1 OVERVIEW

1 Introduction

The Spanish economy is undergoing difficult economic circumstances as a result of the prolongation and worsening of the euro area sovereign debt crisis, and the renewed dip into recession before the weak recovery was able to take root. In the very short run, the outlook remains conditional upon the need to correct the imbalances outstanding and to redress the weaknesses that have emerged during the crisis, which will require seeing adjustments through and will limit growth possibilities. However, pursuing an ambitious agenda of restructuring and reform will help restore the macroeconomic equilibria and competitiveness needed to resume a sound growth path in the medium term. It will also prevent the economy from being trapped in a low-growth scenario over a protracted period of time.

The quicker that the adjustments are completed and that the weaknesses which have placed the economy in a position of vulnerability are addressed, the sooner the foundations for sound growth will be restored and the greater the protection afforded against the shocks and accidents that may arise in the still-unstable euro area scenario. This is because while the unfolding of the sovereign debt crisis will remain a significant external constraint, the country's responsiveness and the appropriate reaction by its agents will more than ever determine how the difficult juncture at which the economy stands can be overcome.

To outline the essential features of this situation and the economic policy challenges posed by it, this chapter commences with an analysis of the euro area sovereign debt crisis. It subsequently delves into the key factors characterising the difficult circumstances of the Spanish economy, with particular attention to the imbalances and institutional inefficiencies bearing down on recovery. Finally, it highlights the major role that economic policy has to play. Chapter 2 in this Report is dedicated singularly to competitiveness. This is a cornerstone of the Spanish economy's adjustment within the Monetary Union, all the more so given that it is vital that all institutional sectors should reduce their level of debt and that the economy as a whole should lessen its dependence on external saving.

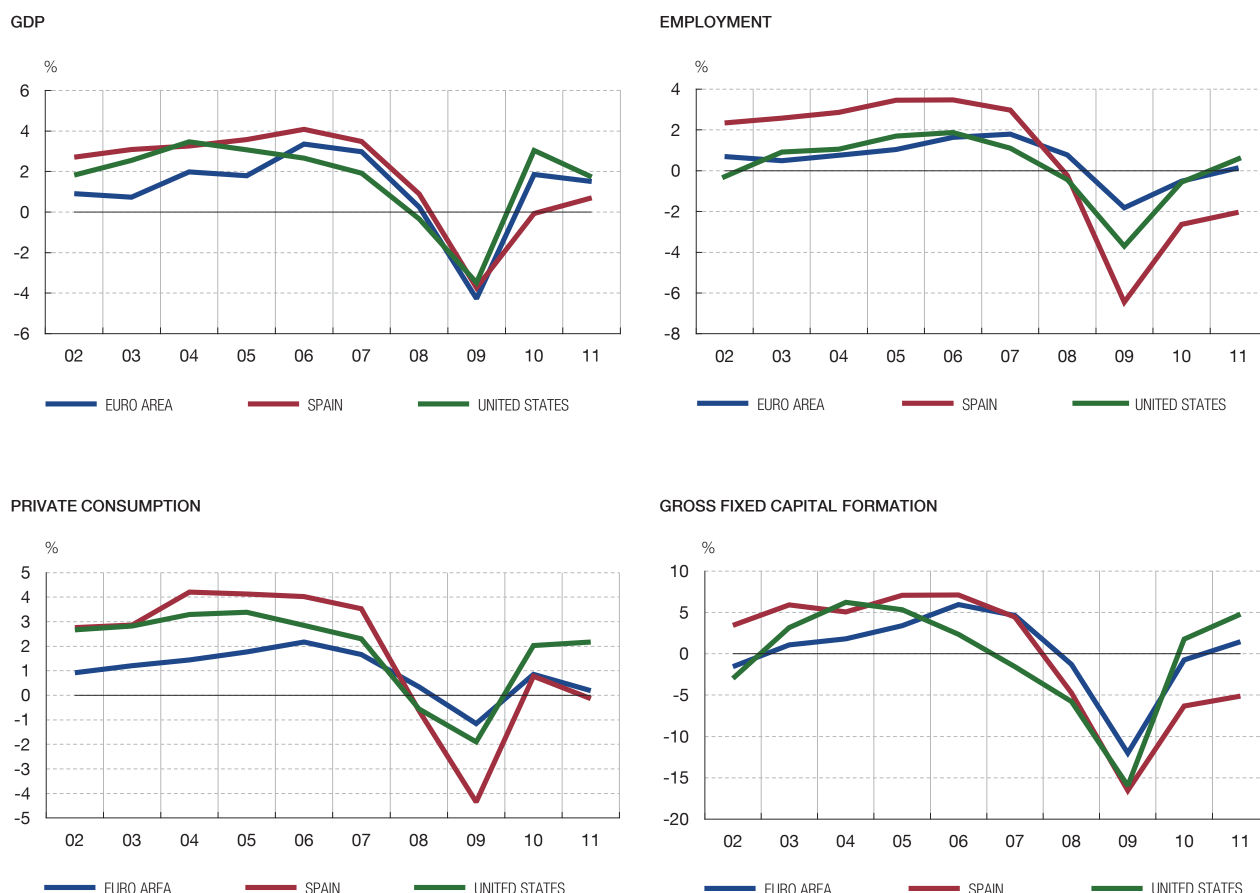
2 The systemic scope of the sovereign debt crisis

In 2011 the recovery in world growth initiated a year earlier was interrupted

The recovery in the world economy that began in 2010 did not see continuity last year (see Chart 1.1). The growth rate of global output fell back 1.4 pp (from 5.3% to 3.9%), and the decline was more marked in the advanced economies. Euro area GDP advanced at a sluggish rate, similar to that of the previous year (1.4% against 1.9% in 2010) and the result of behaviour that differed not only across its Member States, but also over time. While relatively expansionary in the first six months, the dynamism of growth was diminished in the second half of the year. This slowdown in global activity has progressively steadied over the first half of 2012 and, as this Report goes to press, most economic indicators point to some stabilisation which, on most forecasts, would translate into a further – though limited – easing in the expansion of both the most advanced and the emerging economies over the year as a whole.

Initially, emergence from the global crisis was interrupted owing to a series of shocks, such as the tsunami in Japan and its effects on the Fukushima nuclear power plant, and the outbreaks of political instability in the Arab countries. These bore down on financial markets and on international trade. Later, however, the focal point of tensions tended to shift towards the exacerbation and extension of the euro area sovereign debt crisis, ultimately

GDP, PRIVATE CONSUMPTION, EMPLOYMENT AND GROSS FIXED CAPITAL FORMATION — CHART 1.1
Rate of change



SOURCES: Eurostat and national statistics.

acting during 2011, but also in 2012 to date, as a key conditioning factor of the economic performance of the euro area in general, and of Spain in particular.

The euro area sovereign debt crisis became systemic and was one of the main factors responsible for the interruption of world growth

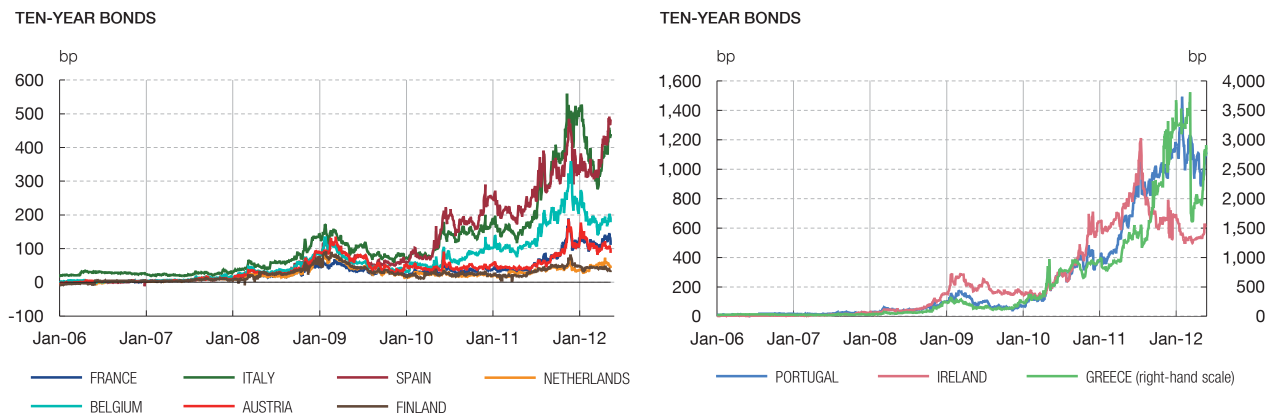
The tensions on euro area government debt markets had continued until summer last year, concentrated in a relatively limited group of countries (see Chart 1.2). Thereafter, however, they began to spread to a greater number of Member States, primarily affecting those showing more vulnerable economic fundamentals and, later, even those in sounder positions. As a result, the European debt crisis ultimately took on a systemic dimension. The causes leading to this key qualitative change are numerous and complex; but, in any event, the shortcomings in the area's institutional arrangements for governance and decision-making in the face of the crisis have had a notable influence.

The distortions in the economic policies of a limited group of countries triggered the tensions

At the source and immediate onset of the tensions on the euro-denominated government debt markets, a central role was played by a group of member countries' policies, the pursuit of which revealed an insufficient understanding of the scope and economic consequences of belonging to a monetary union. Following policies that were hardly consistent with stability in the Monetary Union had given rise to a build-up of various imbalances, which placed the economies concerned in a position of vulnerability to potential shocks such as those which, unfortunately, began to materialise in the second half of the past decade.

EURO AREA: SOVEREIGN SPREADS OVER GERMANY

CHART 1.2



SOURCE: ECB.

Practically from the very start of Monetary Union and despite the Treaty's provisions, some governments failed to exert sufficient control over public finances, which resulted in deficits and debt that were hardly compatible with the demands of a common monetary policy. Fragilities emerged in other equally important areas, as seen in the high levels of private debt accumulated, the weakening of financial systems and continuing rigidities in price and wage-formation mechanisms which, in the short term, constrain economies' ability to absorb adverse shocks and, over a longer horizon, reduce their growth potential. Recent events have highlighted the close links between sovereign risks, banking risks and economic vulnerability, and how, once any of these three components is activated, feedback loops are set in train that exacerbate and deepen tensions (see Box 1.1).

The effects of these distortions were amplified as a result first, of a relatively complacent and benign view of the imbalances generated, and one strongly anchored in the euro's success during its first 10 years; and further, of excessive confidence in the strength of a series of adjustment mechanisms which, it was assumed, would be activated were these imbalances to breach specific safety thresholds. Unfortunately, neither the competitiveness channel, which should have induced price and cost containment in those economies that were accumulating growing external misalignments, nor the market discipline channel, which should have penalised the financing of these imbalances with higher risk premia, functioned as expected. The former channel was deactivated by the persistent lack of flexibility of the price and wage-formation mechanisms, if not directly by the prevalence of dysfunctional factor and product markets. And the latter was cancelled out by the widespread underestimation of the risks not only on European financial markets but also internationally.

The weaknesses in European governance and the ups and downs of the process followed to correct them explain, nonetheless, how the crisis took on a systemic dimension as from the summer

All these factors, while central, do not explain why, as from summer 2011, the tensions also spread to Member States whose policies and economic fundamentals had not deviated significantly from stability. To understand the systemic dimension of the crisis, other factors closely linked to a series of weaknesses in European governance and to the process followed by the European authorities to overcome them must be incorporated into the analysis. Indeed, the process fell far short of the diligence and effectiveness that the seriousness of the circumstances required, as shown by the management of the grave problems assailing the Greek economy.

The destabilising potential of fiscal imbalances within a monetary union was explicitly acknowledged by the founders of EMU. The Maastricht Treaty envisaged a formal budgetary

The strong interrelation between financial crises and sovereign debt crises is an empirical regularity extensively documented in the literature. From a broad historical perspective, systemic banking crises have tended to be followed by public debt crises, so that the former "help to predict" (in the statistical sense of the term) the latter[1]. The mechanism through which this link takes place is well known: financial crises tend to turn into severe economic crises leading to pronounced falls in budgetary revenues and increases in public sector spending and debt, which may ultimately put in doubt the sustainability of public finances. If, moreover, governments have to give direct financial support to their banking systems, the problems are aggravated.

However, episodes in which banking crises and sovereign debt crises have developed (and fuelled each other) in parallel have not been rare either. In fact, the relationship between them tends to be bidirectional, with another causal nexus, existing alongside the one described above, operating in the opposite direction through various channels. First, the fall in government bond prices directly affects[2] the value of the debt holdings on the institutions' balance sheets. In addition, the contractionary fiscal policies deployed in response to possible problems of public finance sustainability typically involve a lower level of economic activity in the short term, which may lead to an increase in doubtful loans. For their part, the deterioration in the quality of bank assets and the associated worsening of the earnings outlook result in a tightening of financing conditions, which may involve the loss of access to the markets in the most extreme cases in which bank solvency is called into question. The power of this transmission channel is also amplified by the special role played by public debt in the financing of banks, being used as collateral and, especially, in repo transactions between private institutions or with the central bank. A sharp deterioration in the quality of sovereign assets raises the haircuts applied in the valuation of the collateral, and ultimately the asset may even lose its eligible asset status. Finally, a particularly powerful channel of transmission of sovereign risk to bank risk is the fact that the credit rating of the sovereign frequently places a limit on that of the domestic banks and, therefore, on their cost of financing. This is because the solvency of the public sector ultimately determines its capacity to provide support to institutions in difficulty and, therefore, the value of the implicit (sometimes also explicit) public guarantees which support banks and supplement their stand-alone ratings. Naturally, most of these effects tend to be less powerful in more disintermediated systems, in which the bulk of financial flows are channelled by the markets and not by the banks.

