1 OVERVIEW

1 Introduction

In the second half of 2013 there was an incipient recovery in the Spanish economy underpinned by both external and domestic factors

As from the second half of 2013, a scenario of incipient recovery progressively firmed in the Spanish economy, continuing into the opening months of 2014. Quarter-on-quarter GDP growth rates turned positive, though moderate, and modest job creation ensued. Both external and domestic factors came into play here. The economic policy decisions adopted by the euro area governments, progress in euro area governance and the ECB's expansionary monetary policy have contributed to relaxing financial tensions, although they still remain high, and to sustaining the fragile recovery in the European economy. In turn, internally, significant headway has been made in restructuring the banking system and in correcting, to varying degrees, fiscal and competitiveness-based imbalances, among others. Joint action on these fronts has led to an easing of the adverse financing conditions and a pick-up in the confidence of both international investors and domestic households and firms, which have enabled the Spanish economy to overcome the extreme tensions of 2012 and exit the second recession of the crisis.

But considerable challenges remain, meaning that the firming of the recovery requires perseverance with the measures that have prompted the turnaround

The characteristics and depth of the crisis pose numerous challenges in terms of entrenching the recovery and setting a new sustained growth path. Uncertainty and risks are still high, and GDP and employment levels remain far below those reached prior to the crisis. To meet these challenges satisfactorily, there must be further economic policy measures at the European level aimed at bolstering still-weak growth and further progress with the roadmap for attaining a genuine Economic and Monetary Union, and most particularly a banking union. At the same time, in terms of domestic economic policy, momentum in correcting imbalances and in pushing through the reform agenda must be maintained. The complex situation of the Spanish economy, according to the analysis contained in this report, highlights the importance of furthering structural measures that anchor the capacity for growth in the long run, enhance competitiveness and help achieve the budgetary stability targets needed to restore the sustainability of public finances. Only thus may domestic and external confidence be durably restored and headway made in progressively reducing the high levels of debt weighing down on agents' spending decisions, a matter to which Chapter 2 of this Report is dedicated.

2 The external boost to the recovery of the Spanish economy

Global economic activity rose in the second half of 2013 and of tensions shifted towards the emerging economies

Following a lacklustre first half of the year, global economic activity rose in the second half of 2013. As a result the year ended with an increase in global GDP of 3% and international trade on a rising trend. The recovery was essentially underpinned by the performance of the advanced economies, most particularly the United States, since the block comprising the emerging and developing economies saw some loss of momentum (see Chart 1.1). The changes in monetary policy implemented by the Federal Reserve in response to the behaviour of the US economy and the course of some of the imbalances that have built up in the emerging economies are prompting an increase in uncertainty and in the risks linked to the future performance of these latter countries.

Inflation rates are, in general, moderate

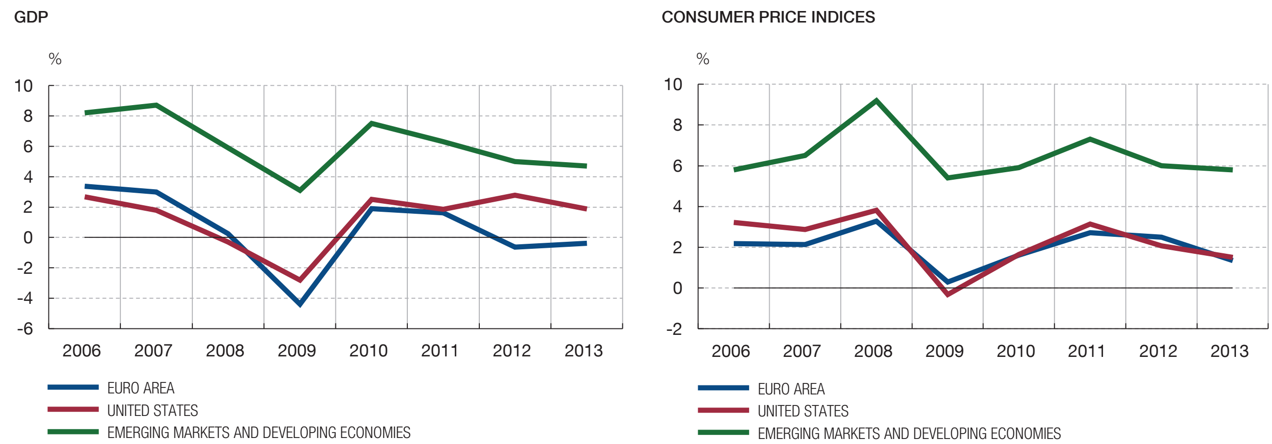
Inflation rates have broadly remained moderate, especially in the advanced economies, where activity continues to be below potential and monetary policies have adopted a strongly expansionary stance.

These same trends have run into early 2014

The economic indicators that have emerged to date in 2014 and forecasts by analysts and international organisations generally point to the main trends observed in the final stretch

GDP AND INFLATION
Rate of change

CHART 1.1



SOURCE: IMF (WEO April 2014).

of last year continuing: a progressive recovery in the global economy, a greater re-balancing of the respective contributions of the advanced and of the emerging and developing economies, a shift in the main focus of uncertainty and of risks from the former to the latter, and the absence of inflationary risks.

Euro area GDP posted positive growth rates from Q2, boosted by a more favourable external environment…

The euro area also participated in the recovery in global activity and, from 2013 Q2, posted positive quarter-on-quarter growth rates. On the whole, however, the year saw a 0.4 pp fall-off in output. The greater buoyancy of international trade boosted external demand, while the progressive shift in focus in respect of tensions towards the emerging economies provided some relief to European financial markets, which had a favourable bearing on the area's internal demand.

… by the economic policy decisions adopted by the Member States' governments, both domestically…

But the growing dynamism of the euro area was also underpinned by the economic policy decisions adopted domestically. On one hand, on the domestic stage, Member State governments continue to push through fiscal consolidation and structural reform, in accordance with the recommendations drawn up by the European Commission under the European Semester. The financial support programmes (for Greece, Ireland, Portugal and Cyprus) saw significant progress made, especially in the cases of Ireland, whose programme concluded in December, and Portugal, where it did so in May. The partial programme of financial assistance for the recapitalisation of the Spanish banking system also concluded in early 2014. Together, this has given an additional boost to domestic and external confidence in the soundness of the European project.

… and as part of the governance of the area as a whole, …

As regards the governance of the area, the European Commission revised in summer 2013 the various Member States' budget deficit objectives in order to align them to a greater extent to the economies' cyclical positions and thus promote fiscal consolidation paths that are not an obstacle to growth.

Significant headway has also been made throughout 2013 and in 2014 to date in the ongoing creation of the Single Supervisory Mechanism (SSM). Its design is practically complete and it will commence operating fully late in 2014. This centralisation of banking supervision enables the authorities to sidestep the problem of economic governance posed by the coexistence – in an economy as heavily banked as the euro area – of a single monetary policy and currency in a setting of free capital movements, on one hand, and a micro-prudential supervision policy that is still fragmented at the level of the Member States, on the other.

Progress has also been made regarding the Single Resolution Mechanism (SRM), the other key element of the banking union project. In this case, however, aspects of great importance have still to be specified, including most notably the design of financial backstops. Banking union marks a milestone on the road to a genuine economic and monetary union, and getting its final design right will determine whether the links between banking and sovereign risk, which continue to pose a major obstacle to overcoming financial market fragmentation in the area and, consequently, to anchoring economic recovery, can be conclusively broken.

… and by the ECB's expansionary monetary policy, in a setting in which inflation stands below and some way off its reference level of 2%

Greater economic buoyancy in the euro area also has the strongly accommodating monetary policy applied by the ECB since the onset of the crisis to thank. This course of action was deepened in 2013. On the conventional front, two new cuts in official interest rates were made, placing the rate on the main refinancing operations at an all-time low of 0.25%, and the rate on the deposit facility at 0%. Regarding unconventional measures, in addition to retaining abundant long-term liquidity provision, an active policy of forward guidance was pursued from the summer. Most specifically, the ECB's Governing Council has conveyed to the public its expectations that interest rates will hold at or below their current level over a prolonged period.

Monetary policy decisions have been taken in a complex setting in which inflation, after standing at 2% in January 2013, moved on a clearly declining trajectory over the year to settle below 1% both in the final stretch of the year and in early 2014. In conjunction with the forecasts by the ECB and by other analysts, these data shape a scenario in which the growth of prices might fall some distance below the threshold of 2% over a relatively prolonged period. Admittedly, long-term inflation expectations remain anchored at levels compatible with the price stability objective set, against a background of ample slack in the euro area economy; but the persistence of low inflation rates over a lengthy period of time increases the risk that expectations may be unanchored, posing a threat to the sustainability of the recovery and an added obstacle to the necessary absorption of the internal imbalances affecting the euro area (see Box 1.1). Accordingly, the ECB continues to maintain a high degree of monetary accommodation and has reiterated its readiness to take further measures, conventional and unconventional alike, if necessary.

In June, after the cut-off date for this Annual Report, the ECB adopted an extensive package of measures. These included fresh cuts to its key interest rates; targeted long-term refinancing operations geared to promoting credit; the extension of fixed rate full allotment tender procedures at least until December 2016; the suspension of the fine-tuning operation sterilising the purchases under the Securities Market Programme, and the intensification of the preparatory work relating to outright purchases in the asset-backed securities market.

Financial conditions in the euro area have clearly improved, although it is not yet possible to talk about normality

The main indicators show an evident lowering of the degree of tension of the area's financial conditions in the area. Risk premia, volatilities and credit ratings have generally improved significantly during 2013 and in 2014 to date (see Chart 1.2). Resilience in the face of political or geo-strategic shocks has also been greater than in previous phases. However, restoring normality is proving slow, is far from complete

Inflation slowed markedly in 2013 both in Spain and in the euro area as a whole, with the respective year-on-year changes in the HICP in December standing at 0.3% and 0.8%. This trajectory has continued in 2014 to date. Projections by private analysts, official agencies and those implicit in financial market prices assume inflation will hold at very low levels for a prolonged period (see accompanying table 1). Specifically, for the euro area as a whole, the projections available point to a very slow return to rates close to 2% and to a negative Spain/euro area differential. However, longer-term inflation expectations remain anchored at levels slightly below the 2% reference (see Panel 1).

The recent downward course of inflation is due to the disappearance of certain temporary factors, linked to fiscal consolidation, and to the trend of energy prices and the exchange rate, although factors of a more permanent nature are also in play. The latter include most notably the moderation of unit labour costs and significant excess slack. The influence of these factors has been greater in Spain than in the euro area as a whole, owing to the adjustment under way here to regain the competitiveness lost during the expansionary phase.

Against this background of very low inflation, analysis of the scenarios in which price declines and, ultimately, deflationary processes – with across-the-board and sustained falls in prices – might arise has become important. In this respect, the diffusion indicators show that price declines are not overly widespread either in Spain or the euro area (see Panel 2)[1], though they have increased in 2013, albeit without yet reaching the highs observed in late 2009 and early 2010. Unlike that period, however, the recent slowdown in prices is proving especially significant in the case of services prices which, as they are particularly labour-intensive, have been more affected by wage moderation and productivity gains.

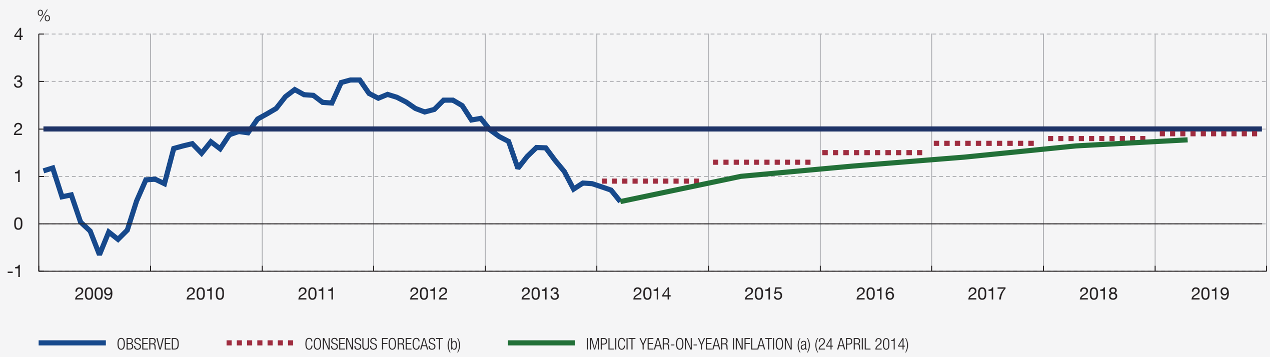
In any event, when evaluating scenarios of sustained price declines a distinction must be drawn between the consequences for the euro area as a whole and for Spain. A fall in a euro area member country's prices might reflect the adjustment of relative prices needed to correct some of its imbalances. In that respect,

1 These indicators measure the proportion of expenditure-weighted and seasonally adjusted HICP items that show month-on-month declines.

