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in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Accompanying the document

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PARLIAMENT AND THE COUNCIL AND TO THE EUROGROUP**

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EXECUTIVE SUMMARY AND CONCLUSIONS

In May 2012, the Commission concluded in the first In-Depth Review (IDR) that Spain was experiencing very serious imbalances, in particular as regards developments related to the external position, private sector debt levels and the financial sector. As to the financial sector, since last year's IDR, a programme for the recapitalisation of the financial institutions was signed in July 2012. The programme remains on track, thereby contributing to the controlling of financial sector related risks. In the Alert Mechanism Report (AMR) published on 28 November 2012, the Commission found it useful, also taking into account the identification of a very serious imbalance in May, to examine further the risks involved and progress in the unwinding of imbalances in an in-depth analysis. To this end, this IDR takes a broad view of the Spanish economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). The main observations and findings from this analysis are that the risks and negative economic trends associated to macroeconomic imbalances, as identified in the 2012 IDR¹, are still powerful and have partly materialised:

- **Negative feedback loops amongst a protracted economic recession, deleveraging and volatile market financing conditions remain a tangible threat.** Private-sector deleveraging is imparting a significant negative impulse to domestic demand and has plunged the economy into a double-dip recession since end-2011, which may extend into 2014. Efforts to stem the rise in general government debt contribute to compress domestic demand. Structural rigidities and tight financing conditions have been hindering a faster and less costly (in terms of output and employment) adjustment of the real economy to post-bubble conditions. In turn, the contracting economy and the associated surge in unemployment are feeding back into a more protracted deleveraging process. Hence, while the adjustment of flow imbalances has advanced in 2012, risks to macroeconomic and financial stability have not yet dissipated.
- **Spain has responded to these challenges and to the country-specific recommendations of the Council under the 2012 EU semester² with efforts to consolidate public finances and reform product and factor markets.** A labour market reform was adopted by the government in February 2012 and passed into law in July 2012. A comprehensive reform plan was presented in September 2012, covering further reforms to support employment, ensure public finance sustainability, and strengthen the business environment and competition. While measures have been taken or launched in all these areas, the reform agenda remains incomplete, and even reforms already adopted have not always displayed their full effects due to implementation lags. As a result, the adjustment capacity of the economy remains unsatisfactory, with much of the burden of adjustment falling on employment.
- **According to the Commission services' 2013 winter forecast, the unemployment rate is projected to rise further to 27% in 2013 (from 25% in 2012).** The share of long-term unemployment is increasing, and with it the probability of hysteresis effects that would lower the growth potential of the economy. Wages have only belatedly and gradually started to respond to the slack in the labour market, partly in reaction to the 2012 reform of the labour market.

¹ European Commission, 2012a.

² <http://register.consilium.europa.eu/pdf/en/12/st11/st11273.en12.pdf>

- **The reduction in disposable income, rising unemployment and falling house prices (down 31% in nominal terms from their peak) are weakening household capacity to repay debt.** While their net wealth diminishes (housing being the bulk of it), more and more households are affected by unemployment. The fall in house prices accelerated in 2012 on the back of a large stock of unsold houses and falling demand. Residential investment and construction activity also fell further. The adjustment in the housing market is not completed, and further drops in both prices and investment are likely to allow a narrowing of the gap between supply and demand.
- **The private sector faces strong pressures to deleverage.** The non-financial private sector debt-to-GDP ratio remains elevated, having declined by only around 15 pps. from the 2010 peak of 227%. The reduction in debt has been faster for non-financial corporation than in the household sector, due to different debt characteristics (in particular the long maturity of mortgages), a stronger fall in non-financial corporation borrowing and larger debt write-downs on non-financial corporation loans. Non-performing loans have increased and are expected to rise further due to the extended economic downturn.
- **Net external debt and the (negative) net international investment position remain close to historical peaks.** Net external liabilities have stabilised at above 90% of GDP since 2009. The vulnerabilities associated with very high net external liabilities culminated in 2012, when a loss of market confidence on Spanish assets led to large private capital outflows, which were partly offset by official capital inflows. In spite of the recent easing, financial market confidence remains highly sensitive to economic and policy developments.
- **Both cyclical and non-cyclical factors have contributed to the sizeable improvement in the current account balance from a deficit close to 10% of GDP in 2007 to a deficit of slightly less than 1% of GDP in 2012.** This improvement has been driven by solid export growth and a sharp fall in imports, which can be related to some recovery in cost competitiveness and to shifts in demand composition, possibly of a lasting nature. Non-price competitiveness factors and the duality of the economic structure (with export companies being typically larger and more productive) have supported the robust export market shares performance of Spain. At the same time, the sharp fall in imports mostly related to the slump in domestic demand suggests that a considerable part of the current account reversal is cyclical. While around half of the losses in cost competitiveness during the boom period have been reversed so far, part of this improvement is related to the impact of labour shedding on apparent labour productivity. Moreover, the decrease in unit labour costs (ULC) has not fed convincingly into final prices. Further competitiveness gains will be needed to underpin the dynamism of exports and import substitution, and thereby bring about a significant reduction of net external liabilities over time.
- **High and fast rising general government debt has been the flip side of the ongoing adjustments in the private sector.** The general government budget deficit has fallen from the 2009 peak of 11.2% of GDP but remains high at 6.7% of GDP in 2012 (excluding bank recapitalisation costs). In spite of a substantial fiscal effort, a faster reduction in headline balances was hindered by the recessionary environment and shifts in tax revenue elasticities. **General** government debt, which has also been affected by the cost of bank recapitalisations, reached 84% of GDP in 2012 and is set to record further substantial increases in the coming years. The unwinding of macroeconomic imbalances

will only have run its full course once the fall-out on the general government sector has also been re-absorbed.

The scale and interrelated nature of the policy challenges stemming from these imbalances require a comprehensive and ambitious policy response. Notwithstanding the measures already adopted or proposed by the government, and whose positive effects depend on their swift and full implementation, a number of elements can be considered:

- The rebalancing of the economy and international competitiveness would be helped by greater flexibility in the reallocation of resources. This would be fostered by measures to strengthen competition in product and services markets (including network industries), improve the business environment, support the growth and internationalisation of firms. A review of the growth-friendliness of the tax system could also be considered.
- The adjustment capacity of the economy, the absorption of the large number of unemployed workers and competitiveness rest decisively on a well-functioning labour market. To this end, it would be useful to (i) undertake a comprehensive review of the impact of the 2012 labour market reform against its stated objectives (greater efficiency and reduced labour market duality, higher internal flexibility, a wage bargaining process that ensures a better alignment of wages to economic conditions, greater employability of young workers and greater use of permanent contracts) with a view to ensure its effectiveness and (ii) to enhance active labour market policies (ALMP), public employment services and vocational training, so as to improve employability and raise the quality and effectiveness of training and job matching.
- The stability of the financial system and its capacity to finance the real economy rely on the swift completion of the recapitalisation and restructuring of the banking sector and the strengthening of the regulatory and supervisory frameworks foreseen in the context of the financial sector programme. Increasing the availability of non-bank financing sources and targeted measures for SMEs would also help to alleviate financing constraints on growth and the reallocation of resources. Measures to foster a larger and more efficient rental market could help stabilise the housing sector and promote geographical mobility of workers.
- Ensuring the long-term sustainability of public finances will require continuous efforts in the years to come. The credibility of the fiscal adjustment would be reinforced by basing consolidation on structural measures (including to ensure the sustainability of the social security system) as required by the recommendations under the Stability and Growth Pact, and by further action to reinforce the medium-term orientation and institutional framework of public finances.