Panel 1 illustrates how the tensions deriving from the 2007 global financial crisis were transmitted to the euro area sovereign debt markets, resulting in a progressive widening of the interest rate differentials (which had previously remained very compressed since the creation of the euro area in 1999). However, it was not until spring 2008 that significant differentiation between countries began to take place. The crisis in the euro area acquired its own dynamic between end-2008 and the start of 2009, following the Lehman bankruptcy and the nationalisation of Anglo Irish Bank in Ireland, but especially with the outbreak of the crisis in Greece in late 2009 and early 2010. According to studies published by the International Monetary Fund[3], it was precisely at that time that the financial, sovereign debt and growth crises showed stronger feedback and became more intertwined. The correlation between sovereign credit risk and credit risk in the banking sector in the euro area has been clearly evident since the summer of last year (see Panel 2).

The interaction between sovereign and bank risk is not specific to the euro area, although some characteristics of the monetary union intensify this link. In fact, in the case of the euro area, the banking sector plays a predominant role in the channelling of credit to the economy, so that bank tensions have greater repercussions on economic activity. Also, the exposure of euro area banks to public debt is relatively high (see Panel 3) and shows a domestic bias that is most acute in those countries that have experienced the strongest tensions in the debt markets, with the exception of Ireland (see Panel 4). Despite this, the greater financial and real integration of the euro area means that the transmission of risks in the euro area is not limited to domestic banks, but extends beyond their borders through bank cross-country exposures. These circumstances, along with the governance problems of the area, revealed by the crisis, are conducive, in the absence of effective firebreaks, to contagion, with the problems developed in some countries eventually spreading to other countries that have fiscal weaknesses or greater dependence on external saving, thus enabling the crisis to become systemic. Finally, the weaknesses and fragmentation in the EU financial crisis management and resolution mechanisms have had a further destabilising effect and have contributed to a certain renationalisation of some market segments (see Box 4.2 in Chapter 4). The absence of a common crisis management and resolution authority offering sufficient protection to the States against liquidity crises not based on fundamentals means that the available fiscal support (potentially very costly, given the size of the domestic banking systems) has a strictly national dimension, which amplifies the possible vicious circles between public finance vulnerabilities and the banking sector.

1 C.M. Reinhart and K. Rogoff (2011), "From Financial Crash to Debt Crisis", American Economic Review, 101, pp. 1676-1706.

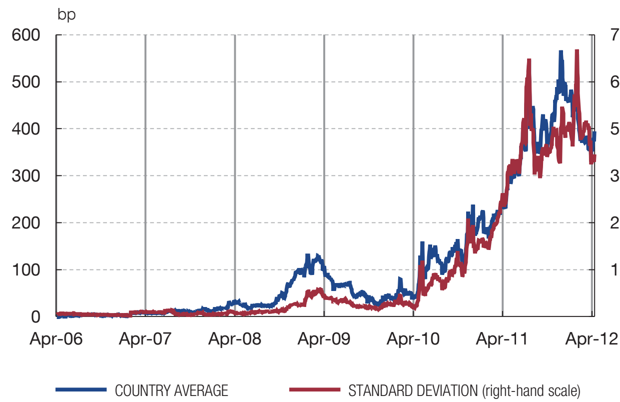
2 However, the reflection of the depreciation of the government bonds on institutions' income statements may be limited by the accounting method employed. Thus, bonds in held-to-maturity portfolios are not available for sale and are valued using an expected loss approach. Therefore, the banks recognise capital losses only if, as occurred in the case of Greek public debt, there is a possibility of restructuring or default by the borrower.

3 A. Mody and D. Sandri (2011), The Eurozone Crisis: How Banks and Sovereigns Came to be Joined at the Hip, IMF Working Paper WP/11/269.

THE INTERDEPENDENCE BETWEEN SOVEREIGN RISK AND BANK RISK (cont'd)

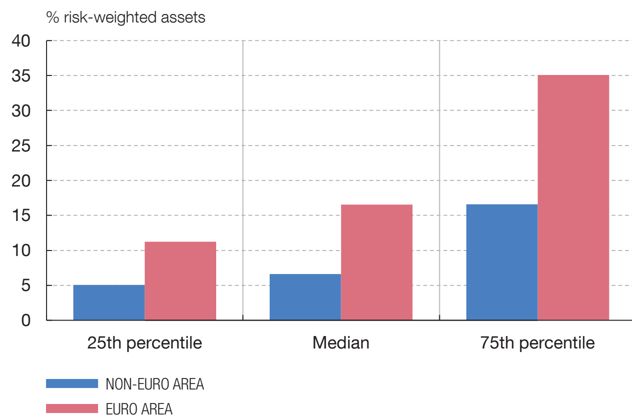
BOX 1.1

1 FIVE-YEAR SOVEREIGN SPREADS OVER THE BUND

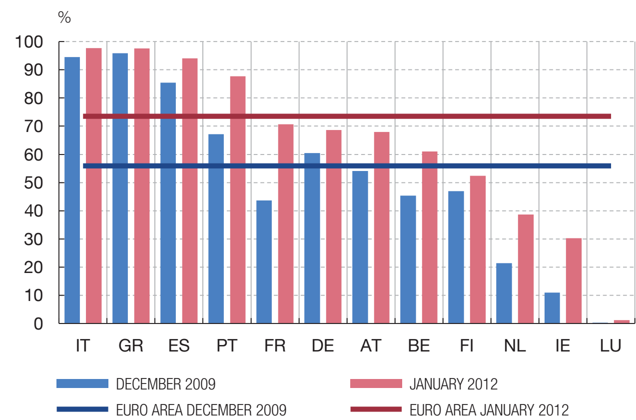


2 RISK PREMIUM IN THE EURO AREA (AVERAGE CDS EXCLUDING GREECE)

3 SOVEREIGN EXPOSURE OF EUROPEAN BANKS (a)



4 DOMESTIC BIAS IN BANK PUBLIC DEBT PORTFOLIOS (b)



INDEX OF CORRELATION BETWEEN BANK AND SOVEREIGN RISK PREMIUMS (CDS) (c)

	Euro area countries (d)				United Kingdom	United States
	All	Under assistance	AAA	Other		
2009-2012 (April)	87	88	85	88	52	47
Second half of 2011	85	65	95	92	93	30

SOURCES: European Banking Authority, ECB, Datastream and SNL.

a Net direct exposure to European sovereigns of the banks participating in the European Banking Authority's recapitalisation exercise (51 euro area and 14 non-euro area banks).
b In the aggregate bank balance sheet, domestic general government debt as a proportion of total euro area general government debt.
c The bank index is the average of the individual bank CDS.
d Includes AAA countries (Germany, France, Netherlands and Austria), countries under assistance (Greece, Ireland and Portugal) and the other countries (Italy, Spain and Belgium). For the groups of countries they are calculated as the simple average of the individual correlations.

discipline surveillance procedure, the Stability and Growth Pact, with ceilings for budget deficits and public debt. Yet the necessary mechanisms were not set in place so that these provisions of the treaty might be properly applied in practice, meaning that the Pact's effectiveness was ultimately very limited. Conditions were even more lax regarding other economic policies, subject to less strict oversight procedures in terms of their theoretical definition and even lighter oversight in respect of their practical application. Coordination of these policies was structured around the so-called Broad Economic Policy Guidelines (BEPGs), by means of which economic policy priorities were set. But oversight of each Member State's degree of adherence to these priorities was based on mere information exchange and on peer pressure mechanisms, which proved relatively ineffective for pushing through far-reaching reforms. Finally, the irreversibility of monetary union and the success reaped in its early years shaped a setting not conducive to reflection on potential crises and on the need to have mechanisms at hand to manage and overcome them. The institutional arrangements underpinning EMU lacked such an instrument, a shortcoming that prevented a flexible response at a sufficiently early stage of the tensions, which would probably have enabled such tensions to be confined and resolved more readily.

Exiting this stressed scenario requires a three-pronged action plan…

Under these conditions, action on several fronts was necessary to lessen the pressure. In the domestic policy realm, resolute action was needed by the economic authorities both to correct the vulnerabilities that had built up and, essentially, to make the required changes to definitively align internal working arrangements to those proper to a monetary union. In terms of European governance, the challenge was to shore up the foundations in which the main cracks had been detected and to set in place effective mechanisms for crisis-management and the provision of financial assistance. Finally, regarding monetary policy, it fell to the ECB to contribute to easing financial tensions through an effective liquidity supply and management policy without detracting from its capacity to react swiftly to any risk to price stability, which is its main objective and a necessary condition for growth, job creation and financial stability in the area.

Throughout 2011 and in 2012 to date, progress in these three areas has been uneven and not without difficulties. The headway made has occasionally been in response to conflicting interests, and the ups and downs experienced evidence the absence of a well-defined plan backed by a high degree of consensus. Notwithstanding, it should be acknowledged that significant steps have been taken, though there is still a considerable way to go.

… namely a re-gearing of domestic economic policies to align them to the area's stability requirements…

Regarding domestic economic policies, there has been significant headway in a good number of the countries subject to greater tensions. Greater details in this connection are given in Chapter 4 of this Report. Broadly, however, mention may be made of the implementation of ambitious fiscal adjustment programmes, progress in the recapitalisation and restructuring of banking systems, and structural reforms in the labour market and in services markets which, at a differing pace and degree of intensity, have been applied by these Member States' governments, in some cases under the terms of conditionality proper to the financial assistance programmes set in train. But experience has also shown the difficulties of defining with any precision the optimal pattern of bringing public finances back onto a sustainable path against the background of a strong economic downturn and the risk that, in this setting, governments may succumb to reform fatigue before they have finished overhauling structures in their respective economies. The long and eventful road that finally led to Greek public debt restructuring and the approval of this country's second financial aid programme vividly illustrates the difficulties of these processes and the costs of not overcoming them quickly and effectively. And far from being confined to the econo-

mies directly involved, such difficulties and costs have – against a backdrop of high systemic uncertainty – tended to spread to other countries, especially those in a situation of greater vulnerability.

… a deep-seated reform of euro area governance …

Turning to European governance, last year's *Annual Report* anticipated the incipient progress made in the first half of last year in the field of fiscal policy. Of particular note is the strengthening of the Stability Pact, resulting specifically, among other factors, in greater emphasis being placed on prevention instruments, greater attention to debt ceilings and a higher degree of automaticity in the procedures for evaluating non-compliance and for setting heavier penalties under the corrective arm of the Pact. Later, along the same lines, a second package of measures was implemented aimed at reinforcing the framework within which domestic budgetary policies are monitored, and there is a new Treaty on Stability, Coordination and Governance to promote explicit recognition of the commitment to budgetary stability at higher levels of national legislation.

Along with progress in the fiscal realm, a new framework has been designed for the prevention and correction of domestic (non-fiscal) and external macroeconomic imbalances, known as the Excessive Imbalance Procedure. This new framework is underpinned by an early-warning mechanism based on a broad set of indicators which, when complemented by timely economic analysis, should help to detect sufficiently in advance those situations of vulnerability that may jeopardise euro area stability and to set in place the measures needed to correct them.

Another significant innovation regarding governance in the area is the so-called "European Semester", which sets a new timetable for the discussion in European fora of all matters pertaining to excessive deficit and imbalance procedures and to the national reform plans which should give expression to the commitments entered into by governments under the Euro Plus Pact and the Europe 2020 Strategy. The Euro Plus Pact is an inter-governmental agreement entered into by the euro area States and other EU members aimed at reinforcing the commitment to pursue policies geared to growth and to improving competitiveness. The Europe 2020 Strategy succeeds the former Lisbon agenda and is an action and structural reform programme oriented to creating employment, raising productivity and increasing social cohesion. The Semester begins with the presentation by the European Commission of its *Annual Report on Growth*, where the economic policy priorities that European countries must tackle are set. In late November last year, the European Commission brought forward the presentation of the Report for the current year.

Since then, significant consensus has been forged in the euro area around the idea that the progress in fiscal consolidation should now be accompanied by a collective effort, tailored in each country to the particularities in place, to boost growth and employment. The details of what has become known as the "Growth Compact" for the euro, which would complement the previously established "Fiscal Compact", are still under discussion in various fora. But the political backing the G8 and EU leaders have given to this initiative at their recent meetings in May in Chicago and Brussels, respectively, is significant.

Taking a longer view, the crisis is also highlighting the need for all these moves to be complemented by the design of a more ambitious agenda. There may then be progress towards a stronger and deeper economic union among the Member States, in which the degree of integration and transfer of monetary policy sovereignty attained may progressively pervade other economic policy areas.

… with particular attention to the design of a mechanism for crisis management and for providing financial support…

Significant headway has also been made in designing a permanent crisis-management mechanism, although it is here that the need for greater ambition, consensus and resolve by Governments is most clearly discernible. The bilateral loan arrangements underpinning the first financial aid programme for Greece paved the way for the European Financial Stability Facility (EFSF). Temporarily, the EFSF was intended to bridge the gap in European governance caused by the absence of a formal mechanism for crisis management and the provision of financial support to Member States facing difficulties. Later, and now on a permanent basis, the European Stability Mechanism (ESM) was set up, and is scheduled to finally come on stream in July.

