1 OVERVIEW

1 Introduction

In 2010, and although GDP fell by 0.1 % over the year on average as a result of the carry-over effects of the previous year's declines in output, the Spanish economy initiated a very sluggish and hesitant recovery amid the sovereign debt crisis in Europe. The situation created poses most considerable future challenges. These involve ensuring the success of the fiscal consolidation programme, the completion of the far-reaching restructuring and recapitalisation of the financial system, and the implementation of structural reforms enabling imbalances to be fully corrected and that would set the economy once more on a path of sustained long-term growth.

2 The sovereign debt crisis

The world economy continues on the path of recovery initiated in 2009, against a background of rising inflation...

The ongoing recovery in the economy continued last year and in 2011 to date, accompanied by a progressive normalisation of the financial markets which, however, were not free from bouts of instability. Of particular note were the episodes on the euro area sovereign debt markets, which have posed the biggest challenge to the common European project since its creation. Inflation has been moving on a rising trend, despite starting from moderate levels in the case of the advanced economies. The acceleration in prices has been largely linked to the cost of commodities and, in the case of the emerging economies, to greater demand-side pressures, too. This tendency has been more evident since December, due to the sharp rise in oil prices resulting from the political instability in the North African and Middle Eastern countries.

… with a marked divergence between the advanced and emerging economies, and considerable heterogeneity across the former

The 5 % increase in world output in 2010, following the 0.6 % decline in 2009, encompasses very different growth rates across the various geographical regions. The emerging economies, which had been less affected by the financial crisis, picked up more rapidly, with a 7.2 % increase in GDP. This headway was largely domestic demand-led and began to be manifest in certain signs of overheating and inflationary pressures. The advanced economies, meanwhile, posted growth rates of around 3 %, largely underpinned by inventories and public-sector support to demand. That said, fragility persisted in certain sectors, such as the real estate and financial industries, and the labour market was lacklustre. Standard indicators continue to show a relatively wide output gap, which helps explain the contained course of core inflation. Yet within this group of economies there have also been significant differences. In particular, the recovery is moving at a slower pace in Europe, with GDP growth of 1.7 % in the euro area in 2010 and of 1.4 % in the United Kingdom, in contrast to the greater dynamism of the United States and Japan (2.9 % and 4 %, respectively; see Chart 1.1). Even within the euro area there were significant differences in economic activity across the Member States, with vigorous GDP growth in Germany and Finland and significant declines in Greece and Ireland.

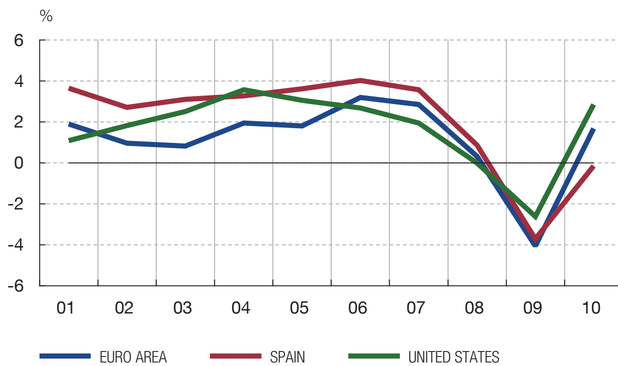
The economic policies adopted also showed divergences, both regarding monetary policy...

Over the course of 2010 there was notable disparity in the economic policy stances applied, reflecting the differences in the cyclical position of the economies in question, the various constraints on their economic policies and the diversity in the assessment of the risks that expansionary measures entail. Regarding monetary policy, the United States adopted further unconventional stimulus measures based on enlarging the Federal Reserve's balance sheet by means of the direct purchase of – essentially government – securities. This quantitative easing strategy, set in train at the outset of the crisis, was added to with a further programme of staggered purchases for a value of $600 billion (QE II) to combat deflationary risks and the signs of weakness that emerged in mid-2010. In the euro

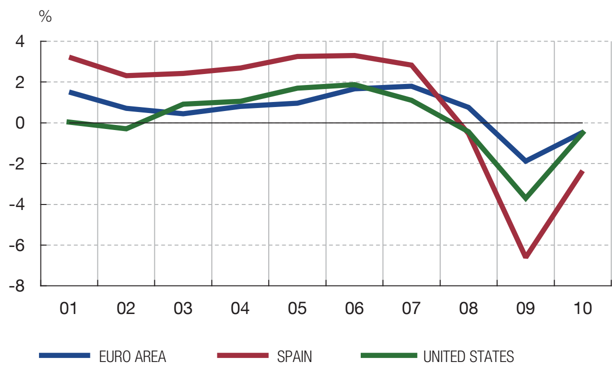
GDP, PRIVATE CONSUMPTION, EMPLOYMENT AND GROSS FIXED CAPITAL FORMATION

CHART 1.1

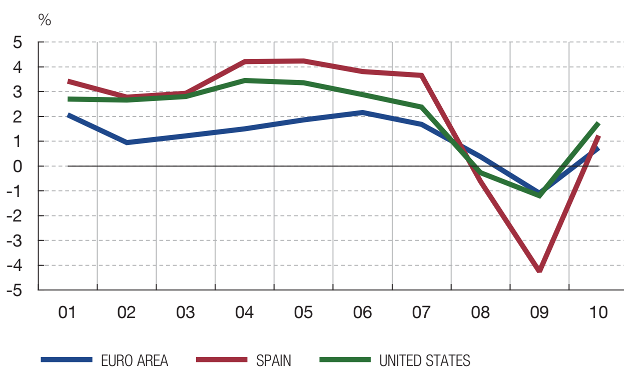
GDP



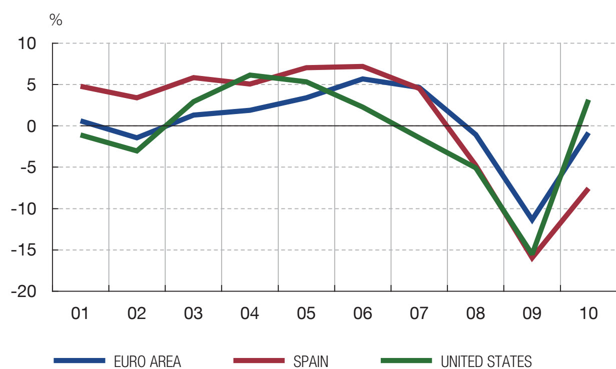
EMPLOYMENT



PRIVATE CONSUMPTION



GROSS FIXED CAPITAL FORMATION



SOURCES: Eurostat and national statistics.

area, monetary policy remained accommodative, but no additional expansionary measures were implemented. Some of the exceptional measures adopted beforehand have gradually been withdrawn; however, given the major tensions on euro area sovereign debt markets, the Securities Market Programme was set up, centred on the purchase of the government bonds of the countries most affected by these tensions so as to preserve the efficiency of the monetary policy transmission mechanism. Conversely, among the emerging economies, adopting a contractionary stance prevailed in response to growing inflationary pressures, a stance which, in some cases, clashed with a reluctance to let the exchange rate float sufficiently freely.

… and, especially, fiscal policy

The differences have proven particularly significant in the fiscal policy arena. In the United States and Japan, the continuing priority was to provide support mechanisms for the recovery, which took the form of new fiscal stimulus plans in both countries. The US budget deficit is thus expected to have stood at around 10 % of GDP at end-2010, with public debt close to 100 % of GDP. Conversely, both in the United Kingdom and in the euro area, vigorous fiscal consolidation processes were undertaken. In the case of the euro area, sovereign debt market tensions clearly put the focus on the risks inherent in a widespread situation of excessive deficits in the Member States, obliging members to take ambitious and swift corrective measures to quell investor doubts over the sustainability of public finances. These doubts, however, did not spread to economies such as the United States or the United Kingdom, despite the large scale of the deficit and public debt in both cases.

The recovery is expected to continue at a moderate rate, against a background of greater inflationary pressures …

The projections available suggest a central scenario for the world economy in which growth will continue to firm over the next two years, at a slightly lower rate than in 2010 but on sounder foundations. This would come about essentially from the application of economic policies whose stance will, broadly, be more contractionary, though not so in the United States. The heterogeneity across geographical areas which characterised the behaviour of GDP last year would be maintained in this scenario.

It is also likely, according to these same projections, that inflationary pressures will increase over the current and the two following years. As in the case of growth, there will be a continuing duality between the emerging economies, where the risk of overheating is higher, and the advanced economies, for which price growth rates are anticipated that, in the absence of second-round effects associated with the rise in commodities costs, would be more contained, in a setting of rather lacklustre employment growth.

… not free from risks

Significant risks surround this central scenario and, though they have tended to diminish, they continue to point to lower growth rates. Such risks include, primarily, those arising from the increase in oil prices, whose ultimate effects on inflation and activity will depend on how long the oil price holds at high levels and how it passes through to the prices of other goods and services, i.e. on the materialisation or not of the so-called indirect and second-round effects. Doubts about the soundness of public finances, the slowness of the return of real estate markets to a normal footing and high private-sector debt in some advanced economies might also check the recovery more than expected. The catastrophes in Japan, too, might have an impact on the world economy which, at present, is still difficult to assess. The pace and pattern of correction of the so-called “global imbalances” remain a source of uncertainty. Finally, as regards the necessary resizing of the financial sector and the restructuring of its regulatory frameworks, there has been progress. Yet the risks that may still arise from the behaviour of the international financial markets should not be underestimated.

There has been further headway in revising international financial regulation, so as to improve prevention and resilience in the face of potential future financial crises

Turning to financial regulation, where the need for far-reaching change became evident with the crisis, the global work led by the G20 has continued, with the Financial Stability Board playing a leading role. Mention should also be made of the recent Basel III Accord, which introduces new capital and liquidity requirements for banking systems. Together, they provide a common reference framework for the deep-seated reforms to national regulatory systems that are needed to correct the weaknesses revealed by the global crisis. The elements of this common framework include most notably enhanced transparency, closer monitoring of developments in the non-regulated financial system and tighter control of the systemic risks generated by financial institutions. This would be done by imposing greater countercyclical capital requirements, limits on the level of leverage and closer surveillance of remuneration arrangements so as to prevent these encouraging excessive risk-taking. Discussions also encompass other aspects such as taxes on financial activity or the establishment of appropriate mechanisms to manage and resolve potential bank crisis episodes. On the whole, this process has evidenced notable international coordination, which must be maintained in the future to ensure the success of the reforms.

Notwithstanding, the international financial markets remain subject to considerable tensions. And these are particularly visible in the euro area sovereign debt markets. Any further episodes of instability here might translate into a tightening of financial conditions that would have unfavourable consequences for corporate and household spending decisions in the economies affected. To properly gauge the scale of this risk, the fundamental reasons behind these tensions should be analysed in detail.

The sovereign debt crisis in Europe began in Greece and spread rapidly to the whole of the area

Tensions in the euro area sovereign debt markets began to brew in late 2009 as a result of investors' growing doubts about Greek public finances. The instability spread initially to the sovereign debt of those economies already perceived to be prone to greater vulnerability. Such perceptions were based on their fiscal position (whether because of the high level of debt or deficit, or because of the pace at which either of these variables was deteriorating), the fragilities in their financial system and the presence of relatively weak foundations for sustaining economic growth. But the problems also reached stock and foreign exchange markets and gave rise to a progressive loss of confidence by international investors which ultimately fed through to bank wholesale funding markets, causing serious liquidity problems to some institutions. As a result, the stability of the financial system of the area as a whole was affected, revealing the tight links between institutions and financial markets within the euro area.

The reluctance of the Greek authorities to request financial support and the doubts expressed by European governments and authorities over the substance and form of any such support were a breeding ground for heightening tensions, which reached a critical point in May. That month saw the approval, finally, of a financial support package for Greece worth €110 billion, strictly conditional upon the Greek authorities adopting an ambitious economic adjustment programme. The funds were contributed by the euro area governments and by the International Monetary Fund. It befell the European Commission and the IMF, in collaboration with the ECB, to supervise compliance with the terms of the agreement. To curb the growing contagion of the tensions, the European Financial Stability Facility was instituted to run to 2013 and be capable of mobilising, along with the EC (through the European Financial Stability Mechanism) and the IMF, funds worth up to €750 billion to provide financial assistance in similar cases and under conditions that could also be equated to those of the Greek programme.

The Irish financial system crisis fanned tensions anew, as did the difficulties in adopting the necessary economic measures in Portugal and concerns over the Greek Treasury's ability to return to the market in 2012 as planned...