1 INFLATION FORECASTS

Spain	2014	2015	2016
Consensus Forecast (April 2014)	0.3	1.0	1.5
European Commission (February 2014)	0.3	0.9	—
IMF (April 2014)	0.3	0.8	0.9
Euro Area			
ECB (March 2014)	1.0	1.3	1.5
Consensus Forecast (April 2014)	0.9	1.3	1.5
European Commission (February 2014)	1.0	1.3	—
IMF (April 2014)	0.9	1.2	1.3
Inflation swap contracts (24 April 2014)	1.0	1.2	1.4

1 LONG-TERM INFLATION EXPECTATIONS



SOURCES: Eurostat.

a Obtained from inflation swap contracts.
b Consensus Forecast forecasts from the third year onwards are only updated in April and October each year.

shocks originating in positive developments on the supply side entail benign price declines, as they are accompanied by higher levels of output and employment. Notable among these are those linked to structural reforms that improve the economy's productivity or heighten competition in product and factor markets.[2] Conversely, contractionary demand-side shocks may be more harmful, bringing together declines in prices and output which, if they feed back into one another, may prompt a deflationary spiral.

A generalised and persistent situation of price declines may dampen activity through various channels. Firstly, expectations of sustained low inflation exerts upward pressure on the expected real interest rate, which leads to private spending being deferred. Moreover, if – as is currently the case – nominal interest rates are close to zero, the capacity of conventional monetary policy to correct this effect is very limited. Secondly, as debt contacts are specified in nominal terms, falls in prices increase the real-terms cost of servicing such debt. That is particularly significant in countries such as Spain, where the volume of household and corporate debt is still high. Lastly, and more generally, very low inflation across the euro area hampers an individual country achieving gains in competitiveness relative to the area as a whole.

In any event, a very moderate inflation scenario may trigger particularly adverse effects if it unanchors long-term inflation expectations, thereby reducing the effectiveness of monetary policy and increasing real interest rates. Nonetheless, at present European households do not seem to expect either that consumer prices will fall (see Panel 3) or that long-term inflation expectations will be far off 2%.

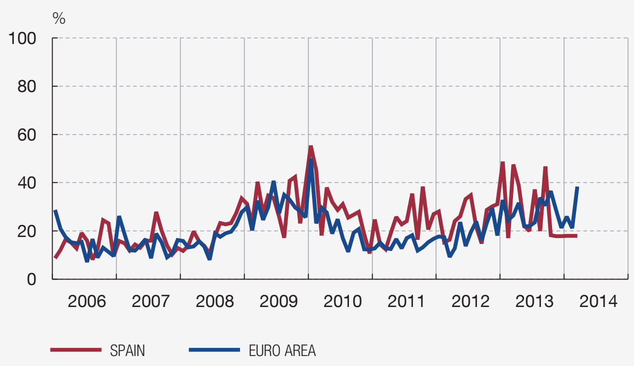
2 See J. Andrés, Ó. Arce and C. Thomas (2014), *Structural reforms in a debt overhang,* Documento de Trabajo del Banco de España (forthcoming), and Box 1.2 in this Chapter.

The Banco de España dynamic stochastic general equilibrium model BEMOD, estimated for Spain and the rest of the euro area, provides for the analysis of the probability of different price scenarios materialising in relation to Eurosystem predictions. In particular, an assessment can be made of the probability with which moderate inflation (lower than 1% on average in 2014) or price falls of some intensity (a rate of change below -1%) might be observed.[3] The estimations show that scenarios of inflation below 1% are highly likely, especially in Spain, while the scenarios of price declines of over 1% are fairly unlikely. In addition, to assess the extent to which a slightly higher level of inflation across the euro area may smooth the competitive adjustment needed in Spain, an alternative exercise has been conducted. In it, as the result of a more expansionary monetary policy, inflation in the euro area increases by 50 bp in 2014 and 2015, drawing closer to the 2% target in late 2015. Under this new scenario, there is an appreciably lower probability that Spanish inflation will be below -1%.

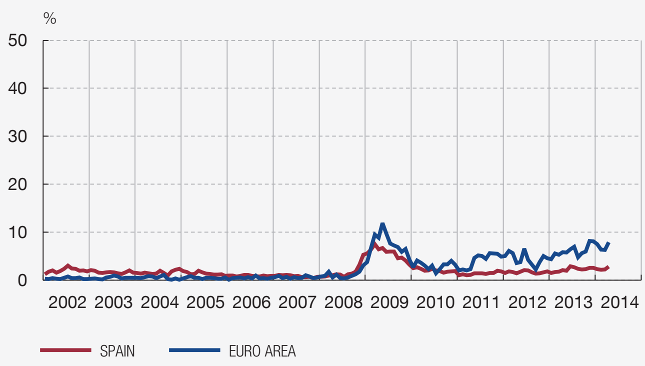
In short, the evidence available would indicate that inflation is going to remain at very low levels over a prolonged period, but that the probability of a costly deflation process arising at present is limited. In any event, the adjustment still required in terms of competitiveness in some economies in the area, such as Spain's, would be assisted if the euro area inflation rate were to converge towards its long-term target at a somewhat brisker rate pace than is currently anticipated.

3 In interpreting the results it should be borne in mind that the simulations performed incorporate the zero lower bound constraint whereby nominal interest rates cannot be negative, although they do not consider the possibility of implementing non-conventional monetary policy measures. In addition, the exercises presented hereafter do not take into account the debt deflation channel, meaning that the total cost of the generalised and sustained declines in prices might be being underestimated. Lastly, bootstrapping techniques are used to take into account the dependence of the structural shocks.

2 DIFFUSION INDICATORS. PERCENTAGE OF EXPENDITURE (a)



3 PRICE DECLINE EXPECTATIONS IN THE NEXT TWELVE MONTHS
European Commission surveys

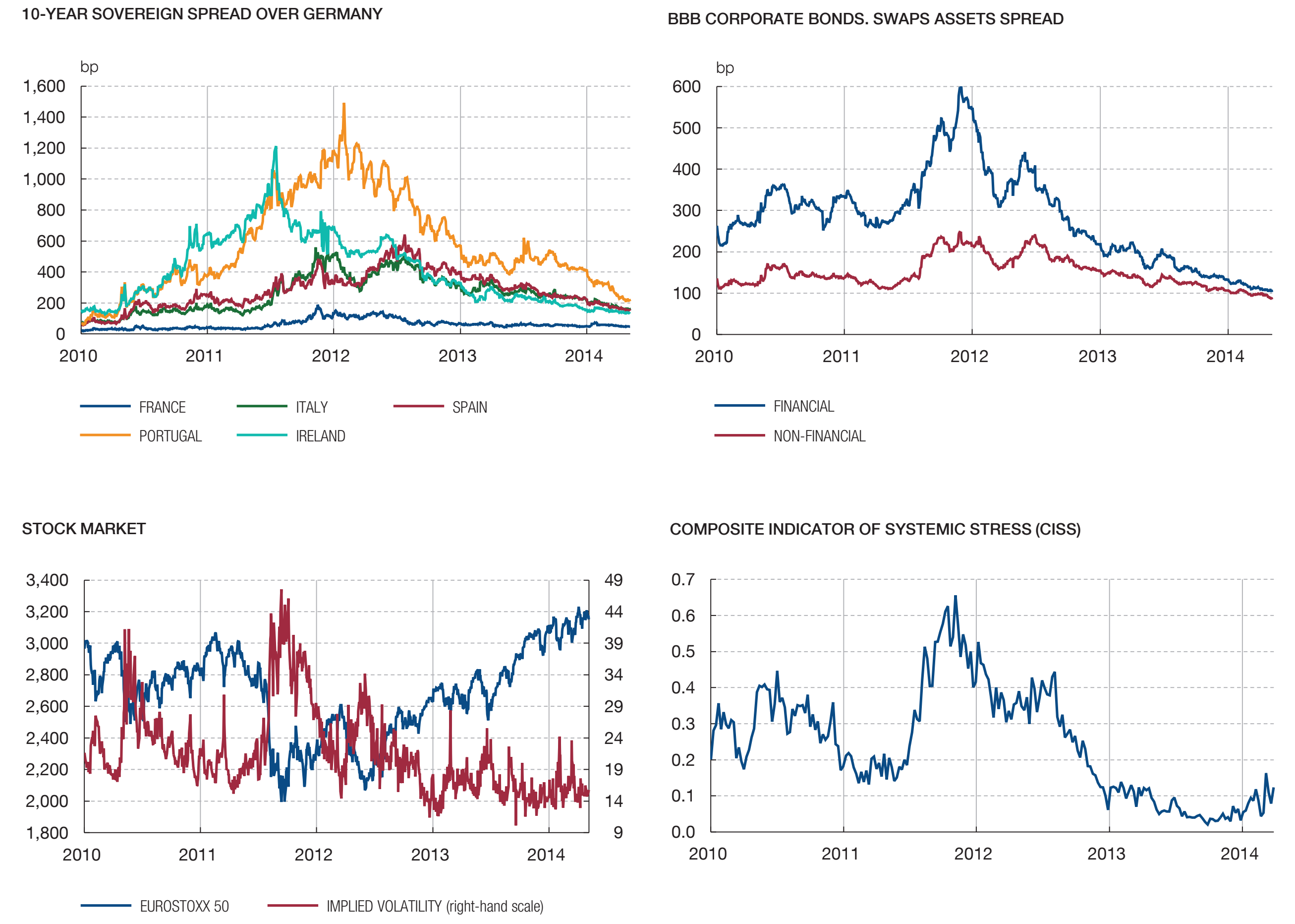


SOURCES: Banco de España and European Commission.

a Calculated with seasonally adjusted series.

EURO AREA FINANCIAL CONDITIONS

CHART 1.2



SOURCES: ECB, JP Morgan and ESRB.

and remains exposed to the risk of further shocks. Adverse developments in credit, and in particular lending extended to firms, affects not only the economies most severely punished by the crisis but also the euro area as a whole, further hampering the process of economic recovery. Moreover, the persisting differences in financing costs across the various Member States still reflect a degree of financial market fragmentation that is not compatible with the normal functioning of a monetary union and which prevents expansionary monetary impulses effectively reaching the areas where they are most needed.

3 Adjustment and recovery in the Spanish economy

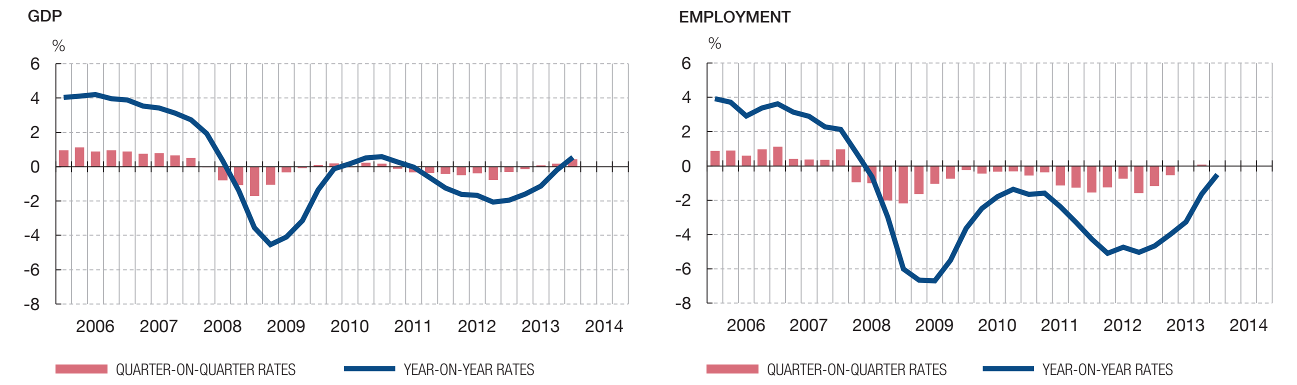
The improvement in the external environment and the abatement of financial instability were conducive to the recovery in the Spanish economy in the second half of 2013

The Spanish economy embarked on a gradual recovery in 2013 and, in Q3, it exited the recession that had begun two years earlier, posting modest increases in GDP (see Chart 1.3). This change in trajectory, which has continued into the opening months of 2014, was helped also by the easing in financial tensions and by a gradual improvement in perceptions about the labour market situation, which contributed to lessening uncertainty and increasing confidence. Adding to this was the greater gradualism in the budgetary adjustment policy, following the European Council's July decision to put back two years the date for placing the budget deficit below 3% of GDP. That entailed a relaxing of the deficit target by 2 pp mid-year, from 4.5% of GDP to 6.5% of GDP.

