1 OVERVIEW

1 Introduction

The world economy has experienced the most serious shock since the Second World War. The ensuing economic policy responses have been on an unprecedented scale. Their reaction has averted a catastrophic spiral and has managed to activate the start of the recovery, although the legacy of the crisis will have far-reaching and multi-faceted repercussions. In Spain, the traumatic impact of this episode has compounded the difficulties stemming from the imbalances that had built up during the previous expansion and from some of the inefficiencies still weighing on the economy. Accordingly, exiting the crisis will be a complex task posing specific challenges.

This chapter addresses the main difficulties Spain faces in emerging from the crisis and the economic policy requirements this imposes. The following chapter, which complements this chapter with a more selective theme-based approach, delves into the medium-term problems related to potential growth and supply-side policies.

2 The world economy's emergence from the crisis

Following the biggest contraction since the end of the Second World War...

Over the course of 2009 the world economy underwent the biggest contraction since the end of the Second World War (see Chart 1.1). In annual average terms, global growth stood at around -0.6%, as a result of the decline in the GDP of the developed economies (-3.1%) and of the strong slowdown in output in the emerging economies (by around 4 pp to 2.3%). Inflation rates fell off to more moderate levels, or even turned negative in the case of the advanced economies, further to cheaper commodities and to the deterioration in the economic situation, which also dimmed any flicker of inflationary pressure over the relevant time horizon for monetary policy.

... the world economy appears to have embarked on a path of recovery, strongly supported by the swift and forceful economic policy response

The growth profile over the course of the year was, however, one of mild recovery. This was thanks above all to the rapid and forceful economic policy response, which managed to check the negative feedback loop between the real and financial sectors into which the world economy had entered. Although the measures adopted were not simultaneous across the different regions, they were generally aimed at providing support to the financial system, to sustaining agents' confidence and to boosting aggregate demand. The first quarter of 2009 saw a continuation of the trends marking the close of 2008, namely extreme fragility on international financial markets and a marked decline in economic activity and foreign trade. But in Q2 there was a turnaround and growth resumed positive rates in the second half of the year. The recovery, nonetheless, is uneven across the different geographical areas, proving more robust in the emerging countries (especially Asia) and weaker in the developed economies.

The stabilising action of economic policies was also discernible in the financial markets, which tended to normalise

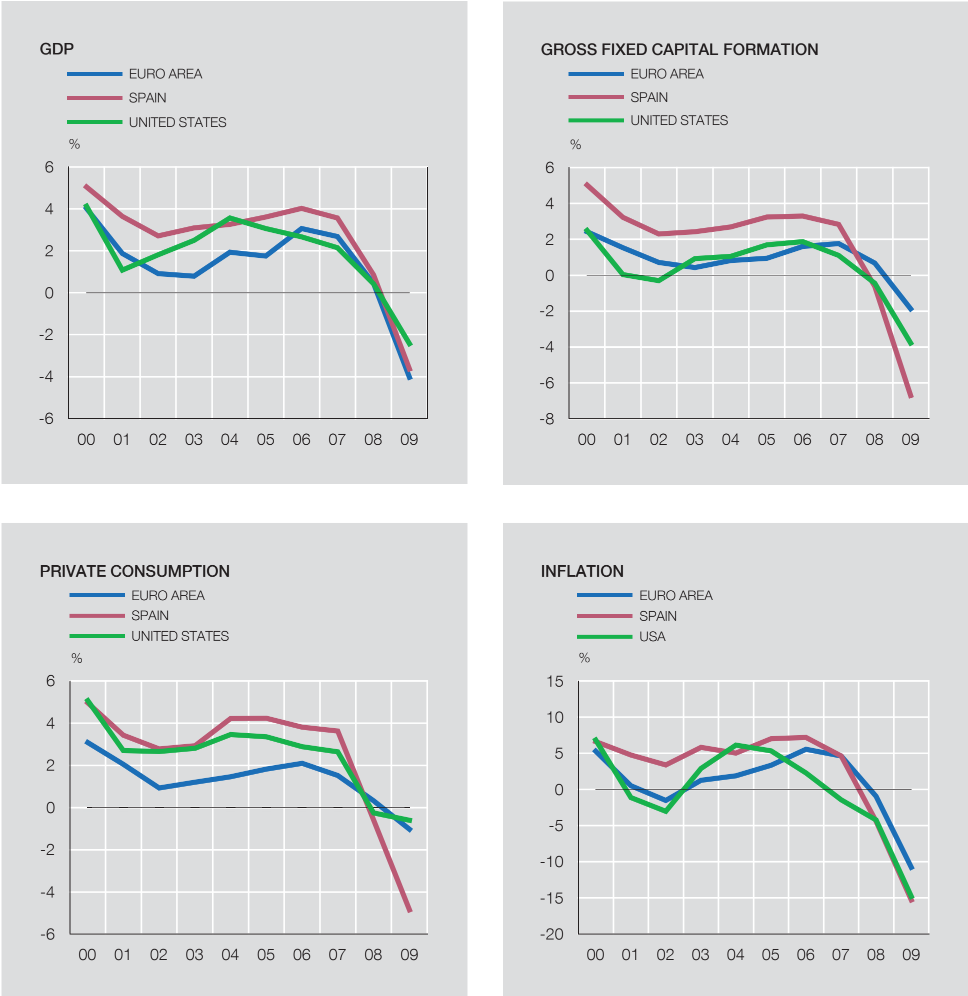
The stabilising action of economic policies was also discernible in the financial markets, which tended to normalise as governments' and central banks' resolute action managed to head off the more extreme risks. Volatility and risk-aversion declined significantly from their peak in late 2008, asset prices picked up and certain segments of the capital markets progressively re-opened, having remained closed when the crisis was at its worst. Nonetheless, the process of normalisation was interrupted on several occasions by episodes of instability, related in some cases to the perception of sovereign risk, which evidence the persistence of certain factors of fragility. These episodes heightened markedly in the opening months of 2010 in the wake of the Greek fiscal crisis and its repercussions on financial markets not only in Europe but also worldwide.

Forecasts point to a progressive recovery in private-sector demand, which would provide a sounder basis for more dynamic activity...

The forecasts available point to a central scenario in which private-sector autonomous demand should progressively take up the baton from the eminently temporary (exceptionally expansionary economic policies and changes in the inventory cycle) and, therefore, insufficiently sound foundations on which the recovery has hitherto been based. As a result, growth

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

CHART 1.1



SOURCES: Eurostat and national statistics.

will continue strengthening during 2010 and 2011, although the debt that has built up will weigh on private-sector demand. That augurs a slow exit from recession and levels of economic activity substantially below potential which, in turn, has also been adversely affected by the crisis. Inflation will hold - at least in the developed countries - at very moderate rates, consistent with the overcapacity generated by the crisis.

... but the uncertainty and risks surrounding this outlook are high

However, the uncertainty and risks surrounding this outlook remain high. The severe shocks at the root of the crisis have exposed significant vulnerabilities on the balance sheets of financial institutions, companies and, in certain cases, households. Absorbing these imbalances may prove slower than the central scenarios envisage. The repercussions of the Greek fiscal crisis reveal that the risks associated with a possible resurgence of financial tension, with adverse consequences for growth and employment, have not been fully overcome. Also, the uneven spread of the recovery across regions may affect commodities prices or the volatility of exchange or interest rates in ways other than those considered in the central scenarios.

The soundness of the recovery will also hinge on governments' and central banks' ability to suitably regulate the pace of withdrawal of the exceptional measures adopted and to draw the pertinent lessons from this crisis and duly undertake the necessary reforms.

Adjusting the withdrawal of the unconventional measures to the ongoing normalisation of financial markets is a major challenge for monetary policy in the short term

After using - and using up in the case of the developed countries - the room for manoeuvre available in conventional monetary policy conduct, and against a background in which distortions persisted in relevant segments of the transmission mechanism, central banks implemented exceptional measures aimed at reinforcing the transmission of interest-rate cuts to agents' financial costs and at easing their accessibility to financing. As a result, their balance sheets expanded notably and the composition of their assets changed. Depending on the respective operational frameworks from which central banks departed, the innovations entailed an increase in the number of institutions with access to central bank funding, the extension of the collateral acceptable in monetary policy operations, the lengthening of the maturities at which liquidity was supplied to the market, and public and private asset purchase programmes (or loans to the private sector for the purchase of such assets). Some of these support measures were gradually withdrawn as the markets progressively normalised, although the pressures associated with the Greek crisis meant some had to be reactivated. In any event, the absence of inflationary pressures on the immediate horizon eases matters, although it would be hazardous to underestimate the risks which, in the medium term, might arise from the earlier mentioned uneven pace at which the recovery is spreading across the different regions or from potentially insufficient headway in consolidating public finances. Nor can it be ruled out, a priori, that the lessons of this crisis may advise retaining some of the measures adopted.

For fiscal policy, the main challenges are the design and implementation of budget consolidation strategies that help restore health to public finances in the medium term

Indeed, the extraordinary measures adopted and the subsequent volume of funds committed have been on an unprecedented scale, exhausting all available room for manoeuvre and giving rise to a marked deterioration in public finances. As necessary as these measures were to reduce uncertainty over the long-term solvency of financial institutions and to boost aggregate demand, they now clash with the need to ensure the medium-term sustainability of public finances. It is essential that governments should prevent the build-up of risks in the public sector from ultimately disanchoring inflation expectations and raising long-term interest rates, with the subsequent harm for growth and employment that would entail. The design and implementation of budget consolidation strategies which, without jeopardising the incipient recovery, allow healthy public finances to be achieved in the medium run, are today the main challenges fiscal policy faces in most developed economies.

And the consequences of the crisis for the optimal size of the financial sector and its regulation have yet to be drawn

Governments also face other challenges in the financial area. It is important that the deleveraging processes under way in a good number of financial systems should be orderly, thereby avoiding potential accidents that might endanger the availability of the funds needed to sustain the pick-up in demand. The financial crisis has also highlighted various flaws in the design of financial regulation. The first steps to correct these deficiencies, within an appropriate framework of international coordination, have begun to be taken in the G20 and the Financial Stability Council (see Box 3.3). But much remains to be done in designing a regulatory framework that reinforces the system's overall security without unduly hampering its development.

3 Monetary policy in the euro area

The euro area has shared the main characteristics described above for the world economy

The euro area economy was likewise affected by the aforementioned trends. The recession was especially acute in 2008 Q4 and 2009 Q1. Thereafter, the effects of the forceful monetary and fiscal policy measures adopted, the change in the inventory cycle, the stabilising of international financial markets and the recovery in the world economy - with the subsequent pick-up in international trade flows - all combined to temper the downturn in domestic spending and to boost exports, despite the fact that the euro appreciated over the course of the year. Accordingly, although GDP shrank by 4% over the year as a whole, it posted low but positive quarter-on-quarter growth rates in the second half.