These decisions contributed to easing tensions, as did too the publication in July of the results of the banking stress tests conducted under coordination across Europe, which offered a picture of banking system stability. However, over the summer and autumn a new source of tension arose, centred this time on the ongoing deterioration of the position of Irish banks and on the consequences of the situation for Irish public finances. Once again, following an initial phase of some reluctance, the Irish authorities finally and formerly requested financial assistance. Their request was approved and took the form of a conditional programme, like that for Greece, worth €85 billion. In April 2011, Portugal joined the group of countries having to request financial assistance in light of its government's difficulty in carrying out the adjustment and reform plans needed and of the worsening of financial market conditions. On 16 May Ecofin approved the related aid programme. Weeks later, the continuing high sovereign spreads in Greece and the worse-than-expected behaviour of its main macroeconomic variables led to investor nervousness about Greece's ability to return to the markets for funding in 2012, as envisaged in the financial assistance programme. Since the Greek authorities and governments of the rest of the euro area were unable to promptly define the strategy to pursue in light of this eventuality, tensions heightened, fuelled by untimely debates about how realistic certain traumatic scenarios were.

...and they made it necessary to change with relative urgency the fiscal policy stance across the entire area

In all three cases, the macroeconomic adjustment packages on which financial support was conditional envisaged ambitious fiscal consolidation programmes geared to restoring the soundness of public finances and thereby restoring investor confidence. In the rest of the area, the tensions experienced on the sovereign debt markets exerted the same effect.

Fiscal consolidation plans were brought forward and stepped up notably in Spain, with structural reforms being introduced at the same time. In Italy, Germany and other economies in the area, austerity programmes were likewise finalised with a view to their application as from 2011. The sovereign debt crisis prompted not only a need to abandon the expansionary approach with which fiscal policy had responded in Europe to the initial wave of the international financial crisis, but also some urgency to reverse it. The traditional positive effects on growth of an expansionary fiscal policy (Keynesian effects) were exhausted and were rapidly replaced by others that operate to the detriment of activity. These are associated with the increases in long-term interest rates that occur when investors perceive a deterioration in the soundness of public finances and which ultimately prompt a fall-off in private spending (Ricardian effects).

The primary and principal source of the sovereign debt crisis lies in the major imbalances built up in certain Member States…

The euro area sovereign debt crisis is essentially the result of a series of imbalances and mismatches built up in the economies of certain Member States and their sudden emergence and worsening as a result of the global economic and financial crisis. With differing degrees of influence in each case, these imbalances include most notably the continuous losses in the competitiveness of some economies; the excessive size of the financial sector and its excessive accumulation of risks, in other countries; and the high levels of private debt prompted, in certain cases, by an expansionary single monetary policy stance insufficiently offset by the action of the other strands of economic policy in the hands of national authorities. Before the crisis, several Member States had high levels of public debt, accentuated on occasions by the existence of contingent public liabilities linked to the progressive ageing of the population or to the potential need to undertake banking system restructuring. The marked deterioration in budget deficits resulting from the operation of the automatic stabilisers and from the application of discretionary expansionary measures, the loss of extraordinary income linked to certain sectors such as the real estate and financial industries, and the influence of the support programs to financial institutions which it proved necessary to implement in some countries also contributed to undermining market confidence in the soundness of public finances. A further factor weakening confidence lay in growth prospects, weighed down by relatively unfavourable productivity and potential growth developments. As is known, the financial markets have a tendency to overreact to news, whereby it is likely that, in this episode too, investors' response may have been excessive in some cases. But that should not mask the real scope of the problems that have emerged.

… whose effects were exacerbated as a result of a series of weaknesses in the structural design of economic governance in the area

The build-up of these imbalances without any mechanism in place to warn about their potential risks and their possible effects on the area also reveals the existence of weaknesses in the euro area's non-monetary economic policy coordination and surveillance mechanisms, which have acted as amplifiers of the tensions. The sovereign debt crisis has highlighted not only the limitations of the Stability and Growth Pact (SGP) and of national fiscal frameworks in promoting a sufficient degree of fiscal discipline, but also the inadequate attention to the accumulation of macroeconomic imbalances that are not necessarily fiscal in nature, as mentioned in the previous paragraph. Further, the scale of the tensions, their contagiousness and their interrelatedness with the thrust of the discussions on how to address economic governance in the area are by no means unrelated to the absence of powerful formal mechanisms to resolve situations such as those experienced by Greece, Ireland and Portugal, and to the difficulties involved in setting such mechanisms in place amid a crisis.

The tensions on financial markets also influenced the decisions of the ECB…

The tensions on financial markets and, in particular, those created by the increase in sovereign risk, affected the monetary policy transmission mechanism and obliged the ECB to take measures supplementing those it had already adopted in response to the crisis. More spe-

cifically, the absence of medium-term inflationary pressures meant that the ECB Governing Council was able in 2010 to retain its expansionary monetary policy stance in the euro area, holding official interest rates unchanged at the minimum level of 1 %. However, to ensure the effective transmission of its decisions, the Eurosystem continued to apply credit support measures, concentrated mainly in the ample provision of liquidity. In addition, the strong tensions on some public debt markets led to the Securities Market Programme being implemented. During the year, nonetheless, the covered bonds purchase programme expired, and repayment fell due of the special longer-term loan operations that had been introduced at the critical points of the international financial crisis. Accordingly, a sizeable portion of the excess liquidity was reabsorbed without giving rise to tensions on interbank markets, which shows how the progressive normalisation of these markets continued apace last year.

… which faces the challenge of bringing financial conditions back onto a normal footing against a background of inflationary risks, slow recovery and tensions on debt markets

In the immediate future, euro area monetary policy will be at a complex juncture that poses significant challenges. The gradual withdrawal of the exceptional measures in place should be carefully calibrated to avoid interfering in the normalisation of financial markets while preventing, too, the maintenance of the measures for too long from reducing the effectiveness of monetary policy, detracting from the ECB's credibility, distorting the relative prices of assets and delaying the reforms needed in certain segments of the European banking sector. At the same time, the rise in commodities prices and the difficulties of assessing their medium-term trajectory are a further complication. This may hamper the adjustment of the monetary policy stance to a scenario in which the consequent risks of indirect and second-round effects that might endanger continuing price stability combine with a slow rate of recovery and, therefore, the slow closure of the output gap, and with a still-uncertain situation on financial markets. Against this background, the ECB Governing Council decided at its April 2011 meeting to raise official rates by 25 bp.

The European institutions likewise face the need to reform economic governance

The challenges for the other European institutions are likewise significant. First, they must successfully overhaul the euro area's economic policy coordination and surveillance mechanisms. As explained in greater detail in Chapter 4 of this Report, the reform targets greater and more effective coordination of national policies, which should move within agreed limits and which will be subject to mutual, rigorous and effective surveillance. The recommendations of the so-called "Van Rompuy Working Group" were, along with the attendant EC proposals, the first steps of a process that should conclude this summer. The measures being considered may be classified under three major headings: those aimed at ensuring greater fiscal discipline, through the strengthening of the SGP; those geared to introducing a new mechanism for monitoring macroeconomic imbalances and competitiveness; and the design of a permanent crisis-management mechanism. Under no circumstances are changes that might require an amendment of fundamental aspects of the EU Treaty envisaged, thereby avoiding the risk of an unwanted stretching out of the reform.

January 2011 saw the start of the European Semester

As part of the reform programme, the EC published in early 2011 the first Annual Growth Report, thus inaugurating the "European Semester" of economic policy coordination. For the first time, the Member States and the Commission will jointly analyse the risks to macroeconomic stability, headway in fiscal consolidation, and the structural reforms and other necessary measures for promoting growth. The European Council's recommendations should be taken into account in preparing the national budgets for 2012 and in the implementation of other national economic policies. Along the same lines, the new "Europe 2020" strategy, aimed at increasing European growth potential, has entailed introduction of a series of emblematic initiatives at the European level, geared to supporting member countries' reform drives.

The governance reforms must be commensurate with the challenges facing the EU, and due attention should be given to the problems the situation in Ireland, Portugal and Greece may pose in the short term

The success of these reforms and their degree of ambition will determine whether the new governance framework is indeed able to withstand the challenges facing the EU. The sovereign debt crisis has highlighted the need to strengthen the European institutional framework and, particularly in the case of the euro area, to attune it to the high degree of integration and economic interdependence attained among its members. A sufficient degree of automaticity and reasonably restrained implementation schedules both for procedures and, where appropriate, for sanctions, will help ensure that the sound working of the mechanisms does not depend on national governments' willingness to meet the commitments entered into.

In this respect, the European Summit on 24-25 March 2011 gave fresh impetus to the legislative reform process that will underpin the new framework for the prevention and correction of fiscal (i.e. a strengthened SGP) and non-fiscal (the creation of the excessive imbalance procedure) imbalances. The Summit also laid down the core principles for a new, permanent crisis management and resolution mechanism that will come into force from 2013 (the European Stability Mechanism), and it approved the "Euro Plus Pact", which enshrines the Member States' political commitment to adopt measures aimed at improving competitiveness, increasing employment, ensuring the sustainability of public finances and reinforcing financial stability in the area. However, more immediately ahead, the situation in Ireland, Portugal and, especially, Greece poses a challenge whose scale should not be underestimated. The transition to this new, reinforced European governance framework is taking place amid the harshest crisis the euro has faced since its creation. If this complex situation is not tackled with the resolve required to overcome it conclusively, the common European project might undergo a setback whose consequences are difficult to foresee and which would jeopardise the success of the efforts made to date.

The European Systemic Risk Board has also started operating in 2011

Another of the structural shortcomings highlighted by the crisis is the absence of macroprudential and eminently pre-emptive economic policies aimed at ensuring the stability of the financial system as a whole and at minimising the effects of instability on the real economy. A consensus has been built around the need to develop a set of early-warning instruments to detect the potential build-up of macroeconomic and financial imbalances capable of leading to large-scale financial crises. The development of macroprudential policy is being addressed through a number of national and international initiatives. These include most notably, within the EU, the institution of the European Systemic Risk Board (ESRB) which, along with the three new European supervisory authorities with a microprudential remit for the banking, securities and insurance sectors, comprise the new European supervisory architecture (the European Financial Supervision System).

At the level of the Member States, the challenges entail fulfilling the fiscal consolidation measures…

The success of the action undertaken at the European level will hinge crucially on whether it is complemented by the measures adopted at the level of the Member States. As regards public finances, the euro area governments have formally undertaken to adopt all the measures needed to meet the fiscal targets envisaged under the excessive deficit procedures. Some countries have adopted additional commitments to speed through the fiscal consolidation foreseen under these procedures and to provide greater guarantees as to the sustainability of their public finances. Such progress towards laying the foundations for a prudent fiscal policy that ultimately provides for the return to a path of balanced and sustainable growth is crucial at the current juncture.

… and adopting the structural reforms needed to promote potential growth and

Now the limits of expansionary demand policies have been reached, structural reforms aimed at increasing the responsiveness of economies to shocks, at making them more flexible and at raising, in the medium term, growth potential and the capacity to achieve

employment, along with the restructuring of national financial systems and the reform of their regulatory frameworks

full employment of productive resources should be the chief priority of economic policy action. Along these lines, the Europe 2020 strategy offers a coherent framework to Member States for implementing a co-ordinated and comprehensive programme of structural reforms, which are vital to boost European growth. Finally, it is important that the ongoing restructuring, resizing and recapitalisation of the crisis-hit European banking systems should be satisfactorily concluded. Along with the above-mentioned global regulatory reforms, these should serve to entrench a sound financial system capable of contributing effectively to economic growth through the efficient intermediation of financial flows.

3 The Spanish economy in the face of the sovereign debt crisis

The sovereign debt crisis had a forceful impact on the Spanish economy…

The financial tensions that rocked European markets from May forcefully impacted the Spanish economy. The main channel of transmission was the diminished confidence of the markets, which was quite acute at certain points in the year, coinciding with the bouts of maximum tension in Greece and Ireland. In an economy like Spain's that is strongly dependent on external saving, these episodes translated into a tightening of lending standards, markedly so for the Treasury and credit institutions. Spain's sovereign debt spread against the German benchmark was subjected to various bouts of pressure which saw it widen to close to 300 bp at the most critical points. Difficulties spread also to the banking sector, which for many months found access to the wholesale markets substantially blocked. And this, temporarily, significantly increased Spanish banks' recourse to the Eurosystem.

As in the case of the other euro area countries, the tensions involved an element of overreaction by investors. But it would be mistaken to dismiss the importance of the problems underlying these tensions. The aforementioned weaknesses of the European institutional framework and the doubts generated about the commitment of European governments in general, and of Spain in particular, to tackle structural problems and deteriorating public finances also played a key role in the initial stages of this latest round of financial instability.

… owing to underlying factors that placed our economy in a position of vulnerability

The vulnerabilities that had emerged further to the crisis seriously increased the Spanish economy's exposure to this type of turbulence, at a particularly delicate juncture. The crisis had given rise to a rapid deterioration in public finances, manifest not only in a very high budget deficit level, up to 11.1 % of GDP in 2009 from a surplus of 1.9 % two years earlier, but also in the swift rise in the public debt ratio, despite the fact that general government debt remained far lower than that of other European economies facing similar pressures. Moreover, the surge in the unemployment rate, as a consequence of the depth of the recession in Spain but also of labour market dysfunctionalities, raised doubts about the possibility of reversing the course of public spending in the absence of reforms conducive to reducing unemployment and boosting growth.