Despite moving on an improving course over the year, GDP fell by 1.2% in 2013, partly as a result of the carry-over effect arising from the marked decline in activity in late 2012.

SPAIN: GDP AND EMPLOYMENT

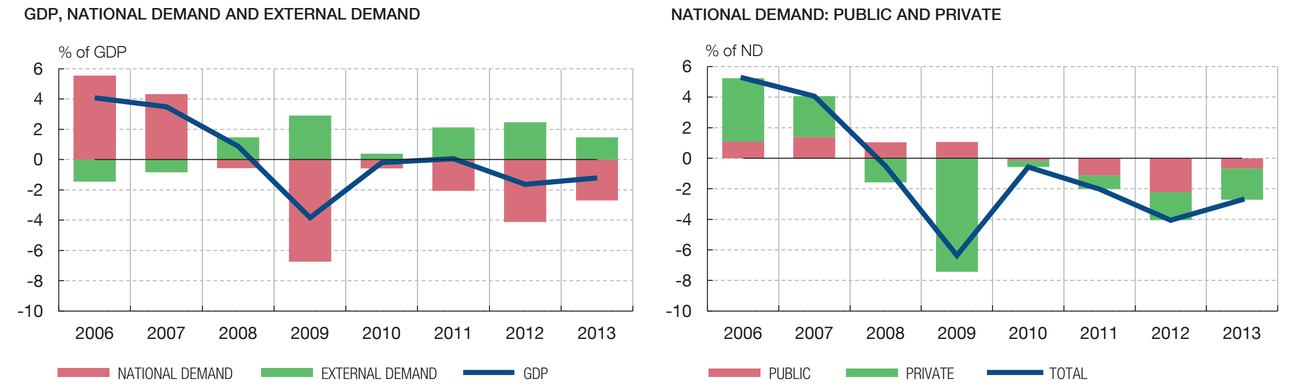
CHART 1.3



SOURCES: INE and Banco de España.

GDP AND NATIONAL DEMAND. CONTRIBUTIONS TO GROWTH

CHART 1.4



SOURCES: INE and Banco de España.

From the expenditure standpoint, national demand fell by 2.7% while the external sector made a positive contribution of 1.5 pp, thereby mitigating, for the sixth consecutive year, the impact of the contraction in domestic spending on activity (see Chart 1.4).

The rebalancing of external and national demand was underpinned by the recovery in investment in equipment and in household consumption

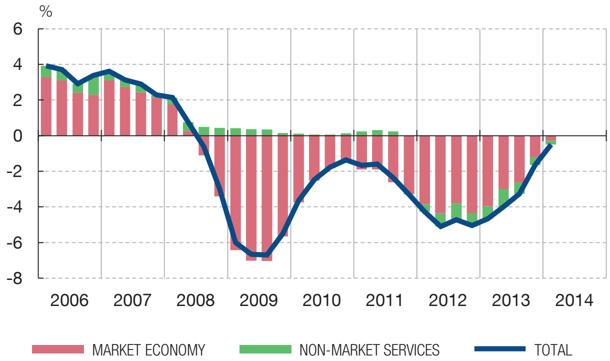
The pace of the contraction in national demand also lessened over the course of the year. Among the private components of domestic spending, investment in equipment began to pick up earlier, right at the start of the year, followed by household consumption as from Q2. In turn, residential investment posted negative figures throughout the year, albeit at an increasingly diminished pace, which took its rate of annual decline to 8%, and its percentage expressed in terms of GDP to 4.4%, 65% down on its 2006 peak. Finally, the negative contribution of the public components of expenditure (government consumption and public investment) to activity lessened against the background of the easing in fiscal requirements mid-year.

The improvement in business investment was confined to the capital goods component, which increased by a moderate 2.2%, assisted by the greater momentum of exports, the reduction in uncertainty, the incipient alleviation of adverse financing conditions and, lastly, the further restructuring of non-financial corporations' financial positions, whose net lending capacity rose to 4.3% of GDP in 2013. The internal resources generated by the surplus in saving relative to investment are helping correct the excessive debt that prevailed in recent years.

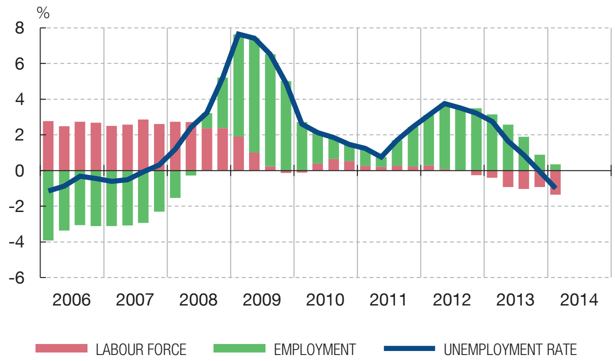
EMPLOYMENT AND UNEMPLOYMENT

CHART 1.5

EMPLOYMENT (a)
Contributions of employment by sector of activity to y-o-y change



UNEMPLOYMENT RATE (b)
Contributions of labour force and employment to y-o-y change



SOURCES: INE and Banco de España.

a Quarterly National Accounts full-time equivalents.
b The EPA (Spanish Labour Force Survey) series follow 2005 methodology and are updated with the 2011 census.

Household consumption picked up in the second half of 2013, although for the year on average it posted a fall of 2.5% following two years of declines, having worsened to a particularly acute extent in the final stretch of 2012. The recovery in consumption over the course of the year came about against the background of the slowing decline in disposable income, which was more marked in real terms owing to the moderate inflation in 2013, and the more favourable trend of households' financial wealth. The pronounced declining trajectory of the saving rate from 2009 was interrupted, and it posted a level similar to that of the previous year (10.4% of disposable income) and similar, too, to its historical average.

Net external demand contributed once again to lessening the contractionary impact of domestic demand on output, although it moved on a declining trajectory

The positive contribution of net external demand to GDP amounted to 1.5 pp. This was the result of buoyant exports, as imports stabilised owing to the improvement in final demand after having declined heavily in 2012. Export growth was driven both by goods sales to the rest of the world, which expanded more than their target markets did, and by exports of tourist services, in an exceptional year for the sector in which tourist revenues were at an all-time high. Gains in competitiveness played a very significant role in both developments, as is discussed below.

That said, the contribution of the external sector was smaller than that of the two previous years, and it moved on a declining trajectory as exports progressively slowed, following the weakening of the emerging economies, and as imports from the rest of the world rose, in step with the pick-up in the components of final demand with a greater import content (exports and investment in equipment).

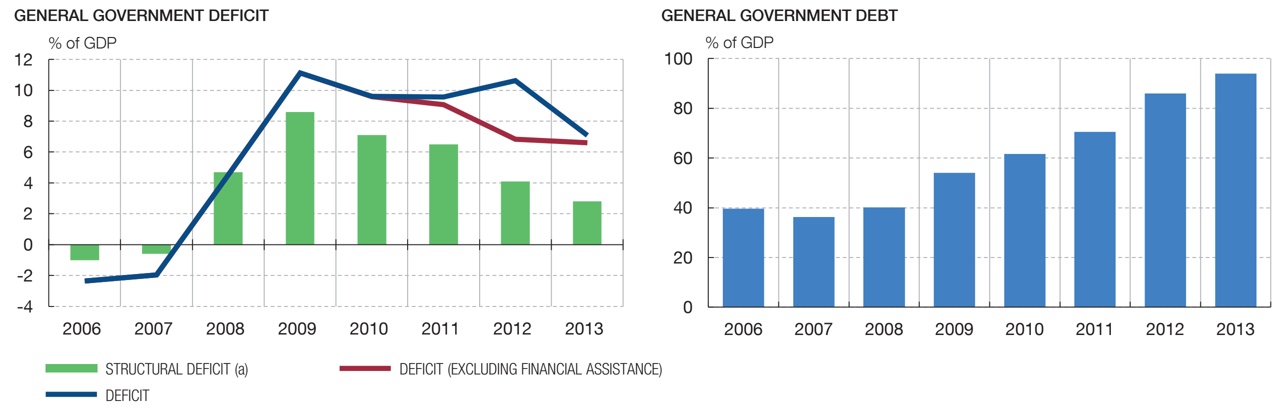
The sequence of the recovery in the different components of expenditure – first exports, next business investment and lastly household consumption – provides a good starting point for anchoring the recovery. However, entrenching the recovery requires certain conditions be met so that household and business spending may grow in a sustained manner, and in the current circumstances that depends essentially on the dynamism of employment.

The rate of decline in employment lessened during the year, until turning marginally positive in the final months, for the first time since 2008 Q2...

The rate of decline in employment eased in 2013 to 3.4% (4.8% the previous year), this rate being much influenced in any event by the adverse behaviour of employment in the final stretch of 2012. Indeed, the pace of job destruction gradually eased as the year unfolded, to the point of showing marginal job creation in the closing months of the year, for the first time since 2008 Q2. This progressive improvement was fairly generalised

GENERAL GOVERNMENT DEFICIT AND DEBT

CHART 1.6



SOURCES: IGAE and European Commission (AMECO).

a European Commission estimate (AMECO, spring 2014).

across the sectors of activity, although it was more marked in certain market services, and has continued in 2014 to date.

... and the unemployment rate began to turn down as from Q1, ending the year at 25.7%. The level of unemployment, its composition and its persistence indicate that a far-reaching adjustment must be made

The unemployment rate moved on to a declining trajectory in Q1, from a level of 26.9% of the labour force (a figure encompassing somewhat more than 6 million unemployed) to 25.9% in the opening months of 2014. These developments in unemployment were assisted by the contraction of the labour supply, which fell by 1.1% (after stabilising the previous year) owing to the decline in the working-age population and to a slight reduction in the participation rate, for the first time since the start of the crisis. The decline in the labour force was more acute among foreign nationals (-5.5%), although it also affected nationals for the first time (–0.6 %) (see Chart 1.5).

However, at the close of the year, the composition of unemployment in terms of age and skills groups had scarcely altered, meaning that the highest unemployment rates were among the less-skilled youths. In turn, the slight rise in unemployment exit flows in the second half of 2013 was concentrated among those unemployed for less than a year, whereby the incidence of long-term unemployment moved on a rising trajectory throughout the year, reaching a rate of 61.6% in Q1 this year. The level of unemployment, its composition and its persistence are indicative of the considerable scale of the problem to be resolved.

For the recovery to firm requires that the correction of the imbalances still in place be completed

The scenario of recovery that has finally taken shape over the past year, after overcoming the sharp double-dip recession, is closely linked to progress in the correction of the imbalances that place the Spanish economy in a position of extreme vulnerability to the international crisis and, particularly, to the euro area sovereign debt crisis. From this starting point, the sustainability of demand and the firming of the recovery depend on job creation gaining in strength and on completing the adjustments still pending in respect of the remaining imbalances.

3.1 FISCAL CONSOLIDATION

The intensity of the budgetary adjustment eased mid-year following the European authorities' decision to tailor deficit targets more to cyclical circumstances

Fiscal consolidation continued in 2013, with an initial overall general government deficit target of 4.5% of GDP, entailing a reduction of 2.3 pp on that of the previous year (6.8% of GDP, once the assistance to financial institutions is stripped out). Mid-year, however, the European Council agreed to better tailor deficit targets to the weakness of the cyclical position, providing for greater gradualism in implementing the policy of budgetary adjustment. In Spain, this decision meant a relaxing of the deficit target for 2013, which was set at 6.5% of GDP. For the 2014-2016 period, the new targets were set at 5.8%, 4.2% and 2.8% of GDP, respectively.

The updated Stability Programme submitted by the Government to the European Commission on 30 April confirmed these targets, though it considered a somewhat more ambitious reduction in the general government deficit in 2014, setting it at 5.5% of GDP.

Acting as a reference point for budgetary conduct were the commitments to reporting and monitoring emanating from the current framework of fiscal rules

The year 2013 was the first full one in which the mechanisms of the Law on Budgetary Stability and Financial Sustainability for the monitoring of the budget outturn, and those geared to ensuring compliance with the targets set for all tiers of government, began to be applied. Furthermore, an extension was made in 2013 to the payments to suppliers plan, which ended in February 2014, and which injected somewhat over €43 billion from mid-2012. Lastly, the close of the year saw the completion of the framework of national fiscal rules, with the creation of the Independent Authority for Fiscal Responsibility.