Inflation developments were largely determined by the course of commodities prices on international markets, against a background of sluggish demand and further excess productive capacity. Inflation averaged 0.3% for the year, although it posted negative rates in the summer months that rose in the final stretch of the year and in the opening months of 2010 (1.4% in March 2010).

The forecasts available point to a period of slow recovery, with low inflation and subject to substantial risks and uncertainty

The forecasts available point to a period of slow recovery, weighed down by the high degree of slack in the economy (low capacity utilisation and high unemployment), low business margins, the necessary restructuring of private-sector balance sheets and the progressive waning of the impulse of the policies applied, all factors which will check the pick-up in consumption and private productive investment. Growth will also be uneven across the euro area countries. Against this backdrop, prices will continue moving at notably contained rates.

The risks and uncertainties surrounding these forecasts remain high. The final scale of the recovery in the world economy and trade, the effects on commodities prices and on the global imbalances built up before - and insufficiently corrected during - the crisis, and the headway in normalising international financial conditions will undoubtedly influence the dynamism of prices and activity in the euro area. And so too will the decisions that the fiscal and monetary authorities have to adopt, in a particularly complex setting.

The contribution of monetary policy has been pivotal in stabilising the economy, by substantially cutting official interest rates...

The absence of inflationary pressures in the medium term, set against the notable downturn in economic activity, led the Eurosystem to adhere to the accommodative monetary policy stance it had initiated in October 2008, progressively cutting official interest rates until they reached 1% in May 2009. A total of 325 bp was thus shaved off rates in seven months, marking a monetary impulse on an unprecedented scale.

... and offering generous liquidity-provision and other unconventional expansionary measures

At the same time, to mitigate the dysfunctions the global financial crisis caused in interbank markets and, therefore, in the monetary policy transmission mechanism, the Eurosystem continued adopting new unconventional expansionary measures which prolonged the enhanced credit support policy initiated at the end of the previous year. Unlike other central banks, these measures were aimed exclusively at the banking system, the importance of which in the intermediation of financing in the euro area is notably greater than in other regions.

More specifically, the demand for funds in all open-market operations continued to be met in its entirety, the expanded list of eligible collateral was extended (to late 2010) and the European Investment Bank was included as an additional counterparty. Furthermore, three new operations maturing at 12 months (double the previous maximum term in force) were conducted. In the first of these tenders a record amount of €442 billion was injected. Mention should also be made of the start-up in July of a covered bonds purchase programme, aimed - inter alia - at improving the liquidity of this market segment, which was strongly affected by the crisis and is of great importance for the funding of banks and their customers. An envisaged maximum sum of €60 billion will be allocated to the programme, which will run until June 2010.

This set of measures has helped the marked easing of the monetary policy stance progressively pass through to the rates applied by banks on their lending and deposit operations. In addition, it has meant that the Eurosystem, in the face of the virtual non-functioning of the interbank markets, has directly met the gross liquidity needs of individual institutions, later mopping up the subsequent excess on top of the system's net structural needs through drainage operations or via the deposit facility. As a result, there was a substantial expansion in central bank balance sheets which was, however, less than in other regions, and which began to be reversed when the first signs of financial normalisation started to emerge, by means of the straightforward procedure of not rolling over operations on their maturity.

The pace at which the exceptional measures are deactivated is being regulated so as not to jeopardise price stability or interfere with the process of financial normalisation

The financial normalisation initiated in the second half of 2009 and the brighter economic outlook accompanying it allowed the ECB to announce, at the end of the year, the progressive interruption of its 12-month and 6-month extraordinary refinancing operations, and the resumption at the original monthly frequency of 3-month operations. Later, in March 2010, the return to the system of variable-rate tenders for 3-month operations was announced. However, faced with renewed market pressures arising from the Greek crisis, the ECB decided to reinforce once more liquidity provision at three and six months and to resume US dollar operations. And, at the same time, it adopted a programme based on intervention in the government and private debt markets whose dysfunctionality was jeopardising the normal operation of the monetary policy transmission mechanism. These interventions are being sterilised so as not to affect the monetary policy stance and not to interfere with expectations about the future course of official interest rates.

Accordingly, the single monetary policy is facing major challenges as to how to regulate the return to a normalised operational framework. This first involves preventing the excessive prolongation of the exceptional measures that might generate risks to price stability, but further entails avoiding interfering in the ongoing normalisation of international financial markets. In addition, the appropriate lessons should also be drawn from this crisis, although it should be said that the original operational framework has proven to be sufficiently flexible and robust, meaning that, at least a priori, far-reaching changes do not appear necessary.

In the medium term, the assessment of the risks to price stability will still have to be made in a setting of considerable complexity

In the medium term, the biggest challenges appear to be associated with the need to calibrate the risks to price stability, in a scenario of slow growth and high uncertainty, which will also hinge greatly on the measures implemented in other economic policy areas. The Greek fiscal crisis has highlighted how the ongoing normalisation of the financial system may yet be subject to occasional tensions that hamper attempts to meet the demand for credit that will be generated when the pick-up in activity takes root. But, above all, it has illustrated the pressures to which insufficient headway in the announced fiscal consolidation programmes might give rise.

Fiscal policy has also contributed decisively to cushioning the downturn in activity, but there has been a very swift and sharp increase in the budget deficit and in debt

Fiscal policy also contributed decisively to halting the dangerous spiral of real and financial deterioration by means of discretionary measures to support specific industries (such as the financial sector and car manufacturing) and more general demand-boosting measures (some of which extend to 2010), and through the free operation of the automatic stabilisers. But these measures have exhausted the room for manoeuvre available and have given rise to an unprecedented deterioration in the euro area countries' public finances, which must now be redressed. On European Commission January 2010 estimates, the euro area budget deficit stood in 2009 at 6.3% of GDP, the highest figure recorded in recent decades and one far above that of 2% for 2008. Thirteen euro area countries have an excessive deficit and the debt/GDP ratio has also moved onto a path of marked growth, and is expected to stand at around 84% of GDP in 2010, compared with 69.4% in 2008. Nor can it be forgotten that these figures do not factor in the contingent liabilities associated with population ageing or those incurred under the plans providing assistance to the financial system.

In light of the fiscal imbalance that has built up, a transparent and credible strategy of medium-term budgetary consolidation must be adopted

Under these conditions, it is vital that governments should lay down ambitious and credible fiscal consolidation plans to eliminate uncertainty over the sustainability of public finances. These plans should seek to act on the supply side of the economy (in particular on employment and saving incentives), and also on innovation and enhanced human capital. Experience also shows that the most successful fiscal consolidation processes have been those based more on spending cuts than on tax increases.

On the basis of the Ecofin recommendations in November 2009, all countries in an excessive deficit situation would have to undertake a major consolidation drive, at the very latest, from 2011. The measures envisaged in the updated Stability and Convergence Programmes presented at the start of this year were a step in the right direction. But the Greek fiscal credibility crisis added a further factor of pressure that clearly highlighted how necessary it was to establish sufficiently ambitious and credible fiscal consolidation commitments, and what the costs of not doing so might be for the countries concerned and for the euro area as a whole. This episode has also exposed certain procedural weaknesses in economic policy governance in the euro area and shortcomings in crisis resolution mechanisms, which must be revised and corrected. In the case of the former, to prevent the build-up of imbalances which, while primarily and fundamentally affecting the economy involved, have adverse consequences too for the area as a whole that must be taken into consideration. And in the case of the latter, to reinforce the soundness of the euro area.

The European authorities have responded decisively and forcefully to these challenges. Firstly, they agreed on a programme of assistance for Greece, the initial scope of which was extended to envisage an amount of up to €110 billion. This programme was activated at the request of the Greek authorities, once they had adopted an ambitious and credible fiscal consolidation programme agreed previously with the EC, the IMF and the ECB. Later, in May, in light of worsening tension and uncertainty, national governments' and European institutions' commitment to stability in the area was further reinforced by the establishment of the European Stabilisation Mechanism. This programme's scope was much broader (it could be increased up to €750 billion) and was agreed on by the Ecofin at its extraordinary meeting on 9-10 May. As in the previous case, the strict conditionality of the assistance is a centrepiece of the arrangement. In parallel to this greater aggregate effort, several national governments - including Spain - have taken additional steps to accelerate and shore up their individual fiscal consolidation programmes.

Complementing these actions is the start-up of a process to review economic governance mechanisms, in light of the lessons that may be drawn from this crisis. While the process is still at an early stage, the main areas on which changes may be expected to focus are already discernible. The preventive arm of the Stability and Growth Pact may require some strengthening, with greater relevance being accorded to matters relating to the sustainability of public finances. It would also seem reasonable to move ahead and design better and more effective incentives and mechanisms to ensure stricter compliance with budgetary commitments. Also likely is an extension of the framework for multilateral surveillance of economic developments so as to cover all macroeconomic and competitive imbalances and to establish a systematic procedure for their diagnosis and monitoring, and for greater ex-ante coordination of economic policies. Into the medium term, regard must also be had to the request of the Heads of State and of Government for a permanent mechanism to be set in place for the resolution of potential future bouts of tension, which ensures the necessary financial assistance, subject always to a principle of strict conditionality.

To round off the economic policy response, structural reforms are needed to prevent fresh financial crises and to increase the economy's efficiency and productivity

Finally, the crisis has made the need to push through twin-pronged structural reforms more pressing. First, there is the sphere of financial regulation and supervision, where the aim is to prevent circumstances such as those that triggered the current situation, with the necessary coordination in the aforementioned international fora. In this respect, the headway made in creating the European Systemic Risk Board and the European System of Financial Supervisors is to be welcomed. Further, on 3 March the European Commission set out its proposal to renew the Lisbon Strategy, namely the Europe 2020 strategy, thereby initiating the process that should lead to the approval of this reform by the European Council in mid-2010. The proposal identifies three priorities (for smart, sustainable and inclusive growth), which are expressed as specific goals in terms of increasing levels of employment and of investment in R&D, and of reducing greenhouse gas emissions, school drop-out rates and the share of the population not having completed tertiary education, and alleviating poverty. Mechanisms are also envisaged to strengthen European economic governance. The strategy should contribute more decisively than its predecessor to driving the introduction of a series of structural reforms, the need for which to sustain growth rates and higher and more sustainable employment is all the more pressing after the crisis.