During the upturn prior to the crisis, Spain had become very dependent on external financing, a situation that persisted – albeit to a lesser extent in 2010 – and which increased the economy's vulnerability to episodes involving a loss of confidence. These episodes hampered access to the external financing that had been routed through credit institutions, whose role was seriously diminished by the doubts over specific segments of the banking industry, related to the scope of the impact of real estate asset impairment on the soundness of their financial position. Lastly, high household and corporate debt and the cumulative losses in competitiveness, the result of spending excesses during the upturn, were perceived by investors as a check on the recovery of expenditure, whereby the uncertainty spread also to the economy's growth capacity, once the real estate excesses had been corrected.

As the fiscal crisis unfolded, some of these vulnerabilities elicited parallels – in many cases unfounded – with the experiences of the Greek and Irish economies, which had to resort to external financial support conditional upon harsh adjustment programmes overseen by the IMF and the European institutions. The labelling of certain countries on the basis solely of the nature of their difficulties, as opposed to the actual scale and potential scope of such difficulties, has been a further factor amplifying the market tensions that have affected the Spanish economy. These financial strains hampered the ongoing adjustment and resizing of the financial system, eroded the confidence of households and firms, which had embarked on a process of slow deleveraging, and further checked the pick-up in private spending.

4 The adjustment and re-balancing of the Spanish economy, and the turnaround in economic policy

The sovereign debt crisis prompted an abrupt turnaround in the economic policy stance

Economic policy reacted with an abrupt shift in stance in the required direction, which had a key bearing on the course of spending and on macroeconomic developments in Spain during the period analysed in this report. Given the source of the tensions, it was vital to dispel doubts over the trajectory of public finances through a demanding fiscal adjustment plan that would ensure compliance with the goals of the Stability Programme for the 2010-2013 period. In parallel, there was clearly a compelling need to tackle the labour market shortcomings that were hampering the absorption of unemployment and the adjustment to the economy, through the reform of some of the institutional determinants of the labour market. Lastly, in the financial arena, bank restructuring was speeded up, a far-reaching reform of the regulation of savings banks was set in train (providing, inter alia, for the transfer of their financial activity to newly created institutions structured in the form of banks and encouraging the entry of private capital into the sector), unprecedented transparency measures were taken and capital requirements were increased so as to dispel doubts about their solvency, even in scenarios of exceptional tension. All these measures are analysed in greater detail at a later stage, when economic policy challenges are addressed.

The Spanish economy began a slow recovery in 2010

In 2010 the Spanish economy slowly embarked on a course of recovery, posting positive GDP growth rates throughout the year, except in Q3. At the same time, progress was made on the adjustment of the imbalances that had built up during the upturn. The correction of the excess in real estate investment, the reduction in net borrowing abroad and the deflationary path in labour costs and final prices all continued, and were joined by the start of a reduction in the budget deficit. The outstanding balance of private-sector credit stabilised, although the sector's debt held at a high level which continued to influence spending decisions. During the opening months of 2011 the pattern of sluggish recovery continued, and GDP posted a growth rate of 0.3 % in Q1, placing the related year-on-year rate at 0.8 %.

The recovery in 2010 began with some delay and less intensity than that of the euro area countries as a result of the greater scale of the crisis in Spain and of the impact that the necessary process of adjustment is exerting on short-term growth rates. The recovery in output was subject, however, to oscillations during the year as a result of certain temporary measures acting on the path of domestic spending. Specifically, the rise in VAT scheduled for 1 July and the foreseeable end of some of the expenditure-promoting public aid programmes (such as the State Fund for Local Investment and the car scrappage scheme) led some spending decisions to be brought forward to the first half of the year, while the effects of the austerity measures approved in May, chiefly affecting the public components of national demand, were felt in the second half of the year.

Despite the gradually improving path referred to, GDP fell by 0.1 % for the year on average, the results of the carryover effect of the declines in output the previous year (3.7 %; see Table 1.1). Overall, domestic demand remained sluggish, influenced by the withdrawal of the public-sector expansionary impulse to aggregate demand, although the impact on

MAIN INDICATORS OF THE SPANISH ECONOMY (a)

TABLE 1.1

	2005	2006	2007	2008	2009	2010
DEMAND AND OUTPUT (b)						
GDP	3.6	4.0	3.6	0.9	-3.7	-0.1
Private consumption	4.2	3.8	3.7	-0.6	-4.2	1.2
Government consumption	5.5	4.6	5.5	5.8	3.2	-0.7
Gross capital formation	6.5	8.3	4.2	-4.3	-15.8	-7.0
Equipment investment	9.2	9.9	10.4	-2.5	-24.8	1.8
Construction investment	6.1	6.0	3.2	-5.9	-11.9	-11.1
Housing	6.1	6.2	2.5	-10.7	-24.5	-16.8
Other construction	6.2	5.8	4.0	-0.8	-0.1	-7.2
Exports of goods and services	2.5	6.7	6.7	-1.1	-11.6	10.3
Imports of goods and services	7.7	10.2	8.0	-5.3	-17.8	5.4
EMPLOYMENT, WAGES, COST AND PRICES (c)						
Total employment	3.2	3.3	2.8	-0.5	-6.6	-2.4
Employment rate (d)	64.3	65.7	66.6	65.3	60.6	59.4
Unemployment rate	9.2	8.5	8.3	11.3	18.0	20.1
Compensation per employee	3.7	4.0	4.8	6.4	4.1	0.7
Unit labour costs	3.3	3.3	4.0	4.9	1.0	-1.5
GDP deflator	4.3	4.1	3.3	2.4	0.6	1.0
Consumer price index (12-month % change)	3.7	2.7	4.2	1.4	0.8	3.0
Consumer price index (annual average)	3.4	3.5	2.8	4.1	-0.3	1.8
Consumer price differential with the euro area (HICP)	1.2	1.4	0.7	0.9	-0.5	0.4
SAVING, INVESTMENT AND FINANCIAL BALANCE (e)						
Resident sectors: saving (f)	22.9	22.6	21.5	19.9	19.3	19.1
General government (f)	4.5	5.7	6.0	-0.1	-6.6	-5.4
Resident sectors: investment	29.5	31.0	31.0	29.1	24.5	23.0
General government	3.6	3.6	4.1	4.0	4.5	3.8
Resident sectors: domestic net lending (+) or net borrowing (–)	-6.5	-8.4	-9.6	-9.2	-5.1	-3.9
General government	1.0	2.0	1.9	-4.2	-11.1	-9.2
General government gross debt	43.0	39.6	36.1	39.8	53.3	60.1
MONETARY AND FINANCIAL INIDICATORS (i)						
ECB minimum bid rate on MROs	2.0	2.8	3.9	3.9	1.2	1.0
Ten-year government bond yield	3.4	3.8	4.3	4.4	4.0	4.2
Synthetic bank lending rate	3.8	4.6	5.7	6.2	3.8	3.3
Madrid Stock Exchange General Index (DEC 1985 = 100)	1,060.2	1,324.0	1,631.8	1,278.3	1,042.4	1,076.5
Dollar/euro exchange rate	1.2	1.3	1.4	1.5	1.4	1.3
Nominal effective exchange rate vis-à-vis developed countries (h)	100.5	100.7	101.7	103.3	103.5	101.9
Real effective exchange rate vis-à-vis developed countries (i)	108.8	111.6	115.4	119.2	116.1	113.0
Real effective exchange rate vis-à-vis the euro area (i)	107.4	110.1	113.0	114.7	111.0	109.6
Cash and cash equivalents	14.4	11.3	-3.1	-3.3	8.6	-0.2
Liquid assets (l)	11.6	8.4	8.3	9.8	1.0	3.0
Households: total financing	20.9	19.6	12.5	4.4	-0.3	0.2
Non-financial corporations: total financing	21.4	27.9	17.7	7.9	-1.5	1.0

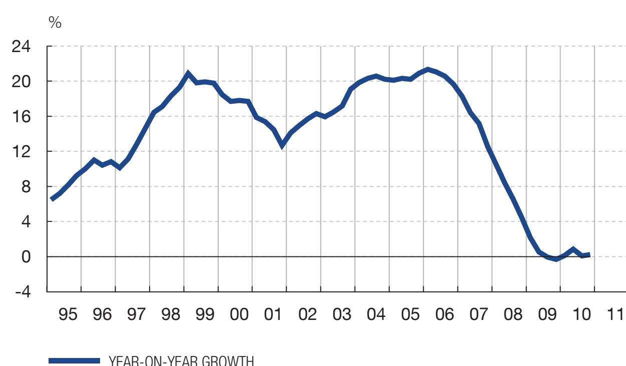
SOURCES: INE, IGAE, AMECO and Banco de España.

a The National Accounts data are calculated on the basis of base year 2000.
b Volume indices. Rate of change.
c Rate of change, except the unemployment rate, which is a level.
d Employment rate (16-64).
e Levels as a percentage of GDP.
f Includes net capital transfers received.
g Annual average levels for interest rates and exchange rates and rate of change for financial assets and liabilities.
h 1999 Q1 = 100.
i 1999 Q1 = 100. Measured with unit labour costs.
j Includes cash equivalents, other bank liabilities and money-market funds.

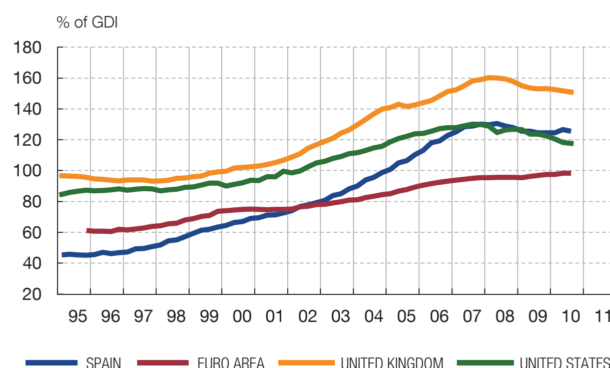
FINANCING OF HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS

CHART 1.2

CREDIT TO HOUSEHOLDS

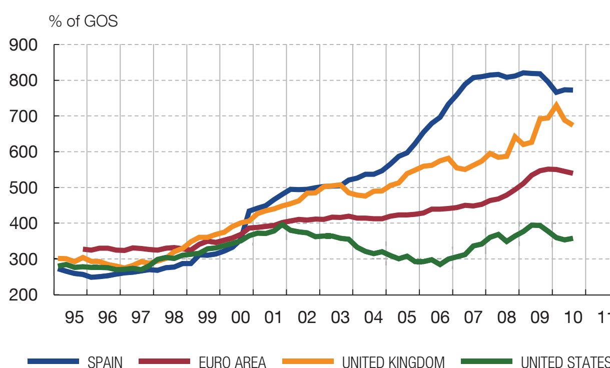


HOUSEHOLD DEBT RATIO



CREDIT TO NON-FINANCIAL CORPORATIONS

NON-FINANCIAL CORPORATIONS´ DEBT RATIO



SOURCES: INE, ECB, Federal Reserve, UK Office for National Statistics and Banco de España.

activity was softened by the positive contribution of net external demand, an effect in which the thrust of exports was predominant.

Household spending began to rise, driven by the increase in consumption …

Household spending showed its first signs of growth following two years of strong declines, although these were centred exclusively on the consumption component, since residential investment fell off once again. The pick-up in consumption was uneven over the course of the year since the rise in indirect taxation from July and the end of the car scrappage schemes prompted households to bring forward their spending decisions to the first half of the year, which lessened the volume of purchases in the final six months.

… despite the contraction in disposable income and the need to reduce debt

The recovery came about in a setting in which high debt continued to significantly restrain any greater buoyancy in spending and in which disposable income fell as a result of the decline in wage income and the lesser contribution of other sources of income that had underpinned it in the recession. There was a fall in the general government contribution which, although it remained expansionary in step with the situation of cyclical weakness still prevailing, accounted for a lesser amount owing to the withdrawal of the stimuli applied in prior years. Wealth also fell, albeit less sharply than in 2009, in both its financial and real estate components. Against this backdrop, the saving ratio fell sharply in 2010, breaking the upward course on which it had moved for three years, standing at 13.1 % of disposable income for the year on average. Set against the lacklustre spending described, the resort to borrowed funds was flat, although the low rates of credit received were ultimately insufficient to significantly reduce the sector's debt ratios (see Chart 1.2).

The contractionary path of residential investment, by contrast, continued...

Residential investment continued to contract, bringing its cumulative fall since the start of the downturn to almost 50 %, which placed the weight of residential investment at 4.7 % of GDP (4.5 pp down on the peak three years earlier), in line with the historical average. These figures suggest that the bulk of the correction of the real estate overhang in terms of activity has already been made. During the year, some housing demand indicators began to rise owing to the bringing forward of property purchases in the face of the tax changes that were introduced (the rise in VAT in July and the partial elimination of tax deductions effective 2011), but also to the improvement in affordability. This meant that, on available estimates that are not free from uncertainty, the stock of unsold housing ceased to increase in 2010, marking the start of a period of absorption of excess stocks which may be prolonged. House prices declined once again in 2010, and this trend continued into the opening months of 2011, placing the fall from the peak at 15.4 % (19.3 % in real terms). The scale of this decline is still less than that observed in the real estate slump in the 1970s, whereby further declines in house prices should not be ruled out.