Evidently, designing a formal mechanism of this nature is a complex task. Strength and flexibility must be combined to maximise its capacity for success. And, at the same time, there must be no weakening of the incentives either for the ambitious fiscal consolidation and structural reform programmes currently required to lay the foundations for sustained medium-term growth, or for the continuing pursuit in years ahead of the orderly and consistent policies needed so as not to jeopardise stability in the area and the future of the common project. Yet the establishment of both the EFSF and the ESM has proven too slow and subject to excessive frictions, given the scale the crisis has reached at some points and the speed with which it has spread. Debate as to their size and the range of instruments with which they were equipped has, while necessary, taken longer than was desirable and has seen too much disagreement. Investors have perceived the difficulties of advancing in this area and, in the absence of consensus, have reacted showing greater mistrust.

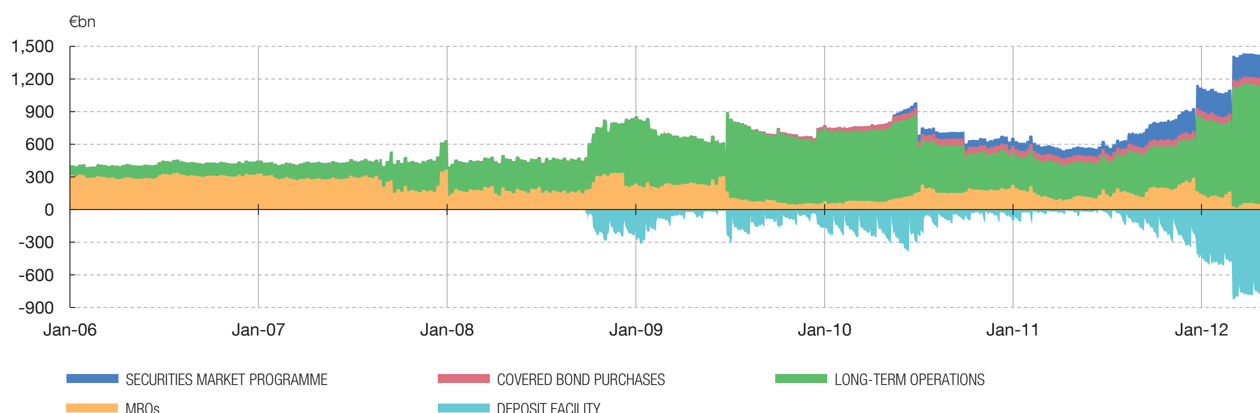
… and, in the shorter term, the contribution of the ECB in its natural sphere of influence

In these conditions, the ECB and its monetary policy decisions have ultimately become the mainstay of stability in the area, providing relief and effective safety valves at times of greatest pressure. The ECB Council faced, in fact, a very complex situation throughout the year, particularly from the summer, when there was a significant turnaround in events. The path of recovery was interrupted and tensions re-emerged forcefully on debt markets, with certain key parts of the transmission mechanism deteriorating substantially. The ECB Governing Council reacted by adopting a series of measures aimed at confirming the expansionary stance of monetary policy, at restoring the functioning of the transmission mechanism and at short-circuiting the feedback loop between risks from the banking system, with great difficulties gaining access to funding, and the sovereign risk market; at that time, the feedback was seriously threatening the stability of the area.

As a result, during 2011 Q4 official interest rates were cut on two occasions, placing them at 1% for the main refinancing operations. The rates on the deposit and marginal lending facilities were set at 0.25% and 1.75%, respectively. In addition, significant unconventional measures were approved. The ECB resumed its Securities Market Programme from 5 August and instituted a second Covered Bank Bond Purchase Programme (including related Spanish instruments) in October. Furthermore, it reinforced its dollar liquidity providing mechanisms and cut the reserve requirement to 1% (down from 2%). In turn, in August and again in October, it extended the fixed-rate tender procedure with full allotment in all its operations (until necessary and, at least, until mid-2012), and it substantially lengthened the term of its liquidity loans to cover a very long period, of three years, in two special operations (the first in December 2011, and the second in February 2012) with which it injected a gross amount of over €1 trillion (see Chart 1.3). So as to prevent any shortfall in collateral from weakening the effectiveness of these three-year LTROs, it also decided to temporarily extend the list of assets eligible as collateral.

LIQUIDITY SUPPLIED BY THE EUROSYSTEM AND SECURITIES MARKET PROGRAMMES

CHART 1.3



SOURCE: ECB.

Progress on these fronts, while uneven, has exerted a stabilising effect whose entrenchment will depend essentially on future actions by national Governments

The combined action on the triple front of national economic policies, European governance reform and monetary policy, along with the approval of the second financial aid programme for Greece after completing the restructuring of Greek public debt held by private creditors, allowed an easing of pressure compared with the critical point reached in the final stretch of 2011. In particular, the ECB's two three-year liquidity operations were decisive in checking an acceleration in tensions that threatened to become a deep-rooted problem and which, against a background of investor hypersensitivity, might ultimately have prompted a financial accident of immeasurable systemic consequences, heightening sovereign risks in the process. By blocking off this potential transmission channel of the difficulties prevailing, valuable time was gained for governments to continue progressing on the other two fronts and for the measures previously adopted to begin to bear their initial fruits. Broadly, the main financial stress indicators have since tended to move on a declining trend, though they have held at excessively high levels. Also, spikes in tension have continued, as has been the case in May, and these, in combination with the high levels of indicators, evidence the need for further headway. In this process, it seems clear that it is now for Governments, responsible both for national economic policies and for the sound working of European governance, to show greater leadership.

3 The double-dip recession in the Spanish economy

The heightening of the sovereign debt crisis interrupted the fragile recovery in the Spanish economy, plunging it once more into a bout of recession

The heightening of the sovereign debt crisis and its interaction with the situation of the financial system acutely affected the Spanish economy, worsening its financing conditions and denting agents' confidence. This broad outlook has been exacerbated by the slowdown in activity in the euro area. And all at a time when job destruction and the unemployment rate were continuing to rise, when the imbalances built up during the upturn remained difficult to absorb and when the need to redress the serious deterioration in public finances during the crisis was becoming imperative.

Against this backdrop, the muted recovery in the Spanish economy in the first half of 2011 weakened as from the summer. Indeed, it was reversed in the final quarter, with GDP declining at a quarter-on-quarter rate of 0.3%, placing the annual average growth rate at 0.7%. This pattern of decline continued into the opening months of 2012 and has seen a new recession ensue.

The adjustment turned once more on domestic demand, which fell sharply, while net external demand once again mitigated this effect

The double-dip has added complications to the adjustment initiated three years earlier. The adjustment has in any event continued, turning on domestic demand. This latter variable fell by 1.7% last year, with a negative contribution of the public and private components of expenditure. The economy's spending capacity has been much restricted by the adverse financial conditions, affected by the tension arising from the sovereign debt crisis and by the ongoing restructuring of the financial system described in Box 1.1. A further contributing factor has been the deterioration in labour prospects and the diminished value of wealth, which have fuelled an increase in uncertainty, a downturn in confidence and, in sum, a curtailing of the propensity to spend. Net external demand once again acted as a counterweight and, for the fourth year running, has mitigated the fall-off in domestic demand, contributing 2.5 pp to output growth, up on the previous year. In 2011, the increase in net external demand was the result of export buoyancy, on one hand, and the sluggishness of imports from the rest of the world, on the other, which were impacted to a greater extent than in 2010 by the weakness of final demand. In the opening months of 2012, national demand once again fell, while net external demand was positive once more.

And on the supply side all the productive sectors lost steam, while job destruction stepped up from the summer

On the supply side, all productive sectors showed diminishing momentum over the year. In the construction sector, where declines in value added were sharper, as has been the case since the crisis began, the decline in activity was centred above all on the non-residential construction segment, owing to the effect of the budgetary austerity plans on civil engineering works. Industrial activity scarcely picked up, despite the sound performance of exports in the face of the adverse trend of national demand. Lastly, the services sectors, which had shown greater resilience to the initial onslaught of the crisis, gradually lost momentum during 2011. This also reflected the extreme weakness of certain domestic expenditure components, in particular household consumption. Employment showed no signs of picking up in 2011; indeed, the path of job destruction even intensified after the summer, running into the opening months of 2012.

There are no recent precedents of a double-dip recession, which poses serious questions as to the capacity to respond…

There are no recent precedents of a double-dip recession in Spain, which poses significant questions about the Spanish economy's capacity to respond. This severe episode has arisen as a result of the interaction of the effects of the deterioration in the sovereign debt crisis with the vulnerabilities generated by the difficulty of pushing through internal adjustments and the inefficient workings of the economy, which are a drag on the recovery and an obstacle to a new path of sustained growth being restored.

… which will depend on the completion of the real estate adjustment, the recovery in competitiveness and employment, the correction of the external deficit, the deleveraging of the private sector and the restructuring of public finances

Indeed, the double-dip recession has come about while the real estate adjustment is still ongoing, job destruction has not halted, the private sector is immersed in a complex process of restoring competitiveness and of financial deleveraging, and the banking sector is undergoing a clean-up, recapitalisation and restructuring process. And, at the same time, it is proving difficult to make headway with a severe fiscal consolidation under the demanding conditions of a scenario marked by the absence of growth. These factors bearing on the double dip are likewise conditioning an exit from this complex situation. An in-depth analysis of each of these factors will form the main thread of this section.

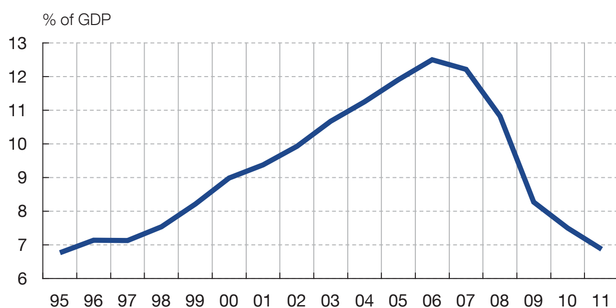
The adjustment of the real estate sector continued in 2011, albeit with a diminishing contractionary impact, while activity in the non-residential construction segment plummeted…

The construction sector remains subject to a severe adjustment process. The collapse in the real estate sector is contributing to lengthening the recessionary trends, albeit with a diminishing impact as the adjustment of the sector advances. The sluggishness of the real estate market continued in 2011 against the background of tighter financing conditions and weak income and wealth prospects. The slackness was felt both in supply, where the number of housing starts continued to fall, and in demand, where new house sales showed no signs of picking up. As a result, the stock of unsold housing scarcely fell, to

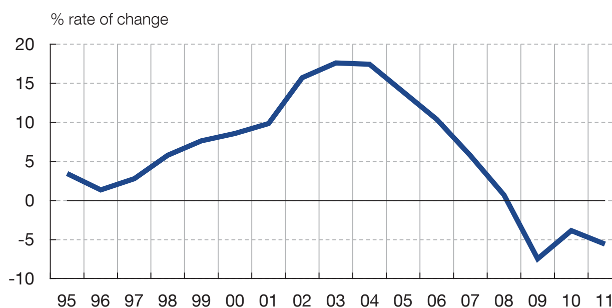
INVESTMENT IN HOUSING AND HOUSE PRICES

CHART 1.4

INVESTMENT IN HOUSING



HOUSE PRICES



SOURCES: INE and Ministerio de Fomento.

the contrary of what was expected at the start of the year. The decline in house prices stepped up in 2011, with the trend running into the opening months of 2012. Accordingly, the accumulated decline in prices from their peak, in 2008 Q1, stands at 22% in nominal terms (27% in real terms), on a greater scale than that recorded in previous real estate cycles. Since the crisis began, the weight of investment in housing in GDP has fallen to less than 7% in 2011 (see Chart 1.4).

…and will continue in 2012 in a recessionary economic environment marked by strict financial conditions

The bulk of the direct and indirect effects on activity triggered by the real estate collapse came about in the early stages of the economic and financial crisis. But some effects continued to emerge in 2011, amplified by the contractionary influence exerted by the non-residential construction segment. Value added and employment across the construction industry as a whole contracted once more, due above all to the fall-off in investment in civil engineering works under the budgetary consolidation plans.

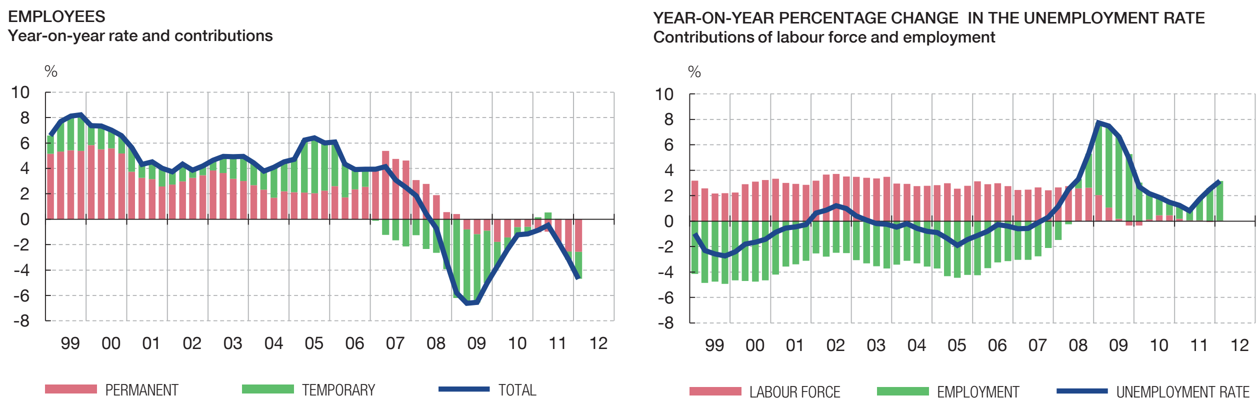
With a view to the immediate future, in an economic environment of low growth and continuing strict financial conditions, the following may be foreseen: residential demand will remain weak, there will be further declines in house prices and the absorption of the stock of unsold housing will proceed slowly, which will delay the recovery in residential investment. In turn, fiscal consolidation will exert an additional restrictive influence on the non-residential construction segment.