4 The challenges Spain faces to emerge from the crisis

In 2009 the Spanish economy saw the biggest fall in activity in recent decades, although the declines in GDP progressively slackened over the course of the year

The Spanish economy underwent a marked contraction in 2009, with the decline in GDP averaging 3.6% for the year, the biggest fall in activity in recent decades. These developments were in step with the severity of global contractionary trends, though they were also influenced by the imbalances that had built up during the previous expansionary phase. The stabilisation of financial markets and the recovery under way in some economies, along with the effect of the fiscal stimuli applied during the crisis and of interest rate cuts, allowed for some easing in the declining path of activity from Q1. The result at the end of the year was a cut in GDP of only 0.1 pp in terms of the quarter-on-quarter rate (3.1% when compared with 2008 Q4). The recession in Spain has, therefore, been extensive, and in the first half of 2010 growth has resumed sluggishly and with some delay compared to most of the industrialised countries.

The forecasts available point to a weak and gradual recovery, and one not free from difficulties

The forecasts available point to a weak and gradual recovery, and one not free from major challenges. Beyond the doubts over global recovery, which naturally affect the Spanish economy too, exiting the crisis in Spain poses particular difficulties as a result of the imbalances that had built up during the previous expansionary phase, the correction of which will influence how growth will resume. These imbalances had taken the form of an excessive concentration of resources in the real estate sector, high private-sector debt and risks to competitiveness, as a consequence of a decade of cost and price rises outpacing those of the euro area coupled with lacklustre productivity. The upshot had been a high external deficit and a continuous increase in external debt. Subsequently, the crisis prompted an extraordinary increase in unemployment and a swift rise in the budget deficit and in public debt, which have compounded the imbalances that must be redressed in order to move back onto a sustained growth path.

The recession in Spain has evidenced singular features: the sharp decline in domestic expenditure...

This set of factors has meant that the recession in Spain has shown a series of distinctive features. These include most notably the significant role that the decline in domestic expenditure has played in the contraction in output (national demand fell by 6.1% in 2009), driven by the fall-off in household consumption (-4.9%) and by the decline in residential investment (-24.5%), which were joined, with some delay, by corporate productive investment. Conversely, net external demand made a positive contribution of 2.8 pp to GDP growth, softening - as in previous contractionary phases - the impact of the fall in domestic spending on activity. Behind this positive contribution in particular, in a year in which trade flows were subject to major convulsions, lies the reduction in imports, dragged down by the contraction in final demand, although exports regained some momentum in the final months of the year. If the excessive relationship traditionally observed between final demand and imports does not change, it will be crucial, as domestic spending stabilises and the growth rate of imports rises, for the share of exports in world trade to increase. And that, given the stable exchange rate setting of the euro area, is a very demanding aim.

... which has contributed most significantly to reducing the nation's net borrowing in terms of GDP...

The abrupt containment of domestic expenditure has provided for a reduction in the nation's net borrowing, which fell from 9.1% of GDP in 2008 to 4.7% of GDP in 2009. A factor that particularly contributed to this was the correction of the trade deficit, owing to the significant fall in imports (see Chart 1.2). The other current account items running a deficit in recent years

MAIN INDICATORS OF THE SPANISH ECONOMY (a)

TABLE 1.1

		2004	2005	2006	2007	2008	2009
DEMAND AND OUTPUT (b)	GDP	3.3	3.6	4.0	3.6	0.9	-3.6
	Private consumption	4.2	4.2	3.8	3.6	-0.6	-4.9
	Government consumption	6.3	5.5	4.6	5.5	5.5	3.8
	Gross capital formation	5.2	6.5	8.3	4.3	-3.9	-15.0
	Equipment investment	5.1	9.2	9.9	9.0	-1.8	-23.1
	Construction investment	5.4	6.1	6.0	3.2	-5.5	-11.2
	Housing	*5.9*	*6.1*	*6.2*	*3.0*	*-10.3*	*-24.5*
	Other construction	*5.0*	*6.2*	*5.8*	*3.3*	*-0.4*	*1.6*
	Exports of goods and services	4.2	2.5	6.7	6.6	-1.0	-11.5
	Imports of goods and services	9.6	7.7	10.2	8.0	-4.9	-17.9
EMPLOYMENT, WAGES, COST AND PRICES (c)	Total employment	2.7	3.2	3.3	2.8	-0.6	-6.7
	Employed labour force (d)	62.0	64.3	65.7	66.6	65.3	60.6
	Unemployment rate	11.0	9.2	8.5	8.3	11.3	18.0
	Compensation per employee	3.0	3.7	4.0	4.5	6.1	3.7
	Unit labour costs	2.4	3.3	3.3	3.8	4.6	0.4
	GDP deflator	4.0	4.3	4.1	3.3	2.5	0.2
	Consumer price index (12-month % change)	3.2	3.7	2.7	4.2	1.4	0.8
	Consumer price index (annual average)	3.0	3.4	3.5	2.8	4.1	-0.3
	Consumer price differential with the euro area (HICP)	0.9	1.2	1.4	0.7	0.9	-0.5
SAVING, INVESTMENT AND FINANCIAL BALANCE (e)	Resident sectors: saving (f)	23.5	22.9	22.6	21.5	20.2	20.3
	General government (f)	*3.1*	*4.5*	*5.7*	*6.0*	*-0.1*	*-6.7*
	Resident sectors: investment	28.3	29.5	31.0	31.1	29.3	25.0
	General government	*3.4*	*3.6*	*3.6*	*4.1*	4.0	4.5
	Resident sectors: domestic net lending (+) or net borrowing (–)	-4.8	-6.5	-8.4	-9.6	-9.1	-4.7
	General Government	*-0.4*	*1.0*	*2.0*	*1.9*	*-4.1*	*-11.2*
	General government gross debt	46.2	43.0	39.6	36.2	39.7	53.2
MONETARY AND FINANCIAL INDICATORS (g)	ECB minimum bid rate on MROs	2.0	2.0	2.8	3.9	3.9	1.2
	Ten-year government bond yield	4.1	3.4	3.8	4.3	4.4	4.0
	Synthetic bank lending rate	4.0	3.8	4.6	5.7	6.2	3.8
	Madrid Stock Exchange General Index (DEC 1985 = 100)	859.9	1,060.2	1,324.0	1,631.8	1,278.3	1,042.4
	Dollar/euro exchange rate	1.2	1.2	1.3	1.4	1.5	1.4
	Nominal effective exchange rate vis-à-vis developed countries (h)	100.7	100.8	101.1	102.3	104.1	104.0
	Real effective exchange rate vis-à-vis developed countries (i)	106.4	108.8	111.6	115.0	118.5	114.6
	Real effective exchange rate vis-à-vis the euro area (i)	105.1	107.4	110.0	112.5	113.8	109.3
	Cash and cash equivalents	11.3	14.4	11.5	-2.9	-3.2	8.5
	Liquid assets (l)	5.9	11.5	8.5	8.4	9.8	1.0
	Households: total financing	20.2	20.9	19.6	12.5	4.4	-0.3
	Non-financial corporations: total financing	13.2	21.4	27.9	17.7	7.9	-0.9

SOURCES: INE, Intervención General del Estado, AMECO and Banco de España.
a. The National Spanish Accounts data are calculated on the basis of base year 2000.
b. Volume indices. Rates of change.
c. Rates of change, except the unemployment rate, which is presented as a level.
d. Employed labour force (16-64).
e. Levels as percentages of GDP.
f. Includes net capital transfers received.
g. Annual average levels for the Stock Exchange General Index, interest rates and exchange rates, and rates of change for financial assets and liabilities.
h. 1999 Q1 = 100.
i. 1999 Q1 = 100. Measured with unit labour costs.
j. Includes cash equivalents, other bank liabilities and money-market funds.

have also been corrected to some extent, while the tourism surplus has declined. Overall, the reduction in the external deficit has a substantial cyclical component; a permanent correction of the deficit will require far-reaching changes in the productive structure and a significant improvement in competitiveness.

From the standpoint of the financial position of the institutional sectors, the adjustment reflects only partly the significant improvement in the lending capacity of the private sector which, since the start of the crisis, has raised its saving and reduced its investment, since general government borrowing requirements have increased considerably. The improvement in the private sector's lending capacity from 2007 to 2009 amounted to 18 pp of GDP, with a relatively similar contribution by households and firms. As a result of this process, the net lending capacity of households for 2009 as a whole was equivalent to 7.1% of GDP, while the corporate sector balance remained in deficit (2.2% of GDP), albeit for a much lesser amount than in 2008.

... and to altering the dynamics of inflation, which posted negative figures for most of the year, influenced too by the fall in energy prices compared with prior-year levels

The decline in domestic demand influenced the course of inflation, whose rate of increase dipped most significantly during the year, affected too by the fall in energy product prices. The fall in the CPI averaged 0.3% in 2009. The easing off in prices was greater than in the euro area, meaning that inflation differentials were negative practically throughout the year, an unprecedented development since the start-up of EMU (see Chart 1.3). The reduction in core inflation further to the fall in non-energy industrial goods prices and to the moderation of prices of services (where the biggest progress relative to the euro area has been made) reflects an increase in the sensitivity of prices to the cyclical situation and, possibly, changes in price-setting processes. It is of paramount importance that such changes become entrenched, since they make a most valuable contribution to improving competitiveness and to the recovery of growth. For the remainder of 2010, price moderation is expected to continue, against a background of sluggish spending, despite the possible impact of the VAT increase from July.

But the most negative feature of the Spanish economy during the crisis has been the scale of job destruction and of the rise in unemployment

The most negative differential feature of the Spanish economy's performance during the crisis has been the intensity of job destruction (-6.7% on average for the year) and of the increase in the unemployment rate (up to 20% in 2010 Q1). These figures evidence a forceful labour market response to the contraction in activity, one more intense than in other European countries and which involves more acute labour market outflows than in previous recessions. Despite the cyclical downturn, real wages rose markedly, although their impact on unit labour costs was softened by the increase in productivity, largely due to job destruction.