... whereas the course of the different components of business investment was uneven

Investment by non-financial corporations during 2010 was uneven by component in a setting of tight lending conditions, excess accumulated capacity and limited headway in ongoing corporate deleveraging. Investment in capital goods picked up slightly following the collapse the previous year, influenced by the need to replace plant, the improvement in export markets and the impact of the plan to stimulate commercial vehicle purchases. By contrast, the component of investment in non-residential construction performed more negatively, as it was affected by the infrastructure investment cuts in the second half of the year.

The net lending capacity of the non-financial corporations sector continued to improve…

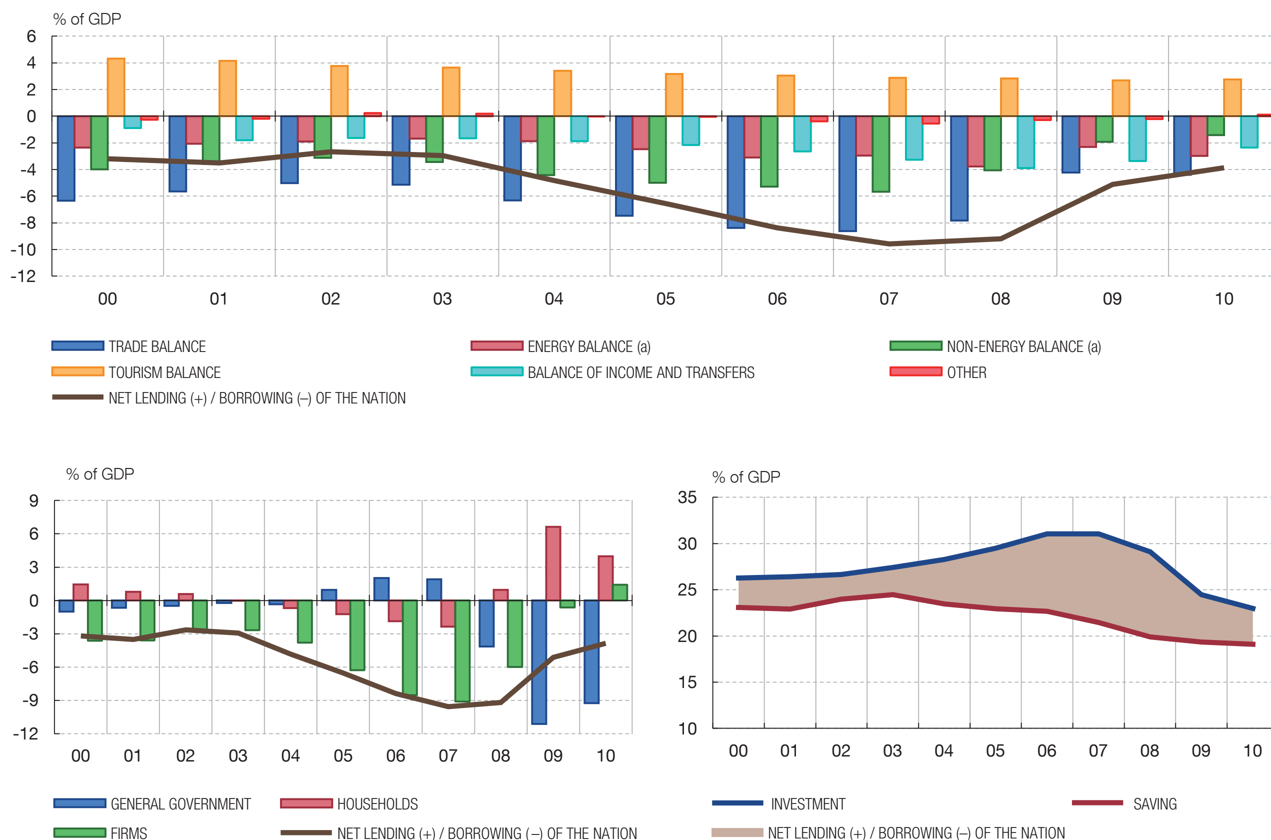
Over the course of 2010 the improvement in the net lending capacity of non-financial corporations continued. The increase in saving, far outweighing that in investment, meant that net lending was equivalent to 0.4 % of GDP for the year on average, an exceptional situation judging by its historical trajectory. This increase in corporate saving was largely based on ongoing staff cuts which allowed for a reduction in unit wage costs, although the significant cut in the interest burden as the lagged result of lower interest rates also contributed. In the case of households, the fall-off in saving, which was sharper than that in investment, led to net lending that was lower than the previous year but positive for the third year running, for an amount equivalent to 4 % of GDP.

…as did the nation's net borrowing, which once again declined

The behaviour of the private sector, along with the cut in the budget deficit, which stood at 9.2 % of GDP, prompted a fresh reduction in the nation's net borrowing to 3.9 % of GDP (see Chart 1.3). This marks a considerable improvement from the levels of maximum external dependence attained in 2007 (close to 10 % of GDP), although behind this are certain risk factors that should be mentioned. From the standpoint of trade with the rest of the world, the headroom for improvement in the trade balance seems somewhat exhausted owing to the adverse impact exerted by the energy bill, amplified in recent months by the hike in oil prices, and a marked decline in the deficit arising on investment income payments. Indeed, the pattern seen in 2010 is illustrative of the challenges that must be addressed in order to further reduce reliance on external saving in the future. A priority will be that exports should be able to continue benefiting from the pick-up in world trade with further adjustments in competitiveness and with the design of ambitious diversification strategies for our markets. It is likewise vital that import dependence be reduced, most particularly in relation to the energy component. It should be borne in mind that the possibility of reducing the income balance deficit, which was cut significantly in 2010, is restricted by the economy's high net debit position vis-à-vis the rest of the world and the current low level of interest rates.

NET BORROWING OF THE ECONOMY

CHART 1.3



SOURCES: INE, Customs and Banco de España.

a The energy and non-energy balance are an estimate of the Banco de España drawing on Customs data.

Job destruction continued for another year, eroding confidence and the capacity for recovery

The economy's capacity to generate jobs was once again weighed down by the ongoing slide in construction activity. This was influenced in 2010 by the fact that civil engineering works ground to a halt, following the cut in public investment under the fiscal austerity plan (see Chart 1.4). Uncertainty over the strength of the recovery, doubts over the scale of the reforms under way and the sluggishness of domestic expenditure further weighed on hiring decisions both in industry and in market services, which continued destroying employment, albeit to a lesser degree.

Labour supply expanded moderately, influenced by the fall-off in the working-age population…

The prolonged deterioration in the labour market altered the dynamics of labour supply, which expanded very moderately (0.2 %), far off the average rate of close to 3 % for the years 2005-2008. Behind this weak increase lies the loss of momentum of the working-age population seen since the previous year, and influenced by the sharp decline in net immigration flows (in the two years spanning 2009 and 2010, these flows were somewhat less than 10 % of the average for the period 2005-2008). This prompted a decline in the foreign working-age population, for the first time since 1990, and a 0.7 % decline in the foreign labour force. Notwithstanding, the participation rate rose slightly owing to the increase in female participation, since the attendant male rate and that of the younger cohorts reacted adversely to the cyclical situation.

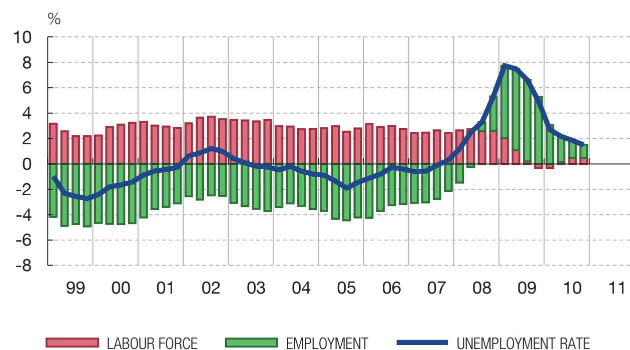
… but unemployment continued to rise, particularly sharply in the long-term component

Despite the check on the increase in the labour force, unemployment continued to rise in 2010, albeit at a more moderate rate than in previous years, and the unemployment rate climbed to 21.3 % in 2011 Q1. Unemployment affected youths, the less-skilled and foreigners more severely. Long-term unemployment rose sharply, accounting for 42.5 % of

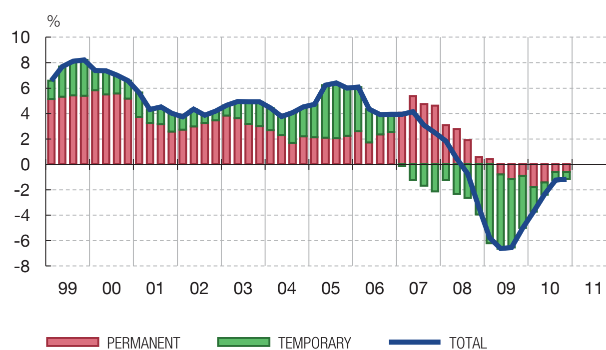
EMPLOYMENT AND UNEMPLOYMENT (a)

CHART 1.4

YEAR-ON-YEAR CHANGE IN THE UNEMPLOYMENT RATE
Contributions of labour force and employment



EMPLOYEES
Year-on-year rate and contributions



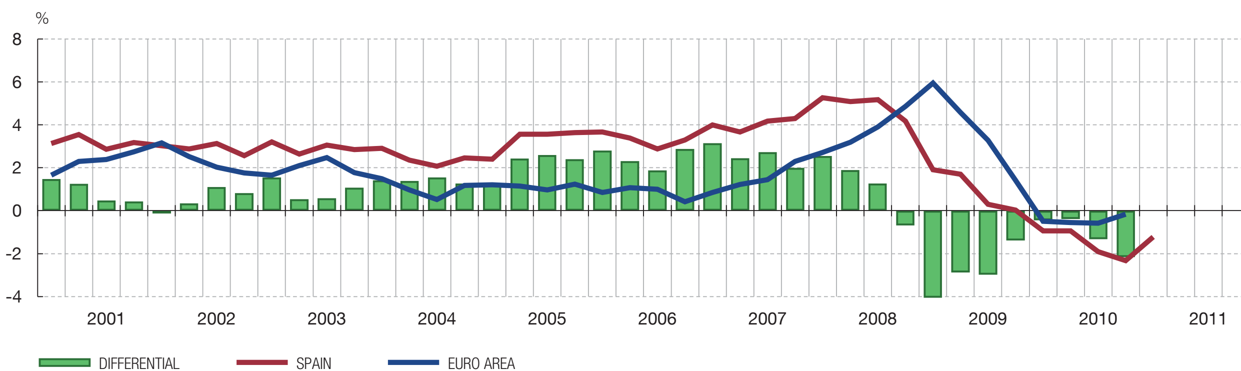
SOURCES: INE and Banco de España.

a The EPA (Spanish Labour Force Survey) series are linked on the basis of the 2005 Q1 control survey and the change in the definition of unemployment in 2001.

LABOUR COSTS

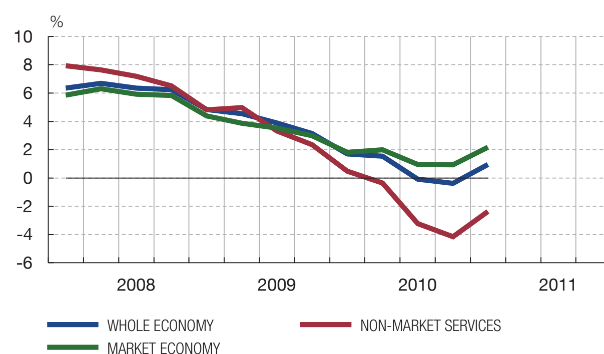
CHART 1.5

SPANISH AND EURO AREA UNIT LABOUR COSTS
Year-on-year rate



UNIT LABOUR COSTS
Year-on-year rate

COMPENSATION PER EMPLOYEE
Year-on-year rate



SOURCES: Eurostat and Banco de España.

a Year-on-year rates with sign changed.

the total for the year on average (46.6 % in Q1 this year). These figures are sufficiently illustrative of the scale of the challenge that bringing back an increasingly larger group into the labour market poses, and it presages a substantial increase in the structural component of unemployment, which demands an energetic economic policy response.

