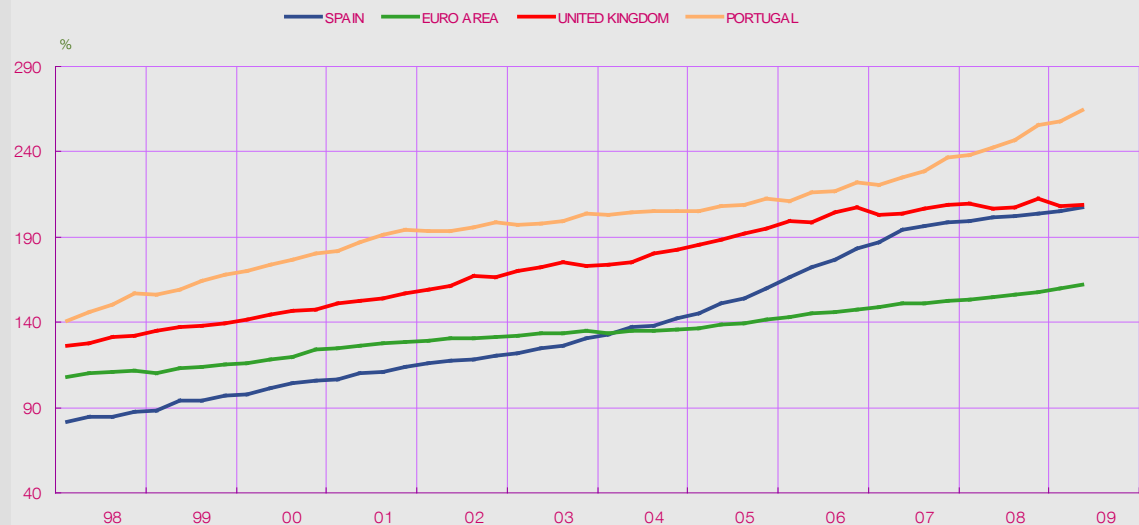
Monetary policy in the euro area was too loose for Spanish conditions.

Low indebtedness of private sector, the predominance of variable-rate loans and strong banking competition also boosted borrowing.

SPANISH REAL 3-MONTH INTEREST RATES



NON-FINANCIAL PRIVATE SECTOR DEBT AS % OF GDP



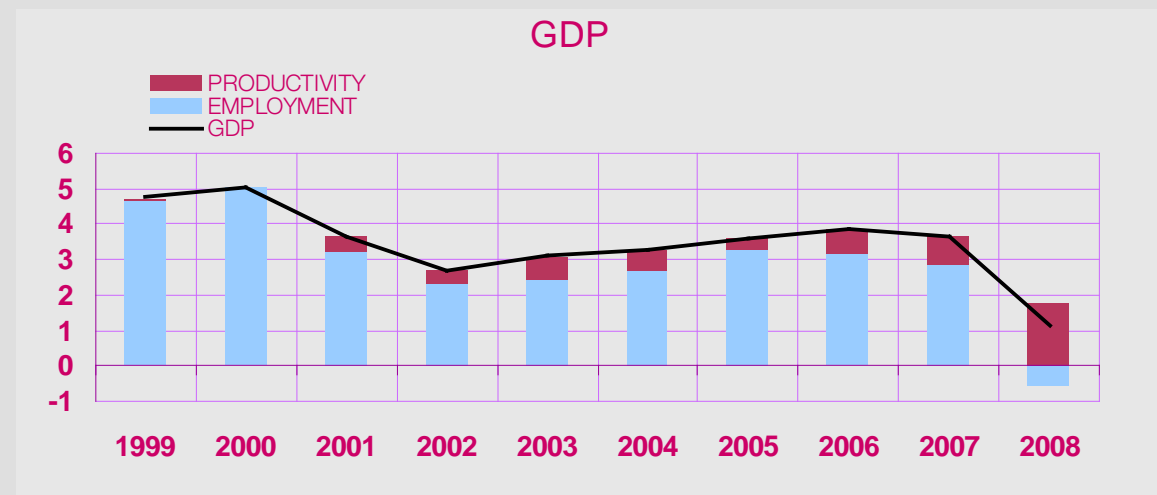
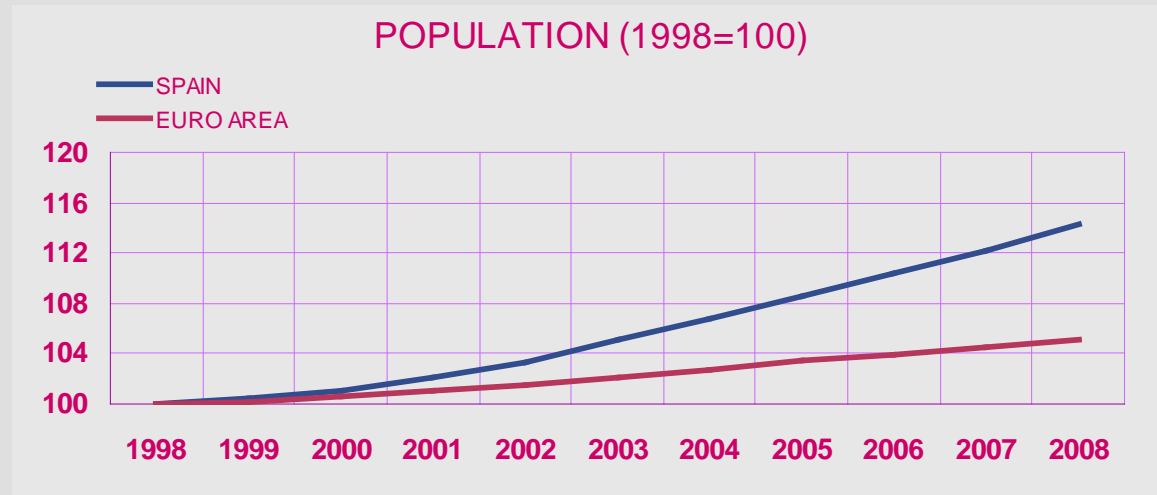
Supply reacted swiftly