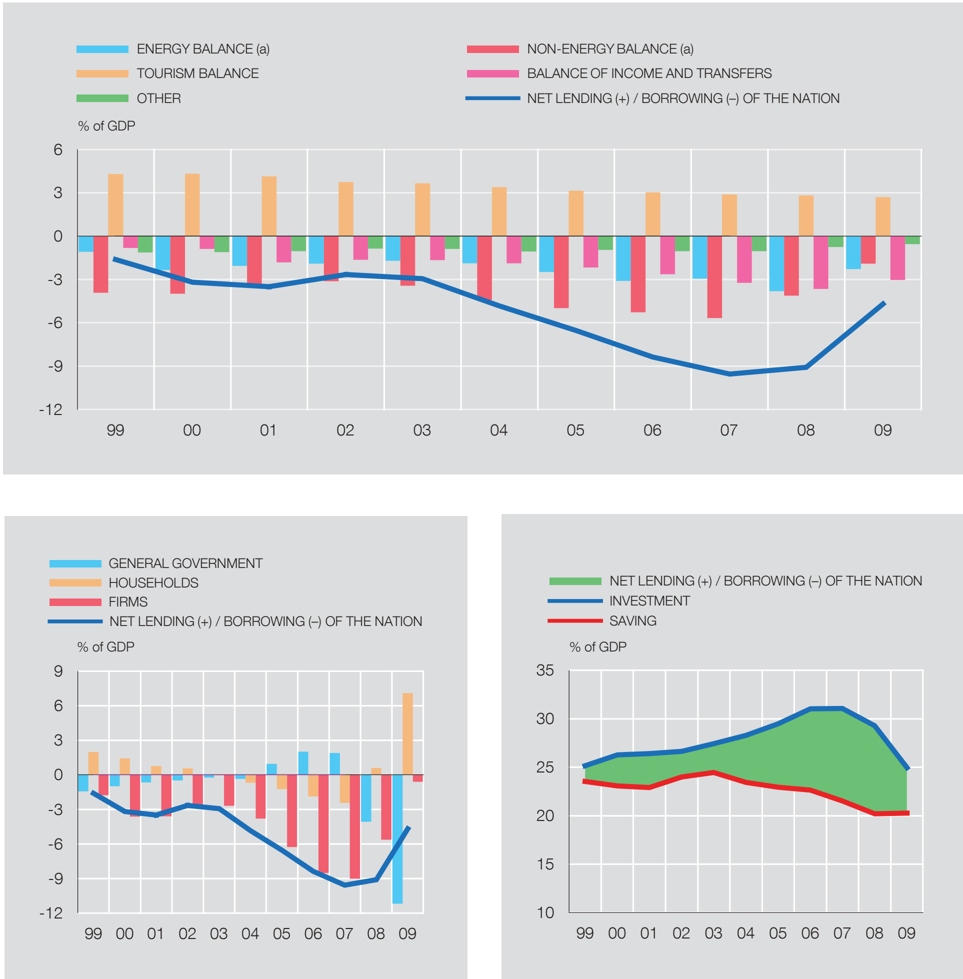
And public finances have worsened severely as a result of the sharp contraction in activity and the exceptional stimulus measures

Another aspect that has become increasingly important as the recession has extended has been the deterioration in public finances. The economic contraction has undermined tax bases, causing a sharp reduction in revenue takings, and it has quickened spending on unemployment benefits and on other items linked to the cycle. But, in addition, the exceptional stimulus measures adopted by the government in the face of the depth of the recession, in line with the steps taken globally, have given rise to a large-scale fiscal impulse that is greater than that in other developed countries and is contributing to widening the fiscal imbalance. In combination, these factors have reduced the public revenue/GDP ratio by 6.4 pp since 2007 (to 34.7%) and have raised the expenditure ratio by 6.7 pp (to 45.9%), taking the budget deficit in 2009 to a record figure of 11.2% of GDP. Public debt stood at 53.2% of GDP, compared with its low of 36.2% two years earlier.

The complexity of the factors underlying the recession in Spain have significant consequences for the recovery of a path of sustained growth. This chapter tackles, firstly, those aspects of the adjustment that are of most importance for anchoring the recovery; specifically, the absorption of the excess capacity in the real estate sector, the normalisation of credit flows, the

NET LENDING (+) / BORROWING (–) OF THE ECONOMY

CHART 1.2



SOURCES: INE, Customs data and Banco de España.

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

labour market response and the adjustment of domestic expenditure. Next, the economic policy requirements emerging from the situation described are set out, leaving for the following chapter a more in-depth and analytical assessment of the medium-term problems related to potential growth and to the role supply-side policies must play in tackling them.

4.1 THE REAL ESTATE ADJUSTMENT

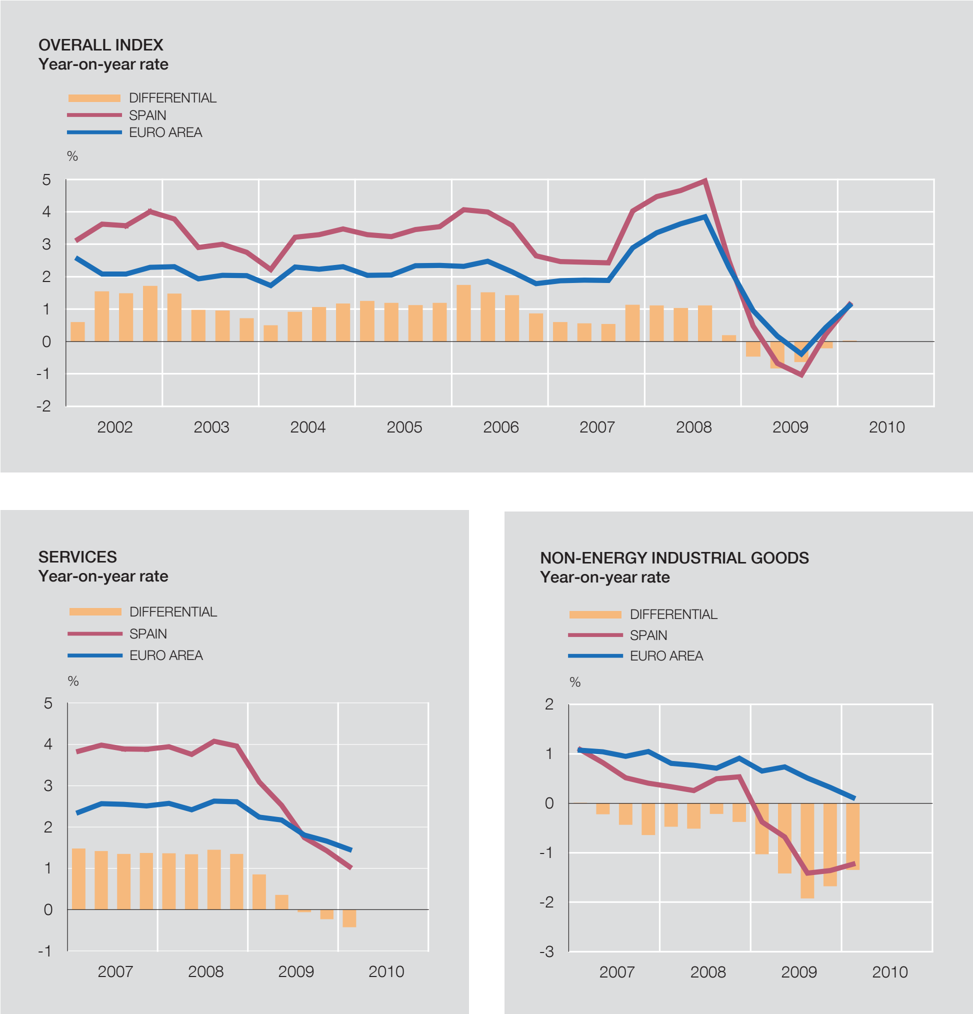
The real estate sector adjustment, which began gradually, has turned sharp...

One of the singular features of the contraction in Spain is the severe adjustment in the real estate sector. During the boom period, which ran for almost a decade, the combination of very generous financial conditions, property appreciation expectations, a substantial improvement in future income prospects and an extraordinarily dynamic demographic environment boosted the expansion of the sector to what would prove excessive levels, both from the standpoint of the productive resources assigned to real estate production and of its valuation and the debt tied to residential activity. This made an adjustment inevitable and necessary. It began to unfold gradually before the financial crisis broke in mid-2007, and was driven by the change in the ECB's monetary policy stance during 2006 and by the downward revision of property appreciation expectations. However, the intensity of the crisis meant that the risks of a severe adjustment suddenly materialised.

... bearing down chiefly on activity in the sector and, to a lesser extent, on prices

Activity in the sector has fallen sharply, with a decline in the residential investment/GDP ratio of 2.3 pp to 5.2% since the peak of the cycle in 2006-2007. This figure is below the average level of the past two cycles, and has entailed a drastic loss of jobs and

SPAIN/EURO AREA INFLATION DIFERENTIAL CHART 1.3



SOURCE: Eurostat.

prompted a significant knock-on effect on other productive branches. Despite the intensity of the contraction, the adjustment has not yet concluded. On the production side, and due to the lag between housing starts and completions, the overhang in the sector continued to increase during 2009, albeit at an increasingly lower rate. The absorption of this overhang will require some time; the longer it takes, the greater the delay in the recovery in demand or in the completion of the adjustment in prices. Also, it will restrict the potential contribution to growth of residential investment, which will hold below its average historical levels. The price correction has been less sharp, with property prices falling by around 12%, depending on the sources taken, although this is an area in which the quality of the statistics is not yet commensurate with the significance of the sector. While less sharp, the correction has diminished the value of real estate wealth. And this, combined with the effect of unemployment and with the loss of confidence, is contributing to holding back private consumption and to an increase in the saving rate (see Box 5.1).

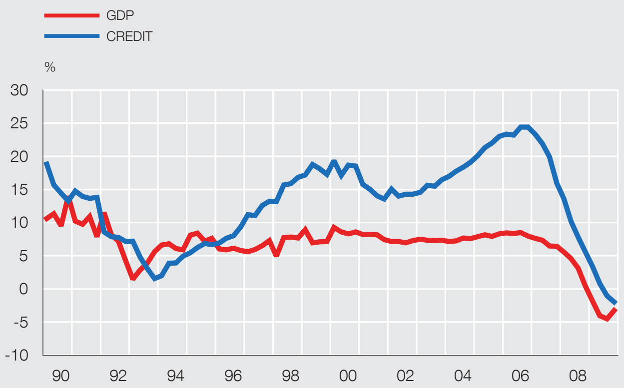
The continuation of the adjustment in the real estate sector until completion will detract from spending in the coming quarters, thereby limiting the scope of the recovery in the Spanish economy in the short run; but it is a key element for providing a sounder basis for economic dynamism.