1. INTRODUCTION

On 28 November 2012, the European Commission presented its second Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances.³ The AMR serves as an initial screening device, which helps to identify Member States that warrant further in-depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific “in-depth reviews” (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists and what type of follow-up it will recommend to the Council.

This is the second IDR for Spain. Based on the previous IDR, which was published on 30 May 2012, the Commission concluded that Spain was experiencing very serious macroeconomic imbalances, in particular as regards developments related to the external position, private sector debt levels, and the financial sector.⁴ Overall, in the AMR the Commission finds it useful, also taking into account the identification of a very serious imbalance last May, to examine further the progress and the risks involved in the unwinding of imbalances in an in-depth analysis. To this end this IDR takes a broad view of the Spanish economy in line with the scope of surveillance under the Macroeconomic Imbalance Procedure (MIP).

Against this background, Section 2 looks in more detail into these developments covering both external and internal dimensions. This is followed by two focus sub-sections in Section 3 on (i) private sector deleveraging and (ii) external debt sustainability and current account adjustment. Section 4 discusses policy conclusions.

³ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32011R1176:EN:NOT>

⁴ These imbalances and adjustment challenges were analysed in detail in the 2012 In-depth Review (European Commission, 2012a).

2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

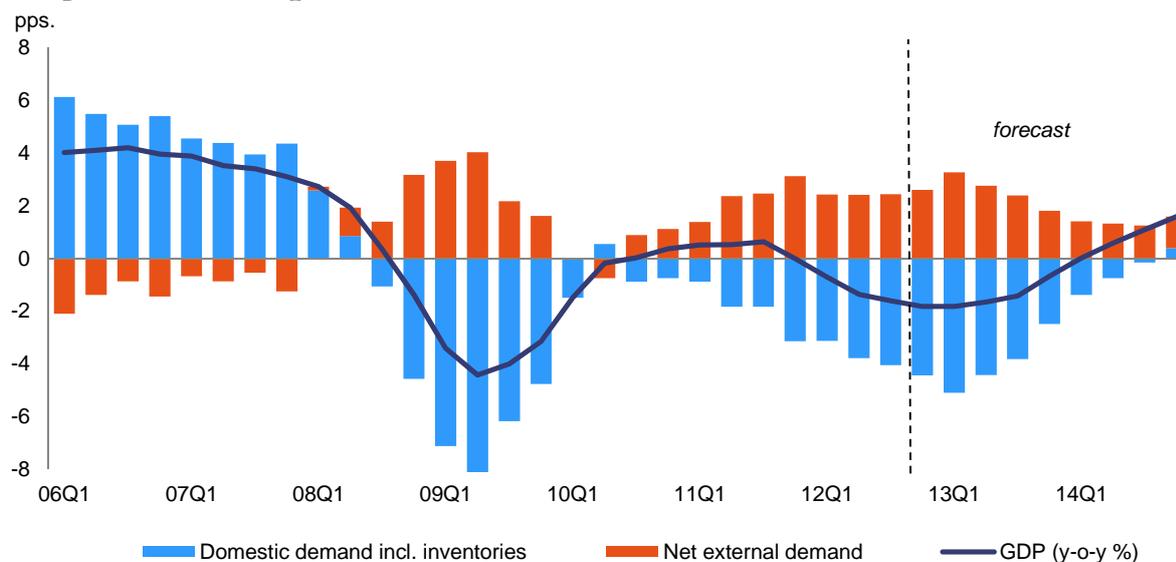
2.1. Macroeconomic scene setter

The credit-driven housing and domestic demand boom of the early 2000s left the Spanish economy saddled with major external and internal imbalances. As analysed in greater detail in the 2012 IDR, the strong economic expansion in the period 1996-2007 (more than 3½% real GDP growth per year) was heavily skewed towards domestic demand and in particular residential investment. This unbalanced expansion, which was fuelled by abundant availability of external private financing following a sharp reduction in risk premia before and after euro-area accession, resulted in the accumulation of high domestic and external debt, the emergence of a massive real estate bubble, significant competitiveness losses and recurrent and widening current account deficits. The sharp correction of this boom in the context of the international financial crisis triggered a protracted economic recession with massive employment losses. Since the beginning of the crisis (Q3 2008 to Q4 2012), real GDP has dropped by around 5.7% and the number of people employed has fallen by almost 3.5 million (17% of total employment).

While the adjustment has started, the unwinding of imbalances will continue to weigh on the medium-term growth outlook. After a temporary stabilisation, the economy fell back into recession at the end of 2011. Real GDP kept on falling throughout 2012 and is expected to stabilise only towards the end of 2013. On an annual basis, a projected contraction of 1.4% in 2013 is expected to be followed by a subdued recovery of around 0.8% (under a no-policy change assumption) in 2014. Private-sector deleveraging, very high unemployment, tight financing conditions, and fiscal consolidation constrain domestic demand and imply a profound shift in the composition of demand towards net exports (see Graph 1). As a result, the current account deficit has been narrowing and is expected to turn into a surplus from 2013 onwards.

Wage growth has belatedly started to react to the sharp fall in employment. The labour market situation deteriorated further in 2012. Unemployment reached 26% in the fourth quarter of 2012 and is expected to keep increasing in 2013. Wage growth started to moderate more noticeably in 2012, finally responding to the sharp deterioration in the labour market. Thanks largely to high apparent productivity growth on the back of labour shedding, unit labour costs sustained their fall in 2012 (-3.4%) and this trend should continue in 2013, albeit at a slower pace. Inflation remains elevated, essentially due to fiscal measures, but also potentially reflecting weak competition in some product and service markets and the application of indexation clauses. Inflation was 2.8% in February 2013, while core inflation reached 2.3%.

Graph 1: Real GDP growth and contributions



Source: Commission services' 2013 winter forecast (European Commission, 2013a).