Population increased by 6 million people from 1999 to 2008, as much as in the previous 27 years.

Women and immigrants boosted the labour force, supporting the strong expansion of some sectors and increasing flexibility in the labour market.

As a result, growth was very rich in its employment content. The employment rate reached 65%, exceeding that of the euro area.

But productivity gains were small, constraining the expansion of supply.



Contributing with other factors to rein in demand pressures



Fiscal consolidation allowed to achieve a budgetary surplus and a substantial reduction in the debt ratio, but its countercyclical role was limited (surely less than was needed).

Banking regulation introduced dynamic provisions as an element to reduce negative effects of pro-cyclicality → more buffers to cope with the financial crisis though that could not avoid the credit boom.

Liberalisation in some product markets, although important reforms still pending.

In particular, in the labour market, where one-third is very flexible, but two-thirds remain very rigid.

But these factors did not avoid the accumulation of imbalances

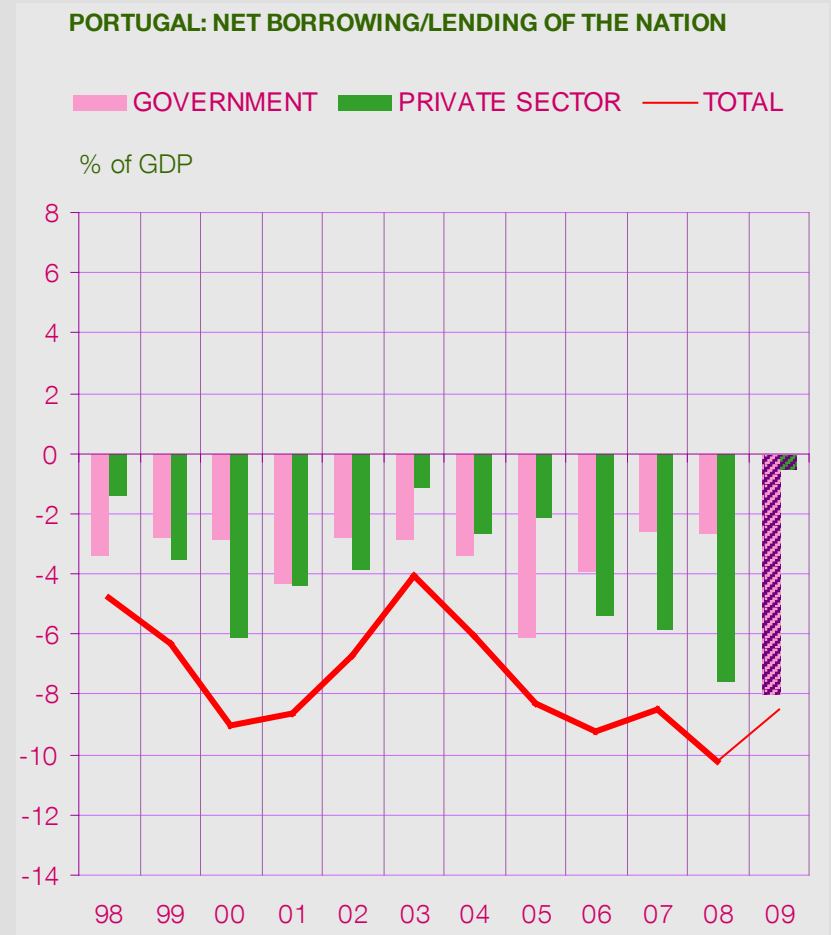
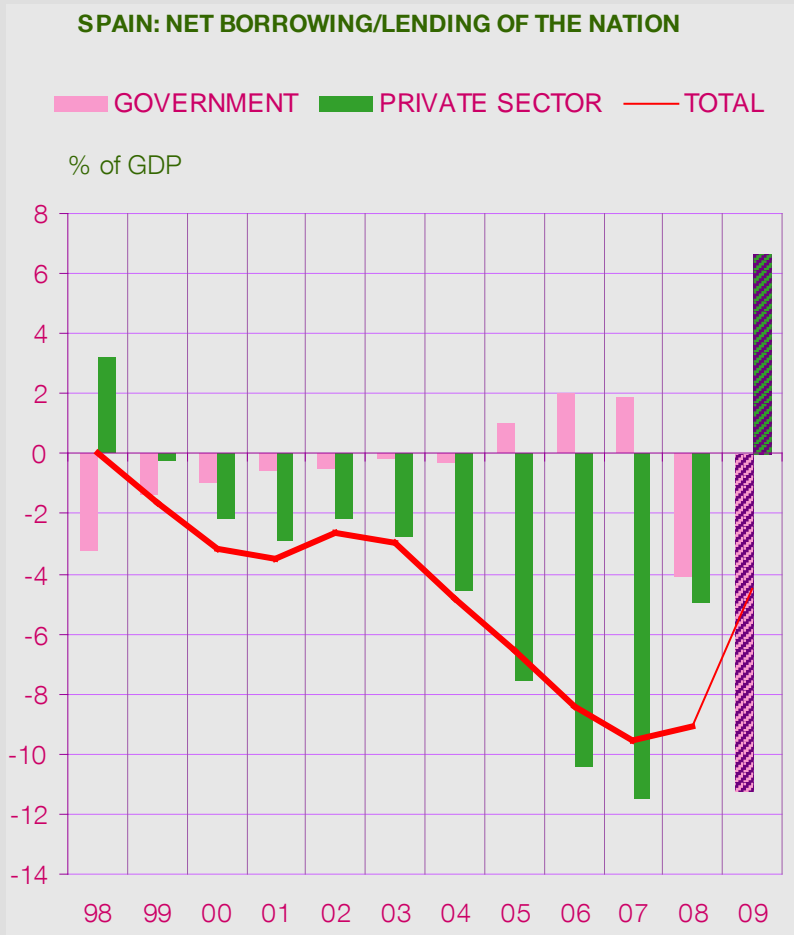


Spending pressures exceeded the supply-side capacity, giving rise to the emergence of a series of imbalances:

- excessive expansion of the real estate sector
- increase in household and corporate debt
- persistent cost and price differentials with the euro area

The high dependence on external finance of the Spanish economy should be interpreted as a reflection of these imbalances.

External deficit was the result of the large net borrowing needs of the private sector, in contrast to Portugal



2. THE CRISIS AND THE CURRENT PERIOD OF ADJUSTMENT



The disequilibria accumulated during the lengthy expansion made an adjustment necessary.

The adjustment already started at the end of 2006, before the outbreak of the financial crisis, when housing investment and prices began to slow down.

The financial crisis amplified the downward correction in housing and added sources of contraction in other variables, such as business investment and private consumption.

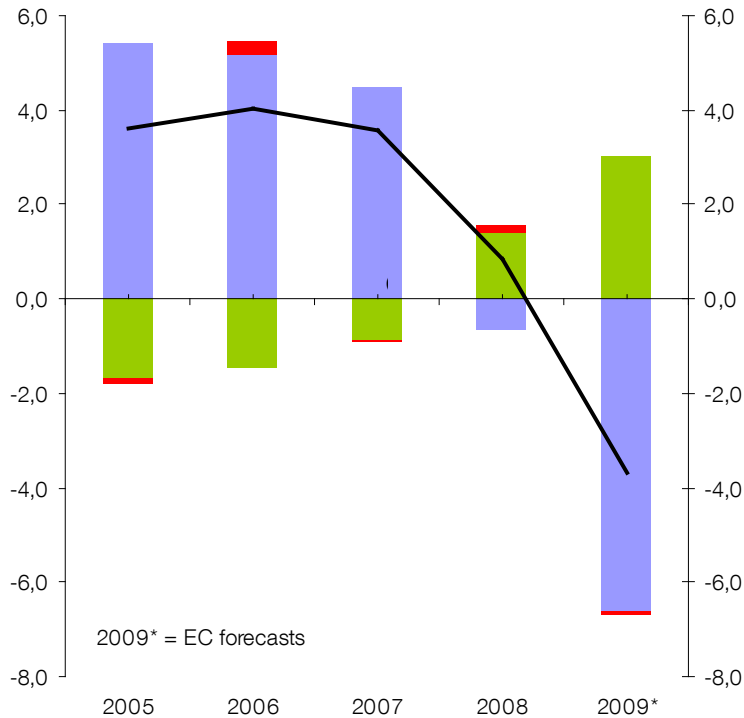
The adjustment in Spain is being driven by a strong contraction in domestic demand