THE OUTLOOK FOR CREDIT TO THE PRIVATE SECTOR IN THE SPANISH ECONOMY

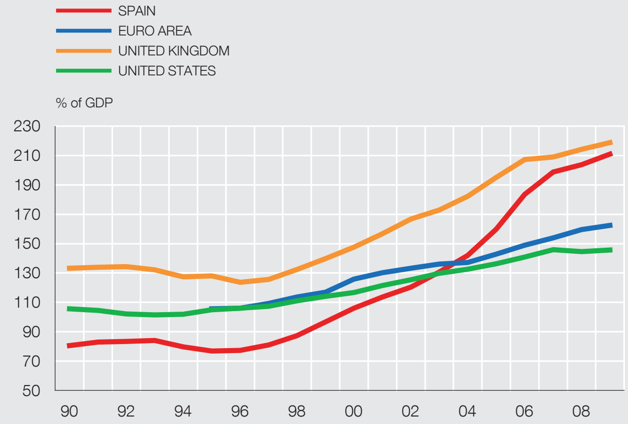
BOX 1.1

Given the role that recourse to bank debt has in the financing of private-sector spending decisions, and in a setting like the present in which these liabilities are contracting, analysis of the outlook for this variable is particularly relevant when assessing the Spanish economy's possibilities of recovery. It may be useful in this connection to begin by reviewing the relationship between credit and the business cycle in comparable past episodes. In this respect, Panel 1 shows the marked procyclical nature of credit. Specifically, in economic upturns it tends to grow at a higher rate than that of GDP, which reflects the fact that during these periods households and firms generally have favourable expectations about their future income, meaning that their readiness to resort to debt to finance their spending increases. Those supplying these funds during such phases tend to approve the attendant applications to a greater extent, as they usually perceive fewer risks in respect of borrowers' solvency. In phases of lower economic growth, the same forces operate in the opposite direction,

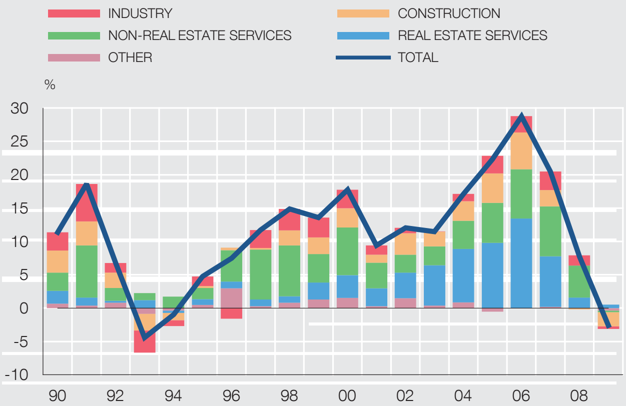
1 CREDIT TO THE NON-FINANCIAL PRIVATE SECTOR AND GDP
(Year-on-year growth in nominal terms)



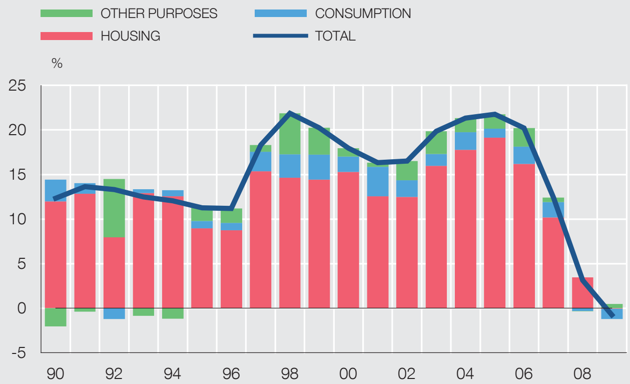
2 NON-FINANCIAL PRIVATE SECTOR DEBT RATIO



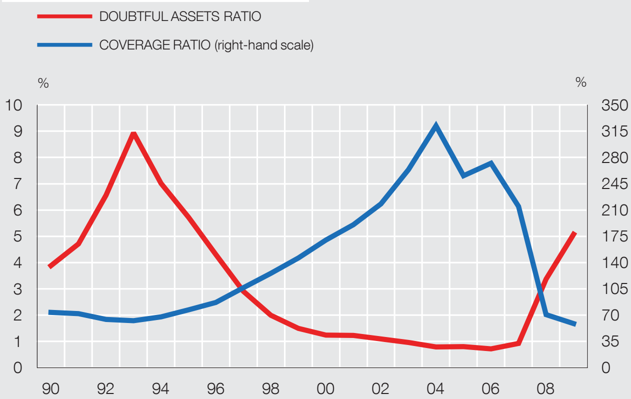
3 CREDIT FOR PRODUCTIVE ACTIVITIES
(Year-on-year growth and contributions)



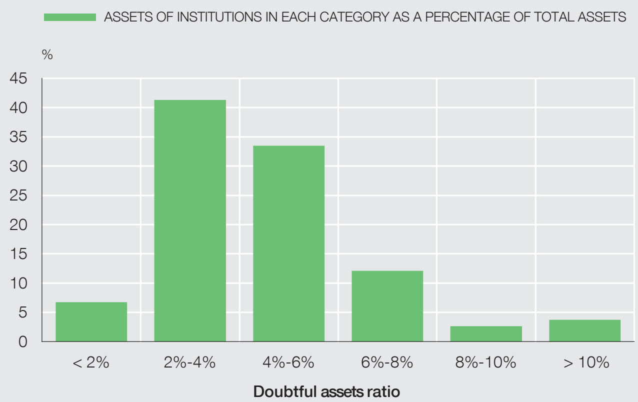
4 CREDIT TO INDIVIDUALS
(Year-on-year growth and contributions)



5 CREDIT INSTITUTIONS. DOUBTFUL ASSETS AND PROVISIONS



6 CREDIT INSTITUTIONS. BREAKDOWN OF DOUBTFUL ASSETS



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

meaning that the dynamism of debt diminishes with greater intensity than that of output, growing at a lesser pace for some time, which allows debt ratios to decline and agents' solvency to improve. Thus, for instance, in the 1992-1993 recession credit reached its low for the cycle (the date of lowest expansion) three quarters after GDP did, and it was subsequently growing less than GDP for almost three years (see Panel 1).

These cyclical effects are clearly apparent in the latest credit developments, where the economic crisis has been accompanied by a strong slowdown in these liabilities. Notwithstanding, at end-2009 credit was continuing to grow at a rate which, though negative, was still higher than that of nominal GDP. The simple extrapolation of past behaviour would suggest that, even in a scenario of economic recovery, bank financing should grow for some time at a rate below that of output. Moreover, if the patterns of previous cycles recur, the point of maximum contraction in this variable would not yet have been reached.

But apart from the traditional cyclical factors, credit over the coming quarters will foreseeably also respond to other factors related to certain adjustments needed in the financial position of both the private sector and the financial system. Regarding the former, the debt ratio of households and firms, which departed from a lower level than that of other developed economies, came to exceed the related average ratio for the euro area and the United States, standing close to that of the United Kingdom (see Panel 2), although in the case of households a comparatively greater portion of these liabilities was used to finance house purchases. This excess leverage, in any event, will tend to restrict the demand for resources, given the lesser relative scope of households and of firms to withstand the obligations associated with new liabilities, especially in a setting in which the dynamism of their income is not likely to recover swiftly. These factors will also bear down on the supply of loans insofar as this situation adversely affects the solvency of borrowers.

The need for private-sector balance sheets to be adjusted will foreseeably be greater for certain groups of agents, such as companies linked to the real estate sector, where the excesses accumulated have been greater and the correction is as yet incomplete. As can be seen in Panel 3, real estate companies were, prior to the crisis, the recipients of a significant proportion of the new financing allocated to productive activities, without any reduction in outstanding volumes of debt - something that can be seen in the other branches - having been observed yet. In the household sector, the growth of credit during the years prior to the crisis, while most considerable, did not reach such high levels, and it was moreover used chiefly for house purchases (see Panel 4).

The financial system, which withstood the first wave of the international financial crisis better than intermediaries in other countries, has more recently been increasingly affected by the impact of the economic crisis on the quality of their portfolios. Specifically, the doubtful assets ratio, which had been standing at what were historically very low levels, has risen rapidly, albeit without having yet exceeded the 1992-1993 recession levels (see Chart 5). As a result, the margins available have progressively diminished. Thus, the doubtful assets coverage ratio fell from 260% in 2006 to less than 60% at end-2009. Consequently, it cannot be ruled out that further impairment of credit portfolios may be reflected to a greater extent than hitherto in falling profits. This impact of the crisis, moreover, is proving heterogeneous across institutions, as illustrated, for example, by the high dispersion of doubtful assets ratios (see Chart 6). There is hence a need to undertake the redimensioning of this sector, a need to which the higher levels of capital required by markets and regulators will also contribute. Against this background, credit supply conditions can not foreseeably be significantly eased.

In sum, although difficulties hampering the recovery in credit may persist in the short term, over a longer horizon the adjustments will provide for the reinforcement of the financial system's soundness, which is a prerequisite for effective financial intermediation that contributes positively to the growth of activity and of employment. The duration and intensity of the phase of sluggish bank lending will depend, in any event, on the speed at which households and firms, on one hand, and the financial system, on the other, complete the adjustments under way.

4.2 THE CONTRACTION IN CREDIT

Credit to households and firms has entered a contractionary phase as a result of a complex set of factors

Credit to households and Spanish corporations, which posted respective growth rates of 20% and 30% at the top of the credit cycle, has fallen to a growth rate of practically zero in the former instance, and has turned clearly negative (around -5%) in the latter case (see Chart 1.4).

It is not easy, however, to isolate the specific contribution made by each of the factors responsible for this change. On one hand, the information sources that explicitly distinguish between the demand-side and supply-side components underlying the behaviour of credit are limited and are based on surveys reflecting subjective opinions. On the other, and more fundamentally, the very cyclical situation of the economy simultaneously affects applications for funds and the conditions under which institutions are prepared to meet them. In particular, a crisis situation entails a downward revision of private-sector spending plans (and therefore less demand for financial resources). But, at the same time, a crisis restricts the ability to pay, thereby reducing solvency, which translates into stricter supply conditions. Such tightening, moreover, is likely to affect households and firms heterogeneously and, among the latter, size will be a further factor. If, as has occurred in this case, an economic crisis coincides with an international financial crisis, the diagnosis difficulties multiply. Nonetheless, viewing recent developments in credit with a sufficiently broad timespan offers very significant aspects for understanding the role credit is playing in this cyclical phase of the Spanish economy.

Prior to the crisis various contractionary forces were already at play, on both the loan-demand and loan-supply sides...