Job destruction intensified from the summer, exacerbating the depth of the crisis…

The shortcomings in the functioning of the labour market have fuelled continuing job destruction and have exacerbated the depth of the crisis. The decline in employment began in early 2008 and has run into the opening months of 2012. To date, more than 2.5 million jobs have been lost, around 13% of the jobs existing at the start of 2008.

In 2011, job destruction intensified from the summer, replicating the double dip in output (see Chart 1.5). Admittedly, part of this additional deterioration in the labour market was attributable to steeper job losses in construction. But the obstacles the other productive sectors face in generating employment and the difficulties in reallocating productive factors across sectors should not be underestimated, indicative as they are of the failures in the functioning of the labour market and of product markets during the crisis. On the labour supply side, there was an increase in the number of foreigners exiting the labour market in 2011. This was offset, however, by further increases in the female participation rate, whereby the labour force stabilised at the levels of the previous year. Unemployment rose substantially in 2011 and in 2012 to date, with the end-year figure showing more than

EMPLOYMENT AND UNEMPLOYMENT (a) CHART 1.5



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.

5 million unemployed. The unemployment rate climbed to 24.4% of the labour force in the opening months of 2012. Of these, approximately half were long-term unemployed.

… which is largely due to the delay in the adjustment of labour costs…

Beyond the forceful knock-on effects on employment caused by the downsizing of the construction sector, the intensity of the effects of the crisis on employment can also be attributed to the delay in the adjustment of labour costs. Despite the severity of job destruction, economy-wide compensation per employee increased by 10% from 2008, although unit labour costs (ULCs) fell by 1% owing to the high productivity gains arising as a result of the decline in employment.

… which, in their market component, rose once more in 2011 owing to the preponderant role of inflation in wage bargaining

Until 2010 there was no turnaround in wage dynamics, a fact which may be largely linked to the cut in public-sector wages and, to a lesser extent, to the demonstration effect it had on the private sector. Nonetheless, market-economy wages rose anew in 2011, after stabilising the previous year. This was due to the impact of two of the features of the collective bargaining system that add most inertia: the preponderant role of inflation in determining wage increases, amplified by the effect of the indexation clauses, and the high proportion of industry-wide multi-year agreements, which hampers their adaptation to the specific circumstances of individual companies. In any event, in 2011 and in 2012 to date ULCs fell back further, assisted by productivity gains, which provided for an improvement in the relative position vis-à-vis the euro area countries (see Chart 1.6).

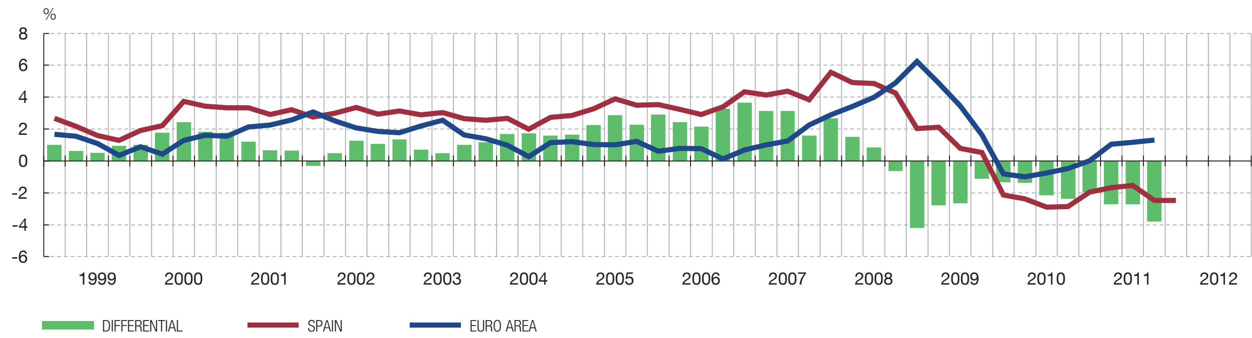
Achieving lasting improvements in competitiveness will require greater adjustments in costs and prices and genuine gains in productivity

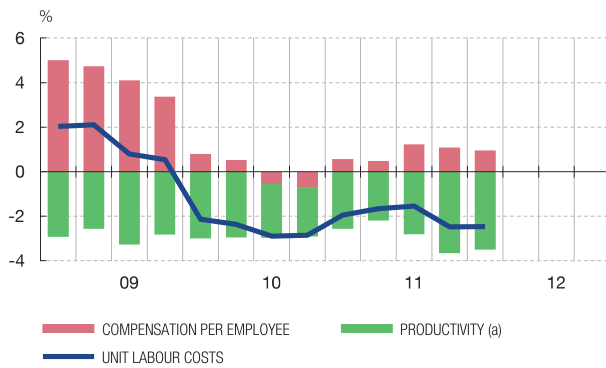
Inflation has been impacted by the weakness of activity in recent years, with increases in the core inflation rate lower than those in the euro area, except on specific occasions since 2009 (see Chart 1.7). In 2011, inflation eased significantly in the closing months of the year once the base effects stemming from the VAT rise in July 2010 and those relating to the increase in tobacco and energy prices in the final stretch of 2010 were stripped out. As a result, the inflation differential became favourable to the Spanish economy once more, a trend that has continued into the opening months of 2012 and which is helping correct the positive differentials that built up during the upturn.

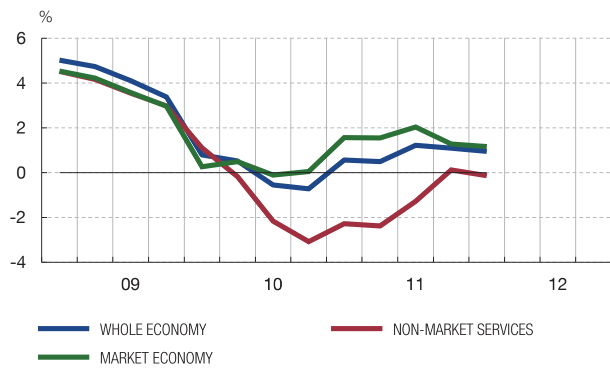
However here, too, price adjustment has been clearly insufficient to restore the competitiveness lost since Spain joined the euro area and to offset, through a greater export impulse, the recessionary trend of domestic demand. Indeed, the real effective

LABOUR COSTS

CHART 1.6





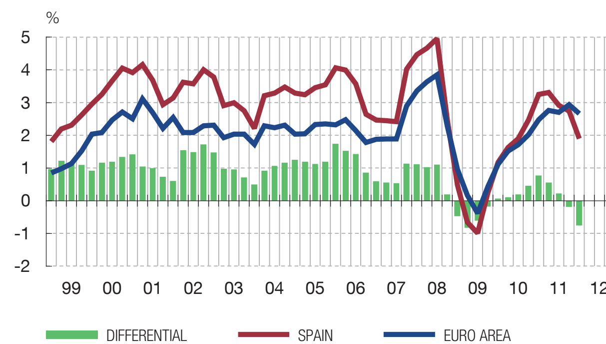


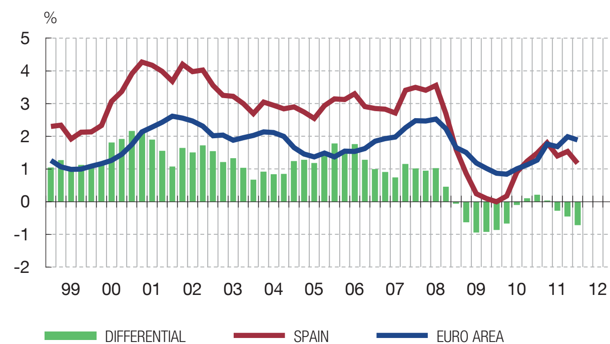
SOURCES: Eurostat and Banco de España.

a Year-on-year rate with sign changed.

SPAIN/EURO AREA INFLATION DIFERENTIAL

CHART 1.7





SOURCES: Eurostat and Banco de España.

exchange rate against the euro area countries has appreciated moderately if the calculation is made in terms of consumer prices. That is in contrast to the gain in competitiveness brought about by exchange rate adjustments in previous recessions, when the exchange rate was available as an economic policy instrument. The adjustment in the real exchange rate has been greater in terms of ULCs (it has depreciated by somewhat over 5%), although this has come about mainly through the gains in productivity induced by severe job destruction. True, this process may have prompted gains in efficiency in sectors and companies that had become excessively big or had not adapted to growing competitive demands, in a setting of financial laxity and strongly dynamic spending. But a significant portion of the apparent productivity gains solely reflects the intensity of the contraction in employment, and is not in response to genuine improvements in productive efficiency, which are what are important for achieving lasting increases in competitiveness. These developments highlight the slow, costly and imperfect functioning of the competitiveness channel, which is pivotal for making adjustments within a monetary union when, as is the case, the economy is in a situation of over-indebtedness.

The current account deficit has fallen significantly, but there are two stumbling blocks that will influence its pattern of adjustment in the future

Since 2007, the external deficit has been substantially corrected, declining from 10% of GDP in 2007 to 3.4% of GDP in 2011. Underpinning this reduction has been the increase in exports and the marked weakness of imports evident in the contraction in domestic demand, while the adjustment of the real effective exchange rate has been moderate. The correction of the external deficit has come up against two factors which will continue to influence its pattern of adjustment over the most immediate horizon. First, the sizeable deficit on the energy balance, which reflects the great dependence of the productive structure and of domestic spending on energy imports, and whose negative impact on the current account increases in situations of sustained energy price rises. And further, the scale of the component of net investment income payments, which has subtracted resources for an amount equivalent to 2.6% of GDP in 2011 (see Chart 1.8) and which is closely linked to the level attained by the International Investment Position (IIP), a more detailed analysis of which is given in Box 6.2 of this Report.

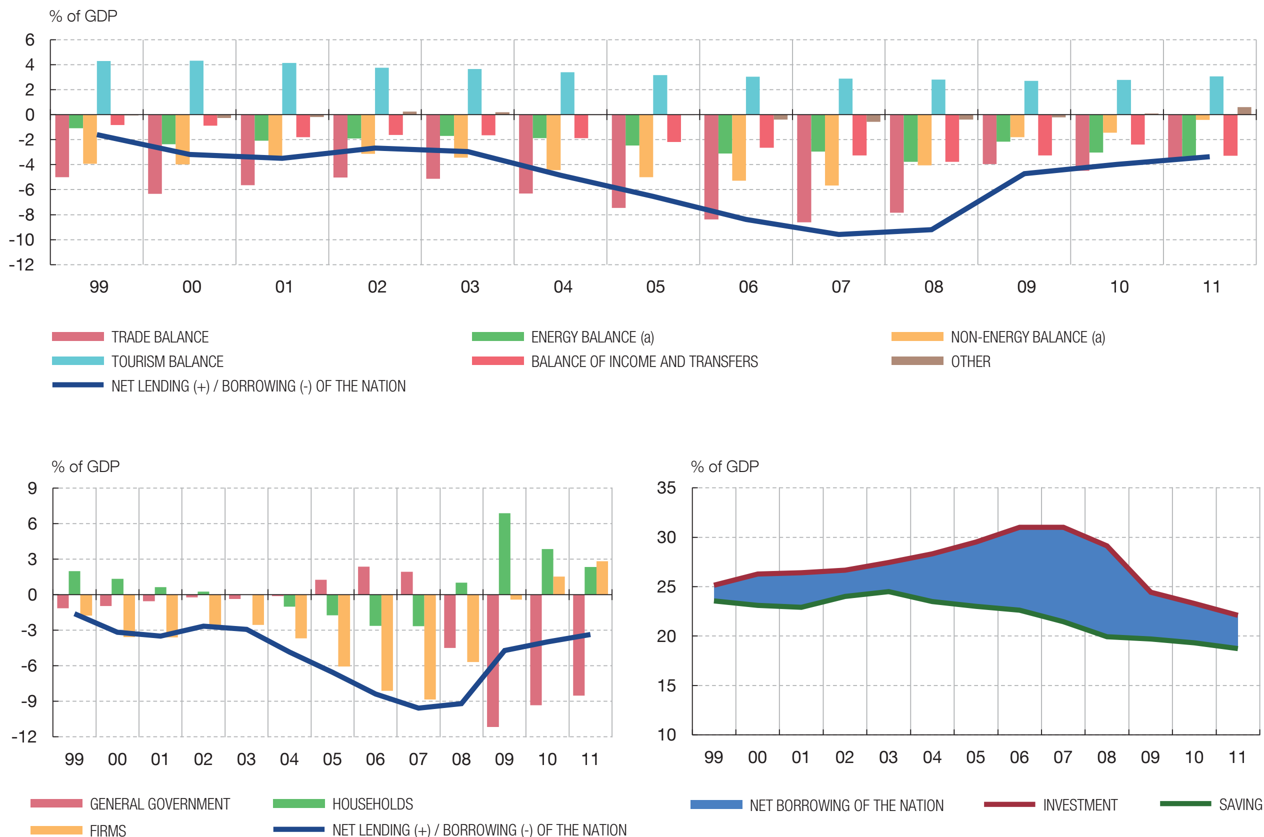
The foreseeable persistence of both developments is a drag on attempts to permanently reduce external borrowing needs, and highlights the importance of reforms that may contribute to mitigating this through the promotion of gains in competitiveness that are conducive to swifter adjustments in the real exchange rate. Only thus may a lasting decline in borrowing needs and a reversal of the rising course of the IIP be attained, once the diminishing effect of the foreseeable weakness of domestic spending on the deficit has been exhausted. The external borrowing requirement has become a major factor of vulnerability of the Spanish economy in the face of the crisis. The erosion of confidence in the euro and the clogging up of wholesale funding markets have created more pressing problems for those countries with a greater dependence on external saving.