SPAIN

Contributions to real GDP growth

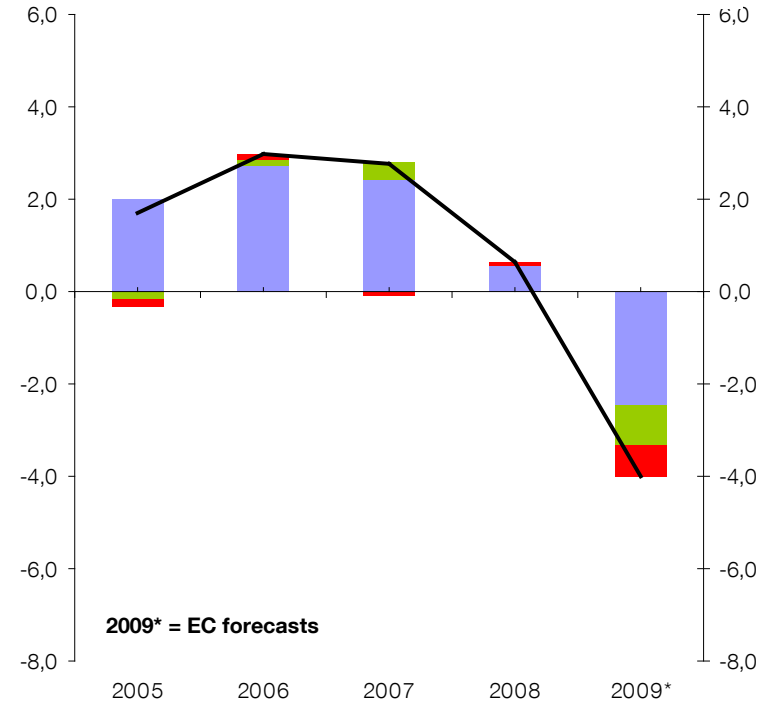
- Changes in inventories
- Net exports
- Domestic demand (excl. changes in stocks)
- Real GDP