The cyclical peak as regards credit behaviour was approximately at the end of 2006, and therefore some time ahead of the start of the crisis. The slowdown in bank loans thus responded, at first, to predominantly idiosyncratic factors, including primarily the very exuberance of the expansion in debt. Credit growth rates of 20% or 30% were unsustainable, and made for household and corporate debt ratios which, though they departed from relatively low levels, swiftly exceeded the averages for the other developed countries (see Chart 1.2).

Another specific factor was the marked concentration of bank loans in the house building, property development and house buying sector. As evidence amassed on the overdimensioning of this sector, downward pressures began to emerge on both the supply of funds by institutions increasingly exposed to this source of risks and on the demand for funds by overindebted agents facing the prospect of subdued real estate prices and activity.

... and these were compounded by the adverse effects of the international crisis on spending plans...

The international crisis brought further and likewise contractionary pressures to bear on demand and on credit supply. Spanish household and business confidence fell sharply, as did their expectations about future income and, therefore, wealth. This was against a background of substantially rising uncertainty, and translated into a strong adjustment of agents' expenditure plans and, therefore, of the demand for funds with which to finance them.

... and on borrowers' solvency...

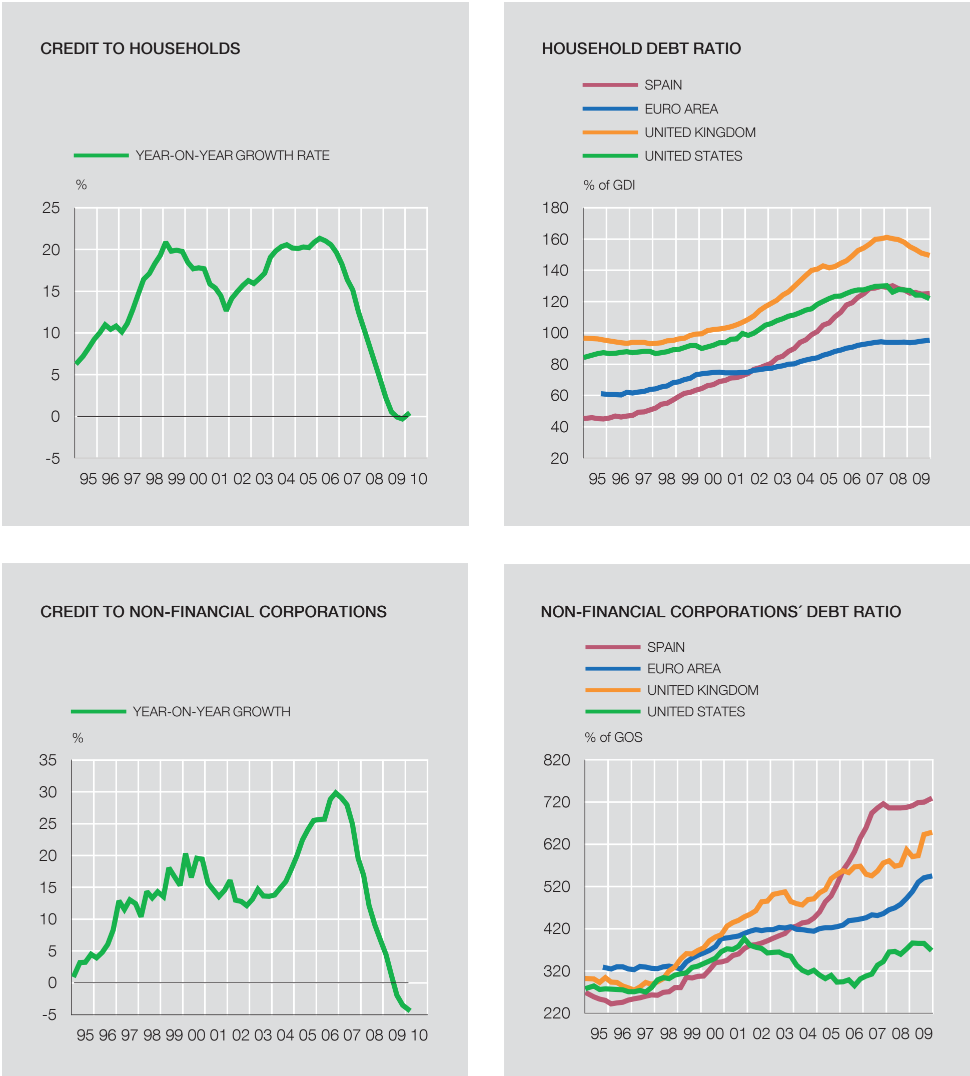
The increase in uncertainty has been accompanied by a generalised reassessment of the level of risk in place in different economies. Before the crisis this level had been clearly underestimated, also by households and firms, whose debt ratios, which may previously have appeared tolerable, now proved clearly excessive. This change affected not only their readiness to apply for new loans, but also their ability to obtain them, given the greater precariousness of their financial position. In this respect, the correction to date in private-sector debt ratios has been limited, even if the conjunctural effect that the 2009 recession has had on these ratios is stripped out. Evidently, more buoyant household and corporate income would contribute positively to mitigating the contractionary effect of this factor on credit supply and demand.

... and also on the optimal leverage and size of the financial sector

The reassessment of risks also affected financial intermediaries, who are more rigorous in their pricing of risks and who face, in turn, more demanding markets. Spanish credit institutions withstood the initial onslaught of the international financial crisis from a position of relative strength, as a result of the combination of a series of factors. These included most notably the high relative weight of their long-term liabilities, which limited their refinancing requirements at the most critical points; their business model, which is eminently geared to retail banking and relatively unexposed to the losses and liquidity problems associated with the now-infamous toxic assets, and which is easier to exploit to increase the depositor base; and the provisioning buffers built up as a result of a prudential regulatory and supervisory system that is more demanding than in other countries. Evidently, the gradual normalisation of international financial markets has also contributed to easing the pressure on credit supply.

FINANCING OF HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS

CHART 1.4



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

Nonetheless, the duration of the crisis and, above all, its effects on the Spanish economy have progressively eaten away at the buffers available, in a setting in which the leverage levels acceptable to markets and regulators will tend to be lower. Hence the need to pursue the redimensioning of the sector, the effect of which on credit supply will tend to be all the greater the swifter and more orderly this process is. The challenges here are greater for banks that took on more risks during the upturn in the credit cycle, and a more resolute attitude is now expected on their part so that they may appropriately exploit the possibilities at hand to ensure the efficiency of the process. To this end, significant regulatory changes have been made that have substantially broadened the means and tools available to adapt and restructure banks, by means of the new framework provided by the creation of the FROB (Fund for the Orderly Restructuring of the Banking Sector). The reforms introduced, with wide parliamentary backing and the prescriptive approval of the European authorities, have allowed the process to be set in train through the start-up of several bank integration processes. As usual, these matters are addressed in greater depth in the *Report on Banking Supervision in Spain* and in the *Financial Stability Report*, but are also tackled on a broader level in Box 6.1 in this Report.

Future credit developments will be influenced by the habitual cyclical behaviour of this variable and by the restructuring process affecting lenders and borrowers

Past patterns of credit behaviour show the marked procyclicality of this variable, which in previous comparable episodes has tended to recover with some delay compared with economic activity. On this occasion, future bank loan developments will also be influenced by the need of both credit institutions and of households and firms to rise to the restructuring challenges set out in this section (and which are analysed in greater detail in Box 1.1). Successfully negotiating these challenges will be vital to prevent distortions from arising in the functioning of the financial channels, as such distortions may hamper the resumption of a sustainable path of output and employment growth.

4.3 JOB DESTRUCTION

But as regards overcoming the crisis, the biggest source of difficulties stems from the intensity job destruction has reached...

But as regards overcoming the crisis, the biggest source of difficulties stems from the intensity job destruction has reached (over 2 million people since employment was at its highest, in 2007 Q3) and the rise in unemployment (standing at over 4.6 million people in the opening months of 2010; see Chart 1.5). Labour shedding has affected disposable income most adversely and, by extension, domestic spending. But it has also exerted a most unfavourable effect on confidence and expectations, amplifying the contractionary tendencies of spending. The continuation of such a situation, in which any recovery in employment were to take time and labour prospects failed to improve, would be a major obstacle to the resumption of growth and to the adjustment of public finances.

... which is bearing down chiefly on temporary employment ...

The scale and speed at which job destruction has come about are proving far greater than in previous recessions. The characteristics of the previous cyclical phase, which was very intensive in generating employment and evidenced substantial biases in respect of sectoral composition, may have influenced this behaviour to some extent. Nonetheless, the only explanation for the severity of the adjustment is the persistence of serious institutional shortcomings in the workings of the labour market, which had remained latent during the upturn, against a background of far-reaching demographic changes and alterations in the composition of labour supply, but which have deployed all their effects as the crisis has unfolded. These shortcomings mean that the labour market adjustment falls disproportionately on employment, and most particularly on temporary employment, the share of which in total employment fell to 24.4% in 2009 Q4.

... and has led to a very sudden increase in the number of unemployed, which has impacted certain groups particularly seriously

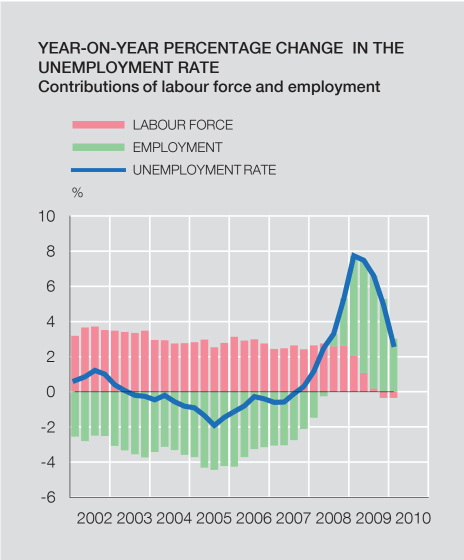
The deterioration in employment expectations ultimately affected the rate of increase of labour supply (with some delay compared with past experiences), as a result of the sharp slowdown in the working-age population, caused by the reduction in net migrant inflows and by the lower pace of the participation rate. Despite diminished demographic buoyancy, the unemployment rate climbed to 20% of the labour force in 2010 Q1. The rise in unemployment affected the different population segments unevenly; the groups most affected were males, immigrants and youths, particularly those with a lower level of educational attainment, for whom the unemployment rate reached 52.2% in the opening months of 2010. The increase in unemployment is entailing a significant rise in the rate of long-term unemployment. The absorption of labour surpluses from construction and the emergence of processes of hysteresis will entail difficulties that raise the risk of unemployment becoming structural. The materialisation of this risk would be an obstacle to recovery and would have adverse consequences for the prospects for potential growth, which would be further diminished by the foreseeably low long-term growth of labour supply, as analysed in Chapter 2.