The general government deficit shrank to 6.6% in a complex macroeconomic setting, marked by cyclical weakness and by the rise in interest payments

In step with these conditioning factors, the fiscal adjustment drive continued in 2013 through a reduction in the primary structural balance of the order of 1.6% of GDP, which was less intense than in previous years (3 pp in 2012). Reducing the deficit was once again hampered by cyclical weakness and by the growing weight of interest payments (which climbed to 3.4% of GDP), as a result of which net general government borrowing shrank to 6.6% of GDP (a figure net of the assistance to financial institutions), 0.1 pp higher than the target set in July (see Chart 1.6).

In terms of sub-sectors, the reduction in the budget deficit reflected the adjustment by the regional and local governments (by 0.3 and 0.2 pp of GDP, to balances totalling -1.5% and 0.4% of GDP, respectively), with a higher surplus in the latter case than that programmed when the targets were set. In turn, the aggregate central government and Social Security System target deficit was exceeded by 0.3 pp of GDP, standing at the close of the year at 5.5% of GDP. As regards components, the slight reduction in net general government borrowing came about chiefly as a result of the increase in indirect tax revenue following the hike in VAT the previous year and the introduction of other, environment-related taxes, although their impact was less than initially foreseen. By contrast, no headway was made in reducing public spending since the increase in interest payments and in welfare benefits could not be offset by the adjustment of certain government consumption and capital expenditure items. In turn, the public debt ratio rose significantly, from 85.9% of GDP in 2012 to 93.9% last year.

3.2 RECOVERY IN COMPETITIVENESS

There was fresh momentum to the recovery in competitiveness in 2013 as a result of the easing in labour costs and in prices

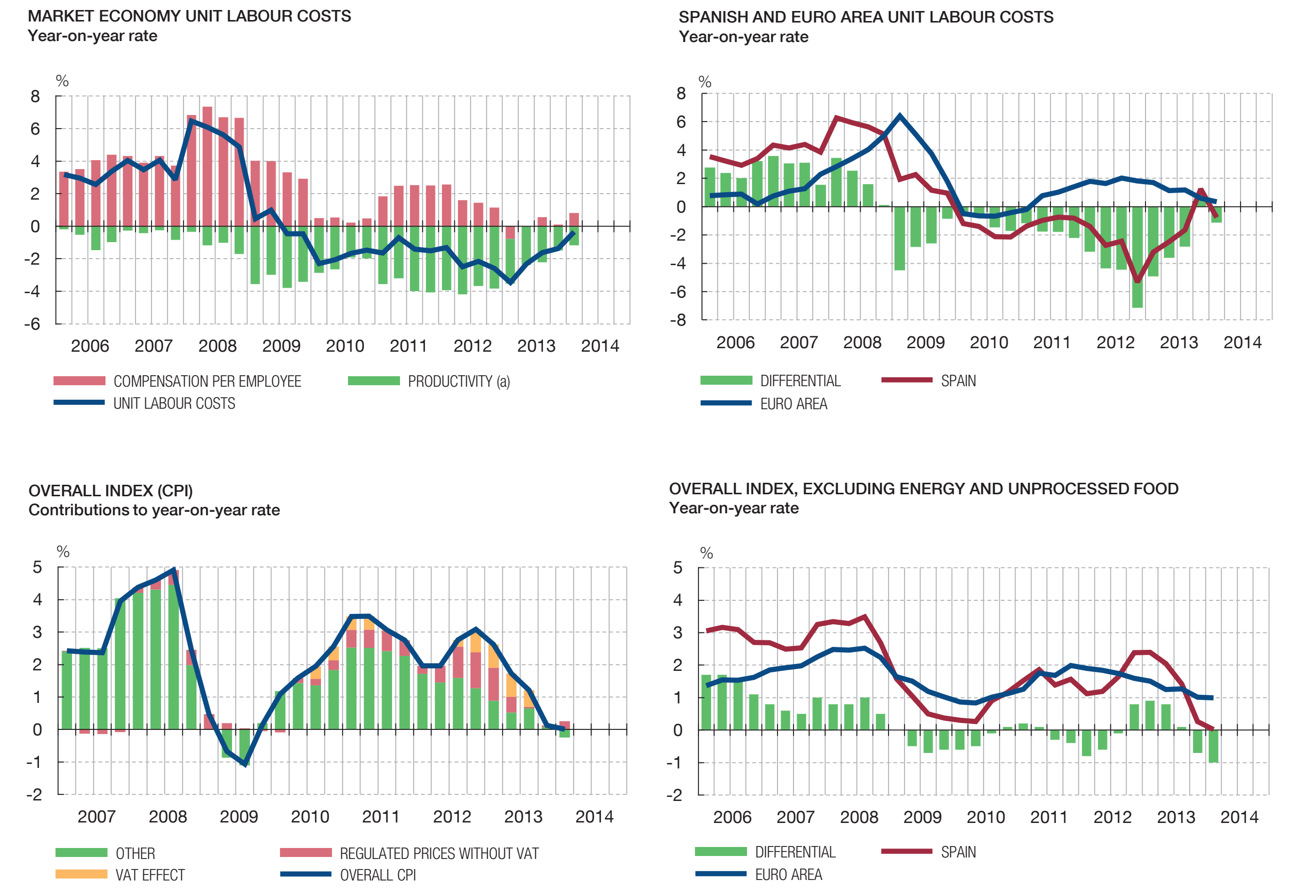
Market economy unit labour costs (ULCs) declined by 2.2% in annual average terms, the result of the stabilisation of compensation per employee in the market economy and an increase in productivity lower than that of the previous year (see Chart 1.7). The decline in economy-wide ULCs was somewhat lower (-1.6%) owing to the base effect that prompted the fall in public-sector wages in December 2012. Overall, these developments entailed the closing of the gap that opened up between the respective Spanish and euro area rates of change of labour costs during the expansionary phase, which had resulted in heavy losses in competitiveness. Unlike in the early years of the crisis, in 2013, as had occurred the previous year, the correction of ULCs turned more on the adjustment of labour costs than on productivity gains, since the latter gradually fell away in step with the diminishing pace of job destruction.

Labour costs reflected the pattern of greater wage moderation, derived in part from the increase in domestic flexibility provided by the new labour market framework

In 2013, labour costs intensified the path of wage moderation that had progressively become discernible in 2012, possibly reflecting the greater sensitivity over the setting of wages to the specific situation of firms in response to the broader possibilities for internal flexibility generated by the entry into force of the labour reform. Under collective bargaining, fewer wage settlements and a reduction in the number of agreements including indexation clauses and in their amount were observed, while wage drift (the difference between wage increases in collective agreements, adjusted where appropriate for indexation clauses,

LABOUR COSTS AND INFLATION

CHART 1.7



SOURCE: Eurostat and Banco de España.

a Year-on-year rates with sign changed.

and the rate of change of compensation per employee) turned negative once more. This latter variable may be viewed as an indirect indicator of the effect of other aspects of the labour reform, in which exact information is not available (cases in point may be the effective use of the possibilities of opt-outs or the amendment of working conditions). As a result, average real wages fell slightly.

And inflation held at a very low level, as the effects of the rises in administered prices and in indirect taxes in 2012 were progressively stripped out

The inflation rate fell markedly during the year, as the base effects of the rise in certain administered prices and the hike in VAT in September 2012 were progressively removed. Stripping out these effects, a situation of practical stagnation in the overall level of prices prevailed throughout the year, and has continued in 2014 to date.

There has been an increase in the sensitivity of cost- and price-setting to the cyclical position...

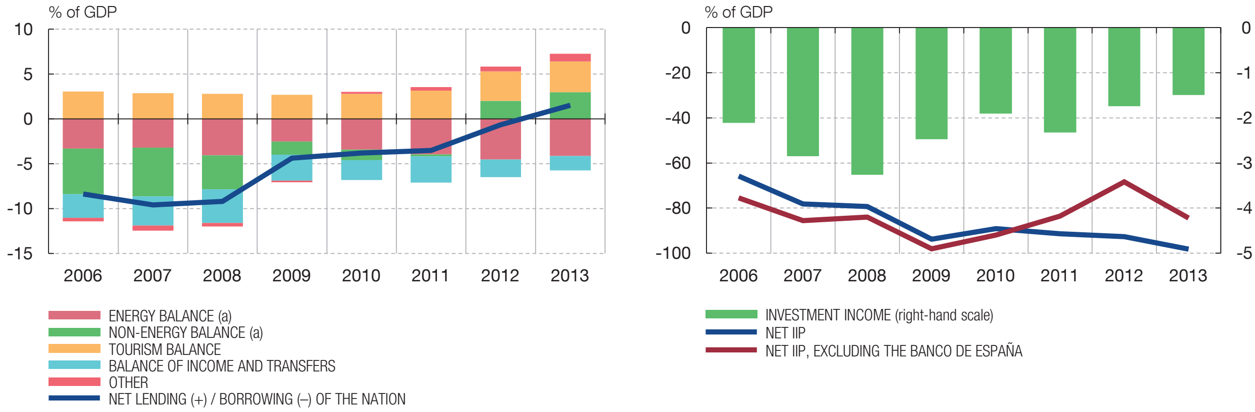
This change in price dynamics reflects an increase in the sensitivity of price-setting to cyclical conditions and is particularly significant in the case of services, where the slowdown in prices is proving more pronounced, after having been the central point of inflationary tensions in the past. This appears to confirm a greater alignment of sale prices to costs borne and to the specific conditions of the business cycle.

... and the recovery in business margins has continued

The high degree of financial tension in recent years would appear to have bolstered the pick-up in margins at this phase of the cycle by inducing certain companies to alleviate the effects arising from tight credit standards by generating funds within the business

NET LENDING (+)/BORROWING (–) OF THE ECONOMY AND INTERNATIONAL INVESTMENT POSITION

CHART 1.8



SOURCES: INE, Customs and Banco de España.

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

The widening of margins would have been assisted by the prevalence of an insufficient degree of competition in certain sectors. In any event, the generation of funds within businesses should be conducive to the incipient investor cycle gaining momentum.

Overall, the prices differential has turned favourable for the Spanish economy

Overall, in recent years there has been a noticeable reduction in the Spain-euro area inflation differential, which has narrowed from 1 pp on average in the 1998-2007 period to 0.2 pp in the downturn. The narrowing of this gap has been of a similar intensity in terms of core inflation. Since September last year, Spanish inflation has stood systematically below that of the euro area (with an average differential of -0.6 pp), ensuring the continuity of the adjustment of relative prices even under the difficult conditions created by low European inflation (see Box 1.1).

The ongoing internal devaluation is exerting a very favourable effect on the Spanish economy's terms of trade

The recovery in competitiveness had a positive impact on foreign trade, whereby in 2013 a current account surplus was posted for the first time since 1997 (0.8% of GDP compared with a deficit of -1.2% of GDP in 2012). This result was in response to an improvement in virtually all the current account components, although most notably so, as has been the case since 2007, in the non-energy trade balance, which marks a most significant advance in the necessary process of external rebalancing (see Chart 1.8). That said, the high dependence on imported energy continues to exert an adverse influence on the external balance. In terms of difficulties, mention should also be made of the persistent deficit on the income balance, linked to the high level of the International Investment Position (IIP). To attain lasting external equilibrium it is thus necessary for the surplus on the trade in non-energy goods and in services to offset the deficits on the imported energy and income balances.

3.3 THE RESTRUCTURING AND CLEAN-UP OF THE BANKING SYSTEM

The crisis severely impacted a sector that was oversized and highly exposed to real estate activity…

Chapter 2 of this Report analyses in detail the implications of the increase in the Spanish economy's debt prior to the crisis, which in a heavily banked system such as Spain's took the form of an expansion in credit institutions' balance sheets and likewise translated into a high concentration of risks in productive activities linked to the real estate market. Both factors (balance sheet expansion and risk concentration) placed banks in a position of vulnerability to adverse macroeconomic shocks, and in particular to those that might affect the real estate market to a greater extent. The incidence of the crisis on the banking system's financial and wealth position was very mixed from bank to bank.

… making it necessary to set in train a restructuring, recapitalisation and clean-up of the banking system and a reform of its regulatory and supervisory frameworks

To face up to the effects of the crisis, a far-reaching reform of the banking system was undertaken. The reform has progressively adjusted to ensuing events and has been structured around four major courses of action: the restructuring of the system, its recapitalisation, the clean-up of balance sheets and the reform of the regulatory and supervisory frameworks.

Some of these measures required the release of a sizeable volume of public funds at a time at which financial tensions and the subsequent degree of market fragmentation meant they could not be obtained at reasonable prices on the markets; accordingly, the Span ish Government formally requested financial assistance in the summer of 2012, which was granted through a sectoral European programme for the recapitalisation of part of the banking system. The programme envisaged the drawdown of a maximum amount of €100 billion, although only €41 billion were used, and it was formalised with the signing of a Memorandum of Understanding (MoU) that detailed the main measures that have shaped the reform process since.