EURO AREA

Contributions to real GDP growth

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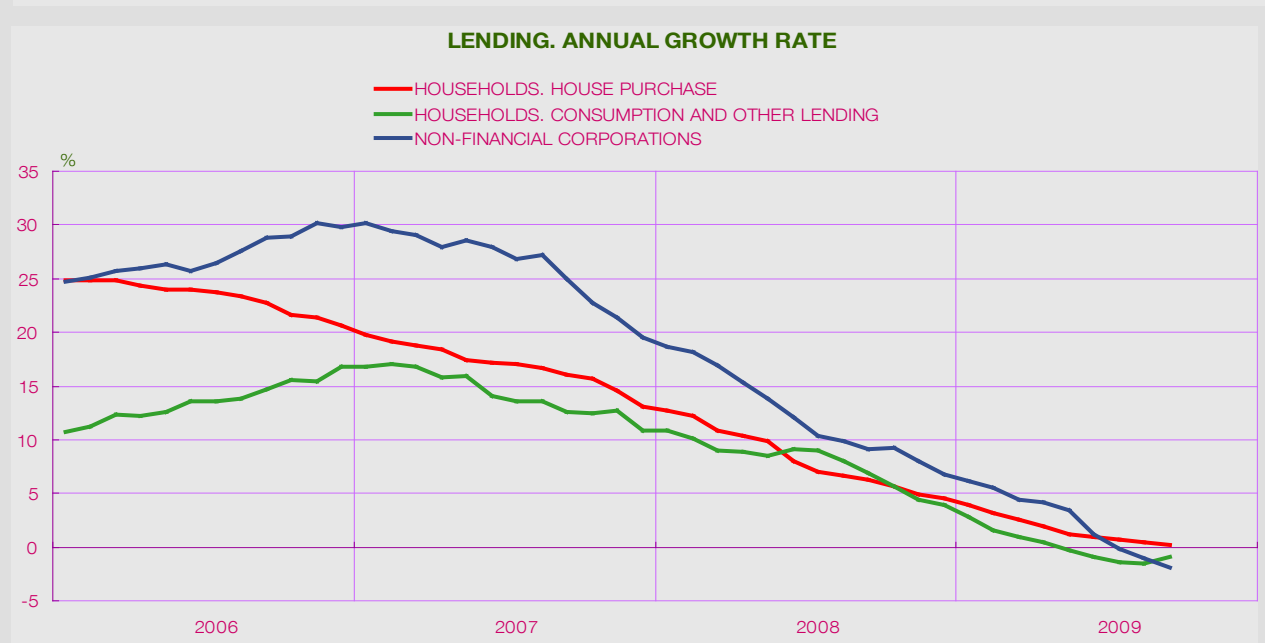
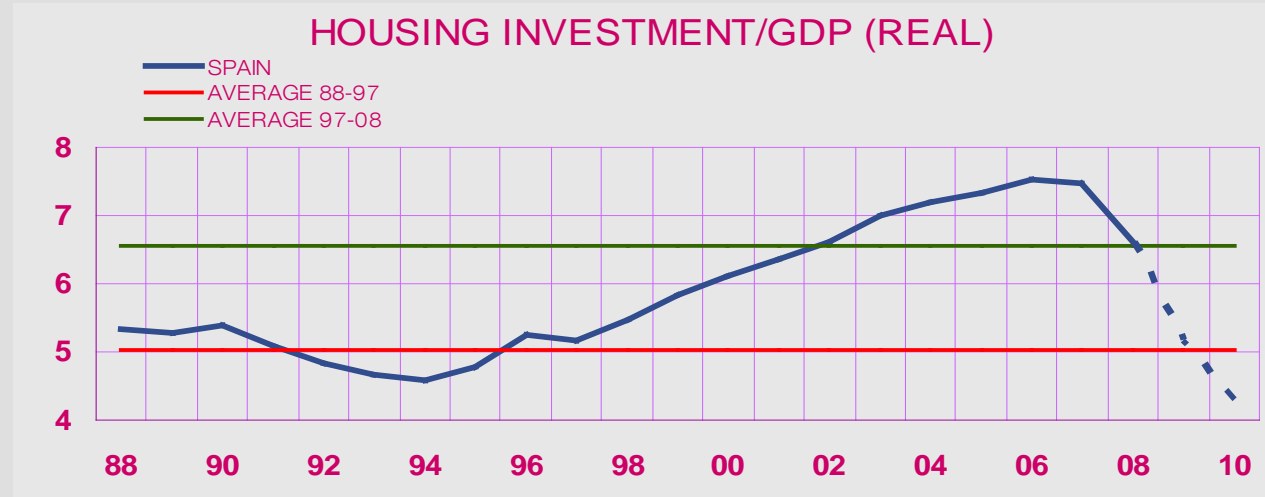


A swift correction of some imbalances is in play, as regards housing and credit to the private sector,