In the setting of labour market weakness, labour costs eased significantly

Against the background of labour market weakness, labour costs eased substantially during 2010. They did so more sharply in the second half of the year, owing to the direct and indirect influence of the cut in public-sector wages (see Chart 1.5). Compensation per employee increased by 0.7 %, in strong contrast to the 4 % increase recorded in labour costs in 2009. A significant portion of the slowdown was due to the change in trajectory of public-sector wages, which declined by 1.8 % (after having increased by 4 % in 2009 and by 7 % over the 2007-2008 period). The remainder was due to the slowdown in compensation per employee in the market economy, which increased at a rate of 1.4 % (compared with the rises of 3.7 % in 2009 and of 5.9 % in 2008, when the sharpest phase of the recession began). Behind this result lay the smaller increase in wage settlements, influenced by the recommendations of the Pact for Employment and Collective Bargaining entered into by the social partners in February 2010, and the absence of inflationary pressures, which in turn provided for a fall in market-economy unit labour costs, for the second year running. Collectively bargained wage settlements in the opening months of 2011 have evidenced a rise which, if it takes root, would jeopardise the improvements in competitiveness needed to reactivate output and employment.

And inflation rose forcefully owing to predominantly temporary factors

CPI inflation rose in the second half of the year, posting a year-on-year growth rate of 3 % in December 2010 (see Chart 1.6). It has continued on this trajectory to date in 2011, placing the year-on-year rate of change of consumer prices at 3.8 % in April, having been strongly affected by the sharp growth in oil prices in recent months. Much of this increase is due to essentially temporary factors, such as tax changes and regulated prices, and the upward course of commodities prices. They all have a direct and significant effect on price levels and on the inflation rate but, if there are no indirect effects on business costs, their impact will ultimately be stripped out of the year-on-year CPI rate after a year. To ensure the rise in inflation is temporary, it is thus vital that these indirect effects should be limited and that there should be no generalised revision of inflation expectations that ultimately affects final prices in a permanent way, either through the prices producers set or through wage bargaining. Any reluctance to accept the temporary losses in real income that the rise in energy prices and in indirect taxation entails for workers and companies would translate into more persistent inflationary pressures and into diminished possibilities of recovery and job creation.

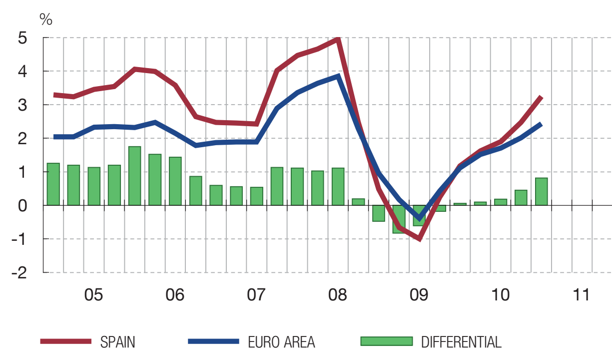
The outlook for 2011 is one of slow recovery that is not exempt from considerable uncertainty

The outlook for 2011 is one of slow recovery and will involve great dependence on the ability to harness the momentum of the rest of the world through substantial improvements in competitiveness, allowing external demands to provide the support needed for the take-off in activity and employment. The pick-up in domestic demand is conditional upon the level of private-sector debt. This scenario is subject to great uncertainty and potential downside risks, associated with the tensions on financial markets that might continue to adversely affect financing conditions and economic agents' confidence. An added risk is that arising from the hike in oil prices, which may alter the course of recovery in the advanced countries and affect economic and financial agents' confidence. This shock may exacerbate the supply-side factors that have traditionally constrained flexibility and the potential for growth in the economy, and which stem from the interplay of high energy dependence with rigidity in cost and price formation in Spain. An easing in inflation and the adjustment of relative prices are essential prerequisites of recovery (see Box 1.1).

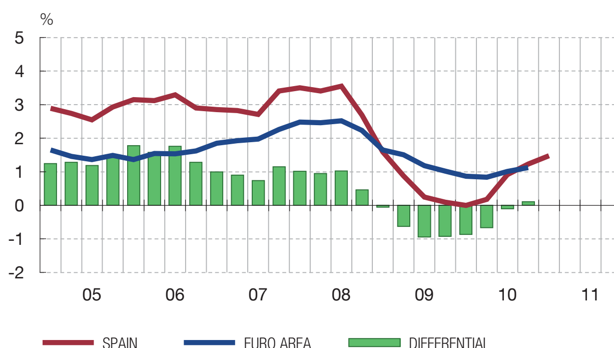
SPAIN/EURO AREA INFLATION DIFFERENTIAL

CHART 1.6

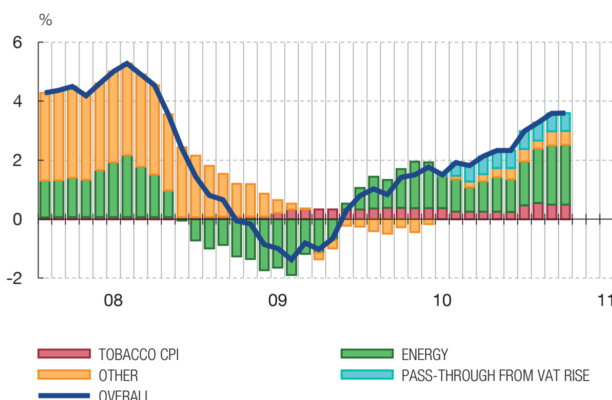
CPI
Year-on-year rate



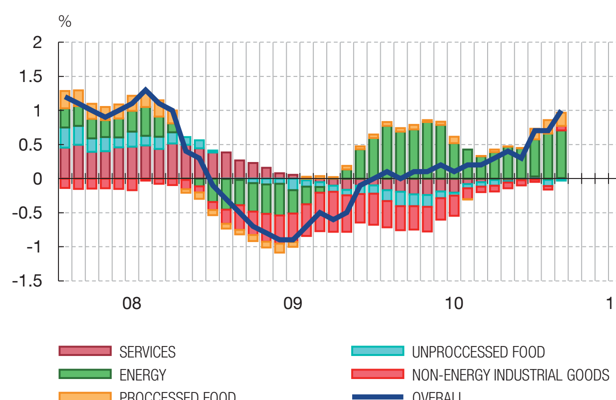
CPI EXCLUDING ENERGY
Year-on-year rate



CONTRIBUTION TO GROWTH RATE OF CPI



CONTRIBUTION TO SPAIN/EURO AREA INFLATION DIFFERENTIAL



SOURCES: Eurostat and Banco de España.

5 The scale of the challenges and the responsibility of economic policy

The Spanish economy faces a difficult situation, and overcoming it will require ambitious economic policies

As highlighted in the previous sections, the tensions experienced by the Spanish economy were largely due to the vulnerabilities that emerged further to the financial crisis, vulnerabilities rooted in the macroeconomic imbalances that had built up during the long upturn. One year into this new phase of the crisis, linked to sovereign debt, the factors blocking a return to a path of sustained growth have not been fully eliminated and nor have the doubts over the economy's medium and long-term growth capacity, despite the shift in the economic policy stance. That all makes for a difficult situation that poses significant challenges, which include bolstering the recovery while completing the adjustments under way, restructuring the economy and restoring confidence.

In these circumstances, the economic policy response is pivotal and the role of the structural reforms central to seeing through the correction of the imbalances. The future trajectory of the Spanish economy will hinge on how demanding the response proves; and most particularly, on the speed and scale of the recovery and its capacity to generate employment. In the past, the pursuit at critical moments of ambitious reforms was key to promoting ongoing modernisation and real convergence. Within the euro area, the design and implementation of structural reforms is even more important because there is no exchange rate available to generate short-term gains in competitiveness and because the leeway for using expansionary demand-side policies has been exhausted. At the current juncture, there is a timely possibility that the adjustment effort may enable the full adaptation of the economy to the macroeconomic stability requirements that euro area membership entails.

THE ROLE OF PRICE AND WAGE FLEXIBILITY IN THE ADJUSTMENT OF THE SPANISH ECONOMY WITHIN THE EURO AREA

BOX 1.1

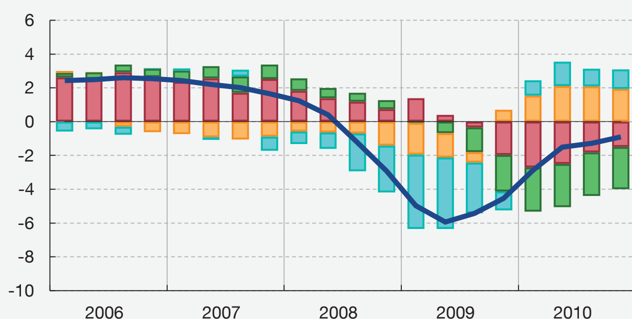
An economy's capacity for adjustment in the face of different shocks depends on a series of structural and institutional characteristics, including most notably the adaptability of prices and wages to changes in their fundamentals. In the case of the Spanish economy, wage- and price-setting mechanisms have given rise to a pattern of adjustment that leads to significant fluctuations in employment and activity, with prices and wages showing more inertia, as demonstrated by various recent papers.[1] In the latest crisis, for instance, the scale of job destruction was far greater than that in other euro area countries where the fall in GDP was of a similar magnitude; subsequently, the difficulties faced by the Spanish economy in generating net employment mean that emerging from the crisis is proving more belated and less intense. Therefore, it is worth questioning to what extent the presence of price and wage rigidities has been a relevant factor in the recession and may hold back the current phase of recovery.

To illustrate the scope of these questions, use is made below of a general equilibrium model (called BEMOD) estimated for the Spanish economy within the Economic and Monetary Union. It reflects the various degrees of nominal and real rigidity existing in Spain and the rest of the euro area, in the form of different values estimated for wage indexation or for the frequency of revision of prices and wages in the face of changes in their determinants, such as marginal cost and the reserve wage, respectively.[2] It should be borne in mind that BEMOD explicitly models no financial aspects other than interest rate movements and, therefore, these results, like all those obtained from highly stylised models, should be

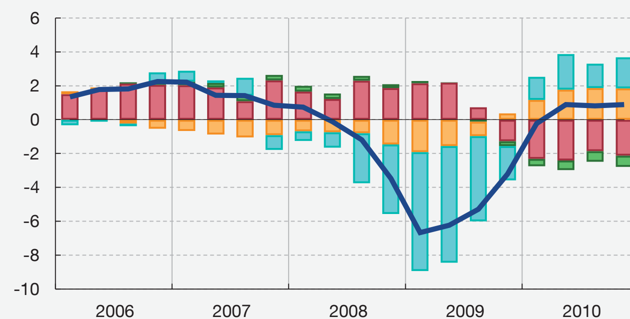
1 For the case of wages, see, for example, P. Cuadrado, P. Hernández de Cos and M. Izquierdo (2011), "Wage adjustments to shocks in Spain", *Economic Bulletin,* April, Banco de España. For price rigidities, a quantification for Spain and other European countries can be found in Dhyne et al. (2006), "Price Changes in the Euro Area and the United States: Some Facts from Individual Consumer Price Data", *Journal of Economic Perspectives.*

2 See the article by Andrés, Hurtado, Ortega and Thomas (2010), "Spain in the Euro: a General Equilibrium Analysis", published in SERIEs, vol. 1.

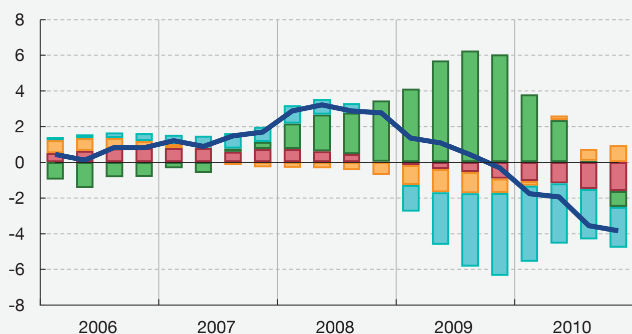
1 YEAR-ON-YEAR RATE OF CHANGE OF REAL GDP: SPAIN



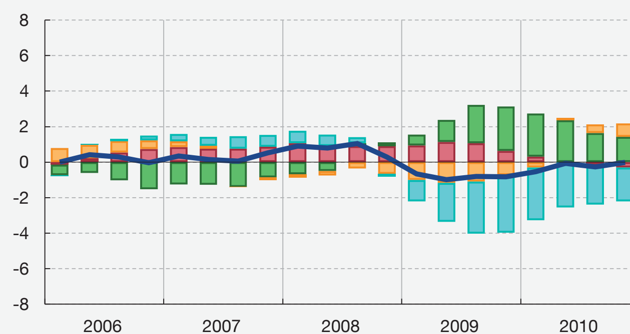
2 YEAR-ON-YEAR RATE OF CHANGE OF REAL GDP: REST OF THE EURO AREA



3 YEAR-ON-YEAR RATE OF CHANGE OF NOMINAL WAGES: SPAIN



4 YEAR-ON-YEAR RATE OF CHANGE OF NOMINAL WAGES: REST OF THE EURO AREA



OTHER SHOCKS: PRIVATE AND PUBLIC DEMAND, PRODUCTIVITY AND FROM THE REST OF THE EURO AREA
INTEREST RATE SHOCKS
DEVIATION OF THE GROWTH OF THE OBSERVED VARIABLE FROM ITS AVERAGE (a)
NATIONAL PRICE AND WAGE SHOCKS
SHOCKS FROM THE REST OF THE WORLD

SOURCE: Banco de España.

a The sum of the contributions of all the shocks envisaged is not equal to the actual growth rate of GDP or of wages, but to the deviation of this rate from its average in the period 1997-2009.

viewed with due caution.[3] In line with recent papers, the model estimates an average duration of prices of less than one year both in Spain and in the rest of the euro area, and of slightly more than one year in wages, as well as a moderate effect of past inflation on prices, which is more significant in the non-tradable sectors than in those exposed to international competition, and similar in both economies. However, the estimated degree of wage indexation is high in Spain and scarcely significant on average in the other European economies.