The reduction in debt is proceeding slowly, in line with the usual pattern in situations of real estate and financial crisis

The high level of foreign debt ensuing from the strong dynamism of domestic expenditure that was largely financed by external saving can be related to the excessive laxity of financing conditions prevailing during the upturn in the Spanish economy. These conditions fuelled a high build-up of debt by households and firms, and led to the excessive size of our banking system, leaving bank balance sheets skewed towards real estate-related risks. The need to correct these imbalances hampers recovery in the economy; it narrows the headroom available for increasing investment and consumption through resort to external borrowing, and it means expansion possibilities depend closely on the funds that can be internally generated to finance expenditure.

NET BORROWING OF THE ECONOMY

CHART 1.8



SOURCES: INE, Customs and Banco de España.

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

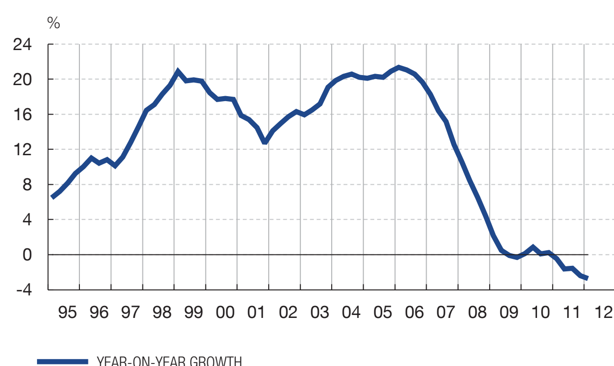
Recourse to credit has been particularly constrained as a result of the European sovereign debt crisis and its adverse repercussions on financing conditions in the Spanish economy. Given their role as a benchmark, high sovereign risk premia have translated into an across-the-board tightening of Spanish financial intermediaries' accessibility to funds, which in turn is feeding progressively through to households and firms. This pass-through appears to have been both through higher lending costs and through quantitative restrictions, although banks have been able to exploit, until very recently, the cushion provided by the greater resort to deposits (which expanded continuously until mid-2011) and to short-term financing in the repo markets. The safety valves of quantitative restrictions, however, have been offering increasingly limited room for manoeuvre. In any event, market frictions and failures have emerged that have singularly affected the accessibility to loans of certain sectors particularly exposed, for conjunctural or structural reasons, to the crisis, as is the case with SMEs.

Experience shows that, in real estate and financial crises, lowering the debt of households and firms is usually a slow process necessarily involving a relatively lengthy initial phase of credit containment. In the current episode, moreover, the restrictions persisting on international wholesale funding markets make it difficult for the deleveraging of the financial system to turn essentially on increasing capital without affecting in some way the extension of loans. The deleveraging pattern followed by the Spanish private sector has so far been in line with this past path. In 2011, credit to the non-financial private sector contracted at a

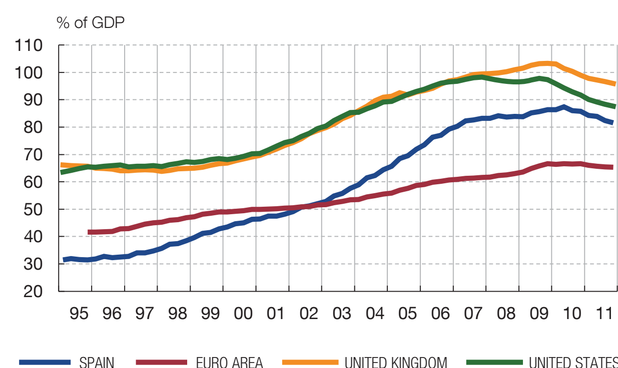
FINANCING OF HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS

CHART 1.9

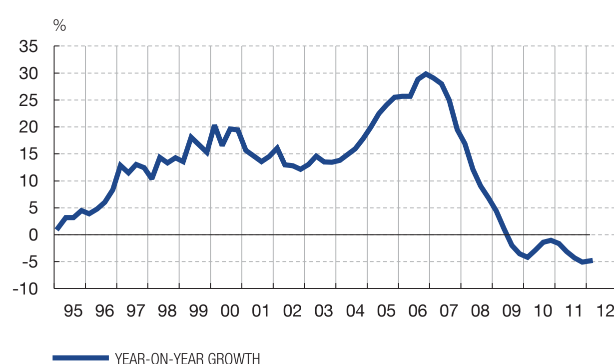
CREDIT TO HOUSEHOLDS



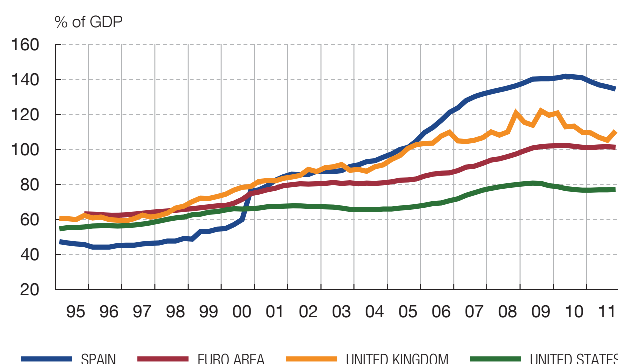
HOUSEHOLD DEBT RATIO



CREDIT TO NON-FINANCIAL CORPORATIONS



NON-FINANCIAL CORPORATIONS´ DEBT RATIO (a)



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

a Debt of non-financial corporations includes intercompany loans.

rate of around 4%, although significant sectoral differences were observed in the behaviour of this variable (see Chart 1.9). In the case of households the related rate was close to -2.5% (the rate of contraction was brisker in the first half of the year), while credit extended to non-financial corporations ran at a rate of around 4%, which has held relatively stable since. The concentration of household liabilities in mortgage loans with notably extended maturities helps explain their slower pace of adjustment.

Among corporations, the contraction was more marked in those sectors of activity such as construction and real estate development in which the prior accumulation of debt was greater and in which the level of activity was on too great a scale. The adjustment needed is, however, less in the case of large corporations that have used a significant portion of the funds they have raised to extend and diversify their business internationally and whose profitability depends to a lesser extent on the Spanish economy's position in the cycle.

The necessary restructuring of public finances is exerting contractionary effects in the short run and will condition the exit from the crisis

The implementation of budgetary consolidation plans is one of the fundamental conditioning factors of the exit route from the recession. The fiscal adjustment plan approved in 2010 and endorsed in the 2011 State Budget affected, above all, public spending (public-sector wages and employment and public investment), although it also entailed the elimination of certain tax deductions in force during the recession, along with some tax increases. The aim of the plan was, in principle, consistent with the imperative need to redress the medium-term trajectory of public finances. But short-term contractionary ef-

fects would have to be generated, due both to the direct effect of general government conduct on activity (government consumption and public investment) and to the indirect effect on household disposable income as, for the second year running, households saw how the public component of net transfers was diminishing.

However, the fiscal outturn was not as envisaged and the budgetary deviation was sizeable. Analysis of the factors underlying this slippage and of the difficulties in bringing public finances onto the path of adjustment established in the Stability Programme is part and parcel of the challenges facing economic policy in exiting the crisis; accordingly, this analysis is tackled in depth in the following section.

4 Policies for overcoming the crisis

The Spanish economy continues to display factors of vulnerability despite the progress in correcting its imbalances

Over the past three years, the Spanish economy has made progress in correcting some of the macroeconomic imbalances built up, though it has done so unevenly and to an insufficient degree, as highlighted in the previous section. Notwithstanding, it continues to display factors of vulnerability that are the outcome of the interaction between protracted economic weakness and certain features of the institutional framework that have tended to amplify the impact of the shocks.

Overcoming the crisis and the necessary protection of the Spanish economy against potential external shocks require an economic policy with a firm medium-term orientation. Such a policy should allow the correction of the macroeconomic imbalances still in place to be completed, along with the in-depth restructuring of all sectors (firms, households, general government and financial institutions) and the reform of the institutional dysfunctions that have become patently evident in numerous areas of the economy, even though the specific measures needed may exert a contractionary effect in the short term. On the basis of the diagnosis made, a stance of this type requires the economic policy agenda to be structured, as has been the case, around the following three pillars: the restructuring of credit institutions, the culmination of an ambitious fiscal consolidation process and progress in structural reforms, including most notably – given its high priority – that of the labour market.

The clean-up, recapitalisation and restructuring of the financial system is vital for restoring confidence and normalising the financing of the economy

In a setting such as the present, any sign of weakness in the financial system runs the sizeable risk of unleashing tensions on the debt market and setting in train perverse mechanisms with feedback loops. To prevent these risks materialising, it is necessary to restore investors' full confidence in the Spanish financial system. On the soundness of the system hinges the efficient financing of the economy, too, allowing the necessary deleveraging of the economy to be compatible with the availability of credit for solvent projects.

The clean-up, recapitalisation and restructuring of the Spanish banking system began in 2009. Since then, the objectives have gradually adjusted to the worsening economic and market conditions, which have amplified the scale of the problems and lessened the leeway available to resolve them. Box 1.2 describes in greater detail the measures adopted during 2011 and in 2012 to date, which have progressively adapted the financial reform process to the requirements of changing circumstances. One particular bout of tension arose in May this year, in connection with the conversion into ordinary shares of the funds previously extended by the FROB to Spain's fourth biggest lender. The changes made have essentially been aimed at strengthening banks' balance sheets through the dual means of capital and provisions, tailoring the size of the sector to the new economic scenario and resolving the governance and ownership problems that were weighing down part of the system.

In the short run, however, this broad approach to the clean-up, recapitalisation and restructuring of the system will certainly have to continue being complemented by one-off

PROGRESS IN THE CLEAN-UP, RECAPITALISATION AND RESTRUCTURING OF THE SPANISH BANKING SYSTEM

BOX 1.2

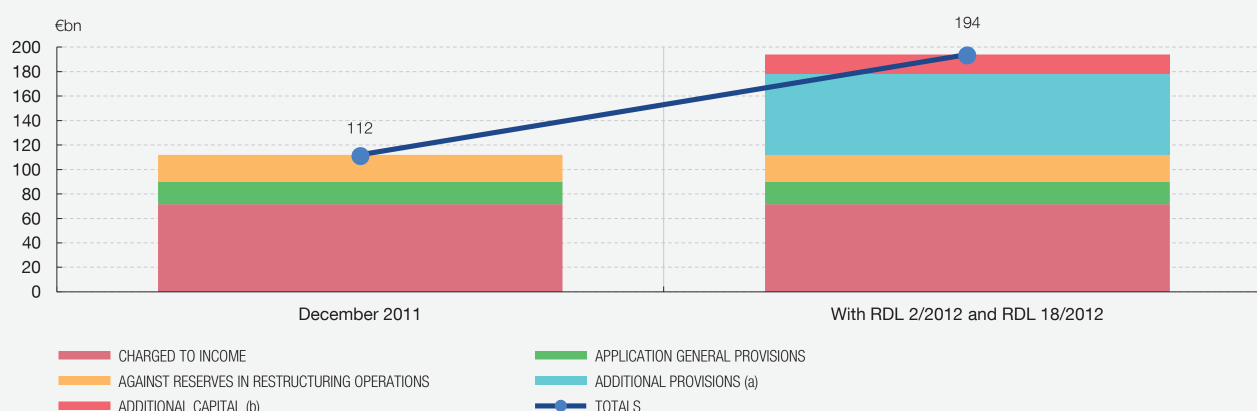
Throughout 2011 and in the opening months of 2012, the ongoing clean-up, recapitalisation and restructuring of the Spanish banking system continued. The basic parameters of this process have had to adjust to the requirements of a new economic and financial scenario that has worsened both in Spain and in the rest of the euro area.

On 18 February 2011 the Government approved Royal Decree-Law (RDL) 2/2011. This legislation raised the minimum required level of capital for banks with a view to reinforcing the soundness of the financial system and contributing to restoring investors' confidence, which had been dented following the outbreak of financial tensions further to the Irish crisis in autumn 2010. Specifically, a new solvency ratio was introduced, which had to be met maintaining core capital[1] of at least 8% of risk-weighted assets, rising to 10% for those institutions in which the relative weight of funding from wholesale markets exceeded 20% and which had not placed at least 20% of their capital with third-party investors. The functioning of the Fund for the Orderly Restructuring of the Banking Sector (FROB by its Spanish acronym) was reformed so that, under specific conditions[2], it could provide the necessary capital for institutions that could not obtain it on the market. The regulation set a timetable for compliance whose deadline was 30 September. The final outcome of its application may be summarised in the following figures: 13 out of a total of 114 registered institutions needed to raise their capital by a total amount of €13.39 billion, 9 of them did so resorting to private investors for a total of €5.84 billion, 3 required the assistance of the FROB for an

1 The definition here is stricter than the previous one for Tier 1 capital, as it eliminates certain items such as preference shares (except those convertible to 2014) and non-voting shares, and includes eligible instruments subscribed by the FROB.