Housing investment share in GDP to reach a new historical low in 2010

Negative rates of growth in lending to households and firms



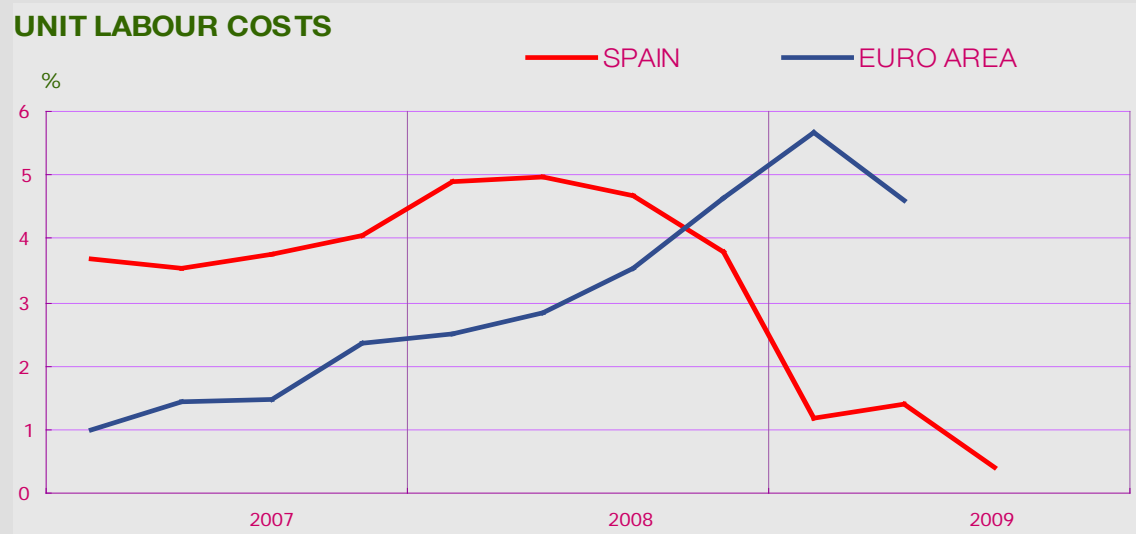
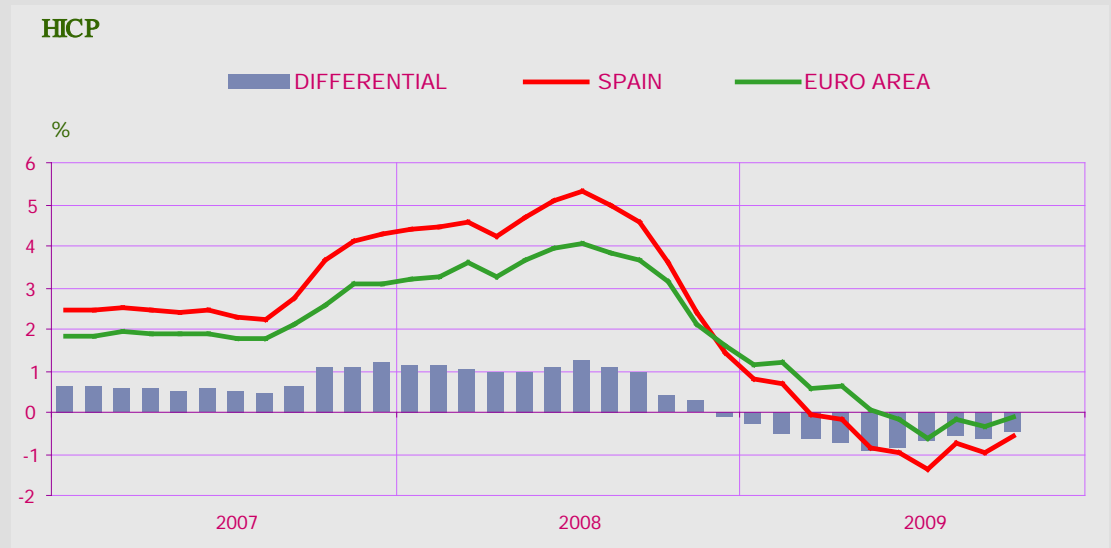
and also price differentials