In early 2014, the European programme for bank recapitalisation was successfully concluded, having entailed far-reaching changes for the size and financial position of the system...

The authorities' positive assessment of the fulfilment of the conditions of the MoU meant that the programme could be considered as concluded in early 2014. The culmination of this stage marks the completion of a process that has deeply transformed the Spanish banking system.

Compared with the situation in 2007, the number of credit institutions has fallen by 17%; that of their offices, by 22%; and that of employees in the sector, by 15%. These adjustments, which under the timetables envisaged for certain banks' restructuring plans will be pursued further, have been particularly centred on the savings banks, which were much affected by the crisis and saw their capacity to respond greatly limited by their particular legal status. As a result, savings banks had to transfer their financial intermediation activity to banking institutions. The net exposure of the system as a whole to the real estate sector was more than halved, further to a substantial increase in provisions required (Royal Decree-Laws 2/2012 and 18/2012 entailed an increase in provisions equivalent to approximately one-fifth of prior net exposure) and, in the case of institutions that receive public aid to recapitalise, through the transfer of claims on real estate developers and foreclosures to a new and mostly privately held institution created to this end under the framework of the MoU: Sareb.

Banks' effort in terms of recapitalisation was also significant. In 2012 a stress test was performed by an independent external consultancy to estimate the funds needed to reinforce the capital of each individual institution. 17 groups of institutions participated, representing 90% of the system's total loans, and at ten of them (with a relative weight in the market for credit of 34%) an increase in capital was required. Two groups were able to cover these requirements by their own means and the remaining eight were able to count on public aid provided by the FROB and financed through the European Stability Mechanism (ESM), under the financial support programme for bank recapitalisation. Adding these contributions to those made in prior years by the FROB and the Deposit Guarantee Fund for Credit Institutions (FGDEC by its Spanish name), the total amount of public injections in the form of capital during the crisis totalled €61 billion. Additionally, through private measures, banks raised their capital by a further €53 billion, meaning that the recapitalisation drive undertaken through public and private means amounted to over 11% of GDP. Private measures included most notably burden-sharing exercises (involving hybrid instrument and subordinated debt-holders).

… and reforms of its regulatory and supervisory framework

There has also been a major reform of banking regulation and supervision with the ultimate aim of reducing the risk of future crises and of better protecting taxpayers and the economy from their potential consequences. A new bank crisis management and resolution framework has thus been established. The resulting arrangements provide for more flexible and nimble intervention by the Banco de España, they define the competencies of the FROB and the FGDEC, and they broaden the range of tools available at all stages of the crisis. The legal framework for savings banks has also been reformed, as it was revealed by the crisis to have certain key shortcomings, and stricter capital requirements have been imposed on them, setting for 2013 and 2014 a minimum level of core capital of 9%, above the minimum threshold laid down by European capital regulations, which have adapted Basel III. The reform also includes stricter requirements for reporting on exposure to the real estate sector and on refinancing operations, so as to increase the degree of banking transparency. Finally, supervisory procedures have been reviewed and reformed, with a series of organisational changes being introduced.

Reducing the State ownership share in the system, the completion of the Banking Union and the macroeconomic outlook nonetheless pose new challenges for the sector

The ongoing exit by FROB (and by FGDEC) from the capital of the State-supported banks also progressed during 2013 and has continued in 2014 to date. These two official funds have now ceased to be stakeholders in Banco de Valencia, Banco Gallego and NCG, and 7.5% of the capital of Bankia was also sold to institutional investors – non-residents in the main – early this year. The sale of shares still in public hands is, in any event, one of the challenges that will need addressing.

Likewise, the start-up of the Banking Union in Europe and the subsequent integration of banks and of the national supervisory authority into the SSM and the SRM poses organisational challenges not only for Spanish banks – and for the Banco de España itself – but also for all Eurosystem banks. This is the case too for the comprehensive assessment to which European banks as a whole are being subjected and which includes a new stress test, which the ECB is conducting in collaboration with the European Banking Authority and with the participation of the national supervisory authorities.

Finally, the Spanish economy's short- and medium-term growth outlook makes for a complex scenario for banks, which will be obliged to gain in efficiency and competitiveness in a setting in which progress towards the Banking Union may well be expected to heighten the degree of competition within the area. Here, too, banks will have to continue reinforcing their capital in response to the greater demands of regulators and investors.

3.4 THE PROGRESSIVE NORMALISATION OF THE FINANCING OF THE ECONOMY

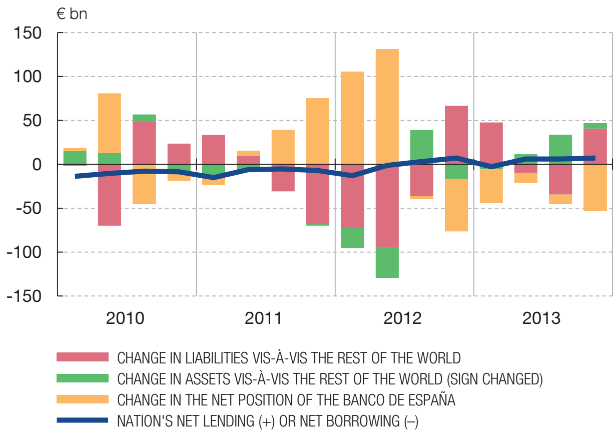
The easing of tensions in the euro area and the headway on the adjustment of the Spanish economy have been conducive to improved financing conditions.

In conjunction with the easing of tensions and European markets, headway in the adjustment of the Spanish economy favourably influenced investors' confidence and translated into substantial improvements in financing conditions in Spain for credit institutions, for general government and, though comparatively to a lesser degree, for households and firms. The costs of European wholesale market funds, on which the Treasury, banks and major national corporations draw, fell. So too, though more moderately and in the final stretch of the year, did funds from bank loans. In terms of amounts, the decline in private-sector financing slowed and signs were detected of the restoring of financial flows towards companies that are in a sound position and which, therefore, are better placed to efficiently use such funds. Along these same lines, three of the main rating agencies upgraded Spanish sovereign debt in the opening months of 2014. That said, euro area financial market fragmentation has not yet been eliminated, whereby these conditions continue to be overly strict for the strongly accommodating stance of the single monetary policy and for the specific circumstances of the Spanish economy's incipient recovery.

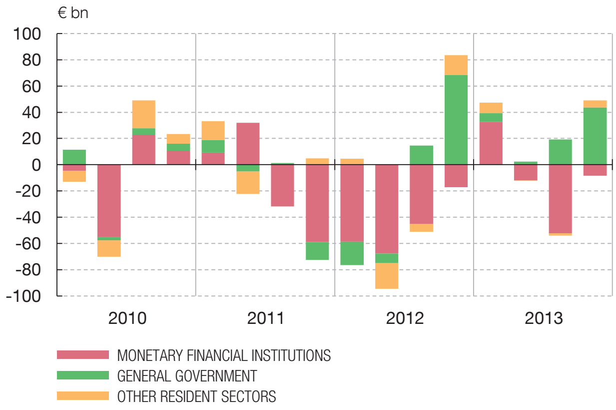
BALANCE OF PAYMENTS FINANCIAL ACCOUNT

CHART 1.9

NET TRANSACTIONS



NET CHANGE IN LIABILITIES, BY SECTOR (a)



SOURCE: Banco de España.

a Excluding the Banco de España.

External funding flows picked up, but will have to continue to do so sustainedly in order to redress the high debt position vis-à-vis the rest of the world

The pick-up in investor confidence is also visible in the Spanish economy's external funding flows (see Chart 1.9). Leaving aside the compensatory role the Banco de España balance sheet plays in this respect, the figures from the balance of payments financial account show how, following the outflow of funds totalling over €174 billion in 2012, there was a net inflow of funds of almost €88 billion in 2013. Net non-resident portfolio investment increased by almost €44 billion last year, compared with the contraction of over €55 billion observed a year earlier. However, these positive movements in terms of flows should not mask the fact that the Spanish economy's net debtor position vis-à-vis the rest of the world remains excessively high compared with peer countries and is a factor of vulnerability.

The adjustment of the International Investment Position will involve sustaining our positive trade balance with the rest of the world, as reflected by the figure recorded in 2013 for the nation's net lending (equivalent to 1.5% of GDP), the first time a positive figure has been posted since 1997. The turnaround was accompanied by a large-scale readjustment in the balances of the different institutional sectors. With the crisis, households and non-financial corporations have shown strong increases in their lending capacity, while general government borrowing needs have likewise grown substantially. From this sectoral perspective, the continuity of the adjustments under way should clearly also translate into an improved contribution of the general government sector to the economy's overall balance.

The adjustment of private-sector overindebtedness must also continue

In this respect, there was also progress in correcting private-sector overindebtedness in 2013, although the adjustment is, in comparative terms, proving somewhat slower. Chapter 2 in this Report is dedicated exclusively to the Spanish economy's debt and, in this connection, it offers a detailed analysis of how the adjustment is being made and of the main challenges it poses. As is explained, both the cyclical position of our economy and past experience suggests that credit must continue on the path of adjustment, but increasingly more moderately so, until the recovery firms and provides for a more dynamic increase in household and corporate income. Consequently, the main challenge in the short term is how to square credit containment at the aggregate level with a shift in the mix of inflows of fresh funds, with this shift enabling such flows to be allocated to those uses with a more positive impact on growth and employment. While the evidence available

MAIN INDICATORS OF THE SPANISH ECONOMY (a)

TABLE 1.1

	2008	2009	2010	2011	2012	2013
Demand and output (b)						
GDP	0.9	-3.8	-0.2	0.1	-1.6	-1.2
Private consumption	-0.6	-3.7	0.2	-1.2	-2.8	-2.1
Government consumption	5.9	3.7	1.5	-0.5	-4.8	-2.3
Gross capital formation	-4.2	-18.3	-4.2	-5.6	-6.9	-5.2
Equipment investment	-2.9	-23.9	4.3	5.3	-3.9	2.2
Construction investment	-5.8	-16.6	-9.9	-10.8	-9.7	-9.6
Housing	-9.1	-20.4	-11.4	-12.5	-8.7	-8.0
Other construction	-1.6	-12.2	-8.4	-9.2	-10.6	-10.9
Exports of goods and services	-1.0	-10.0	11.7	7.6	2.1	4.9
Imports of goods and services	-5.2	-17.2	9.3	-0.1	-5.7	0.4
Contribution of national demand to GDP growth	-0.6	-6.7	-0.6	-2.1	-4.1	-2.7
Contribution of net external demand to GDP growth	1.5	2.9	0.4	2.1	2.5	1.5
Employment, wages, costs and prices (c)						
Total employment	-0.2	-6.2	-2.3	-2.2	-4.8	-3.4
Employment rate (d)	65.4	60.8	59.7	58.8	56.5	55.6
Unemployment rate	11.3	17.9	19.9	21.4	24.8	26.1
Compensation per employee	6.9	4.2	0.4	1.3	0.2	0.7
Apparent labour productivity	1.1	2.5	2.2	2.3	3.3	2.3
Unit labour costs	5.7	1.6	-1.7	-1.0	-3.0	-1.6
GDP deflator	2.4	0.1	0.1	0.0	0.0	0.6
Consumer price index (12-month % change)	1.4	0.8	3.0	2.4	2.9	0.3
Consumer price index (annual average)	4.1	-0.3	1.8	3.2	2.4	1.4
Consumer price differential with the euro area (HICP)	0.9	-0.5	0.4	0.3	-0.1	0.2
Net lending (+) or net borrowing (-) and financial balance (e)						
Resident sectors: domestic net lending (+) or net borrowing (-)	-9.2	-4.4	-3.8	-3.5	-0.6	1.5
General government	-4.5	-11.1	-9.6	-9.6	-10.6	-7.1
General government (excluding aid to financial institutions)	-4.5	-11.1	-9.6	-9.1	-6.8	-6.6
Households and NPISHs	1.2	6.3	4.2	3.7	2.4	2.5
Companies	-5.9	0.4	1.6	2.3	7.5	6.1
Financial institutions	1.8	1.3	0.9	1.9	6.4	1.8
Non-financial corporations	-7.7	-0.9	0.7	0.3	1.1	4.3
Net international investment position	-79.3	-93.8	-89.1	-91.4	-92.7	-98.2
General government gross debt	40.2	54.0	61.7	70.5	86.0	93.9
Monetary and financial indicators (f)						
ECB minimum bid rate on MROs	3.9	1.2	1.0	1.3	0.9	0.5
Ten-year government bond yield	4.4	4.0	4.2	5.4	5.8	4.6
Synthetic bank lending rate	6.2	3.8	3.3	4.1	4.1	4.1
Madrid Stock Exchange General Index (Dec 1985 = 100)	1,278.3	1,042.4	1,076.5	971.8	767.5	879.8
Dollar/euro exchange rate	1.5	1.4	1.3	1.4	1.3	1.3
Nominal effective exchange rate vis-à-vis developed countries (g)	103.3	103.5	101.9	101.8	100.4	101.7
Real effective exchange rate vis-à-vis developed countries (h)	119.0	116.2	113.0	110.6	103.8	102.1
Real effective exchange rate vis-à-vis the euro area (h)	114.9	111.8	110.4	108.4	103.1	99.9
Households: total financing	4.4	-0.3	0.2	-2.4	-3.8	-5.1
Non-financial corporations: total financing	8.2	-1.4	0.7	-1.9	-6.1	-5.1

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 Annual average levels for the Madrid Stock Exchange General Index, interest rates and exchange rates, and rates of change for finanancial assets and liabilities.
g 1999 Q1 = 100.
h 1999 Q1 = 100. Measured with unit labour costs.

suggests this shift is already taking place, it would be worth considering potential means of speeding up and deepening the process.