2.2. Adjustment of internal and external imbalances

Spain faces daunting adjustment challenges and risks following the bursting of the housing and credit booms. The correction of imbalances started in 2008 and is ongoing. The adjustment of flows (i.e. current account deficit, investment in construction, credit growth) has advanced, but the adjustment of stock variables has been much more gradual and will take considerable time. Very high external debt leaves the economy vulnerable to changes in external financing conditions. Restoring external equilibrium requires a move to a sizeable current account surplus position, backed by further improvements in competitiveness and a major re-allocation of resources to the tradables sector. Private sector deleveraging is weighing on economic growth, while the economic recession and the deterioration in the labour market are simultaneously making the reduction of private debt more difficult. The bursting of the construction and housing bubble has weakened bank balance sheets, creating risks for financial stability and adding to overall tight financing conditions, which can in turn slow down the rebalancing of the economy. Moreover, the economic downturn and the cost of support to the financial sector have resulted in a substantial deterioration of public finances, which is reflected in the rapid increase in general government debt. The links and feedbacks between the sovereign, the banking sector and the real economy are strong, calling for enhanced monitoring of the adjustment progress in all areas.

An important development since the 2012 IDR has been the granting of financial assistance to Spain for the recapitalisation of financial institutions.⁵ Spanish banks have been adversely affected by the bursting of the real estate and construction bubble and the economic recession that ensued. The banking sector was characterized in the previous IDR as a source of vulnerability with respect to financial stability and credit provision to the real economy. Growing market tensions in the run up to the request for financial assistance of 25 June 2012 confirmed this assessment. Up to EUR 100 billion were made available via the

⁵ See the Commission, services' reports on the financial assistance programme to recapitalise financial institutions in Spain, *European Economy-Occasional Papers*, 118, 121, 126 and 130.

ESM, upon agreement by the Eurogroup in July 2012, while actual disbursements amounted to EUR 41.4 billion. The core of the programme is an overhaul of the weak segments of the Spanish financial sector through significant recapitalisation and restructuring as well as a segregation of problematic assets from those banks receiving public support in an external Asset Management Company (AMC). Regulation and supervision will also be reinforced. The financial assistance will be provided for the period July 2012 to end-December 2013.

The banking sector programme is having a positive impact on the stability of the financial sector in Spain. The second review under the programme, concluded in February 2013, confirmed that the programme is on track.⁶ Successful implementation of the programme is contributing to reducing the funding costs of banks. This should gradually feed into an easing of lending conditions to households and non-financial corporations. Given deleveraging pressures, credit growth is likely to remain subdued for some time, but this is compatible with restoring credit flows to productive sectors.

The economy remains at a critical juncture, leaving no room for complacency on the reform side. The capacity of the economy to undergo the necessary structural transformation depends on the smooth functioning of its factor and product markets. The sharp fall in employment and sluggish adjustment of prices suggest significant shortcomings in these areas. Increasing price and cost competitiveness through sustained wage and price adjustment and increasing labour productivity beyond the cyclical adjustment related to labour shedding is a precondition for returning to a higher growth path, generating employment opportunities, ensuring the external rebalancing of the economy, limiting the costs (in terms of output and employment) of private sector deleveraging, and supporting the consolidation of public finances.

2.2.1. Current account and external debt

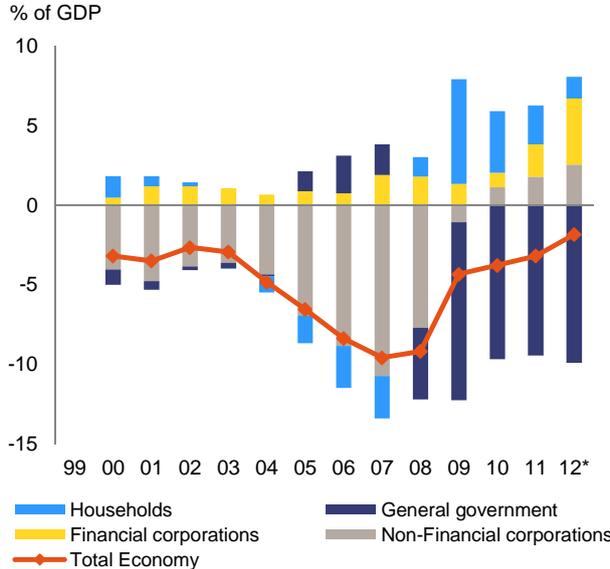
The current account deficit has narrowed further in 2012. The long period of economic expansion that began in the second half of the 1990s and ended in 2007 was characterized by rising current account deficits and growing external indebtedness (see Graph 2 and Graph 3). During this time, both households and non-financial corporations significantly increased investment expenditures, the bulk of which went into residential investment. These investments were largely financed by capital inflows channelled via the Spanish banking sector. As explained in the 2012 IDR, the deterioration of external financing conditions prompted a relatively rapid adjustment of the current account balance. The current account deficit fell to 0.8% of GDP in 2012, from a peak of 10% in 2007 (and 3.7% of GDP in 2011). The reduction in the external deficit (including both current and capital accounts) has been even more pronounced. The medium-term evolution of the external deficit will depend on the extent to which recent adjustments have been of a permanent rather than cyclical nature (see Section 3.2 for more details). In the short-term, according to the Commission services' 2013 winter forecast, the external balance is expected to shift from a deficit to a surplus in 2013 (1½% of GDP) and this surplus is set to double in 2014.

The improvement in the net lending position of the private sector has consolidated. The net lending/borrowing (NLB) position of the non-financial private sector has reached close to 10% of GDP by end-2012 (Graph 2). According to the Commission services' 2013 winter forecast, both households and non-financial corporations are expected to remain net lenders

⁶ http://europa.eu/rapid/press-release_MEMO-13-58_en.htm

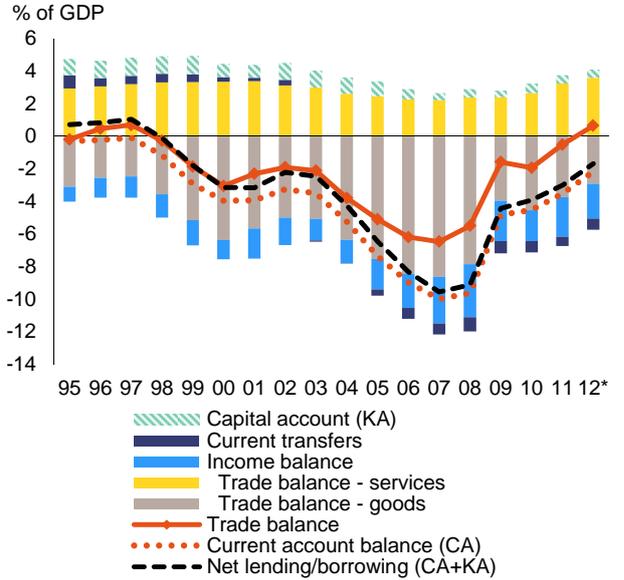
over the forecast horizon (2013-14). This confirms the assessment of the previous IDR. However, there has been some shift in the composition of private sector NLB, with non-financial corporations accounting for an increasing share at the expense of households. This development has been mainly driven by a change in the behaviour of saving rates. Households have been accumulating savings since 2008, with the saving rate averaging 14% (i.e. 3 pps. above the long-term historical average). This trend was reversed in 2012, when the household saving rate plummeted to a historical low of under 9% (four-quarter moving average) amid falling disposable income and rising unemployment.⁷ Conversely, the saving rate of non-financial corporations has been sharply on the rise, as companies reduce costs and strive to rebuild their balance sheets. The impact of higher private sector net lending on the external deficit has been largely counteracted by a sizeable net borrowing position of the public sector since 2008. From a sectoral perspective, the move to a sustained current account surplus will therefore require further balanced improvements in both private and public sector NLB.