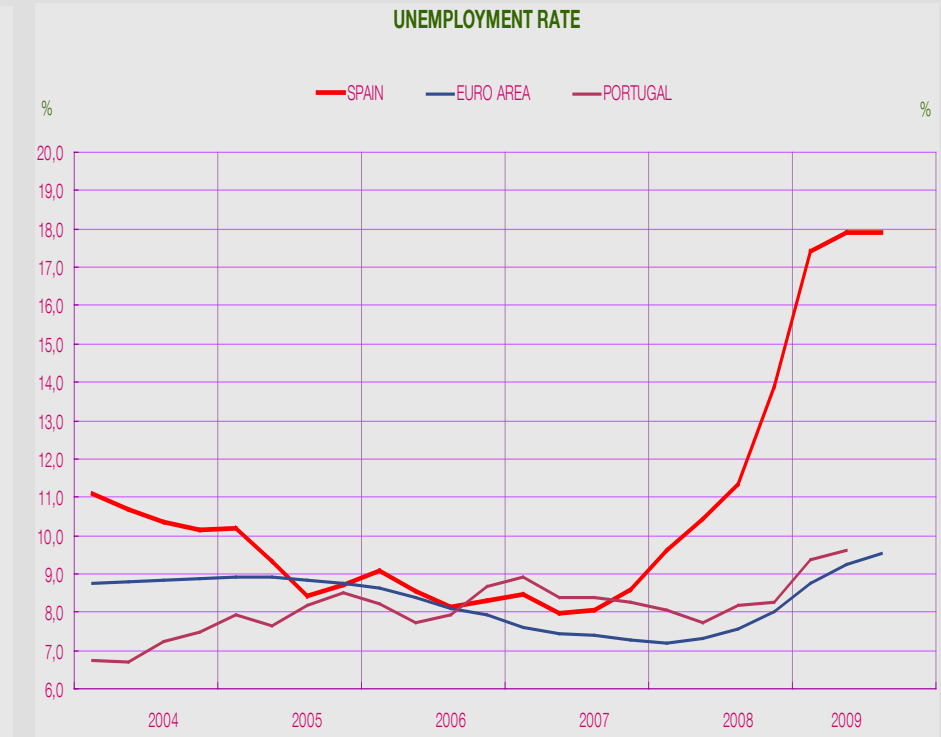
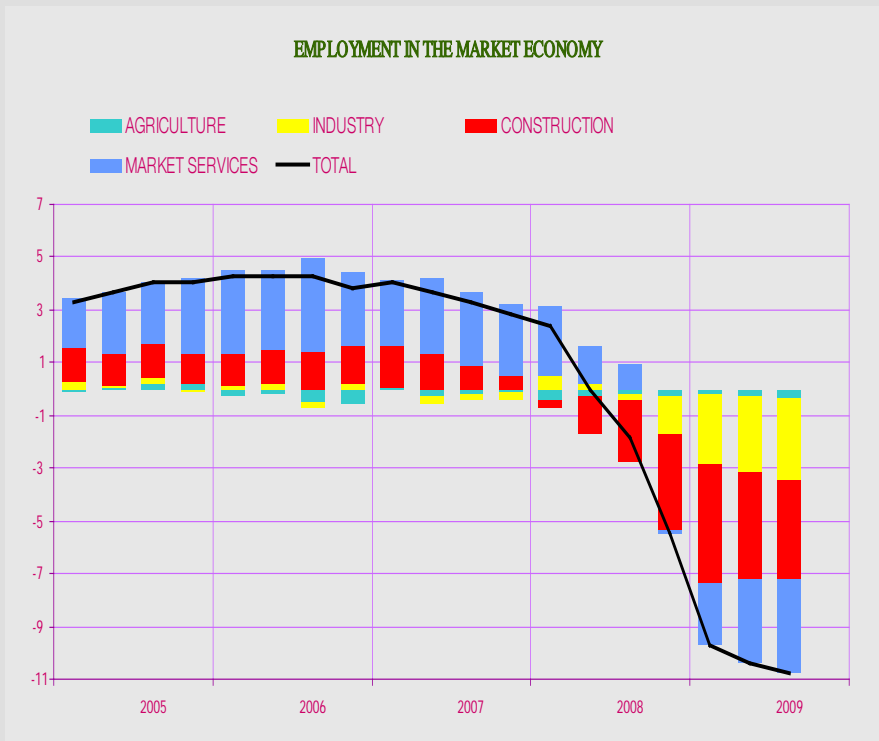
HICP sensitive to the negative cyclical conditions.

Leading to a negative differential with the euro area.