2 Obligation to sell the securities within five years, the need to submit a recapitalisation plan to the Banco de España, a seat for the FROB on the board of directors and, if a savings bank or IPS is involved, the obligation to transfer all financial business to a commercial bank using the mechanisms envisaged under RDL 11/2010.

WRITE-DOWNS MADE SINCE JANUARY 2008 AND ESTIMATION OF THOSE REQUIRED UNDER RDL 2/2012 AND RDL 18/2012



SUMMARY OF INTEGRATION, CAPITALISATION AND INTERVENTION OPERATIONS TO CLEAN UP BANKING SECTOR BALANCE SHEETS (MAY 2012) (c)

	Integration phase		Recapitalisation phase		Restructuring of non-viable institutions		Total
	No. Processes	Assistance €bn	No. Processes	Assistance €bn	No. Processes	Assistance €bn	Assistance €bn
FROB	7	9.29 (d)	2	4.18 (e)	2	0.39 (f)	13.87
DGF (g)					2	6.20	6.20
TOTAL	**7**	**9.29**	**2**	**4.18**	**4**	**6.59**	**20.07**

SOURCE: Banco de España.

a This figure is based on the provisional estimate that the Ministry of Economic Affairs and Competitiveness has made of the requirements under RDL 18/2012.
b These would not be provisions, but greater capital requirements.
c Not including the additional capital requirements arising from the clean-up plan submitted by BFA-Bankia at the end of May 2012.
d Implemented through preference shares convertible into shares subscribed for by the FROB. Not including the Unnim operation, with a value of €380 million, since these securities, which had been converted into ordinary shares in the recapitalisation process, have been transferred after their sale to BBVA. Includes €4.47 billion corresponding to BFA-Bankia which are going to be converted into shares.
e Not including the €568 million corresponding to the purchase of Unnim shares by the FROB, since they have been transferred following their sale to BBVA.
f Estimated cost of the asset protection scheme of the Cajasur operation.
g Ordinary shares acquired by the DGF in the CAM operation and assumption of losses in the sale of Unnim. The possible cost of the asset protection schemes in these operations is not included.

amount of €4.75 billion[3] and 1 institution was intervened and subsequently sold by auction, with the Deposit Guarantee Fund providing €5.25 billion of the capital needed.[4] In addition, virtually all the financial activity of savings banks was transferred to commercial banks.

One of the first effects of this regulation on Spanish banks' solvency could be seen in the second stress test exercise conducted by the European Banking Authority (EBA), whose results were published on July 2011. As a result of the test, Spanish banks did not require further capital increases, despite the fact that the criteria applied were more demanding than those in 2010 and that, once again, the degree of coverage attained in Spain, namely 93% of total assets, was far higher than the 50% minimum required by the EBA.

However, the worsening of the sovereign debt crisis during the summer of 2011, which took on a systemic nature, led the Community authorities to adopt a recapitalisation plan for major banks, which affected five Spanish institutions. Specifically, an extraordinary capital buffer of a temporary nature – until market confidence problems are resolved – was established, linked to the estimated losses on the sovereign debt portfolio in accordance with market prices. Also, likewise temporarily, the Tier 1[5] ratio was raised to 9%. The calculation of the new requirements, which was made on the basis of data as at September 2011, reflected additional needs for Spanish banks of €26.17 billion, to be covered by June this year. Moreover, the three previously existing funds were unified in a single Deposit Guarantee Fund for Credit Institutions, further reinforcing this vehicle's capacity to shore up the solvency and sound functioning of banks.

Despite all these measures, the worsening economic situation in Spain and the difficulties in completing the ongoing review of European governance contributed to the problems of confidence in the Spanish financial system remaining in place, and its major difficulties in gaining access to wholesale funding continued. A by no means insignificant portion of these difficulties continued to be linked to the sector's high exposure to real estate development-related assets and to doubts over their valuation, especially in those cases, such as loans linked to land or to developments in progress, where, owing to their lesser liquidity, it was more complicated to obtain a market price. In an attempt to eliminate this source of uncertainty, the Government approved in February and May 2012 RDL 2/2012 and RDL 18/2012, respectively. This legislation sets in place an accelerated and transparent process for the clean-up of potential losses associated with real estate assets. RDL 2/2012 includes, moreover, various other measures: incentives for consolidation operations; the improved governance of institutions resulting from integration processes; the simplification of organisational and operational structures; the regulation of the distribution of the surplus of savings banks that pursue their activity indirectly, and limits on the remuneration of the directors and managers of institutions that have received aid from the FROB. For its part, RDL 18/2012 stipulates the obligation to take the foreclosed assets or those received in payment of debts linked to the real estate sector to a public limited company, other than the institution, for their management and sale. Also in May, the government entrusted the Ministry of Economic Affairs and Competitiveness with drawing up two external and independent valuation reports on the extent of the clean-up of bank balance sheets.

Against this background, the Ministry and the Banco de España agreed on 21 May to hire Roland Berger and Oliver Wyman as independent appraisers to value, within the space of a month, the Spanish banking system's balance sheets. In a second stage, audit firms, which had not yet been selected at the time of this Report going to press, will perform field work on the quality of the procedures for recognising and provisioning for loan losses. This stage will take longer.

The new measures on write-downs establish an increase in specific and general provisions[6] and, in the case of problem assets relating to land and developments in progress[7], they require a capital buffer that covers the potential losses on such assets. In this way, levels of coverage for the total real estate development-related asset portfolio would be attained for 45% of their total amount[8], which would be for 53% in the case of problem real estate assets and, within the latter, for 80% in the case of land and for 65% in the case of developments in progress. The accompanying panel gives a breakdown of the initial estimates of additional write-downs and of the increase in capital that the application of these rules would entail, namely some €82 billion[9], notably increasing the volume of those made between 2008 and end-2011 (€112 billion).

The February RDL gave institutions until 31 March to submit their plans to comply with the new requirements. On 17 April, following revision of the plans presented by the institutions, the Banco de España deemed that most of them had made this first additional clean-up and recapitalisation drive or that they were in a position

3 Subsequently, the Unnim operation required an additional increase in capital of €380 million through the conversion into shares of the preference shares held by the FROB as a result of the previous integration phase.

4 The FROB subsequently took control over another institution.

5 Basic capital comprising ordinary shares and reserves, although it includes other capital instruments arising from public aid.

6 In specific provisions the percentages set out in CBE 4/2004 are increased and certain items are added, and in general provisions additional provisioning for a total of 30% of the outstanding balance of standard real estate exposures is introduced.

7 This would affect both assets already foreclosed and loans backed by these assets, and would require covering with capital the difference between the provisions already set aside on these items and the required coverage of 80% and 65% of their value.

8 The result of the sum of the outstanding balance of loans extended and the balance-sheet initial book value of assets foreclosed in payment of debt.

9 This figure is based on the provisional estimate by the Ministry of Economic Affairs and Competitiveness of the requirements arising from RDL 18/2012.

to do so without major difficulties. At other institutions, envisaged compliance would be a closer-run matter, although with reasonable prospects of being achieved. In these latter cases, the Banco de España required additional measures on top of those initially proposed, along with contingency measures to withstand possible deviations. At the same time, it stated that it would monitor much more closely compliance with the plans. Further, of the total number of institutions, 27 (12 of them credit cooperatives) reported that they might take part in merger and acquisition operations which, if they materialised, would involve a slightly longer time margin in which to comply with the new requirements. Although envisaged under the rules, no institution then applied for intervention by the FROB. In early May, the country's fourth-biggest financial institution applied for the conversion of preference shares previously subscribed by the FROB into ordinary shares. As a result, the FROB will hold a very significant percentage of its capital. Subsequently, this same institution agreed to asked the FROB to subscribe an additional capital increase for an amount of €19 billion, as part of a new clean-up plan.

In accordance with the May RDL, institutions have until 11 June to submit new plans to comply with the additional provisioning requirements. Those that so need it, in the opinion of the institution or the Banco de España itself, may avail themselves of financial support from the FROB, either in the form of ordinary shares or securities convertible into shares, on an arm's length basis.

In parallel with these measures, the restructuring of the Spanish banking sector has moved ahead in 2011 and in 2012 to date. The mergers initiated in 2010 have been completed, other new mergers are under way and the change in the savings-bank legal organisational model has been implemented, leading to virtually all the institutions concerned transferring their financial activity to a commercial bank (around 99% of the sub-sector's risk-weighted assets). Taking stock, it can be seen that, as at March 2012, the 45 savings banks previously existing had been transformed into 11 banking institutions.[10] This sub-sector concentrated all the aid received which, as can be seen in the adjoining table, amounted to €9.29 billion in the integration phase. With €4.18 billion used for recapitalisation and €6.59 billion for operations involving non-viable institutions[11], the result is a total volume of aid of €20.07 billion (€13.87 billion provided by the FROB and €6.2 billion by the DGF).[12]

These developments have been accompanied, at the merged institutions, by an average reduction of around 11% in staffing and 13% in the number of offices, in the period from December 2008 to December 2011. Further, at all savings banks management teams have been renewed, both voluntarily and by force, with the entry of public or private investors.

10 Including the integration of Caja3 into Ibercaja and that of CEISS into Unicaja.

11 These figures show the result of the integration of Unnim into BBVA, which entailed the return to the FROB of all the funds provided via the instruments acquired in the integration and recapitalisation phases, €380 million and €568 million, which accounted for 100% of the capital. Unnim's assets and liabilities were then transferred to the BBVA for €1, with the DGF assuming the estimated losses on this operation (€953 million).

12 These figures do not include the additional capital requirements arising from the clean-up plan submitted by BFA-Bankia at the end of May 2012.

policies supporting specific modes of lending. These should help correct the market shortcomings whose effects tend to be more acute at times of great stress like the present and that may restrict the access to credit of solvent agents whose creditworthiness, nonetheless, is particularly difficult to evaluate. Special mention here should be given to the support to SMEs, channelled essentially through the ICO (Official Credit Institute). In any event, it should not be forgotten that neither the ICO nor, generally, this type of one-off policy can replace the role of a sound financial system in efficiently allocating financial resources in an economy.

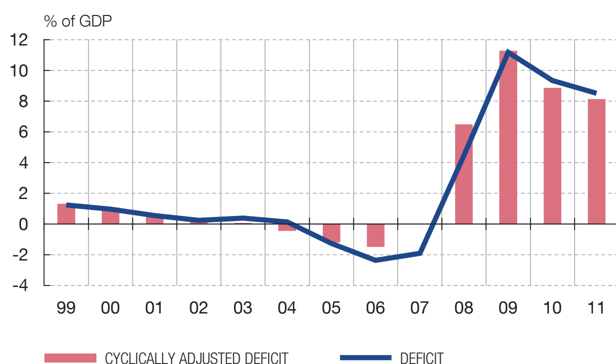
In 2011, the actual deficit figures substantially exceeded the initial projection…

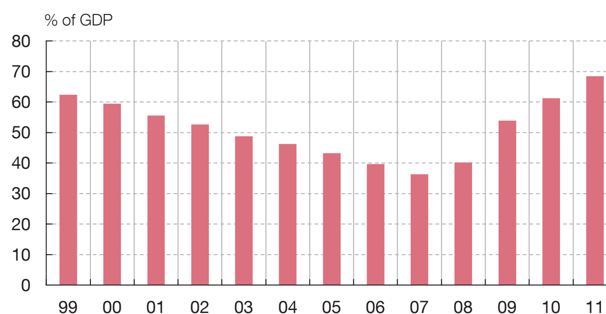
In the budgetary area, the measures adopted in 2010 and 2011 sought first to ensure compliance with the objectives laid down in the Stability Programme, and further, to reinforce the fiscal framework and improve the sustainability of public finances.

As to the first of these objectives, budgetary measures focused on implementing the adjustment plan designed in May 2010 and subsequently completed by the 2011 State Budget. This plan had been defined on the basis of a scenario of some recovery in activity, which would subsequently be revealed to be excessively benign, and aimed to reduce the budget deficit from 9.2% of GDP in 2010 to 6% of GDP in 2011, entailing a reduction in

GENERAL GOVERNMENT DEFICIT AND DEBT

CHART 1.10





SOURCES: IGAE and Banco de España.

the structural deficit of 3.1 pp (from 7.8% to 4.7%)[1] (see Chart 1.10). This ambitious plan resided chiefly on public spending cuts and encompassed all tiers of government. Nonetheless, there was uncertainty over its actually being met owing both to the inertia of certain expenditure items and to the behaviour of local and regional government, whose budgetary effort had scarcely been discernible in the 2010 figures.

From the summer, a risk of slippage in the programmed overall general government target began to be perceptible. It was therefore necessary in August 2011 to adopt additional fiscal consolidation measures, with an estimated fiscal impact of 0.5 pp of GDP. Nonetheless, the cyclical downturn in the closing months of the year bore down even more on tax revenue and social security contributions, preventing attainment of the deficit target for that year.

Indeed, 2011 saw a substantial overrun in terms of the actual as opposed to the projected general government deficit, which stood at 8.9% of GDP. That marked a 2.9 pp deviation from the target set in the Stability Programme. All levels of government had a higher-than-forecast deficit, but the biggest deviation was in the regional governments. Here, it amounted to 2.0 pp, which has affected the credibility of the budgetary projections and has increased the scale of the budgetary consolidation effort still needed.