Graph 2: Net lending/borrowing by sector



Source: Commission services (Eurostat)
* own estimates

Graph 3: Net lending/borrowing by component



Source: Commission services (Eurostat)

The improvement of the trade balance is only partly driven by permanent factors and remains incomplete. A precise quantification of the relative weight of cyclical versus non-cyclical factors is not straightforward (see Section 3.2 for more details). In the case of exports, while non-price-related factors continue to play a role (increasing geographical diversification and product specialisation), recent improvements in price competitiveness should help sustain the strong export performance in the coming years. With regard to imports, the observed shift in the composition of final demand towards exports implies a reduced overall response of imports to final demand, as their elasticity to domestic demand is much higher than their elasticity to exports (1.5 compared to 0.6). Nevertheless, the slump in domestic demand and

⁷ Record low saving rate of households in Q3 2012 has been also driven by some temporary factors. Households increased their consumption in this quarter as they advanced their purchases ahead of the expected Value Added Tax (VAT) increase.

the severe deterioration in the labour market have clearly been key drivers of the fall in imports and have contributed to the adjustment in the trade balance. Without these factors the current account would have recorded a much higher deficit. While part of the fall in demand can also be considered to be of a lasting nature, further improvements in export performance and a further rebalancing of the economy away from domestic demand are needed to bring about the durable external surplus required to reduce the very high level of net external liabilities⁸ (see Section 3.2 for more details).

Since 2009, the net international investment position (NIIP) has remained broadly unchanged in terms of GDP.⁹ The NIIP stands at a very high level of -92%, substantially above the MIP scoreboard threshold of -35%. The composition of Spain's NIIP adds to the vulnerability of the Spanish economy to external financial shocks (see Section 3.2 for more details). Indeed, in the first half of 2012, Spain experienced a major shortage of private external financing, which was filled by an increased reliance on Eurosystem financing. While these problems have abated since late 2012, they demonstrate the extent of vulnerabilities and the potential repercussions on financial stability, the real economy and, thus, also public finances. Central bank credit has counteracted the potential impact of a 'sudden stop' in external financing and a major credit crunch, thus making it possible for policy-makers to introduce policies addressing the underlying structural problems.

2.2.2. Export performance and competitiveness

Exports of goods and services have been resilient. Despite a significant loss of cost and price competitiveness during the boom years, Spain experienced a modest loss in export market share in comparison to other European countries. As discussed in the 2012 IDR and in Section 3.2, this puzzle can be explained by the duality of the Spanish economy (different characteristics of export firms compared to the national average) and the impact of non-price competitiveness factors. Spanish export firms remained relatively competitive during the decade prior to the crisis, while on average the economy recorded significant losses in competitiveness. In addition, Spain's good export performance appears to be due to improved product specialisation as well as to geographical diversification. In the most recent years, the robust export performance has also been supported by some improvements in cost competitiveness, as unit labour costs have been falling since early 2010 (see Graph 4). This trend is expected to continue in 2013-14, according to the Commission services' 2013 winter forecast, but at a more moderate pace. While exports of services have been less dynamic than exports of goods in the period 2010-2011, this trend reversed in 2012, driven by rapid growth of exports of non-tourism services (see Section 3.2 for more details). Exports of non-tourism services are expected to increase their relative importance in the composition of Spanish exports in the coming years.

An unfavourable size distribution of firms may hamper further improvements in export performance. Spain has traditionally been characterized by a relatively low number of exporting firms compared to its European peers, although this number has been steadily increasing. Thus, the rise in the number of exporting firms (the extensive margin) appears to

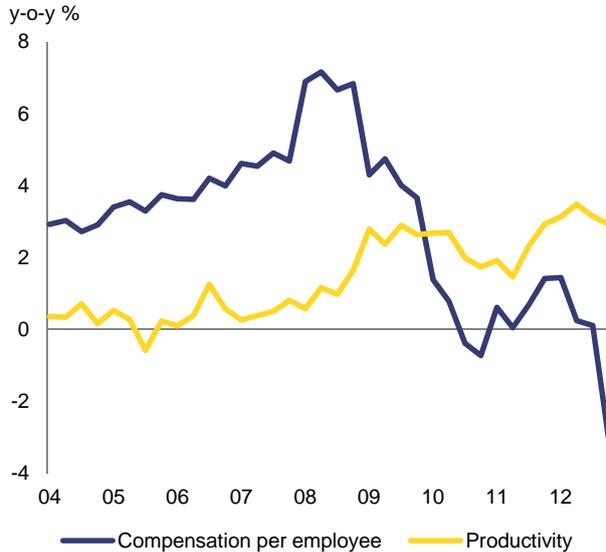
⁸ As an illustration, according to the Commission services' estimates, a primary current account surplus of 1% of GDP would be required on average to reduce the net international investment position (NIIP) to 50% of GDP over 20 year horizon.

⁹ The negative NIIP peaked in 2009 at 93.8% of GDP, declined slightly to 89.5% of GDP in 2010 and increased again to 91.7% in 2011, driven by the denominator effect.