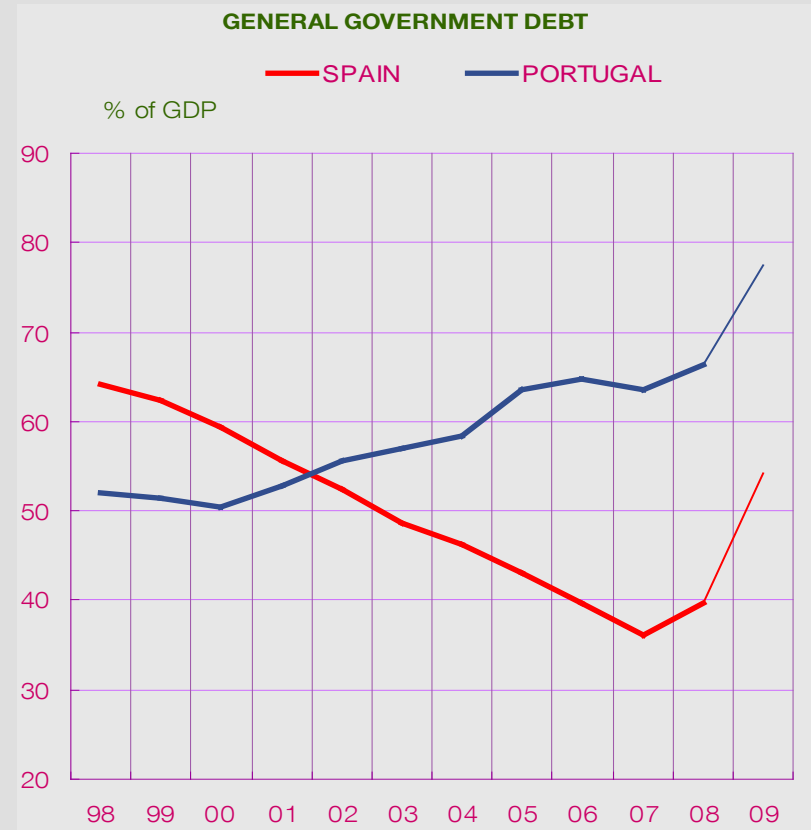
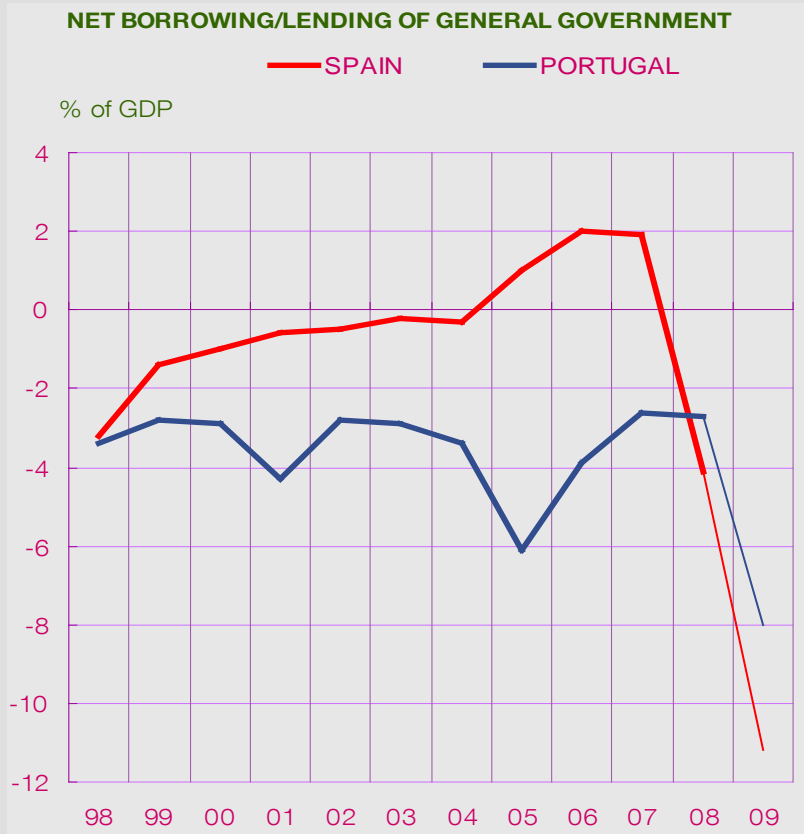
ULC differentials reversing as well.



But this process is having very negative consequences in terms of the unemployment rate and labour demand



And also in terms of public finances



The surplus achieved in 2005/07 has rapidly disappeared → this points to the difficulties to identify the true structural balance in the upper part of the cycle

Strong increase in deficit in 2008 and 2009 is the result of automatic stabilisers, discretionary measures and shortfall revenues. The inertia of non-cyclical expenditure also contributed to enlarge deficit.

Only the initial low debt ratio provided some relief, at least temporarily.

3. THE DESIRABLE ECONOMIC POLICY RESPONSE



To limit the costs of the recession, facilitate the adjustments and bring forward a sustainable recovery of demand and output, the role of economic policies is crucial.

After an intensive use in the last two years, the scope of budgetary policy to support demand has been exhausted.

A credible strategy of fiscal consolidation is much needed to support the recovery.

Experience suggests that -to be successful- the adjustment should mainly rely on cuts in public expenditure.

Autonomous Communities and Local Governments should also contribute to the adjustment.

2010: start of such consolidation period by introducing a number of measures, in particular, an increase in VAT, the removal of a previous personal income tax rebate, a wage freeze in civil servants and cuts in current expenditure and public investment.

But the key source of adjustment is the supply side measures



Structural reforms are the key to success and action should in particular be focused on three areas:

a) The labour market, with emphasis on

The reform of the dual system of contracts, which implies strong employment volatility and discourages human capital investment.

The collective bargaining mechanisms, to relate labour costs more directly to the economic conditions of sectors and firms.

The removal of inflation adjustment clauses.

b) The liberalisation of markets for

Services, with the European Directive being an opportunity to increase competition in professional services and retail trade sector.

Network industries.

Housing rental market

c) The financial system

A new financial landscape (in Spain and elsewhere) seems unavoidable, with fewer and more efficient institutions.

The restructuring of the banking sector in Spain will be channelled through the recently created Fund (FROB).



THANKS FOR YOUR ATTENTION

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