The model enables the various factors behind the fall in activity in Spain and the euro area during the latest crisis to be identified. The top panels in the accompanying chart depict GDP growth in Spain and in the rest of the euro area along with the contributions of the main shocks that made these economies deviate from their historical average growth pattern.[4] Of note at the start of the recession is the sizeable negative contribution of the "rest of the world" item, which captures, above all, the effect of the strong fall-off in world demand and which exerts a greater influence on the rest of the euro area than on Spain, which is less open to the rest of the world. It was also the pick-up in external demand that made a firmer contribution to the economic recovery in 2010 – once again to a greater extent in the rest of the euro area – along with the continuing expansionary stance of monetary policy, with lower interest rates than would be denoted by the estimated response in the model of these rates to inflation and growth (the estimated Taylor rule suggests that, for the observed decline in GDP and inflation, the reduction in interest rates might have been sharper and swifter). The red bars show a broad set of shocks, mainly those related to public demand (which had a very marked positive effect during the public stimulus programmes of 2008 and 2009, and a negative impact with the consolidation measures introduced in 2010) and national private demand (which posted very negative contributions in 2008 and 2009), but also those connected to productivity, and those from the rest of the euro area.[5]

Along with these contributions of various shocks to the crisis, a clearly negative effect on growth was identified in 2009-2010 owing to the insufficient adjustment of prices and wages to the changes in their determinants, even in relation to the above-mentioned gradual response estimated by the model, through a non-immediate resetting of prices and wages and of indexation to past price inflation, which was virtually non-existent in wages in the rest of the euro area, but close to 50 % in the case of wages in Spain. The contributions of the various shocks to wage developments represented in the lower panels of the accompanying chart show that wages grew in Spain above their determinants (the positive shocks are depicted by green bars) from 2008. In the absence of that rigidity, for example, wages would have declined by 1.4 % in 2009, compared with the 4 % growth observed. Given the delayed effect of wages on employment and activity, that would have prompted a positive impulse of 2.6 pp to GDP in 2010. In the rest of the euro area, although wages have outgrown their determinants since 2009, they have done so to a lesser extent than in Spain and their impact on activity is small.

With a view to the recovery phase ahead for the Spanish economy, it is therefore necessary to insist on the advisability of pursuing the required reforms so as to have a greater degree of price and, especially, wage flexibility. In the context of the euro area, the

3 Interest rates are modelled following an estimated Taylor rule where the short-term rates on which the ECB acts change in response to movements in inflation and activity in the euro area as a whole. That said, they may undergo shocks that make them take values above or below these fundamentals.

4 That is to say, the sum of the contributions of all the shocks envisaged is not equal to the GDP or wage growth rate, but to the deviation of this rate from its average value in the model's estimation period (1997-2008).

5 Some of these contributions are very significant individually, but on being grouped together they tend to cancel one another out, hence the relatively small size of the contribution of this set of shocks.

SIMULATION OF A 50% RISE IN OIL PRICES (a)

%

	Accumulated level differences in the second year compared with the baseline scenario			
	Spain		Rest of the euro area	
	Estimated rigidities	Flexible economy	Estimated rigidities	Flexible economy
GDP	-1.59	-1.14	-1.11	-0.93
Employment	-1.12	-0.62	-0.78	-0.57
Consumption deflator	1.74	1.34	1.18	1.01
Nominal wages	0.04	-0.82	-0.21	-0.76

SOURCE: Banco de España.

impossibility of devaluing our currency should be made up for by a degree of price and wage flexibility that provides for the possibility of gains in price-competitiveness. Such flexibility is, moreover, vital in a setting in which further shocks will come about, such as the recent rise in oil prices.

To illustrate how a reduction in these rigidities might help the recovery in the Spanish economy over the coming years, the accompanying table simulates with BEMOD the effects of a rise in oil prices under different scenarios. When the model is used with the degree of rigidity estimated with observed data, it can be seen that, given a persistent increase in oil prices of 50 %, GDP in Spain would decline by 1.6 pp relative to the baseline scenario after two years, and employment by 1.1 pp, also relative to the baseline scenario. In the rest of the euro area, however, the deviations in activity and employment would be only 1.1 pp and 0.8 pp, respectively, due to both their greater observed flexibility and to the lesser weight of energy in their productive processes and in their consumption basket. A simulation has also been performed of what would happen in a scenario of total wage flexibility in which the second-round effects on prices of an inflationary shock are cancelled out, such that both in the Spanish economy and in the rest of the euro area wage indexation disappears and wages are revised each quarter (this counterfactual scenario is rather extreme, therefore the quantifications obtained should be viewed with caution). In this case, the negative impact on GDP and employment in Spain would be smaller, because wages fall in the face of the decline in activity and employment, enabling the outcome of the shock to be a lesser adjustment in employment, and therefore also in GDP. As a result, faced with the same rise in oil prices simulated before, under this scenario of total flexibility 85,000 more jobs would be maintained, that is to say, approximately half the jobs would be destroyed in the second year as would be under the scenario with rigidities. In the case of the rest of the euro area, the differences between the two scenarios are smaller, since the degree of price and wage flexibility prevailing is closer to the counterfactual scenario of wage flexibility.

In the past year there has been a shift in the economic policy stance in three major areas

As indicated, over the past year reforms have been undertaken in three major areas: the restructuring and recapitalisation of the financial system[1]; fiscal consolidation; and structural reforms. The reform drive must persist and further progress must be made in these three closely interconnected areas.

In the financial area, a far-reaching process of write-downs, restructuring and recapitalisation is taking place.

In the financial area, the imbalances accumulated in a part of the banking sector (especially in certain institutions in the savings banks sector) led as early as 2009 to the adoption of measures aimed at prompting substantial write-downs along with the restructuring and recapitalisation of the segment, which is where investors' loss of confidence tended to concentrate. At the core of these imbalances were problems of excessive size, excessive concentration of real estate exposures and high dependency on wholesale market funding. Further compounding these imbalances were the difficulties arising from certain singular features of savings banks that have magnified the perception of these institutions' vulnerability: their particular ownership structure, an insufficiently robust corporate governance model, difficulties in raising top-quality capital on the markets and the complexities which, compared with other credit institutions, arise from a legal framework that sees measures taken at both State and regional government levels.

In 2009 the Fund for the Orderly Restructuring of the Banking Sector (FROB) was created. Its dual aim was to resolve in an orderly fashion potential situations of bank non-viability, and to pave the way for integration processes between viable institutions. In this latter case, financial support from the FROB was conditional upon the submission of an integration plan, containing the business and restructuring plans, which had to be approved by

1 There are more detailed analyses of the Spanish financial system and of its restructuring and recapitalisation in other specialist Banco de España publications such as the Financial Stability Report and the Report on Banking Supervision in Spain.

the Banco de España (Box 1.2 offers greater details on the FROB and on the other measures discussed below).

The process is considered vital to tackle confidence problems that have been exacerbated by the sovereign debt crisis…

The first wave of the sovereign debt crisis in spring last year entailed a widespread loss of investor confidence which, owing to the reasons indicated, particularly affected a group of countries of which Spain was part. Ultimately, these circumstances highlighted the need to speed through integration processes, so as to achieve synergies allowing cost cuts, the idea being to create better managed and more efficient institutions with a greater volume of assets that would be better placed to raise funding on the markets. The reaction was swift and took the form of the approval of a significant number of integration operations, most with the financial support of the FROB, which affected a highly significant portion of the savings bank subsector. As a result, the number of savings banks or groups of savings banks in this subsector has, as at the end of May, fallen from 45 to 18, while the integration plans approved envisage significant reductions in both the number of branches and in staff levels at the institutions involved.

In summer 2010 the highly detailed results of the stress tests conducted in coordination at the European level were published. In Spain's case the tests covered listed banks and all savings banks. The results showed that the Spanish financial system as a whole could withstand relatively unlikely extreme shocks, and that only four groups of savings banks would not, in the event the assumptions materialised, manage to maintain the levels of capitalisation required in the tests.

The restructuring and recapitalisation drive undertaken, along with the write-downs made by the institutions, were an appropriate response to savings banks' problems of excessive size and accumulation of risks, as confirmed by the stress tests. At the same time, savings bank reform legislation was passed in summer 2010, the main aim of which was to improve the governance of these institutions and their ability to raise own funds on capital markets.

These measures were also boosted by others taken at around the same time at the European (the financial support mechanisms and the unconventional monetary policy measures) and Spanish (fiscal consolidation and labour market reform) levels. Tensions began to abate after the summer and investor confidence started to pick up. There was thus a reduction in the risk premia on assets issued by the public sector and by financial institutions, and a gradual resumption of foreign capital flows.

… and later refuelled, again, by the tensions caused by the Irish banking crisis

However, this process was abruptly interrupted in the autumn as a result of the outbreak of the Irish banking crisis. Tellingly, as this episode was centred on the banking sector, it proved particularly harmful to the savings bank restructuring and recapitalisation process. The fact that the two Irish banks that had participated in and passed the aforementioned stress tests were an integral part of the problems substantially weakened investor confidence in the results of the tests. Thereafter, bank funding costs once again began to rise and the difficulties in gaining access to the wholesale markets increased. Spanish credit institutions, and especially savings banks, thus saw how much of the headway made thanks to the previous reformist drive was lost.

In November, the Banco de España imposed a particularly intense transparency exercise on savings banks to obtain a proper picture of their situation. Prior to end-January 2011, it published detailed data on their exposure to the real estate development and construction sector and on the volume of wholesale funding and their liquidity situation, the two factors

SPANISH BANKING SYSTEM BALANCE-SHEET WRITE-DOWNS, RESTRUCTURING AND RECAPITALISATION: THE MAIN STEPS TO DATE

BOX 1.2

This box describes in some detail the main characteristics of the different measures adopted as part of the Spanish banking system balance-sheet write-down, restructuring and recapitalisation process discussed in the main body of the text. The process began with the creation of the Fund for the Orderly Restructuring of the Banking System (FROB), further to Royal Decree-Law (RDL) 9/2009 of 26 June 2009, which had a dual aim: to provide a solution for institutions that ceased to be viable, and to pave the way for integration processes involving viable institutions by promoting their restructuring. The former aim has only been used in one instance (Cajasur), although before the creation of the FROB control was taken over another institution (Caja Castilla-La Mancha) through the participation of the Deposit Guarantee Fund. The overall weight of these two savings banks scarcely exceeded 1 % of the system's total assets. The second aim was instrumented through the subscription by the FROB of convertible preference shares, equity units or contributions to the capital of credit cooperatives, for a maximum term of five years, extendible by a further two years, and earning a minimum return of 7.75 %.[1] The aid was conditional upon the submission of an integration plan approved by the Banco de España. This second arrangement was instrumental in supporting eight savings bank integration processes, in which the FROB committed itself to aid totalling €10.07 billion (around 1 % of GDP).[2] Together with a further four processes which have not required FROB participation, the resulting restructuring has proven far-reaching, as the accompanying table shows.[3] Overall[4], 39 out of a total of 45 savings banks are involved, accounting for 88 % of the assets of this subsector and 32 % of those of the national banking system. The result is a reduction in the number of savings banks or groups of savings banks to 18, with an average size in terms of total assets of €70 billion, almost 2.5 times greater than was previously the case. The integration plans approved also envisage a cut of between 20 % and 25 % in the number of offices and of between 12 % and 18 % in staff. These developments have been accompanied by a substantial balance-sheet write-down drive which, for Spanish deposit institutions as a whole, has amounted to €96 billion (9.5 % of GDP) in the three years from 2008 to 2010, as the accompanying chart shows.

In spring 2010, stress tests coordinated at the European level were conducted. It was considered that the target level of core (Tier 1) capital institutions had to reach following the exercise was 6 % of risk-weighted assets (higher than the figure of 4 % in the regulations then prevailing). In Spain, the exercise was conducted covering 90 % of the system's total assets. The results, which were disclosed in extensive detail in late July, highlighted the resilience of most Spanish institutions since only four groups of savings banks required additional capital, for a total of €1.84 billion, under the adverse scenario. In spring 2011 a similar exercise has been conducted, the results of which are expected to be published in June.

In July last year, the government approved the reform of the savings bank law by means of RDL 11/2010. The aim was to tackle the two structural weaknesses in the sector, linked to its singular legal structure, which have become clearly manifest during the crisis:

1 The return shall be the higher of 7.75 % and the return on 5-year Spanish public debt plus 500 bp at the time of approval of the operation and shall increase by 15 bp each year up to the fifth year, and by 100 bp for each additional year if the operation is extended.