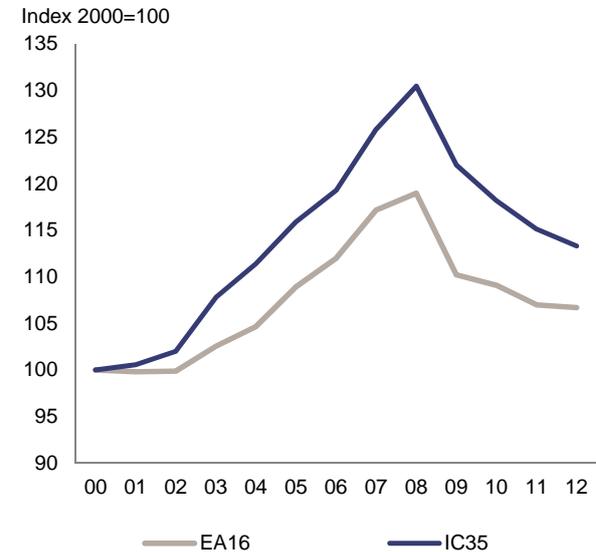
have contributed significantly to the growth of exports since 2008. However, how lasting is the presence of smaller firms in export markets remains to be seen. More generally, international evidence suggests that the export performance of different countries is closely correlated with firm size. This highlights the need to review possible regulatory and other obstacles that could prevent the emergence of a firm structure more conducive to a stronger export orientation of the economy (see Box 1).

A rise in apparent labour productivity and stronger wage moderation have brought about an improvement in indicators of international cost competitiveness. . Considering the real effective exchange rate (REER) vis-à-vis industrialized countries (IC-35) deflated by the Harmonized Index of Consumer Prices (HICP), the appreciation of REER between 2000 and 2008 was significant (around 20%) and the subsequent adjustment has been much smaller (around 7%). The REER deflated by unit labour costs (ULC) in manufacturing, suggests instead that Spain has already recovered about half of the cost competitiveness lost up to 2008 (see Graph 5-7), extending further the trend observed in the previous IDR.¹⁰ However, the adjustment of ULC has been largely driven by the economic recession and very high unemployment, and it could partly reverse once the cyclical conditions improve. Further lasting improvements in competitiveness and the rebalancing of the economy towards tradable sectors will also require further adjustments in relative prices and wages between the tradable and non-tradable sectors. The adjustment of relative wages has started to be supportive of the rebalancing only more recently. In the long run, increases in productivity at firm level would need to accompany apparent labour productivity improvements to a larger extent to deliver sustainable competitiveness gains.

Graph 4: Productivity and wages



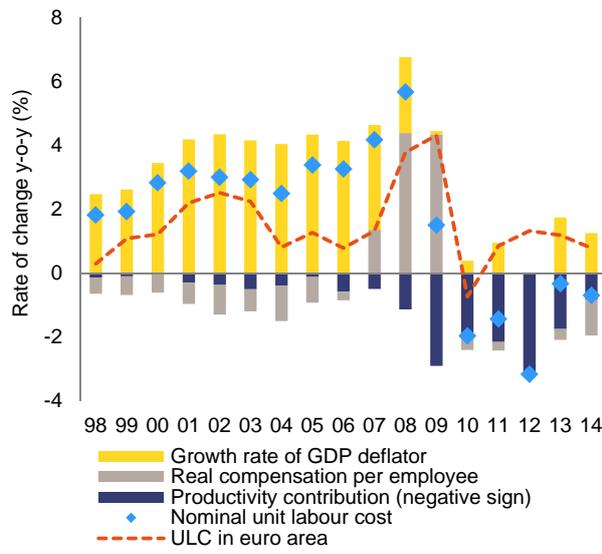
Graph 5: REER (ULC in manufacturing) vis-à-vis EA16 and IC35



Source: Bank of Spain (BdE), Spanish National Statistics Institute (INE) Source: Ministerio de Economía y Competitividad

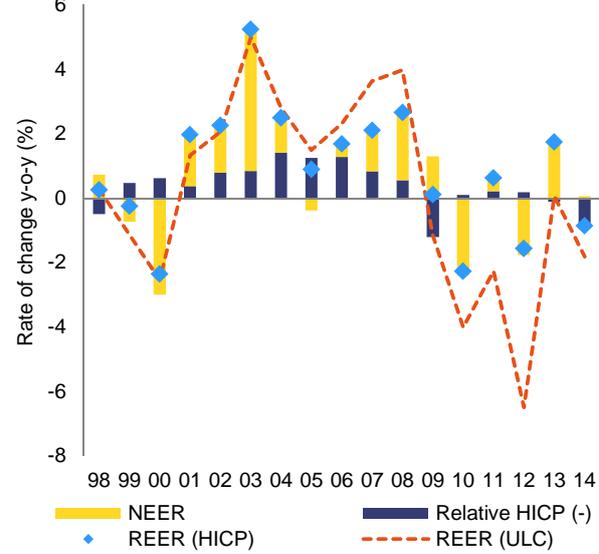
¹⁰ While REER deflated by ULC has adjusted significantly, the adjustment has been less pronounced if REER deflated by export prices is considered, where only about one third of the competitiveness lost has been recovered. This implies that improvements in external cost competitiveness will not be as fast as implied by the ULC reductions.

Graph 6: Decomposition of developments in ULCs¹¹



Source: Commission services (Ameco)

Graph 7: Decomposition of developments in the REER (ULC-based)¹²



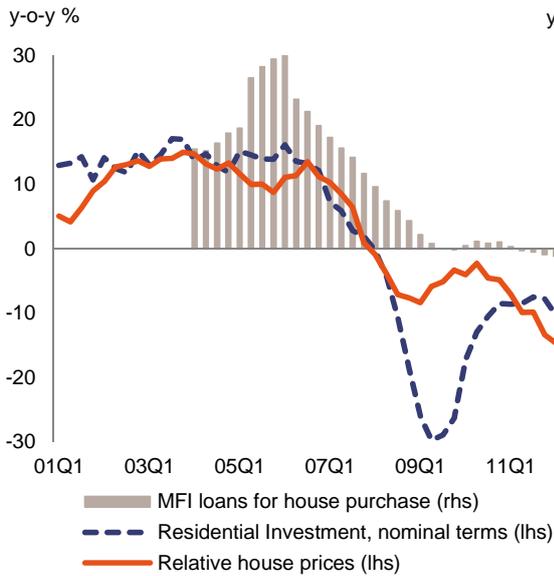
Source: Commission services (Ameco)