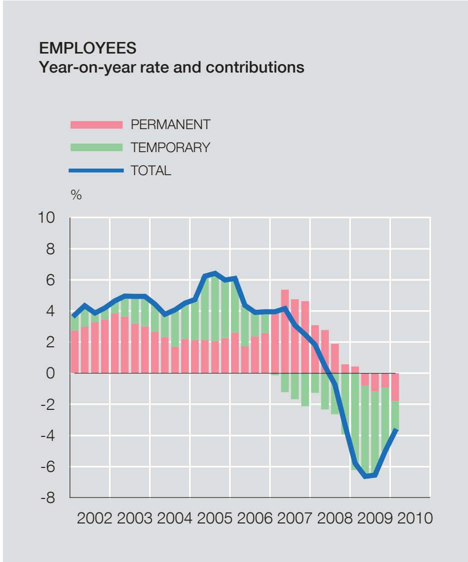
4.4 THE DECLINE IN DOMESTIC EXPENDITURE

The magnitude of the contraction in domestic expenditure has been considerable

The decline in domestic expenditure has been on a particularly large scale in Spain. This has been due, in part, to the significant reduction in residential investment, as earlier discussed; but also of importance has been the contraction in consumption which, for the second year running, has been the domestic demand component that has most contributed to the decline in GDP.

EMPLOYMENT AND UNEMPLOYMENT (a) CHART 1.5





SOURCES: INE and Banco de España.

a. The EPA series are linked on the basis of the 2005 Q1 control survey and the 2001 change in the definition of unemployment.

The slowdown in income, the reduction in wealth, the tightening of lending standards and uncertainty over job prospects have prompted a decline in consumption

During the adjustment phase disposable income maintained a positive - although moderate - growth rate, underpinned by the sizable transfers of income from general government, lower interest payments and the moderation of prices, which offset the strong fall-off in wage income. Wealth has fallen above all as a result of the decline in real estate prices. Nonetheless, the downscaling of household expenditure plans during this phase has exceeded what the trend of these determinants might have led to expect. Other factors, such as the tightening of lending standards, households' perception about the need to restore health to their financial position, and the downturn in confidence and in future income expectations (aspects closely tied to the labour market situation) are also playing a decisive role in the contraction of household spending. Only by having regard to these considerations may an explanation be found for the rapid increase in the saving ratio, which stood at 18.8% of disposable income at the end of the year, marking a historical high.

Business investment has fallen sharply

Business investment also reacted sharply, with an unprecedented fall of 20% for the year as a whole. This was amid highly adverse global conditions for this type of expenditure, both because of the demand outlook and the contraction in profits (which, however, is being eased by the reduction in financial charges, unlike in previous recessionary cycles) and because of the tightening of financing conditions. As a result of this disinvestment process, the economy's capital stock has been eroded, with potential implications for long-term growth that are analysed in the following chapter.

An improvement in the sector's financial position is vital for restoring spending on sustainable bases

Looking ahead, private-sector spending decisions will be influenced by the need to reduce the still-high level of leverage in a setting in which the scant dynamism of income will slow the correction of debt ratios in the short term. To achieve substantial improvements in the financial position of households and firms will require moderate consumption and investment patterns, but this is a necessary step if the recovery is to be on the basis of a sustainable spending path.

5 *Economic policies*

Economic recovery in Spain faces major challenges. Only once the excesses in the real estate sector have been eliminated and financial restructuring in the private sector is complete may domestic expenditure resume sustained growth. The financial restructuring of the private sector should, moreover, run in parallel with the restructuring of credit institutions, so that financing flows are sufficient to support households' and firms' spending plans. But above all, the Spanish economy's traditional structural problems - whose effects are being felt particularly sharply during the recession - must be resolved, as they restrict the capacity for adjustment and for long-term growth within the euro area. Here, economic policies have an important role to play.

Supply-side policies play a key role in exiting the crisis and in the resumption of growth in the medium run

The absence of supporting factors in respect of demand-side policies and the need to lift the obstacles hampering growth capacity in the medium and long term mean that supply-side economic policies play a crucial role in exiting the crisis and in the recovery of potential growth. On the monetary policy front, the foreseeable recovery in activity in the euro area will perhaps lead to some gradual normalisation of interest rates, which remain at all-time lows, meaning that additional stimuli to those already in place would not be appropriate. Nor is there any room to apply expansionary fiscal measures, as the fundamental challenge involves, as analysed below, giving structure to the programme announced to restore budgetary stability and the sustainability of public finances in the medium term. Accordingly, the main area for economic policy conduct lies in the structural measures and reforms that provide for job creation, increase competitiveness, improve efficiency and corporate profitability, and help, all told, to restore spending on solid foundations and to obtain a flexible and efficient response by productive resources.

5.1 BUDGETARY CONSOLIDATION AND THE SUSTAINABILITY OF PUBLIC FINANCES

The budget deficit is eminently structural

Fiscal policy has made a great effort to counter private-sector contractionary impulses through the free play of the automatic stabilisers and the adoption of very large-scale discretionary measures, some of which are temporary. Nonetheless, the Spanish budget deficit is eminently structural, as it is due, above all, to a permanent loss of revenue as a result of the redimensioning of the real estate sector. This in turn has compounded a rising trajectory in spending that is outpacing trend growth. Accordingly, a fiscal consolidation to check the rapid deterioration in debt dynamics is unavoidable. The fiscal effort required in this connection, in a situation in which the forecasts available point to a moderate growth scenario, is very great and may become more demanding depending on the course of interest rates. Testifying to this are the latest developments on financial markets, in particular the sovereign debt markets, triggered by the Greek fiscal credibility crisis and the contagion effect towards other vulnerable economies, and by the effects of the crisis on the economy's potential growth (see Box 1.2). Mention must also be made, more into the medium term, of the impact on the deficit and debt of the cost of population ageing, which, in the absence of reforms to the public pension system, will be one of the highest in the EU according to the estimates available.

Consolidation is vital to prevent the debt burden rising on markets increasingly responsive to the situation of public finances

The arguments that make fiscal consolidation a pressing need are manifold. First, high deficit levels and growing rates of public debt may entail interest rate rises, especially when the markets are alerted to the possibility of fiscal crises occurring in some countries and to these spreading tension across the bond markets. This risk has begun to materialise already in the euro area, in the wake of the Greek fiscal crisis. It has led the government bond spreads of the most vulnerable countries to widen significantly, in spite of their different fiscal positions and of the fact that the nature of their risks is not on a par with those of Greece. Second, the significant dynamic effects of the fiscal deterioration must be taken into account. When this is very swift, the financing of the significant increases in the interest burden poses the harsh dilemma of cutting primary expenditure or raising taxes, with both options exerting adverse effects on growth, although these will generally be greater in the long run if the second option is taken. Finally, a high level of public debt reduces the capacity of fiscal policy to respond to future adverse shocks. In this respect, the Spanish experience, at the start of the crisis, is illustrative

According to the updated Stability Programme (USP) presented on 29 January by the Spanish government, general government debt is expected to increase by 38 pp of GDP between 2007 and 2013, in a benign scenario for economic growth and the interest burden. Although the level of Spanish public debt was below the European Union average in 2009, the risks associated with the strong inertial component of this variable should not be forgotten. Specifically, once public debt reaches high levels, it is difficult to break the trend unless significant budgetary adjustments are made. This Box illustrates these aspects drawing on the definition of various alternative scenarios for the path of Spanish public debt to 2013, constructed using alternative assumptions of GDP growth, interest rates and fiscal adjustment.

A change in the public debt/GDP ratio from one year to the next depends on four fundamental factors. First, on the level of the primary public balance, whereby a negative balance in this variable translates into an increase in debt of the same amount. Second, on nominal GDP growth: positive (negative) growth gives rise to a reduction (increase) in the debt/GDP ratio. Third, on the interest payments on public debt that have to be financed. And, fourth and finally, on the debt-deficit adjustment, which reflects, inter alia, the need to finance the acquisition of financial assets.

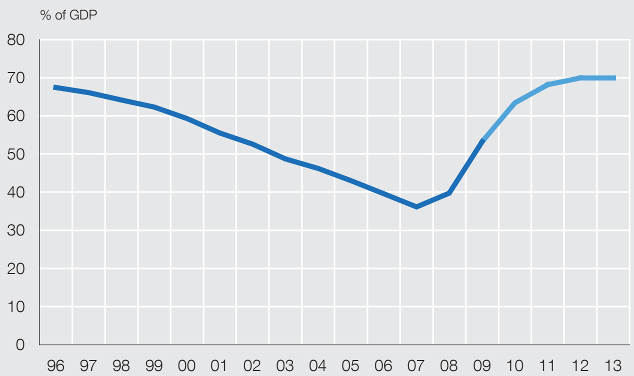
To illustrate the relative significance of each of these factors, it is useful to analyse the role each played in the process of public debt reduction that began in the 1990s in Spain and which allowed for a 30 pp cut in the public debt/GDP ratio between 1995 and 2007. This period saw an adjustment to the primary balance of the order of 0.8% of GDP a year from 1994 to 1999, and of 0.2% from 2000 to 2007. Conducive to this adjustment were high nominal GDP growth rates, which averaged over 7% in the 1994-2007 period, and the favourable trend of interest rates, which fell by 4 pp over the same period (see accompanying panel).

To assess the impact of these same factors on debt dynamics over the coming years, various scenarios are considered that take as a basis the projections for each of these variables envisaged by the USP. The first scenario considers the public debt projection of the USP's central scenario, adjusted for the new public deficit path approved by the Spanish government on 20 May 2010 ("Central scenario")[1], in which average nominal GDP growth stands at 3.4% in the 2010-2013 period, the average implicit interest rate on debt is at around 4% and the adjustment of the primary public balance is 2.4 pp of GDP on average between 2010 and 2013. The second scenario is obtained by jointly considering the two risk factors of the USP ("risk scenario"), which involves assuming lower average nominal GDP growth in 2010-2012, of the order of something over 0.5 pp compared with the central scenario, and interest rates 1 pp higher than those of the base scenario.[2] Thirdly, in addition to the assumptions of the previous scenario, it is assumed that the fiscal adjustment made in each year of the 2010-2013 period is lower and, specifically, similar to the average adjustment made in the last fiscal consolidation process (adjustment of the primary balance of 0.8% of GDP). Finally, to illustrate the risks that not undertaking a budgetary consolidation process would entail, the last scenario assumes that the primary balance holds at the 2009 levels in the 2010-2013 period. It should be noted that, in the last two scenarios, what is purely an accounting exercise is performed, with the remaining assumptions of the USP being retained.