2 These figures do not include the initial Banco Base IPS (Institutional Protection Scheme) project, for which aid totalling €1.49 billion (making for a total of €11.56 billion) was envisaged, and which was finally not granted. The two institutions or groups resulting from this collapsed project have reconsidered their recapitalisation strategies in accordance with the new requirements laid down in RDL 2/2011.

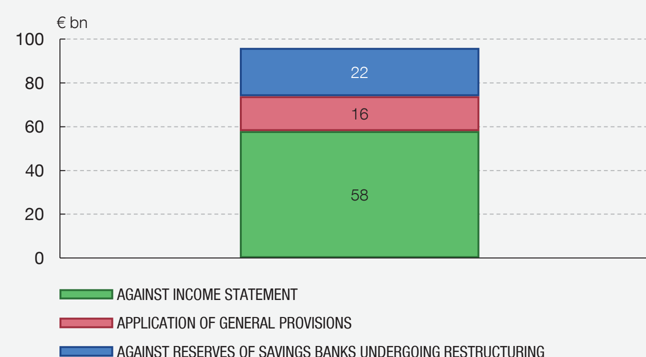
3 Integration processes have also taken place between other institutions in the Spanish financial system (commercial banks and credit cooperatives) in the form of voluntary initiatives aimed at improving efficiency.

4 Taking into account the collapse of the Banco Base IPS project.

SAVINGS BANK RESTRUCTURING PROCESSES

	Participating institutions	Final institutions	Total assets (€ m) (a)	Assets as % of savings banks total	Assets as % of banking system total (b)
Integration processes with FROB aid	33	9 (4 SIP)	863,353	68.1	24.8
Integration processes without FROB aid	7	3 (1 SIP)	330,263	26.1	9.5
Total restructuring (c)	40	12 (5 SIP)	1,193,616	94.2	34.3
Other	5	5	73,452	5.8	2.1
Total savings banks	45	17	1,267,068	100	36.4

PROVISIONS SET ASIDE SINCE JANUARY 2008



SOURCE: Banco de España.

a Consolidated balance sheet data as at 31.12.2010.
b Sum of national banking instituions' consolidated balance sheets.
c Including the restructuring of CCM, although in this case the traditional DGF framework was used.

SPANISH BANKING SYSTEM BALANCE-SHEET WRITE-DOWNS, RESTRUCTURING AND RECAPITALISATION: THE MAIN STEPS TO DATE (cont'd)

BOX 1.2

governance problems and a limited capacity to raise high-quality capital. As regards the former, more restrictive limits were placed on the presence of general government representatives on the governing bodies of savings banks, who were further required to demonstrate their professional suitability. To redress the second shortcoming, a more attractive legal regime was introduced for equity units, and the legal structures through which savings banks may provide their financial services were broadened, allowing them to pursue their financial activity through public limited companies with the category of commercial banks, either through Institutional Protection Schemes (IPSs) or through the creation of a commercial bank to which their financial business would be transferred.

Also in summer 2010, the Banco de España issued a circular (CBE 3/2010) amending the accounting rules for provisioning, with three aims in mind: to recognise the value of different real estate guarantees according to the type of asset involved, but applying substantial precautionary haircuts and shortening the period over which provisioning is made for the risk as a whole; to increase the minimum provisioning charges for foreclosed assets, which depend both on appraisals and on the passage of time; and to encourage the setting of greater prudential margins for the granting of loans. Later (in November), the central bank required savings banks to publish detailed information on their exposures and provisioning, especially exposures to the real estate sector, on the volume of wholesale funding and on their liquidity situation, which they duly did before the end of January 2011. That same month, all banks were formally required to incorporate this information into their 2010 financial statements.

On 18 February 2011, the government approved RDL 2/2011. This legislation increased the minimum capital level required of banks, introducing a new solvency ratio that must be met maintaining common equity Tier 1 capital[5] of at least 8 % of risk-weighted assets, and raising this ratio to 10 % for those institutions in which the relative weight of funding from wholesale markets exceeds 20 % and which have not placed at least 20 % of their capital with third-party investors. The functioning of the FROB was also reformed so that it may be used to recapitalise those institutions that cannot meet these requirements by tapping the markets. Specifically, the FROB is authorised to subscribe ordinary shares under market conditions, which it must sell before five years have elapsed, provided that the institution submits a recapitalisation plan for approval by the Banco de España. In these cases, the FROB shall take a seat on the board of directors of the institution affected. If a savings bank or savings bank integration process by means of an IPS is involved, all lending activity must be transferred to a bank by one of the means provided for in RDL 11/2010. The new requirements have to be met by September this year, although an extension of three months, extendible to six months in the case of market listing processes, may be requested. On 10 March 2011, the Banco de España made known the capital requirements arising from the new regulations, with the result that 12 institutions (two Spanish banks, two subsidiaries of foreign banks and eight savings banks) evidenced additional capital needs for a total amount of €15.15 billion (€14.08 billion of which relating to savings banks). On 14 April the Banco de España approved the strategies for complying with these new capital requirements. In the case of the institutions participating in the original Banco Base IPS, separate strategies have been submitted for the capital requirements of the two institutions or groups of institutions resulting from the collapsed project. On 28th April, within the legally stipulated term, the institutions or groups of institutions that have requested from the FROB, as the primary source, the funds they need to meet these capital requirements, submitted their recapitalisation plans. Thereafter, the measures envisaged in the new RDL 2/2011 have continued to be pursued both by the Banco de España and by the FROB so as to comply with the formalities and schedules laid down.

5 This definition is stricter than the above-mentioned core (Tier 1) capital and is based on the Basel III concept applicable in 2013, with some amendments.

perceived by markets as the main factors of risk of savings banks. In turn, in February 2011 the government approved a Royal Decree-Law whereby the minimum levels of solvency required of all banks were raised and the FROB was authorised to acquire, temporarily and subject to approval by the Banco de España of a recapitalisation plan, shares in the capital stock of those institutions that could not obtain the funds required on the market within the period established. Capital requirements have been raised to a greater degree for institutions in whose capital there is not sufficient participation by third-party investors and which are more reliant on wholesale markets, and it has also been stipulated that recourse to the FROB by a savings bank shall entail the transfer of its business to a bank, which would translate into a substantial change, inter alia, in its corporate governance regime and in its possibilities of gaining access to capital markets.

The aim of this new set of measures, along with the forthcoming publication of the results of the new European stress tests, is to contribute decisively to restoring international

investor confidence in our financial system, reducing the risk of an extension of the tensions that might undermine the recovery of the Spanish economy.

Turning to fiscal policy, a demanding budgetary consolidation strategy was defined for 2010 and 2011,…

In the budgetary domain, the government approved a package of deficit-cutting measures for 2010 and 2011 in May, supplementing the 2010 Budget (the withdrawal of some of the extraordinary expansionary measures, in force during the crisis, and a VAT rise from 1 July, among others). The May package involved an additional cut in spending of around 1.5 % of GDP for these two years, whereby the deficit-reduction path was set at 9.3 % of GDP, 6 % of GDP and 4.4 % of GDP in 2010, 2011 and 2012, respectively.

… bringing forward the adjustment drive envisaged for 2013 to the 2010-2011 period. It was based predominantly on structural spending cuts

The consolidation strategy defined by the government brought forward the bulk of the adjustment to the 2010-2011 period, underpinning it with spending cuts, many of which structural, including most notably the cut in public-sector employees' compensation from June 2010, the reduction in public investment, the freeze on public-sector wages and pensions in 2011, and the 10% ceiling on the rate of replacement of public-sector employees. The State budget for 2011 validated these measures, introduced further cuts to other budgetary items and provided for specific tax rises (a tax rise in the State personal income tax tranche for incomes above €120,000 and the elimination of the tax deduction for purchase of the habitual dwelling for incomes above €24,170.2). The Updated Stability Plan for the period 2010-2014, which the government approved on 29 April, confirmed the above-mentioned path of adjustment to 2013 and further set a deficit target for 2014 of 2.1% of GDP, which would be compatible with a public debt/GDP ratio of 68.9%. Accordingly, if the targets of the proposed consolidation plan are met, the deficit will embark on a declining course in 2014.

The public finances outcome at end-2010, entailing a general government deficit equivalent to 9.2 % of GDP and a public debt ratio of 60.1 % of GDP, show that the measures adopted in 2010 have proven effective in reversing the upward trajectory of the budget deficit. They do, however, involve an uneven budgetary adjustment drive across the different tiers of government: while the State cut its deficit by 4.3 pp (to 5 % of GDP), the regional governments' shortfall increased by 1.4 pp (to 3.4 %). The Social Security fiscal position also worsened by 1 pp, posting a deficit of 0.2 %.

The fiscal projections for 2011 and 2012 point to some risks of deviations …

The fiscal projections for 2011 and 2012 by the Banco de España as part of the annual macroeconomic projections exercise suggest some risks of deviations from the consolidation path. The projected reduction in the deficit is based on macroeconomic projections which, if they are not confirmed, might translate into a less favourable performance by revenue. Furthermore, potential deviations at the territorial government level cannot be ruled out.

The fiscal consolidation programme is a centrepiece of the overall economic policy strategy, whose success hinges on a major budgetary effort that is unprecedented in terms of its size and extension to all levels of general government. In meeting these targets it will not be possible to count on the help of other potential sources of improvement that were present during the expansionary phase. On one hand, the extraordinary revenue linked to the real estate boom will not be resuming and, on the other, neither the business cycle, which is following a very gradual pattern of recovery, nor the interest burden, which has already moved onto a rising course, will help improve public finances.

… and averting this will require action by all levels of government and a strengthening of the budgetary stability rules

To prevent the risks of a deviation from the fiscal consolidation path materialising, it is necessary to set in place sound foundations for the reduction of the deficit and the control of medium- and long-term debt, in line with the proposals made in Chapter 2 of this report, which focuses on this matter. It is crucial to involve all levels of government in the fiscal

consolidation process, to strengthen the institutional commitment to budgetary stability and the mechanisms for enforcing the rules, to increase the transparency of public finances and to reinforce budgetary planning in the medium term.

Fiscal consolidation must be accompanied by an ambitious structural reform programme

The application of structural reforms providing for enhanced employment generation and growth capacity is crucial for embedding a durable recovery and facilitating fiscal adjustment (see Box 1.3). Supply-side policies that improve the working of the markets for goods, services and factors are vital to pave the way for a durable expansion of activity and employment; and, therefore, to also increase government revenue and, through this means, to promote the medium-term sustainability of public finances. In turn, an appropriate distribution of the adjustment drive between public spending and revenue would contribute to boosting activity and would have positive effects on employment.

The pensions reform approved in March this year has positive effects on the sustainability of public finances and growth potential

The reform of the pensions system, the draft legislation for which was submitted to Parliament in March 2011, is an example of measures that harness the complementarity between the sustainability of public finances and the creation of favourable structural conditions on the supply side. The reform approved in Spain amends certain parameters of the system, raising the legal retirement age and increasing the number of years taken into account to calculate pensions. The combination of both measures could, on one hand, increase participation by more elderly workers and thus raise growth potential; and, on the other, it could enhance the sustainability of the pensions system and contribute to the restructuring of public finances (see Box 2.3).

Labour market reform remains one of the fundamental economic policy measures needed …

The labour market reform approved last year (Law 35/2010 of 17 September 2010) took certain steps towards improving the functioning of the labour market in the medium term. In terms of internal flexibility, one aim of the reform was for companies to be able to change certain aspects of how work was organised (in particular regarding the conditions for setting wages) compared to what was stipulated in industry-, region- and nationwide collective bargaining agreements; that would bring about a more decentralised model, allowing a closer relationship to be established between working conditions and the specific needs of companies. However, this would all be done without yet altering the collective bargaining system. In turn, in the case of hiring mechanisms, changes were made to the modalities already in place in order to boost permanent hiring (facilitating the possibilities of terminating permanent contracts for objective causes and extending the possibility of using employment-promoting contracts), while new limits were added in the case of temporary hires. On the whole, these are so far partial measures that do not alter the key features of the labour framework, such as hiring and collective bargaining arrangements, and they cannot therefore decisively change its present functioning.

Any assessment of the impact of these measures would be premature. The as yet very partial information available points to an increase in employment-promoting contracts which, however, would appear to have crowded out other permanent contracts, while the impact on temporary employment is not yet discernible. Also evident is a greater use of objective dismissals, with lower severance costs, and a greater use by companies of the possibilities to reduce the working day, on a temporary basis. Some time will be needed to accurately ascertain the link between the changes being observed and the effectiveness of the steps taken.