2.2.3. *Housing market*

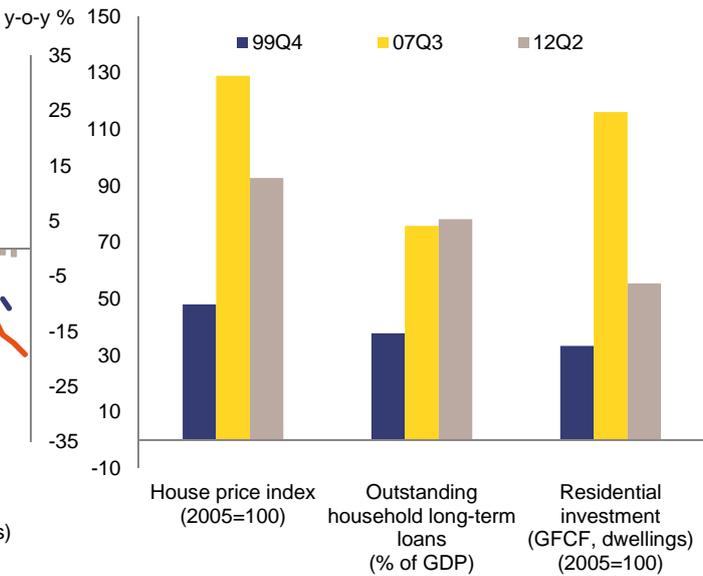
The adjustment in the housing sector has been severe but has not bottomed out yet. The housing boom in Spain was unusually long and intense. House prices almost tripled between 1997 and early 2008, while the construction of housing more than doubled from its 1995 level (see 2012 IDR). The weight of investment in construction reached 22% of GDP in 2006-07, up from 15% in 1995. This represented a significant diversion of productive resources from the tradable sector to the non-tradable construction sector. The turning point had already been reached in late-2006 and early-2007, when interest rates started to rise. As the economy still grew by close to 4% in 2007, the initial adjustment was relatively soft. However, the economic and financial crisis in 2008 triggered a much sharper correction (see Graph 8 and Graph 9). In particular, a combination of a sharp drop in housing demand and existing oversupply of houses resulted in a downward correction of house prices, which has accelerated in recent quarters.

¹¹ 2012-14 based on Commission services' 2013 winter forecast (European Commission, 2013b).
¹² 2012-14 based on Commission services' 2013 winter forecast (European Commission, 2013b).

Graph 8: Dynamics of housing and Graph 9: House prices, mortgages and residential investment



Source: BdE, Eurostat, ECB, OECD



Source: BdE, Eurostat, OECD

The fall of investment and employment in construction is continuing, driven by residential construction. The share of residential investment in total GDP fell from 12.5% of GDP in 2006 to 5.3% in the fourth quarter of 2012, below the historical low of 7% in 1997. However, the adjustment is still ongoing, with residential investment falling by 8.7% year-on-year in the fourth quarter of 2012. At the same time, employment in the construction sector fell by around 1.6 million (2008-12), and continues to fall even though the weight of construction in employment has reached its lowest level since 1976. In addition, the number of house permits is still declining, suggesting that the trough in this sector may not be reached before 2014-15.

Absorption of the excess supply of houses is progressing slowly. The oversupply of new housing is estimated by the government to be around 700,000 units.¹³ Demand for housing has been weak and is set to deteriorate further in line with its fundamental determinants, including falling household real disposable income and declining population. Tight financing conditions and the expectation of further price declines also contribute to depressing demand. Sales of new houses fell from more than 400,000 in 2007 to around 115,000 in 2012. Taking into account the number of transactions between July 2011 and June 2012, it could take approximately six years to absorb the remaining stock of unsold houses.¹⁴

House prices are expected to fall further. The fall in house prices accelerated in 2012 (-12.8% year-on-year in Q4 2012), reaching an overall fall of 31% in nominal terms and 38% in real terms since the peak in 2007.¹⁵ This is consistent with what was anticipated in last year's IDR. Given the still ongoing adjustment in the construction sector, the stabilization of house

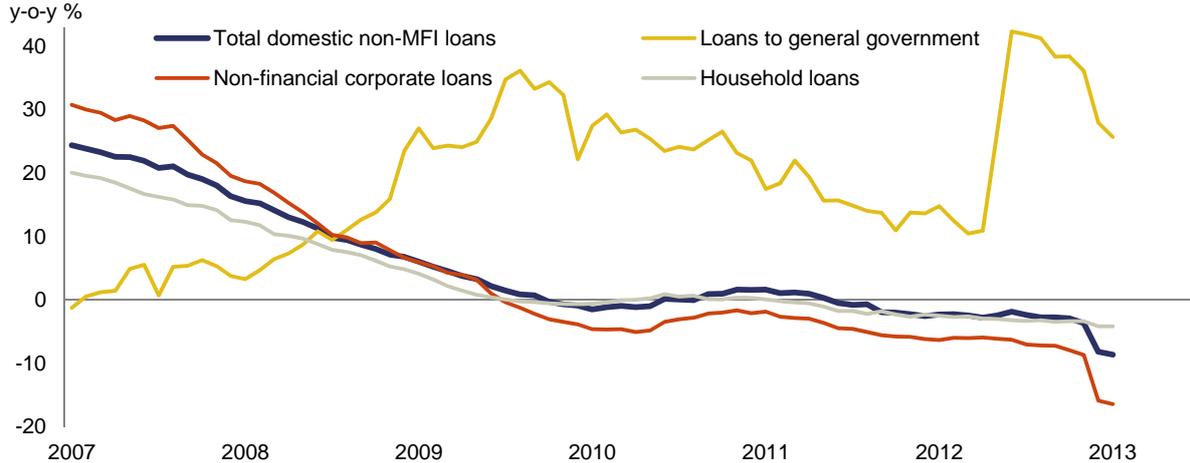
¹³ An updated estimate should be available in the first half of 2013
¹⁴ Housing needs are estimated to exceed 200,000 dwellings per year (considering the evolution of population and the recent trends in home composition). To the extent that these housing needs are converted into an effective housing demand, the stock of unsold dwellings could be absorbed in a period of about four years.
¹⁵ Based on the Spanish National Statistics Institute's (INE) house price index.

prices may have now been pushed towards 2014, notwithstanding considerable variation in housing market conditions across regions. Other factors impacting on house prices include the elimination of tax incentives as of the beginning of 2013 and the transfer of problematic real estate assets from state-aided banks to the AMC (Sareb¹⁶). Sareb's large portfolio of foreclosed assets will consist predominantly of houses. While its sales of assets are likely to be gradual, its presence may incentivise other players in the market to accelerate their sales, thus leading to a faster adjustment of prices and a quicker stabilisation of the housing market.

2.2.4. *Deleveraging by households and non-financial corporations*

Private sector deleveraging is progressing predominantly through the adjustment in net lending. The credit boom, with annual growth rates of around 20% in the middle of the last decade, was largely driven by loans related to construction and housing, although loans for household consumption also played a role. The fall in housing demand from 2008 onwards, along with the tightening of credit conditions, contributed to a contraction of credit. In November 2012,¹⁷ total domestic credit shrank by 3.6% year-on-year, driven by the decline in credit to the private sector (-4.5%, see Graph 10). Domestic lending to non-financial corporations and households fell by 8.7% and 3.4% year-on-year respectively.