… confirming the difficulty of achieving effective adjustments in adverse cyclical situations…

These outturns allow some lessons to be drawn on severe fiscal consolidation processes in adverse cyclical situations and in a setting of fiscal decentralisation such as that prevailing in Spain. The cyclical weakness has weighed on tax revenue. The composition of economic activity in 2011 may have influenced this result as it was very biased towards exports, whose impact on tax revenue is lower. But the deviations indicate that the forecasts of revenue were generally high, even for the macroeconomic scenario projected. Notable under revenue was the decline in indirect taxes, in particular excise duties and transfer tax and stamp tax, linked to real estate activity. In contrast, public spending contracted on a scale similar to that established in the Stability Programme owing to the fact that less public investment than was budgeted for offset the upward deviations under the interest payments heading.

1 This objective was in line with a deficit-correction trajectory which, according to the Excessive Deficit Procedure to which Spanish public finances were subject, should place the budget deficit in 2013 at 3% of GDP and which required a 1.5 pp reduction in the structural balance over the 2010-2013 period.

MAIN INDICATORS OF THE SPANISH ECONOMY (a)

TABLE 1.1

	2006	2007	2008	2009	2010	2011
DEMAND AND OUTPUT (b)						
GDP	4.1	3.5	0.9	-3.7	-0.1	0.7
Private consumption	4.0	3.5	-0.6	-4.3	0.8	-0.1
Government consumption	4.6	5.6	5.9	3.7	0.2	-2.2
Gross capital formation	8.0	4.2	-4.2	-16.5	-6.1	-5.2
Equipment investment	8.2	10.2	-2.9	-22.3	5.1	1.4
Construction investment	6.7	2.4	-5.8	-15.4	-10.1	-8.1
Housing	6.6	1.4	-9.1	-22.1	-9.9	-4.9
Other construction	6.8	3.6	-1.6	-7.6	-10.4	-11.2
Exports of goods and services	6.7	6.7	-1.0	-10.4	13.5	9.0
Imports of goods and services	10.2	8.0	-5.2	-17.2	8.9	-0.1
EMPLOYMENT, WAGES, COSTS AND PRICES (c)						
Total employment	3.5	3.0	-0.2	-6.5	-2.6	-2.0
Employment rate (d)	65.7	66.6	65.3	60.6	59.4	58.5
Unemployment rate	8.5	8.3	11.3	18.0	20.1	21.6
Compensation per employee	3.9	4.7	6.1	4.3	0.0	0.8
Unit labour costs	3.3	4.2	4.9	1.4	-2.6	-1.9
GDP deflator	4.1	3.3	2.4	0.1	0.4	1.4
Consumer price index (12-month % change)	2.7	4.2	1.4	0.8	3.0	2.4
Consumer price index (annual average)	3.5	2.8	4.1	-0.3	1.8	3.2
Consumer price differential with the euro area (HICP)	1.4	0.7	0.9	-0.5	0.4	0.3
SAVING, INVESTMENT AND FINANCIAL BALANCE (e)						
Resident sectors: saving (f)	22.6	21.4	19.9	19.7	19.3	18.7
General government (f)	6.0	6.0	-0.3	-6.6	-5.4	-5.8
Resident sectors: investment	31.0	31.0	29.1	24.4	23.3	22.1
General government	3.6	4.1	4.2	4.6	3.9	2.7
Resident sectors: domestic net lending (+) or net borrowing (–)	-8.4	-9.6	-9.2	-4.7	-4.0	-3.4
General government	2.4	1.9	-4.5	-11.2	-9.3	-8.5
General government gross debt	39.7	36.3	40.2	53.9	61.2	68.5
MONETARY AND FINANCIAL INIDICATORS (g)						
ECB minimum bid rate on MROs	2.8	3.9	3.9	1.2	1.0	1.3
Ten-year government bond yield	3.8	4.3	4.4	4.0	4.2	5.4
Synthetic bank lending rate	4.6	5.7	6.2	3.8	3.3	4.1
Madrid Stock Exchange General Index (Dec 1985 = 100)	1,324.0	1,631.8	1,278.3	1,042.4	1,076.5	971.8
Dollar/euro exchange rate	1.3	1.4	1.5	1.4	1.3	1.4
Nominal effective exchange rate vis-à-vis developed countries (h)	100.8	101.9	103.3	103.4	101.9	101.7
Real effective exchange rate vis-à-vis developed countries (i)	111.8	115.8	119.1	116.2	112.3	108.8
Real effective exchange rate vis-à-vis the euro area (i)	110.3	113.6	115.0	111.7	109.4	106.3
Cash and cash equivalents	11.3	-3.2	-3.3	8.5	-0.2	-1.6
Liquid assets (j)	8.4	8.3	9.7	0.8	3.2	0.1
Households: total financing	19.6	12.5	4.4	-0.3	0.2	-2.4
Non-financial corporations: total financing	28.0	17.7	8.2	-1.4	0.6	-1.8

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

a Spanish National Accounts data, base year 2008.
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 the Madrid Stock Exchange General Index, interest rates and exchange rates, and rates of change for financial assets and liabilities.
h 1999 Q1 = 100.
i 1999 Q1 = 100. Measured with unit labour costs.
j Includes cash equivalents, other bank liabilities and money market funds.

… and the presence of significant failings in the institutional design for budgetary monitoring, early-warning and control mechanisms, especially in respect of the regional governments

The budgetary deviation in 2011 has revealed the presence of significant failings in the institutional design available for the budgetary monitoring, early-warning and control mechanisms, more markedly so in the case of regional and local government. Despite having budgetary stability legislation that set ceilings on the deficit for all levels of government and a procedure for the correction of imbalances, the monitoring and control mechanisms, along with those intended to ensure compliance with the targets set, proved clearly insufficient.

The shortcomings in the availability of information on the regional and local government outturn prevented the detection in time of budgetary deviations and led to a delay in the rule-enforcement mechanisms being activated. Accordingly, the regular publication of the regional and local government outturn is vital, with the same periodicity, degree of detail, lag and accessibility as for central government. Also, the information in the budget should furnish data on both central and regional government in National Accounts terms, which is the relevant definition for the fiscal rules in place, making explicit all the necessary information so as to evaluate the appropriateness of revenue projections to the macroeconomic scenario. Furthermore, the mechanisms enforcing correction of the budget deficits proved insufficient. On one hand, the information in the plans for their correction was not always public and its format prevented comparison with the initial budgets. On the other, the conditionality of the authorisations to incur debt was not automatically applicable, which detracted from their usefulness.

Progress in fiscal consolidation hinges crucially on reinforcing the budgetary framework. The reform of the Constitution and the Organic Law on Budgetary Stability and Financial Sustainability are two key steps in this connection

In order to correct the shortcomings, to reinforce the budgetary framework and to improve the sustainability of public finances in the medium term, significant initiatives have been set in train. In September 2011 a reform of the Constitution was approved to incorporate the deficit and debt ceilings set at the European level.[2] This was subsequently implemented in the Organic Law on Budgetary Stability and Financial Sustainability, the provisions of which are fully in keeping with the European governance reforms.

Along with a firm commitment to budgetary stability, this legislation includes stricter reporting requirements and new coercive mechanisms to ensure compliance with the fiscal targets for all levels of government. The possibility of establishing sanctions is included, the automatic adjustment of regional government spending is obligatory in specific cases of non-compliance, and provision is also made for the imposition of adjustment measures by central government that local and regional government must observe. The rigorous and immediate application of the legislation, particularly concerning the monitoring and control mechanisms, and those intended to enforce compliance with the targets set by all tiers of government, is decisive for ensuring adherence to the fiscal consolidation path.

The “non-bailout” clause envisaged in the aforementioned law is crucial for preventing the cost of inappropriate fiscal behaviour by one level of government from passing through to the others and so that the capital markets may exert disciplining effects. At the same time, regional and local government are allowed to request extraordinary liquidity-support measures of central government. In that case, they are required to submit a plan that ensures the attainment of fiscal targets, and the outlay in tranches of the financial aid will be conditional upon compliance with such targets. In this respect, in the opening months of the year the Government set in train various financial-support mechanisms for regional and local government so as to facilitate the refinancing of their previous debts or the

2 Previously, in July, a rule on the growth of public spending for central government and for large municipalities had been introduced. Under this rule, the rate of increase of public spending could not annually exceed the economy’s medium-term nominal growth rate; its application to regional government was subject to approval by the Fiscal and Financial Policy Council.

payment of trade creditors. The financing mechanisms agreed upon require the definition and fulfilment of adjustment plans whose duration will span the debt repayment period. To prevent these mechanisms from diluting the incentives for regional and local government to strictly meet their budgetary targets, it is essential to apply rigorous conditionality to the provision of the funds. The economic and financial plans approved by the Fiscal and Financial Policy Council to re-balance regional government finances on 17 May entail spending-reduction and revenue-increasing measures which, in principle, are consistent with compliance with the conditionality requirements.

Lastly, mention should be made of the approval in July 2011 of the Law on Social Security Reform, in light of its importance for the sustainability of public finances. This legislation progressively raises the retirement age, extends the number of years taken into account for calculating the final pension and includes a factor of sustainability that will provide for the adaptation, from 2026, of the parameters of the system to future demographic developments.

On 30 March the Government approved the State Budget for 2012, setting the deficit programmed for this year at 3.5% of GDP, a figure compatible with the overall general government deficit of 5.3%, approved some weeks earlier. The projected decline in the State deficit is based chiefly on spending cuts – affecting goods and services purchases, public investment and capital transfers – and draws essentially on the increase in direct taxation (personal income tax and corporation tax).

For the reasons outlined earlier, over the rest of the year it will be necessary to ensure highly rigorous budget implementation and swift application of the mechanisms that allow any emergence of slippage to be detected sufficiently in advance, so as to offset this with additional measures. If this were the case, further adjustments to current expenditure would have to be made, given that the leeway for measures affecting capital spending has narrowed enormously. Also, new tax measures would have to be introduced, preferably relating to indirect taxation, with less of a distorting effect on growth and resource allocation.

The updating of the Stability Programme for the 2011-2015 period, which the Government approved on 27 April, confirmed the path of adjustment to 2013, when the deficit is projected to stand at 3% of GDP and the public debt ratio at 82.3% of GDP. It also set deficit targets for 2014 and 2015 of 2.2% and 1.1%, respectively, which would see a reduction in the public debt ratio to 80.8% in the latter year. Almost 75% of the adjustment envisaged for the 2011-2015 period would be made in the first two years of the Programme. It would essentially be structural in nature and 80% of it would focus on spending cuts.

Without a pick-up in employment and in activity, progress in fiscal consolidation will be more costly…

Of all the factors responsible for the limited progress made in correcting the budget deficit in 2011, the extreme weakness of the labour market and the absence of growth stand to the fore. Without a pick-up in employment, it will be more costly to further fiscal consolidation. This is because the increases in revenue will be limited and because the adjustment in primary expenditure will be hampered by the need to earmark a substantial portion of this item to the payment of unemployment benefits. Such a scenario might further be exacerbated by ongoing financial deleveraging and lead to increases in bad debts, with the subsequent adverse impact on the quality of bank balance sheets. Ultimately, this would have highly adverse consequences for potential growth, whose possibilities would be checked by the foreseeable loss of demographic dynamism.

… making it a priority to boost structural reforms, a cornerstone of which is labour market reform

It is thus a pressing matter to boost structural reforms enhancing the supply side of the economy. The cornerstone of this strategy involves making the labour market work efficiently, so as to generate employment, provide suitable incentives to smooth the reallocation of resources across sectors and alter the market's pattern of adjustment in the face of adverse shocks.

The Spanish labour market had been one of the main handicaps of our institutional framework. Traditionally structured around a dual hiring system – with dismissal costs that were high for permanent contracts and low for temporary ones – and collective bargaining arrangements in which an intermediate level of bargaining was predominant, thereby encouraging highly uniform wage increases bearing little relation to the specific situation of companies and adding rigidity to non-wage conditions in such a way as to stymie productivity, the labour market has amplified the effects of the crisis. Economic policy measures to tackle this problem were launched in June 2010. These included a reform of hiring mechanisms that did not alter the existing types of contract and the introduction of means to boost companies' internal flexibility, without changing the collective bargaining system, a change that would be postponed until July 2011. In both cases the measures were partial and did not alter the key features of the labour framework.

The labour reform approved in March improves key aspects of labour market workings and is conducive to job creation…

In January this year the social partners entered into an agreement with recommendations of wage moderation for the 2012-2014 period and amendments to the definition of and activation procedures for wage indexation clauses, the application of which would reduce the nominal inertia of wages. Further, in March, the Parliament ratified a new labour market reform[3], with a more comprehensive scope than that of those implemented to date. Changes to collective bargaining have been made to increase decentralisation in the bargaining process and to bolster companies' internal flexibility. Contract-termination mechanisms have also been substantially changed and a new permanent contract has been created for SMEs, which entails a series of tax incentives.[4]

The amendments to the reform improve key aspects in the functioning of the labour market in Spain. The overall effects will be conducive to job creation and job stability. However, given the marked weakness of activity lying immediately ahead, if the reform's internal flexibility measures to adapt working conditions to the specific needs of each company are not extensively harnessed, there might still be some further adjustment to the level of employment. The reform should also contribute to containing the growth of labour costs and thus boosting the competitiveness of Spanish companies. To do this, though, conditions would have to be reinforced so that business margins do not absorb and curtail the gains arising from cost moderation (see Box 1.3). In any event, the reform should ideally be completed with more ambitious active policy measures that include an exhaustive assessment of the programmes under way, closer links with passive policies and alternatives to hiring incentives which, so far, have proven relatively ineffective in terms of aggregate employment creation.