… and it should go ahead with substantial changes to the collective bargaining system …

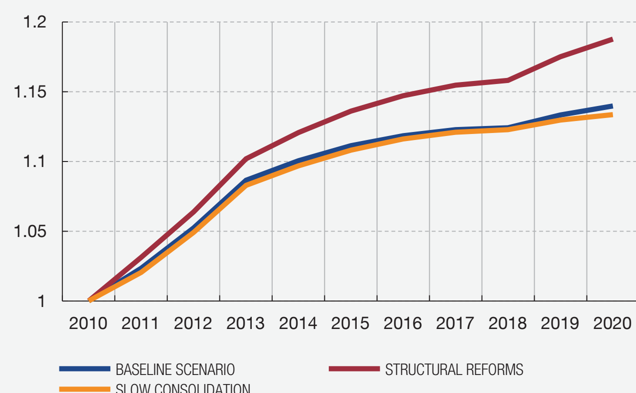
The behaviour of employment continues to be the source of most concern in the economy, and the wage rises observed in the opening months of the year indicate that the measures already taken must be complemented by far-reaching reforms to collective bargaining and

The substantial fiscal consolidation the Spanish economy needs to correct the budgetary imbalances arising from the crisis faces various problems; compounding the difficulties derived from the very scale of the imbalances are further complications due to growth expectations limited by the depth and extension of the crisis and by the impact of population ageing on spending on social policies. These are major obstacles standing in the way of public finances sustainability. In such a situation, a factor of great importance is the complementarity of fiscal consolidation policy and supply-side policies which, by improving the functioning of the markets for goods, services and factors, may lead to an expansion in potential growth, increasing public revenue and allowing certain spending items to be reduced.

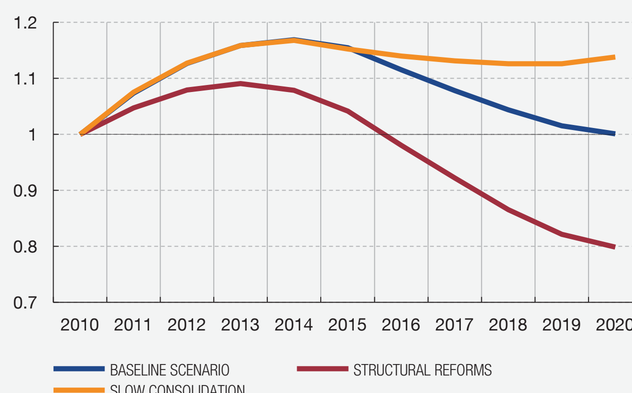
To illustrate the effects that fiscal consolidation and structural reforms have on GDP and public debt in the short and medium term, this box presents simulations performed using a calibrated model for Spain that has two essential ingredients. First, in line with the standard approach in much of the recent economic literature[1], the model incorporates distortions in the labour and product markets, in the form of monopolistic competition, which give rise to a gap between marginal costs and prices and to the inefficient allocation of productive factors. Second, so as to capture the impact on the economy of population ageing, the model's demographic structure is highly detailed, in the form of overlapping generations of households.[2]

1 See, for example, L. J. Christiano, M. Eichebaum and C. L. Evans (2005), "Nominal Rigidities and the Dynamic Effects of a Shock to Monetary Policy", *Journal of Political Economy,* 113 (1), pp. 1-45.
2 For a detailed description of the model and its calibration, see A. Gavilán, P. Hernández de Cos, J. F. Jimeno and J. A. Rojas (2011), "Fiscal Policy, Structural Reforms and External Imbalances: A Quantitative Evaluation for Spain", *Moneda y Crédito,* forthcoming.

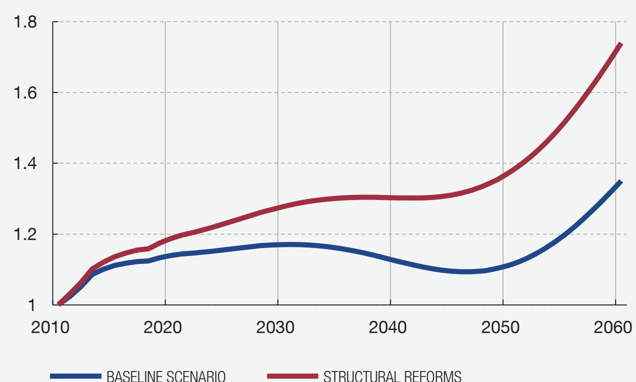
1 GDP PER CAPITA (a) (2010-2020)



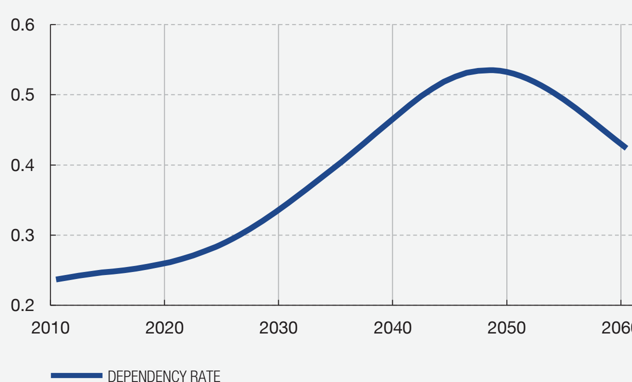
2 PUBLIC DEBT (% of GDP) (a) (2010-2020)



3 GDP PER CAPITA (a) (2010-2060)



4 DEPENDENCY RATE (b) (2010-2060)



SOURCE: Banco de España.

a The variables depicted have been normalised taking their 2010 value.
b The dependency rate is defined as the ratio of the over-65 population to the working-age population (16-64).

Panels 1 and 2 show the response of GDP and of the public debt/GDP ratio from 2010 under different scenarios. The baseline scenario incorporates a public spending trajectory for the period 2009-2013 in line with that established in the April 2011 Stability Programme. It further entails the continuation of the fiscal consolidation process after 2014, whereby the public debt/GDP ratio in 2020 settles at 60 %. This scenario does not, however, consider the introduction of structural reforms. Before addressing the potential impact of these reforms, and to assess the significance of the time path of the adjustment, this scenario is compared with the so-called "Slow Consolidation" scenario, in which the effects of cutting future budget deficits more moderately, again in the absence of structural reforms, are simulated. As can be seen in Panels 1 and 2, a slower fiscal adjustment than that considered in the baseline scenario would entail a significant delay in the stabilisation of the public debt/GDP ratio, without any benefits in terms of short-term growth. These results illustrate the advantages of the strategy of bringing the fiscal adjustment forward.

An assessment follows of the consequences of introducing structural reforms, for instance, those affecting the markets for goods and services. In the "Structural Reforms" scenario, it is assumed these reforms would narrow the prevailing margins between marginal costs and prices in the goods and services and labour markets by 2 pp[3], and that they would increase the growth rate of productivity in the economy by 0.5 pp once the crisis were overcome.[4] As can be seen in panels 1 and 2, the structural reforms considered, by reducing the distortions existing in the markets, would improve the allocation of resources, exert a significant positive impact on activity and make for a swifter improvement in public finances in the short and medium term, widening the fiscal policy room for manoeuvre.

In the long run, the dynamics of activity and of public finances will be notably influenced by the population ageing currently characterising Spain, and most other developed countries. With its highly detailed demographic structure, the model used in this box can capture the impact of this ageing process on spending on pensions and on labour supply, along with other general equilibrium effects on prices and wages. In this setting, the adoption of structural reforms would also have a considerable positive effect since, as shown in panel 3, it would significantly soften the effect of population ageing on growth (see panel 4).

The results presented assume that the cost of financing for all domestic agents (households, corporations and government) is independent of the volume of debt in the economy. However, as was clear in the sovereign debt crisis episodes in 2010, the perception of international lenders may be that an economy's risk of default rises with its volume of debt, and they may demand a growing premium in return. In this case, the advantages of undertaking structural reforms and accelerating fiscal consolidation would be even greater than those resulting from the simulations presented in this box.

3 This reduction in margins is approximately equivalent to one-third of the competitive differences estimated in the literature across different countries. See, for example, J. Andres, E. Ortega and J. Vallés (2008), "Competition and Inflation Differentials in EMU", *Journal of Economic Dynamics and Control,* 32 (3), pp. 848-874, and R. Christopoulou and P. Vermeulen (2008), "Markups in the Euro Area and the US over the Period 1981-2004 – A Comparison of 50 Sectors", *European Central Bank Working Paper Series,* no. 856

4 The positive impact on productivity derived from regulatory improvements in the goods and services and labour markets is empirically documented, for example, in G. Nicoletti and S. Scarpetta (2006), "Regulation and Economic Performance: Product Market Reforms and Productivity in the OECD", in T. Eicher and C. García–Peñalosa (eds.), *Institutions, Development and Growth*, MIT Press, and A. Basanini, L. Nunziata and D. Venn (2009), "Job Protection Legislation and Productivity Growth in OECD Countries", *Economic Policy*, 24 (58), pp. 349-402

active employment policies. The collective bargaining system in Spain concedes to inflation a predominant role among wage-increase determinants. Also, bargaining is carried out at an intermediate level which foments highly uniform wage increases that are barely linked to the specific economic conditions of companies. This furthermore prevents relative wages from acting as a mechanism to allocate resources towards sectors with greater development potential.

A more appropriate design of collective bargaining would help improve the capacity to redistribute employment across sectors, companies and regions, which would provide for a swifter exit from unemployment for the large number of jobless workers. An improvement here is vital, moreover, so as not to jeopardise the gains in competitiveness that have come about during the adjustment phase and so as to lay the foundations for a sound recovery in the economy. The increase in purchasing power that would ultimately

ensue as a result of this improvement in the competitive environment would also enable demand to be sustained. In sum, the appropriate functioning of the wage-setting mechanisms is a cornerstone of the capacity for macroeconomic adjustment within the euro area and of the structural change that the economy needs, following the serious shock it has undergone.

… complemented by a far-reaching reform of active and passive unemployment policies

The changes should, moreover, be complemented by a far-reaching reform of active and passive unemployment policies, so as to help prevent the increase in unemployment from becoming structural. In this respect, the incentives of the benefits system should be reconsidered so as to make eligibility conditional upon active job search, complementing this with active policies aimed at enhancing training. The reforms approved in February 2011 are in this direction, although it is once again too soon to assess their effects.

Increasing the quality of human capital requires substantial improvements on the educational front …

Some of the problems in our educational system, such as the high drop-out rates, can be found to be associated with the scant wage dispersion derived from our collective bargaining system, which does not generate the right incentives for prolonging schooling.[2] However, improving human capital also requires significant steps to be taken in the educational system, including lifelong training.

The Spanish economy would be better placed to bring about a change in the productive model that has prevailed over the last business cycle if the design of the educational system and of labour institutions were to appropriately encourage companies' and workers' training decisions, to provide for job mobility across firms and industries, and to increase the capacity for adjustment in the face of the various shocks the economy may undergo, assigning less weight to employment fluctuations over the course of the business cycle.

… and the drive to liberalise and deregulate the markets for goods and services must continue

In recent years there has been a notable drive to liberalise and deregulate the market for goods and services, but there is room to take some of the measures already undertaken further and to launch new reforms.

In the housing market, house rentals as opposed to house purchases should continue to be encouraged. A more balanced market will pave the way for the provision of housing services under more favourable conditions, it will contribute to absorbing the excess capacity in the residential sector and it will provide for job mobility, which is essential for infusing dynamism into the adjustment of the labour market across regions and industries. To this end, the latest initiatives adopted – such as greater legal efficiency in tenancy-related proceedings and the elimination of the tax deduction for incomes above €24,000, equating it to the rental deduction – should be complemented by measures aimed at adding flexibility to the mandatory term of contracts and the control of rental incomes.

The most substantial progress in structural reforms in recent years has been in connection with the liberalisation of the services sector, among others, and with the lessening of administrative burdens, further to the transposition of the Services Directive. However, obstacles remain in respect of the liberalisation of certain activities, such as retailing, where the regional governments can continue to establish administrative authorisation

2 See A. de la Fuente and J. F. Jimeno (2009), «The Private and Fiscal Returns to Schooling in the European Union», *Journal of the European Economic Association*, December, vol. 7, no. 6, pp. 1319-1360.

“for reasons in the general interest”. Such reasons may ultimately interfere in the allocation of productive resources and price-setting. In addition, the reform of professional services should advance along the same liberalising path, given the significance of this sector in Spain and the numerous obstacles in place compared with those in other countries.

Turning to the network industries, there remain segments in telecommunications in which certain rigidities and limited progress in the degree of competition are discernible, specifically in those most closely connected to the new communications technologies (broadband). In the energy industry, the degree of *de facto* competition is also scant and final prices should be more closely aligned to costs in order to bring about by means of incentives a reduction in our energy dependence. In the fuel distribution market, further steps are needed to eliminate the barriers to entry and to the expansion of new operators, in line with the recommendations of the National Competition Board (CNC by its Spanish acronym). As to transport, there is scope for liberalising rail transport, in particular freight.

Lastly, while the general government technology investment drive has increased considerably, the carryover effect of public funding into private investment seems rather limited; accordingly, Spain’s relative lag in technological and scientific production has, overall, scarcely been corrected. In this respect, it would be advisable to improve governance of the public research system and the mechanisms for managing incentives to R+D+i.