Graph 10: Evolution of domestic credit



Source: BdE

Despite a significant adjustment in terms of credit flows, private sector debt remains particularly elevated. Households and firms remain overly indebted relative to other EU countries as well as by historical standards as measured with respect to their assets and their capacity to repay debt (see Section 3.1 for more details). Overall, the private sector has reduced its indebtedness by about 15pps. of GDP from its peak, but leverage is still much above the pre-boom levels and the MIP scoreboard threshold (213% of GDP in Q3 2012 against the MIP scoreboard threshold of 160%). Given the size of the imbalances as well as

¹⁶ Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria, S. A.
¹⁷ The latest available data are for January 2013. However, these data (as well as data for December 2012) are artificially affected by the impact of the transfer of assets from banks which were already state-owned at the time of the stress test to Sareb.

the historical and cross-country experience, the deleveraging is likely to take long (see Section 3.1 for more details) and to continue to hold back domestic demand. By the third quarter of 2012, the debt-to-GDP ratio had declined by around 7 pps. for households and 8 pps. for non-financial corporations compared to their respective peaks.

Non-performing loans (NPL) are set to rise further. The current double-dip recession could put additional strain on the balance sheets of households and non-financial corporations. The already-record-high unemployment rate is projected to increase further and to affect to a greater extent those households with formerly stable employment, who are the most exposed to housing loans (see Graph 11). The level of non-performing mortgage loans, although still relatively low, has been increasing in recent quarters, reaching 3.5% in the third quarter of 2012 from around 3% in 2011. The real estate and construction sectors account for the bulk of total NPL. In the third quarter of 2012, the share of NPL stood at 30% for real estate activities and 26% for construction sector, compared to 8% level for industry, excluding construction and a similar level for other services. As the adjustment of the housing market continues and further drops in house prices are expected, the NPL in these two sectors are likely to increase further in the coming months.

Spanish financial institutions have significantly increased their loan loss provisions since the beginning of the crisis. This process has accelerated in 2012 with Royal Decree Law (RDL) 2/2012 and RDL 18/2012, which raised the provisioning requirements for real estate developers exposure. Between 2008 and September 2012, banks increased their specific provisions by about EUR 92 billion (around 8% of GDP). The ongoing recapitalisation of the Spanish banking sector under the financial assistance programme ensures capital buffers in the event of further rises in NPL.¹⁸

The high stock of private debt remains a drag on growth and a source of vulnerability, exacerbated by rigidities in product and service markets. Prolonged deleveraging implies significant negative effects for growth, financial stability and, via these two channels, for public finances. Even though risks for financial stability stemming from the deterioration of bank's assets are being addressed by the ongoing banking sector capitalisation and restructuring, they could still be reignited in case of a steep deterioration in the economic environment or external financial shocks. There is in particular the risks of negative feedbacks between deleveraging in the non-financial private sector and fiscal consolidation, lower growth and employment, the capacity of households and companies to repay debt and the capacity and willingness of the banking sector to provide financing to the real economy. The negative impact of the necessary adjustment is greater in an environment of inflexible labour and product markets (see Section 3.1 for more details).

2.2.5. *Public debt*

General government debt is a rapidly emerging imbalance, largely as a consequence of the adjustment in the private sector, the weak macroeconomic outlook and financial sector support. The misalignment between public expenditure and public revenues, which were based on a tax-rich growth pattern during the housing boom, has contributed to fuel the

¹⁸ The capital needs were estimated on the basis of an asset-quality review and a bottom-up stress test. Both the baseline and adverse scenarios of this exercise can be still considered valid references according to current developments and updated macroeconomic forecasts. For details, see http://www.bde.es/f/webbde/SSICOM/20120928/informe_ow280912e.pdf.

increase in debt. In nominal terms, general government debt has increased by about 102% since end-2008 (until Q4 2012 when it reached 84% of GDP) and is expected to reach close to 100% of GDP by 2015 despite fiscal consolidation. One of the important effects of rising fiscal deficits and growing general government debt has been a significant increase in Spanish risk premia, with knock-on effects on the cost of financing of the financial and non-financial private sector.

The 'electricity tariff deficit' implies a considerable contingent liability for the budget as well as non-negligible macroeconomic risks and may negatively affect the debt dynamics in the future. In 2012, the deficit (i.e. the gap between regulated 'access tariffs' paid by consumers and various regulated costs - including distribution costs and subsidies for renewable energy production) reached over EUR 5 billion (around 0.5% of GDP), exceeding the envisaged level of EUR 1.5 billion by a wide margin. Some new measures were recently adopted to contain the deficit in the future, including new taxes on energy production, a revision of the annual adjustment of regulated costs, and a simplification of the system of support to renewable energy sources. Despite these measures the electricity tariff deficit is still expected to be sizeable in 2013, leading the authorities to propose in February an extraordinary credit from the state budget of EUR 2.2 billion. The accumulated tariff debt amounts to almost 3% of GDP.

2.2.6. Labour market

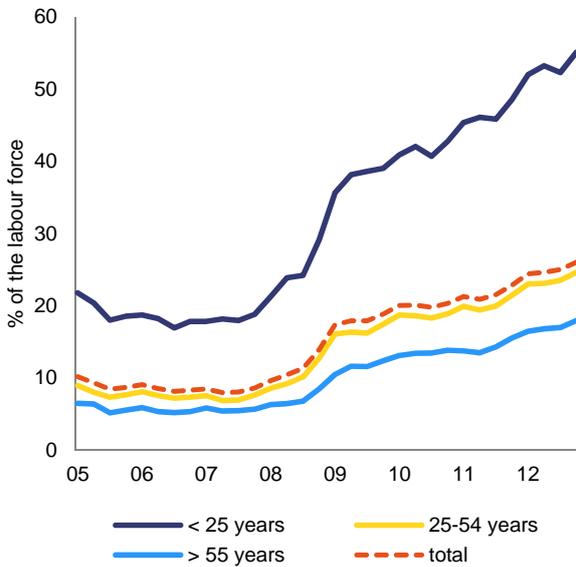
The economic adjustment in the context of a dual and overly rigid labour market structure has contributed to a dramatic decline in employment. Employment was affected disproportionately by the economic downturn due to the downsizing of the construction sector and to rigidities in the labour market. The lack of flexibility at the firm level coupled with a system of dual employment protection has resulted in a massive dismissal of (mostly) temporary workers. A comprehensive labour market reform was adopted in February 2012 and passed by law in July 2012. This reform allows firms greater flexibility to adjust wages and employment (including working hours) to their specific economic situation. It also lowers dismissal costs of permanent workers and reviews dismissal procedures as a means to reduce duality. However, severance pay for unfair dismissals remains elevated in international comparison, while the gap between severance pay for temporary and permanent contract is biased in favour of employment of limited duration. Given the current weakness of the Spanish economy and the relatively short time span since the entry into force of the final provisions of the reform, it may still take some time before its effects become fully apparent. However, evidence regarding wage moderation and duality appears to be more mixed and a thorough assessment of the reform would have to critically review the impact on wage dynamics and labour market segmentation. Active labour market policies (ALMP) play a still insufficient role in promoting labour mobility and in reducing the occupational and skills mismatch.