4 The legacy of the crisis and the role of Spanish economic policy

The firming of the recovery also faces significant challenges related to the aftermath of the crisis

The economy has emerged from the double-dip recession and is moving into economic growth territory. The gradual improvement in activity has been accompanied by the correction of the main imbalances built up during the previous upturn. However, anchoring the recovery faces major challenges related to the depth of the effects of the crisis. The level of unemployment and the debt of the resident sectors are possibly the most significant challenges, not only because of their scale but also because their absorption will foreseeably require considerable time. Against this backdrop, the pick-up in domestic demand will come about at a more moderate pace than in previous episodes of recovery.

The weighty legacy of the crisis will continue to bear down significantly on economic policy action, which must square the deleveraging of the public and private sectors (with the inevitable restrictiveness this entails) with the ongoing adjustment of relative costs and prices needed to further improve competitiveness and push through the reallocation of resources to sectors with higher growth potential in the new economic conditions. Achieving progress in both areas faces the added difficulty posed by the macroeconomic scenario that will prevail on the more immediate horizon, given the forecasts for the continuation of a prolonged period of low inflation and moderate productivity gains.

The leeway for applying expansionary macroeconomic policies is very limited

The adjustments pending and the constraints high debt imposes mean that the leeway for applying expansionary macroeconomic policies is very limited. The stance of the single monetary policy is already exceptionally accommodating and the room to adopt further measures at the euro area level is limited. Of most relevance to the Spanish economy, however, despite the measures adopted, is the fragmentation persisting on euro area financial markets and preventing the proper transmission of monetary impulses to the economies, such as Spain’s, hardest hit by the crisis. Resolute action addressing the causes behind this fragmentation, beyond the strictly monetary realm, will contribute to the normalisation of financial conditions that recovery in the Spanish economy requires.

Fiscal action, in turn, is constrained by the pressing need to ensure the sustainability of public finances as a key ingredient of the deleveraging of the economy. That is an unavoidable condition for sustaining confidence and external funding flows.

Fiscal policy must keep as its primary objective the reduction of the deficit and the stabilisation and subsequent reduction in public debt

The revision of the budgetary adjustment path in the summer of 2013 eased budgetary restrictiveness in the short run but shifted a significant portion of the fiscal drive needed to restore budgetary stability to the 2015-2016 period. According to estimates from the latest Updated Stability Programme, the fiscal drive that would be required to fulfil the target path set, proxied by the change in the primary structural balance, would be around 2.5 pp, which would be on top of the effort already made. This figure illustrates the fact that the achievement of the budgetary targets cannot hinge solely on an improvement in the cyclical situation. According to the same estimates, only strict fulfilment of the programmed objectives would enable the rising trajectory of the public debt/GDP ratio to be halted from 2015, after having reached a ratio of 101.7% of GDP.

In this highly complex setting, economic policy must maintain the reduction of the budget deficit by the amount mentioned as its priority objective. The design of a well-defined medium-term fiscal consolidation programme might contribute to anchoring expectations and to easing the way for the implementation of the measures needed to bring the budget deficit trajectory back towards more comfortable levels.

The composition of the fiscal adjustment can play a key role in improving growth potential through a more efficient fiscal system and expenditure structure

The fiscal consolidation process should also be accompanied by the definition of a public spending and revenue structure more conducive to economic growth. In the case of public spending, an adjustment has been under way since 2012, involving certain healthcare and education spending-related measures, followed by the entry into force of the local government reform, the Law on Public Sector Rationalisation and other government reform measures. Seeing these reforms through is essential for ensuring a more efficient contribution by the public sector to economic activity, laying the foundations for achieving a more lasting adjustment in public spending and placing public finances in a better position to ensure their sustainability in the medium and long run. The depth and consistency of this process would benefit from being accompanied by an assessment and comprehensive review of overall general government public spending, in line with the recommendations of the European Council.

There was further progress in 2013 towards the medium-term sustainability of pensions following the definition in December of the so-called sustainability factor, which had already been envisaged in the 2011 reform, and the introduction of the pension revaluation index. The sustainability factor, whose entry into force is envisaged for 2019, will enable life expectancy to be incorporated into the determination of initial pensions. In turn, the revaluation index replaced the automatic updating of this public spending component on the basis of past inflation with the new procedure that takes into account Social Security finances and which sets floors and ceilings for the revaluation amount (0.25% in the first instance, as was the case for 2014, and the CPI plus 0.5% in the second instance). The budgeting of pensions spending for 2014 (entailing a 0.25% revaluation) has already been made following this criterion.

As regards public revenue, the government has announced the approval of a tax reform in the second half of this year with a view to its being operational in early 2015, in compliance with the commitments entered into at the European level. The aim of the reform is to redress the problems afflicting taxation in Spain, which came particularly to light during the crisis. First among the aspects to be reviewed is the existence of legal rates on the main taxes that are similar to or higher than the average for other European countries but which have less revenue-raising capacity, a fact that may be attributed to the wide range of tax benefits in place and, probably, to high tax evasion. And, secondly, a tax structure skewed towards indirect taxation and social security contributions, which is more harmful for employment and competitiveness. Importantly, the tax changes introduced must, in addition to improving the efficiency of the tax system, be fully compatible with and conducive to budgetary consolidation.

Prior to adopting the reform, the Government entrusted a Committee of Experts with producing a report, which was released in March 2014. The report sets out avenues of reform which, overall, would tend to improve the efficiency of the tax system. Specifically, their proposal resides on the need to increase the weight of indirect taxation, which would allow reductions on an equivalent scale to be made in social security contributions and in the direct taxes raised on households and firms. It further proposes eliminating tax rebates, reductions and exemptions, greater neutrality among real and financial saving instruments, and the reduction of the relative tax incentives favouring debt that are currently in place.

The highly decentralised general government structure poses specific challenges that must be addressed

One of the prominent features of Spanish general government is the high degree of decentralisation. As a result, and as manifest over recent years, regional government conduct is crucial both for the success of the fiscal consolidation process and for the definition of a more efficient public revenue and expenditure structure. This is why the ongoing rationalisation of public spending requires the active collaboration of this tier of government. At the same time, the design of a public revenue framework commensurate with their spending responsibilities is crucial. In this respect, the reform of territorial government funding arrangements considered for the second half of 2014 must improve the link between expenditure management and the resources available to regional governments to finance such spending.

Structural reforms have an essential role to play in speeding through the adjustment and raising long-term growth capacity

Given the limited leeway available to demand-side policies, reforming the factor and product markets is the primary area in which economic policy can act to see through the adjustments, minimise their costs (see Box 1.2) and thus contribute effectively to restoring the economy's productive potential. The scope of these reforms is directly related to long- and, indeed, short-term growth capacity, since they can be influential in removing the obstacles hampering entrepreneurial initiative, productivity gains, the reallocation of resources across sectors and employment generation. All these aspects are, moreover, essential for increasing the economy's resilience in the face of potential shocks in a global context marked by persistent and numerous factors of uncertainty.

Far-reaching reforms have been undertaken on different fronts in recent years, and their effects are already discernible, particularly in respect of internal devaluation

The reforms adopted have made for appreciable headway in the area of internal devaluation. The heightened cyclical sensitivity of prices is providing for a correction of the competitive lag that built up over the past expansionary cycle, while the greater flexibility of the labour market has been conducive to wage moderation. There has also been a change in the role played by past inflation in determining costs and incomes. This is a change of significance in adapting to the requirements of euro area membership, which has been boosted by several initiatives.

Firstly, because of the latest agreement on collective bargaining entered into by the social agents in 2012, which recommended a new framework for defining wage indexation clauses geared to softening the impact on wages of increases in the inflation rate brought on by transitory shocks, such as that prompted by a temporary rise in fuel prices. Other measures have sought to reduce the degree of indexation in other markets; a case in point is the reform of the Law on Urban Rentals, which eliminates the mandatory indexation of rental contracts to the CPI. To this same end, the entry into force in the coming months of the Law on Deindexation, which will be applicable to contracts entered into in the public sector domain (and for certain public revenue items), will build on this change of behaviour. It will do so to the greatest effect if it also passes through to the private sector, where the application of the provisions of the law is not mandatory but provides the necessary instruments should this option be chosen. The upshot should be that price-setting falls into line with its supply- and demand-side fundamentals, allowing an improvement in the determinants of competitiveness and preventing the re-emergence of some of the imbalances that compounded the crisis in Spain.

The effects in terms of job creation are more incipient

In terms of employment, the effect of the labour market reform began to be perceived initially in an easing of job destruction flows in 2012, despite the still-weak economic environment. Adding to this was an initial rise in job creation flows in the closing months of 2013 (which has continued to date this year), centred mainly on the services sectors and chiefly in temporary and part-time employment. Precisely in an attempt to influence labour market duality, incentives were established in 2013 to create jobs among groups

In the current setting, there is scant headroom to boost aggregate demand by means of conventional monetary policy (interest rate cuts) and fiscal policy (countercyclical balances) instruments. Accordingly, one of the main economic policy options for reinvigorating activity is the application of structural reforms that make product and factor markets more efficient and competitive.

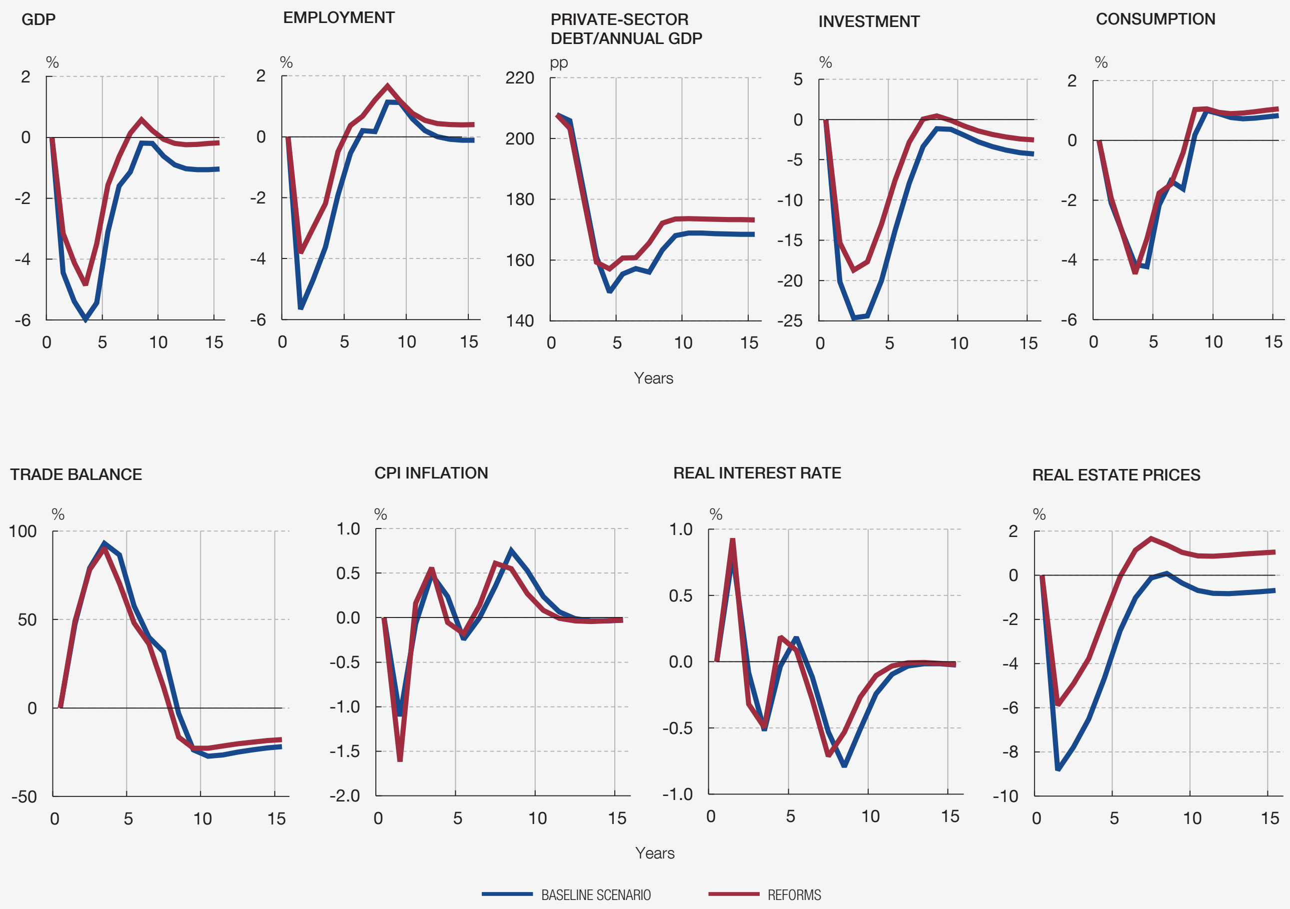
In the long run, there are few doubts over the positive effects of these reforms: insofar as a market becomes more competitive, the volume of activity grows, prices fall and the opportunities for improving economic agents' welfare increase. Through the expectations of the latter, who discount a greater future spending capacity, a portion of the durable benefits of the reforms normally materialise in the short run (the *expectations channel*). However, the moderation in prices typically prompted by structural reforms may give rise to increases in real interest rates and, therefore, to declines in household and corporate spending in the short run (the *interest rate channel*). Moreover, given debt whose nominal amount is predetermined, a moderation in prices prompts a higher real value of debt (the "Fisher effect" or the *debt deflation channel*[1]), with the subsequent restrictive effect on debtor agents' budgets.