… although to achieve these effects, fresh momentum must be given to the liberalisation of markets for goods and services…

To fully reap the benefits of the labour reform, fresh momentum must be given to the liberalisation of product markets, promoting competition in the most sheltered sectors. Competition-fostering policies are the main instrument for disciplining the formation of margins and for increasing the sensitivity of price formation to demand conditions. Both issues are key to the proper functioning of the competitiveness channel, which is so important for exiting the crisis, as is analysed in the following chapter. Moreover, events in recent years

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3 Royal Decree-Law 3/2012 on urgent labour market reform measures.
4 A description of the reform can be found in "La evolución del empleo y del paro en 2011, según la EPA", *Boletín Económico,* February 2012, Banco de España.

Exiting the current double-dip recession in the Spanish economy will necessarily involve restoring competitiveness at levels which allow, by means of a forceful export impulse, a recovery in activity and employment. In this respect the labour market reform in March this year, along with the new collective bargaining framework agreement (CBFA), may induce wage moderation that contributes effectively to achieving these objectives.

Under the new CBFA, the social partners agreed new wage guidelines for the 2012-2014 period, which include the recommendation that wage increases should not exceed 0.5% in 2012 and 0.6% in 2013, and should stand between 0.6% and 1.5% in 2014.[1] Substantial changes in the design of wage indexation clauses are also recommended, which may reduce nominal wage inertia and help entrench moderate behaviour in this variable.[2] In light of the experience of the previous CBFA, there is a risk that the agreed recommendations will not be strictly adhered to[3]; accordingly, there should be insistence as to the need for the social partners to effectively pass these recommendations through to the collective agreements currently under negotiation.

Turning to reforms, in March this year a new labour market reform was approved.[4] Among other aspects, it contains a set of measures aimed at enabling companies more readily to adapt themselves to changes in the economic situation through means other than labour shedding, such as changes to working hours and to wages. The measures include most notably: i) priority in respect of application to firm-level agreements as opposed to industry-, region- and nationwide agreements in a broad list of matters (wages, working hours, distribution of work time, adaptation to professional status arrangements, etc.); ii) extension of the areas in which employers can substantially change working conditions or decide not to apply conditions agreed in a collective agreement at a higher-than-firm level; iii) a maximum ceiling

1 Based on GDP growth in 2013, whereby the wage increase will not exceed 0.6% if GDP grows below 1%, 1% if GDP grows between 1% and 2%, and 1.5% if GDP grows above 2%.

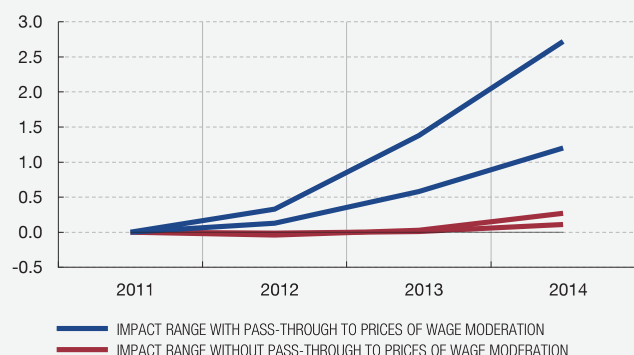
2 Specifically, it is recommended they should be activated once inflation exceeds 2% at the end of the year, instead of the increase effectively agreed upon in each collective agreement, and that indexed payments are not built into wages. Moreover, if Spanish inflation exceeds that of the euro area, the latter figure will be used to calculate the excess. Additionally, in the event of significant rises in oil prices (over 10%), the benchmark inflation indicator will exclude the heating and vehicle fuel items. In this way the moderating impact of the CBFA is reinforced, preventing potential transitory increases in inflation from feeding through to wages.

3 The previous CBFA recommended a wage increase of below 1% for 2010, a figure to which there was no adherence even in newly signed agreements, in which a 1.2% wage increase was agreed (rising to 1.7% on taking the wage indexation clauses into account). Furthermore, only 55% of the newly signed agreements settled on wage increases below 1% that year. Nor was there a high degree of compliance in respect of wage indexation clauses, where it was recommended that they should be of a multi-year nature, which was not generally passed through to collective bargaining agreements.

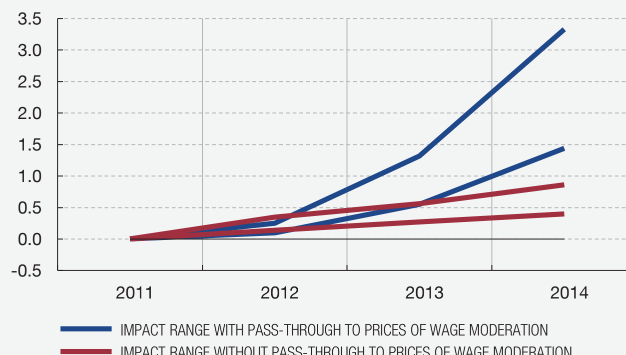
4 Royal Decree-Law 3/2012, approved on 10 February, ratified on 8 March as a draft bill, and currently under passage through Parliament, where amendments may be made.

1 RESULTS OF THE WAGE MODERATION SIMULATION EXERCISE USING THE MTBE

1.1 GDP (a)



1.2 EMPLOYMENT (a)



SOURCES: INE and Banco de España.

a Accumulated level differences in percentage points.

of two years on the applicability of collective agreements following the explanation of their term of validity (known as "ultra-activity"), and iv) simplification of the procedures for lay-off schemes involving shorter working days and contract suspension. The labour reform has also considerably reduced dismissal costs for permanent employees, making the related procedures more flexible.

Overall, these measures will foreseeably be conducive to increased decentralisation of collective bargaining and to greater wage flexibility tailored to firms' specific conditions. That will help redress the scant wage differentiation between firms and industries induced by the bargaining structure in force to date. In turn, the changes will also result in the greater adaptability of working conditions to potential changes in the economic situation. On the whole, the interaction of the reform and internal flexibility measures with the new CBFA should contribute to containing labour costs and to boosting competitiveness.

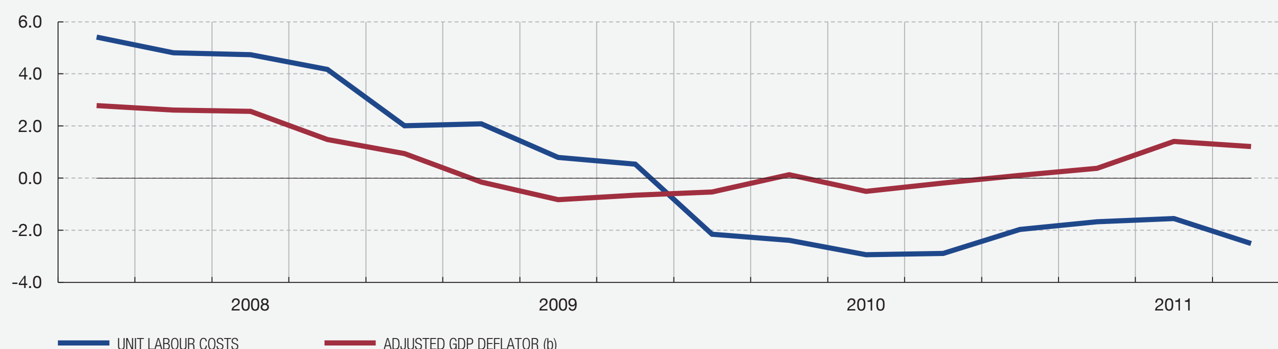
In order to assess the impact of wage moderation on GDP and employment, simulation exercises have been conducted with the Quarterly Macroeconomic Model of the Banco de España (MTBE) where we calibrate the effects of greater moderation arising from the estimated impact of the CBFA and the labour reform on growth and employment. Strict compliance with the wage guidelines set by the new CBFA for the 2012-2014 period might give rise to a scenario of lower wage growth, of 0.6 pp in 2012 and 1 pp in 2013 and 2014, compared with a benchmark scenario under which the Agreement had not been reached.[5] Added to this effect is a very tentative estimate of the additional impact that might arise from the recent labour market reform, chiefly as a consequence of an increase in the number of firm-level and working-day-reduction agreements, and of greater use of wage opt-outs. As a result, it is assumed that the overall impact of the CBFA and of the labour reform might lower wage growth in respect of the benchmark scenario in a range of between 0.6 pp and 1 pp in 2012 and between 1 pp and 2 pp in 2013 and 2014.

The MTBE simulations show that the simulated wage moderation scenario would have a positive effect on GDP and employment growth, although the scale of this hinges crucially on the extent to which lower labour costs pass through to final prices. If wage moderation is accompanied by an adjustment of a similar scale in prices (blue lines in panel 1), the resulting gains in competitiveness would prompt an increase in the demand for Spanish products that would activate other expansionary processes. At the same time, the purchasing power of wage income would be maintained and, consequently, that would give rise to a higher level of private consumption and investment. Overall, the cumulative increases in employment and in GDP to 2014 would be in a range of between 1 pp and 3.5 pp and between 1 pp and 2.5 pp, respectively, significantly contributing to

5 The inertia in wage rates added by multi-year agreements entered into in previous years is what explains the difference in the impact between 2012 and the two following years.

2 GDP DEFLATOR AND ULCs

GDP DEFLATOR AND UNIT LABOUR COSTS (a)



SOURCES: INE and Banco de España.

a Year-on-year percentage change.
b GDP deflator adjusted for tax increase.

reducing the unemployment rate. In contrast, under an extreme scenario, in which the moderation of wage costs to not pass through to prices because margins widen by the same amount (red lines in panel 1), the simulations denote a much smaller impact both on GDP and on employment, since this more inflationary behaviour would deprive the economy of the expansionary effects of price moderation on exports and private consumption.

In this respect, the recent behaviour of inflation and of unit labour costs (see panel 2) indicates there is room for the containment in ULCs to pass through to prices with greater intensity than that observed to date, which would enable the potential expansionary effects of a wage moderation scenario to be maximised. This result highlights the importance of complementing the recent labour reform with a product-market liberalisation drive that promotes competition in the most sheltered sectors and enhances the feed-through of cost moderation to prices. Indeed, on the evidence available for other countries[6], the simultaneous application of both types of reforms reinforces the beneficial effects of labour reforms (by promoting employment generation to a greater extent) and mitigates their costs (by helping maintain the purchasing power of wages).

6 Having examined four European experiences of far-reaching labour market reform in the past 20 years (in the United Kingdom, the Netherlands, Ireland and Denmark) that were successful in terms of reducing unemployment, Annett concludes that the gains in employment were greater thanks to the fact that the reforms were complemented by product-market liberalising processes [A. Annett (2007), Lessons from Successful Labor Market Reformers in Europe, IMF Policy Discussion Paper 07/1].

have highlighted the need for all sectors and activities to adapt effectively to the environment of flexibility that Monetary Union participation requires. In this connection, reforms promoting genuine gains in efficiency and productivity are vital, with a view to strengthening the sources of medium and long-term growth.

... by means of regulatory changes in a wide number of sectors and activities…

Numerous measures affecting a wide number of sectors and activities need to be taken. Many are squarely on the list of economic policy measures the Government wishes to deploy in the coming months, as envisaged in the National Reforms Programme (NRP) approved on 27 April. The housing sector has undergone a drastic adjustment in recent years, but this has not been accompanied by fundamental changes in some of the factors that contributed to the previous boom. The tax treatment of house purchases following the reintroduction of tax relief continues to be very favourable to owner-occupiers. Also, until very recently, rental regulations, which maintain very strict obligatory periods that discourage supply, had not been amended. Some of these aspects, particularly the term of rentals, are under reconsideration in the recently approved draft bill of measures to invigorate the house rental market. As is also indicated in the NRP, measures to boost competition in transport, retail trade and professional services, and to remove obstacles to business start-ups, will have appreciable effects on cost and price formation and on productivity.

The proper functioning of competition-monitoring agencies and of those entrusted with regulating the network industries is vital for further progress in the much-needed process of liberalisation. The ongoing reform of these agencies should primarily be to strengthen their independence, their accountability channels and their technical capacity, ensuring that sectoral experts can deliver decisions that counter the pressures that still emerge in some of the industries more sheltered from competition. Changes of an organisational nature and in the distribution of functions should not, under any circumstances, detract from the attainment of these objectives.

Among the network industries, the energy sector merits particular attention, as is also envisaged in the NRP. The process of liberalisation is still far from completion and there is

broad scope to step up competition in all sectors. To redress these problems, resolute progress on vertical deintegration would be necessary, with the segregation of ownership between network activities and production and marketing activities, where it would have to be ensured that the market structure were sufficiently competitive. In the hydrocarbons industry there is room to increase competition in the distribution segment.

Under energy activities, the electricity industry has its own particular set of problems. These must be urgently resolved taking a medium and long-term view so as to redress certain imbalances built up in recent years arising from economic regulation in various segments, while enabling competitiveness to combine with safety as regards supply and the protection of the environment.

Finally, greater transparency in energy price formation, and in particular the remuneration of regulated activities, is essential to improve the functioning of the market. Unquestionably, the Law on Transparency, Access to Public Information and Good Governance, which is applied to all industries in which the general government sector intervenes, may contribute – along with the better functioning of regulatory agencies – to this objective.

... training in new technologies, the fostering of innovation and improvements in human capital

To boost productivity gains, moves must be made to overcome the problems of education in Spain, which displays low levels of quality on international standards. It would further be advisable to foment the use of the new information and communications technologies (in the educational system, and in the continuous training of employees and the unemployed) and to offer incentives for small firms to incorporate new technologies. To improve the quality of technological capital, efforts should focus on nurturing innovation in the private sector, which requires assessing the support tools in place and strengthening the connection between basic research and companies.