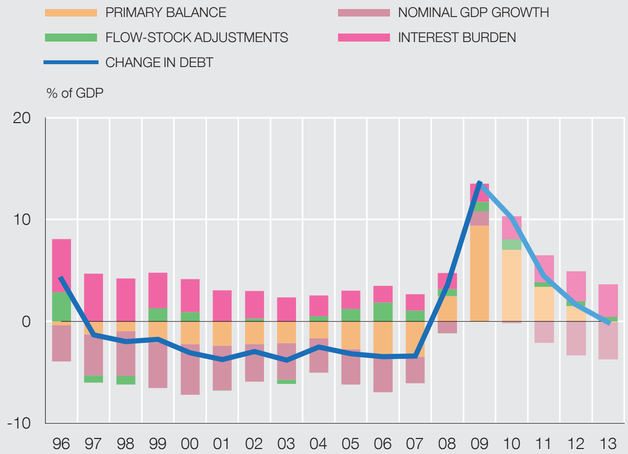
In the central scenario the debt ratio would stabilise at a level of close to 70% of GDP in 2013. The USP risk scenario would raise the public

1. It is further taken into account that the 2009 deficit/GDP and public debt/GDP ratios were respectively 0.2 pp and 2 pp lower than the initial estimates in the USP. **2.** The sensitivity exercises (risk analyses) for the USP (table 5.2 of the USP) only cover the 2010-2012 period. For 2013, the change in the level of debt provided in the USP (see table 4.5 of the USP) is applied to the level of debt of this scenario in 2012.

1 PUBLIC DEBT/GDP RATIO



2 DETERMINANTS OF THE CHANGE IN THE PUBLIC DEBT/GDP RATIO



SOURCES: Updated Stability Programme 2009-2013 and Banco de España..

NOTE: The central scenario projections of the Stability Programme 2009-2013 have been taken from 2009, modifiied by the budget deficit approved in May 2010.

debt ratio in 2013 to 75% of GDP, 5 pp above the base scenario, which highlights the significance of the behaviour of the macroeconomic variables for debt dynamics. Finally, both the "non-consolidation" scenario and the "similar consolidation to the 1990s" scenario show that, if the adjustment is on a limited scale or delayed, debt might rapidly rise to very high levels.

Beyond 2013, it is worth considering some further factors of risk that might affect public debt over the longer term. These relate chiefly to population ageing, given the current and projected demographic structure. Specifically, on the basis of common demographic and macroeconomic assumptions made by the Working Group on ageing, of the EU Economic Policy Committee, ageing-associated spending as a percentage of GDP is estimated to increase by 9 pp over the 2007-2060 period. Against this background, the need to see through fiscal consolidation is all the more pressing.

The simple exercises presented in this box help illustrate the risks associated with the build-up of public debt, even when the starting point is a low level when compared with the EU average. Given the fiscal situation in 2009, with a deficit of 11.2% of GDP, the fiscal adjustment is absolutely necessary if it is sought to avoid excessive public debt growth. Furthermore, the fiscal adjustment should be on a most significant scale and one far greater than that undertaken between 1993 and 2007. This is because the starting fiscal situation is now also more negative and the interplay of GDP growth and interest rates will foreseeably not be conducive to reducing the public debt/GDP ratio, unlike the case in the previous fiscal consolidation period. Naturally, higher-than-expected GDP growth in the scenarios presented in this box would have beneficial effects for public debt dynamics, which highlights, also from this perspective, the importance of undertaking the structural reforms needed to improve the economy's growth potential.

of the room for manoeuvre that the starting position of public finances provided, which advocates restoring a healthy budgetary position as soon as possible.

Fiscal consolidation faces the difficulty of pursuing the dual goal of effectiveness in order to reduce the budget deficit and stabilise debt, and of minimising its potential adverse effects on growth in the short term. Past experience shows that the best means of negotiating such a situation is to focus the consolidation drive on cutting current expenditure, although given the scale of the budget shortfall, resort must inevitably be had also to increasing resources through the taxes that generate least distortion. To do this, clear and transparent fiscal rules will be needed, using the full range of provisions offered by our institutional framework: namely, the Budgetary Stability and the Stability Programme Laws, as newly conceived, which will provide for more effective mechanisms to ensure compliance with the commitments made.

In Spain, once expansionary conduct had run its course, the best contribution fiscal policy could make to growth was via the rigorous implementation of the fiscal consolidation plan within the term set by the Stability and Growth Pact. The government undertook to pursue a fiscal consolidation programme, in accordance with the November 2009 Ecofin recommendations, whose guidelines were given specific form in the updated Stability Programme unveiled in January this year. The Programme acknowledged the existence of a high structural deficit and aimed to reduce it in the period 2010-2013, placing the deficit at 3% of GDP at the end of the projection horizon. This would be on the basis of a marked cut in public spending, although the projected macroeconomic scenario taken was relatively benign, meaning that compliance might require additional efforts to those envisaged, as formulated by the Ecofin Council in its opinion on the updated Stability Programme.

Subsequently, as part of the moves to reinforce governments' and European institutions' commitment to stability in the area before the tension generated by the Greek fiscal crisis worsened, the Spanish government adopted a more ambitious fiscal consolidation programme on 20 May. It sought thereby to avert a deterioration that would have had grave consequences for the economy and for euro area stability. The programme frontloads a sizeable portion of the reduction in the deficit in 2010 and 2011, when it would stand at 6% of GDP, and it involves a series of measures that act directly on the structural component, which might be cut by more than half, as described in Chapter 5 of this Report. This austerity drive by the government is in response to the exceptional nature of the situation and to the wish to redress public finances. In any event, it is vital to ensure that the objectives are strictly implemented, since any deviation will give rise to significant credibility problems. To ensure strict compliance, it will be necessary to reinforce monitoring and surveillance procedures, to seek formulas that ensure compliance with the objectives laid down, particularly in the case of territorial governments, and to redress the dynamics of certain spending items.

In the current situation, pension reform is particularly timely

In circumstances like the present, and given the demands the situation poses, the adoption of pension system reforms, in line with the government's proposal, is particularly timely; this allows for an improvement in the long-term sustainability of public finances without generating adverse effects on short-term growth.

5.2 OTHER STRUCTURAL REFORM POLICIES

Structural reforms are crucial for boosting long-term growth and amending labour market shortcomings...

The main instrument available to national authorities to boost long-term growth prospects is that of structural reforms. These are all the more pressing after the crisis, as it is vital to resolve as soon as possible the inefficiencies that the crisis highlighted. This will call for some of the institutional frameworks in place and rooted practices to be changed.

The behaviour of employment during the current cyclical phase indicates that the Spanish labour market's pre-crisis adjustment mechanisms are not working properly, since they have the weight of the adjustment fall excessively on employment. This type of response reveals the presence of major labour relations deficiencies, and this is very costly from the standpoint of long-term economic growth and social well-being.

Excessive labour market segmentation (stemming from the coexistence of a very high degree of protection for employees with a permanent contract and of a wide range of temporary contracts with very low termination costs) determines high costs for stable hiring and job stability, and leads labour mobility to be concentrated, almost exclusively, on a very large group of workers with temporary contracts, who have scant training and recycling options open to them. The collective bargaining system tends to exacerbate, moreover, some of the consequences of labour market segmentation by encouraging uniform wage increases, which show scant cyclical sensitivity and are highly indexed to past inflation. It is a system which, on the whole, largely prevents relative wages from acting as a signalling mechanism for the reallocation of resources towards sectors with greater development potential.

It is therefore a priority to overhaul labour market institutions through reform that simultaneously influences collective bargaining systems and hiring arrangements and which, at the same time, reinforces training and intermediation systems. That would allow for better job reassignment across companies and sectors, it would increase the economy's capacity for adjustment in the face of shocks and it would help promote a change in the productive model that has prevailed over the past business cycle.

... and must also affect the housing market, services activities and the network industries

The regulation of the housing market - in particular of those aspects that have hampered the development of the rental segment - coincided with the gestation of one of the biggest imbalances that built up during the economic upturn and it also gave rise to substantial adjustment inefficiencies during the recession. Measures promoting the development of the rental market would contribute to providing an outlet for the stock of unsold housing, to smoothing access to accommodation and to promoting the regional mobility of workers. Various such measures were approved in 2009, including most notably the announcement of a series of initiatives aimed at increasing legal efficiency in rental-related cases, and certain aspects of the Leasehold Law were amended. However, the main features of this law relating to mandatory contract duration and to rent control have been retained. The draft sustainable economy legislation, which is in passage through Parliament at the time of this report going to press, and which has been designed to boost long-term growth, proposes a way forward in the re-balancing of the tax treatment of rented and owner-occupied housing. Turning to services, the easing in final prices over the course of the past 18 months reflects a substantial increase in the cyclical sensitivity of these prices, which may be partly due to changes in price-setting arrangements in increasingly competitive environments. The most specific progress in structural reforms has in fact been aimed at the liberalisation of the sector and at the reduction of administrative burdens. In this respect, headway was made in 2009 in the transposition of the Services Directive, with the aim, among other aspects, of providing free access to the provision of specific services and of reducing administrative burdens. It will be attempted to deepen both avenues of reform with the Sustainable Economy Law. Nonetheless, the persistence of obstacles to the free pursuit of certain activities, such as retail trade, remains discernible.

As to the network industries, the effects of the liberalisation processes of the past decade are most visible in the telecommunications sector, although some segments remain in which certain rigidities are still perceptible, and these are of vital importance for harnessing the advantages provided by the development of the information society. In the energy industry, despite the numerous regulatory changes made with greater liberalisation in mind, the degree of de facto competition is far from what it should be if the sector is to be able to deploy its potential synergies to the rest of the economy. Effective improvements in the competitive environment in which energy companies operate must therefore be achieved, in line with the European Commission's recommendations. Finally, in the transport industry, the draft sustainable economy legislation includes various measures to increase competition in the intercity passenger transport market and to foment railway transport through, for example, the improved interconnection of different modes of transport.

Finally, the reform of the education system and the re-design of incentives for a greater accumulation of technological capital would also contribute to raising the efficiency of factors of production and, therefore, to increasing the economy's potential growth. These reforms are addressed in greater detail in the following chapter, which also analyses in depth the obstacles posed by the institutional design of labour relations to a prompt and sustained recovery of the Spanish economy.