The relative intensity of the foregoing channels – expectations, on one hand, and the interest rate and debt deflation, on the other – determines the sign of the short-term impact of the structural reforms. Some recent research has emphasised the fact that the lack of headroom to make nominal interest rate cuts may be pivotal in inclining the balance in favour of contractionary channels.[2] This type of analysis would appear to point to the

1 See I. Fisher (1933), "The debt-deflation theory of great depressions», *Econometrica* vol. 1, pp. 337-357.

2 See, for example, G. Eggertsson, A. Ferrero and A. Raffo (2014), "Can structural reforms help Europe?", *Journal of Monetary Economics*, vol. 61, pp. 2-22.

1 EFFECT OF STRUCTURAL REFORMS IN A DELEVERAGING PROCESS (a)



SOURCE: Banco de España.

a All variables expressed as deviations from their initial state, except private-sector debt/GDP, which is in percentage points.

advisability of postponing the reforms until their contractionary effects may be countered by expansionary macroeconomic policies.[3]

Nonetheless, most of the macroeconomic models used in the foregoing research are designed to analyse the fluctuations proper to a traditional economic cycle, rather than those arising from a deep-seated macrofinancial crisis such as the present one. In a recent paper, Andrés, Arce and Thomas (2014)[4] develop a specially designed model to analyse the effect of structural reforms on an environment similar to that currently characterising the Spanish economy, namely one of slow leverage, owing to the presence of a high volume of long-dated debt, and of restricted access to financing. Further, the model considers that the domestic economy is part of a monetary union that has no leeway to lower interest rates. Businesses and a portion of households take on debt using the value of their real estate assets as collateral; however, when the value of their assets falls below a specific threshold, the extension of fresh credit is interrupted and, in that case, debtors restrict themselves to repaying their outstanding debt according to the maturities stipulated in their debt contracts.

The starting point is a *baseline scenario* that includes a persistent tightening of loan access conditions for households and firms, and that entails, in particular, a reduction in the loan-to-value ratios of the new loans granted to these agents. The blue lines in Panel 1 show the response of the economy to this financial shock (the magnitudes of the simulations are merely illustrative of the qualitative behaviour of the model and should not be interpreted as realistic quantitative approximations). The slump in real estate prices and, therefore, in the value of the collateral means the flow of new credit shrinks sharply, which gives rise to a long and slow process of private deleveraging. The need for households and firms to generate saving to repay their debts and clean up their balance sheets leads them to reduce consumption and investment levels. In parallel, the trade balance improves thanks to the gains in competitiveness to which the disinflationary effect of the shock and the subsequent contraction in domestic demand gives rise. Yet this improvement does not suffice to prevent a prolonged decline in GDP. When the value of the assets of the households and firms applying for funds reaches the minimum threshold for satisfying loan access conditions, the flow of fresh credit re-starts. Thereafter, a virtuous circle takes hold, with a vigorous pick-up in asset prices, in credit and in agents' spending capacity. As a result, consumption and investment, and GDP too, begin to recover.

The unbroken red lines in Panel 1 show the responses of the main variables when *structural reforms* are adopted that involve increases in the degree of competition in the product and labour markets. These reforms induce a lasting reduction in business mark-ups and give rise to more moderate wages.[5] In the long run, these measures have a clearly positive effect on GDP and employment; but they also relieve the adverse effects of deleveraging in the short and medium term. This is chiefly due to

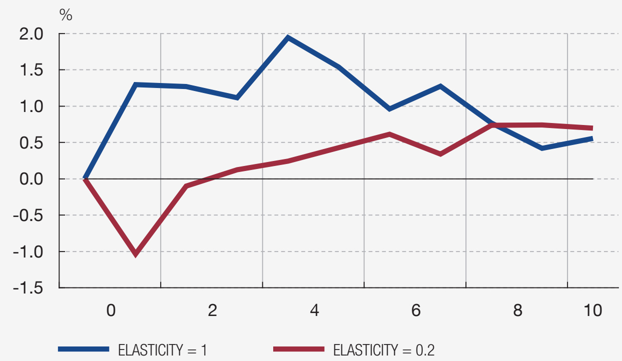
3 Some theoretical developments pointing along these lines can be found in the following papers: G. Eggertsson, G. (2012), "Was the New Deal contractionary?", *American Economic Review*, vol. 102, pp. 524-555; G. Eggertsson, and P. Krugman (2012), "Debt, deleveraging, and the liquidity trap: a Fisher-Minsky-Koo approach", *Quarterly Journal of Economics*, vol. 127, pp. 1469-1513; and J. Galí, and T. Monacelli (2014), "Understanding the gains from wage flexibility: The exchange rate connection", CEPR discussion paper 9806.

4 See J. Andrés, Ó. Arce and C. Thomas (2014), "Structural reforms in a debt overhang", Documento de Trabajo del Banco de España (forthcoming).

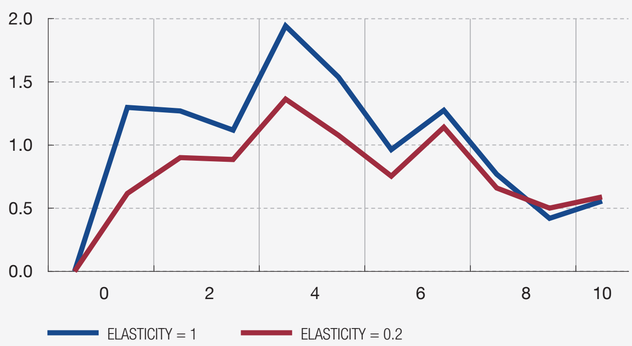
5 Specifically, there is a reduction in price mark-ups (i.e. the difference between production prices and marginal production costs) and wage mark-ups (that between wages paid to workers and their reserve wages).

2 ROLE OF THE EXTERNAL SECTOR IN THE TRANSMISSION OF THE EFFECTS OF THE REFORMS (a)

EXPORT ELASTICITY



IMPORT ELASTICITY



SOURCE: Banco de España.

a The panels show the differential effect of the structural reforms on GDP, i.e. the difference between the two lines in the top-left hand graphic in Panel 1, for different values of the elasticities of exports and imports to relative prices.

the better performance of investment. Specifically, anticipation of the beneficial effects of the reforms in the long run means that, in the short run already, households and firms increase their investment demand relative to the baseline scenario. This greater demand entails a lesser decline in real estate asset prices. That contributes to curtailing the severity of the decline in debtors' financial worth and, therefore, helps them regain earlier the minimum threshold at which new credit may be granted. Combining with this positive effect on firms' financial capacity is a contraction in these agents' consumption which, in the context of this model, may be assimilated to smaller dividend payouts (and, therefore, a greater accumulation of retained earnings).

In this way, the reforms *bring forward* the end of the deleveraging process and, therefore, of the recession, thus reinforcing the *expectations channel.* At the same time, since the flow of new credit slows substantially during the deleveraging phase, private spending decisions at the aggregate level are relatively insensitive to the increase in the real interest rate induced by the deflationary effect of the reforms. This leads to a loss of intensity in the *interest rate channel*. The combination of both effects – the reinforcement of the expectations channel and the weakening of the interest rate channel – results in a net positive effect of the reforms on activity and employment in the short run already, which prevails over the negative Fisher effect arising from a path of lower prices. In this respect, the presence of a high proportion of long-term debt – which is an essential factor in the current crisis, especially in the case of household mortgage debt – operates by substantially cushioning the short-term contractionary effect of the debt deflation channel.

One significant channel for the transmission of the effects of the reforms is that of foreign trade. As can be seen in Panel 1, the reforms do not bring about a significant effect on the trade balance in the short term. This apparent lack of effect encompasses two opposing forces: although the reforms bring about an additional lowering of the prices of domestic products, they also prompt an improvement in domestic demand. This behaviour of the external balance depends largely on the sensitivity of trade flows to the relative prices of domestic and foreign goods. The left-hand graphic of Panel 2 shows the differential effect of the reforms on GDP[6] for two different calibrations of the elasticity of exports to relative prices: unit elasticity (the baseline value[7]), and a very low elasticity of 0.2. In this latter case, the effects of the reforms in the short run turn negative, owing to the insufficient positive contribution of exports. In the case of imports (right-hand graphic), reducing their price-elasticity also reduces the positive effect of the reforms, though not to the extent of changing the sign of this effect. This example illustrates, therefore, that a key condition if the reforms are to have beneficial effects in the short term is that the resulting gain in competitiveness should pass through with sufficient intensity to trade flows.

6 The differential effect of the reforms on GD Pis equivalent to the vertical distance between the two lines in the upper left-hand graphic of Panel 1.
7 The calibration of the unit elasticity of exports is based on estimates for Spain by C. García, E. Gordo, J. Martínez-Martín and P. Tello (2009), "*Una actualización de las funciones de exportación e importación de la economía española",* Documentos Ocasionales, no. 0905, Banco de España.

with the highest unemployment rates (such as unskilled youths). Also, measures were taken to boost permanent hires, through the introduction of greater flexibility in part-time hiring arrangements or through the reduction, early this year, in the social security contributions payable in connection with new permanent jobs. This programme of incentives might provide a boost to permanent contracts this year; however, on the evidence available on the impact of this type of rebate, the effects on net employment are estimated to be more uncertain.

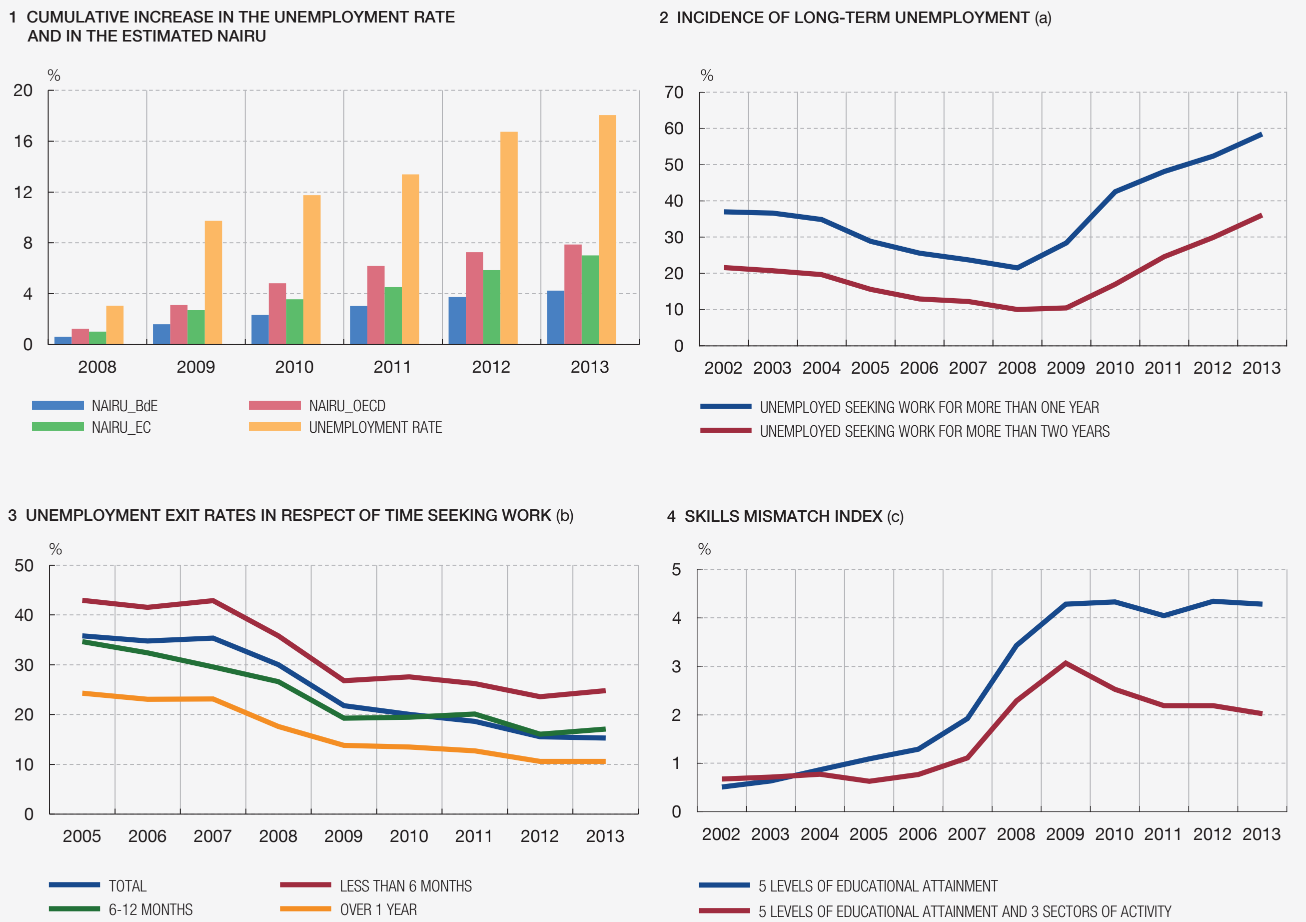
Looking ahead to the coming quarters, it is expected that, as a result of the greater flexibility provided by the new labour market framework, employment will grow at rates which, while moderate, are high in relation to the increase in output, which will necessarily entail a declining path of productivity. Nonetheless, even under this relatively favourable job creation scenario, the unemployment rate will fall slowly, and the risks that its structural component will increase remain present (see Box 1.3). To prevent such risks materialising, there will be a need to ensure the continuity of gains in competitiveness and of the recovery in employment. Here, it will be necessary to monitor developments in collective bargaining arrangements and, especially, progress in wage flexibility, most particularly for smaller firms, along with the degree of decentralisation of such arrangements. To reduce the

The unemployment rate in the Spanish economy peaked in 2013 Q1 (at 26.9% of the labour force), marking an increase of close to 20 pp on the low recorded in 2007 Q3. Since then, unemployment has moved on a progressively declining path, dipping to 25.9% in 2014 Q1. The latest macroeconomic projections of the Banco de España, released in March, point to the continuation of this trajectory over the remainder of 2014 and in 2015 in a setting in which the gradual recovery in activity is forecast to pass through intensely to job creation, assisted by ongoing wage moderation and its extension over the projection horizon. Notwithstanding, the unemployment rate in the Spanish economy is expected to hold at very high levels in comparative terms.

There are different reasons why an initially cyclical increase in unemployment may become persistent, generating an increase in the structural component of unemployment through what is usually known as a hysteresis effect that hampers subsequent reductions in the unemployment rate, even in an economic upturn. Such hysteresis can be caused by various factors. Thus, enduring unemployment status over a prolonged period may ultimately exert permanent effects on the human capital of the unemployed, on their intensity of job search and on firms' perception of their skills or background. These effects may be more significant in a context of sectoral reallocation of employment in which the skills demanded by firms differ from what the unemployed have to offer.

One way of analysing the degree of persistence of unemployment consists of estimating the structural rate of joblessness, a concept that can be interpreted as the unemployment rate of the economy in the medium term, once the impact of cyclical factors is stripped

THE IMPACT OF THE CRISIS ON THE STRUCTURAL COMPONENT OF UNEMPLOYMENT



SOURCES: EPA (INE) microdata and Banco de España.

a Percentage of total unemployed.
b Percentage of unemployed who find work in the following quarter.
c Mismatch between the distribution by educational attainment level (primary studies or less, first-phase secondary studies, higher secondary studies, vocational training and university studies) of the employed and the unemployed. Having regard to the sectoral dimension, three major sectors of activity are used (manufacturing, construction and services) and both the unemployed seeking their first job and the long-term unemployed, on whom no information on the sector of activity is available, are excluded.

out. This structural component is, however, non-observable and estimating it is subject to high uncertainty as there are different methodological approaches that provide different results. Presented below are the results of the application of a methodology that involves estimating the disaggregation between the structural and cyclical components of unemployment using the Phillips curve approach.[1] Specifically, a relationship is assumed between wage growth and deviations of unemployment from its structural component, i.e. the cyclical component of unemployment. Hence, if unemployment is below (above) its equilibrium or structural level, higher (lower) wage growth will tend to be observed, meaning that the structural unemployment rate, which under this approach is usually called the NAIRU, could be interpreted as that level of the rate that were compatible with stable inflation.

The top left-hand hand graphic of Panel 1 shows the cumulative increase in the NAIRU since 2008 following the above-mentioned methodology. The high uncertainty constantly surrounding these estimates usually advises analysing medium-term trends rather than the discrete levels estimated.[2] The results show that the Spanish economy's structural unemployment rate would have increased by around 4 pp since the onset of the crisis.[3] the estimates available for Spain by the OECD and the EC tend to offer a somewhat higher increase, with the NAIRU showing a more procyclical profile.

This result would reflect the impact of hysteresis effects on the NAIRU. Thus, the average duration of unemployment episodes has risen from around 2.8 quarters to over 6.5 quarters in 2013, raising to 60.7% the proportion of the unemployed experiencing this status for more than a year. There has also been a most substantial increase in the percentage of those unemployed for a very long period, of over two years, to 38.9% of total unemployed (see the top right-hand graphic of Panel 1). This phenomenon is concentrated, moreover, in certain groups, such as employees over 50 years of age or the more unskilled unemployed, for which this percentage stood at around 50% at end-2013.

Unemployment exit rates, which have fallen appreciably for all unemployment durations, have begun to rise slightly in 2013, at least for the unemployed with less duration in this situation (see the bottom left-hand graphic of Panel 1). Foreseeably, the incipient recovery will help entrench this improvement which, nonetheless, will probably be slower among the group with longer durations.[4] This diminished cyclicality of exits from unemployment once a large amount of time has been accumulated experiencing this status might limit the aggregate recovery of the unemployment exit rate in the face of a cyclical upturn.

Unemployment persistence might also be related to the increase in the skills mismatch between labour supply and demand observed since the start of the crisis. In this connection, the bottom right-hand graphic of Panel 1 shows the changes in a skills mismatch index that seeks to measure the discrepancy between the breakdown by level of educational attainment of the employed and unemployed populations.[5] In principle, it is expected that the bigger this mismatch is, the more difficult it will prove to reabsorb unemployment. The clear increase in the level of skills mismatch is observed during the crisis, caused by the concentration of job destruction among the lesser-skilled. If the sectoral dimension is taken into account, the pattern is similar and highlights how the acute job destruction in the construction industry, especially at the start of the crisis, prompted a considerable increase in the relative weight of the low-skilled unemployed. These results indicate that a reduction in unemployment will require the adaptation of unemployed workers' skills to job requirements.

In short, although a significant portion of the increase in unemployment since the start of the crisis is closely associated with the cyclical downturn, it cannot be ruled out that there has in parallel been an increase in the structural component of unemployment, which might hamper any reduction in unemployment in the near future. These difficulties appear to be particularly marked for specific groups, among whom very high unemployment durations are observed. The overall design of active and passive policies of support for the unemployed should focus on increasing the employability of these groups, analysing the links with the various social protection mechanisms and facilitating wage flexibility.

1 See J. Gali (2011), "The Return of the Wage Phillips Curve", Journal of European Economic Association, June, 9 (3), pp. 436-461.

2 See, for example, Estrada, Hernando and López Salido (2000), *Measuring the NAIRU in the Spanish Economy,* Documentos de Trabajo, no. 0009, Banco de España; or ECB (2012), *Euro Area Labour Markets and the Crisis,* Occasional Paper no. 138.

3 This increase is also similar to that estimated by Doménech (2013), "Potential Growth and Structural Unemployment in Spain, EMU and the US", BBVA Research, mimeo, using an alternative methodology drawing on Okun's Law.

4 In particular, an analysis of the likelihood of exiting unemployment conducted for the 2005-2013 period, drawing on microdata on EPA flows, shows that this likelihood increases by 2.1 pp given a 1% improvement in GDP for the short-term unemployed, while for the longer-term unemployed the impact of an improvement in activity is only 1.3 pp.

5 In particular, the distribution of the employed and unemployed population is used following five levels of educational attainment drawn from Spanish Labour Force Survey data. For further details see M. Izquierdo, S. Puente and P. Font (2013), "Evolución del desajuste educativo entre la oferta y la demanda de trabajo en España", *Boletín Económico*, June, Banco de España.

unemployment rate to a level comparable with that in other European countries will require an overhaul of active employment policies. Recent measures in this area have focused on moving forward, in coordination with the regional governments, by means of a new system of active policies that reinforces the link between the funds received and the effectiveness of the programmes undertaken in each region. Still under preparation is the strategy for the application of the so-called youth guarantee, which will offer training opportunities or job-search support to unemployed youths. Both initiatives will be pursued during the current year, as envisaged in the National Reforms Programme (NRP) submitted by the Government to the European Commission on 30 April.

Product market reforms must be pushed through, providing for heightened competition and gains in efficiency

If internal devaluation is to be successful, the reduction in labour costs must be accompanied by the containment of margins and efficiency gains in productive processes. In this respect, margins at the aggregate level during the crisis have been influenced, at least in part, by the effects arising from very tight financial conditions, as earlier indicated. Yet this behaviour also reveals the presence of barriers to competition in some industries that are hampering competitive devaluation and increasing the attendant costs; accordingly, it is vital to further reforms that increase competition in the product markets and boost the comparative quality of the goods and services produced.

Some of the reforms adopted in the past year are along these lines, and include most notably the respective Laws on Entrepreneurs, Market Unity Guarantee and Insolvency (the latter is addressed in greater detail in Chapter 2). The Law on Entrepreneurs launched a series of fiscal measures to facilitate small firms' economic activities, including most notably the simplification and reduction of tax obligations. In turn, the aim of the market unity guarantee legislation is to eliminate potential inefficiencies arising as a result of different regional legislations for product marketing or services provision. In this same connection, various initiatives have been pursued to reduce the duration of legal procedures and thus cut into the high business costs stemming from the high number of lawsuits brought in Spain.

Significant headway has thus been made in product market reform, but in some cases the effective implementation of these reforms faces major difficulties. In particular, the effectiveness of the precepts laid down in the market unity guarantee legislation will hinge critically on the degree of cooperation among the different tiers of government. Nor is implementation of the reform of the electricity industry and, more generally, of an energy policy geared to reducing Spain's high dependence on imported energy proving free from difficulty. Lagging further behind in terms of implementation is the draft bill on professional services and associations, which proposes establishing a general regime of freedom of access and practice throughout Spanish territory in respect of services. The delays in the implementation process for this bill have so far prevented its final approval.

Improvements in efficiency are also crucial for shoring up gains in competitiveness and, in particular, for increasing the economy's growth potential in the medium term. Their role is all the more important in a setting in which the demographic projections available augur population declines that pose major challenges for long-term growth and the sustainability of public finances in the medium and long run.

The above-mentioned liberalisation of product and services markets is a key ingredient of any strategy to raise productivity. Such measures should be accompanied by measures aimed at improving the economy's human and productive capital. In this connection, the Organic Law for Improving Educational Quality amends various aspects of how the

Spanish educational system is organised, though the challenges the economy faces mean this measure must be complemented with far-reaching reforms in university education and vocational training. The aforementioned NRP develops this latter aspect.

In sum, fiscal consolidation and the deepening of the reform agenda are the fundamental economic policy instruments for building on the exit from the crisis and helping entrench incipient growth and job creation. Indeed, these are the only sound bases for tackling the necessary deleveraging of the economy and the lingering uncertainty in the international and European spheres.