There are growing risks of hysteresis effects in the labour market and thereby of a reduction in future potential output growth. The unemployment rate reached 26% in the fourth quarter of 2012 (see Graph 11) and is expected to increase further in 2013, according to the Commission services' 2013 winter forecast. The youth unemployment rate reached 55%. A novel trend since the previous IDR is that permanent employment is now decreasing at similar rates as temporary employment (see Graph 12). Moreover, the duration of the crisis has led to an increase in long-term unemployment. In the last quarter of 2012, more than one half of total unemployment was long term - twice the level of 2008. In this context, the

employability of young and long-term unemployed (many of the latter are low-skilled workers, especially from the construction sector) poses a major challenge.

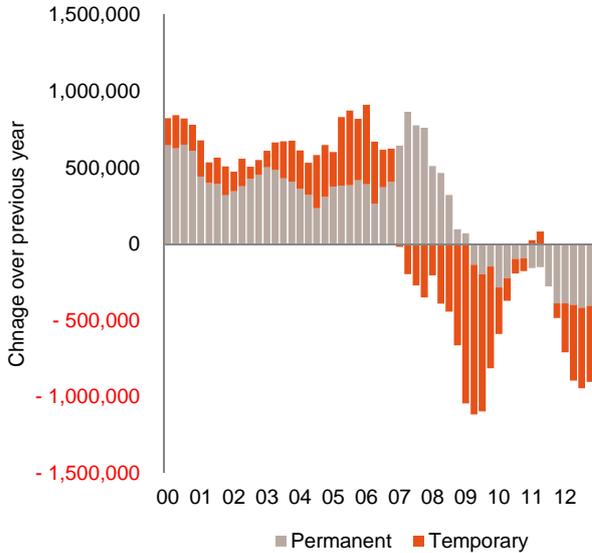
Improving employability would be important to address these risks and ensure the effectiveness of the February 2012 reform. Reinforcing active labour market policy could help activating the unemployed and upgrading their skills, especially for those more at risk, like the young and long-term unemployed and low-skilled. It would also contribute to promote the rebalancing of the economy towards more export-oriented sectors.

Graph 11: Unemployment by age group



Source: Commission services (Eurostat)

Graph 12: Change in the number of employees by contract duration



Source: INE

3. IN-DEPTH ANALYSIS OF SELECTED TOPICS

3.1. Private sector deleveraging

3.1.1. Introduction

Private sector indebtedness remains a major macroeconomic imbalance in Spain. Both households and non-financial corporations more than doubled their debt levels as a share of GDP in the decade following the introduction of the euro. With credit flows averaging around 23% of GDP during 2000-2007, the stock of private sector debt peaked at 227% of GDP in 2010, leaving the Spanish private sector amongst the most indebted across the Member States. The large debt overhang implies significant deleveraging pressures, which will take time to be alleviated and will continue to weigh on domestic demand and economic growth. The overexpansion of lending has also resulted in a large amount of impaired assets in banks' balance sheets, requiring public support for the recapitalisation of a significant part of the banking system.

While the deleveraging¹⁹ process gained speed over 2011 and 2012, the impact on debt stocks is gradual. The total stock of debt stood at 213.5% in the third quarter of 2012, some 15 pps. of GDP lower than the peak reached in the second quarter of 2010, mostly due to a fall in non-financial corporation debt. A gradual decline in debt is in line with historical experience showing that deleveraging processes take considerable time and imply large output losses, particularly when accompanied by banking and housing crises.²⁰ A reduction in the debt-to-GDP ratio can occur through different levers: (i) negative net credit flows, (ii) inflation, (iii) real GDP growth, and (iv) debt write-offs.²¹ In Spain, it is being driven mainly by the reversal of credit flows, although write-offs are also playing a role in the corporate sector. The prolonged economic contraction hampers the deleveraging process via the denominator effect but also via its impact on the saving potential of households and non-financial corporations. Labour and product market rigidities and a high degree of price and wage inertia have magnified the loss in output and employment associated with the reallocation of resources in the economy and deleveraging.

Different benchmarks suggest that the private sector is subject to high deleveraging pressures. Both households and firms remain overly indebted in terms of both the actual level of debt and the build-up of debt over the boom period 2000-08. When comparing current debt levels to static benchmarks such as that based on the MIP threshold methodology or pre-boom level of the debt ratio in 2000, the required remaining adjustment of the debt-to-GDP ratio is considerable: for households it would be 24 to 36 pps. and for non-financial corporations 45 to 60 pps. (see Graph 13 and Graph 14). In an alternative approach private sector debt is

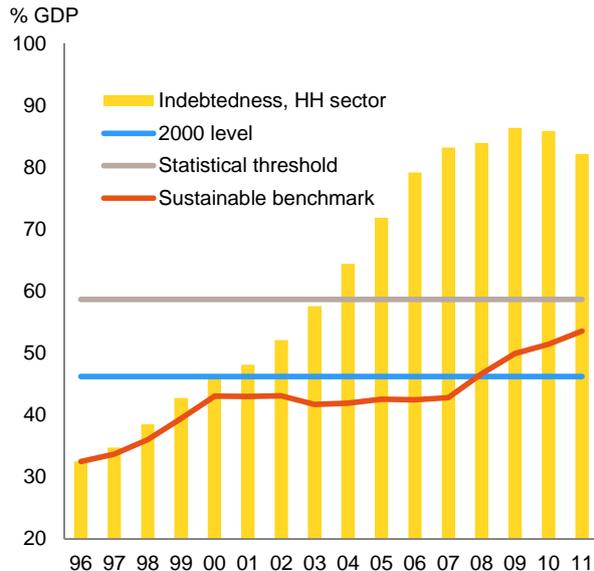
¹⁹ Throughout the text, deleveraging should be interpreted as a decrease in the debt-to-income or the debt-to-asset ratios, as specified in the text.

²⁰ Countries with boom-bust credit cycles typically have deep recessions and sluggish recoveries, with GDP remaining 9-10% below the pre-crisis trend in the next 5-10 years (IMF (2009)). Deleveraging episodes accompanied by a housing crisis took 5.5 years on average across high-income OECD economies and reduced private debt-to-GDP ratios by 20 pps. If they were accompanied by a banking crisis, they took 7 years, the reduction in debt-to-GDP was 30 pps. on average and the recovery in GDP was considerably slower (see Aspachs-Bracons, et al., 2011). Evidence presented by IMF (2012a) indicates that housing crises, which are preceded by a build-up of household debt, result in a fall in real private consumption and GDP of 4%, on average, over a 5-year period. In the absence of a banking crisis the decline in private consumption is limited to 2%.

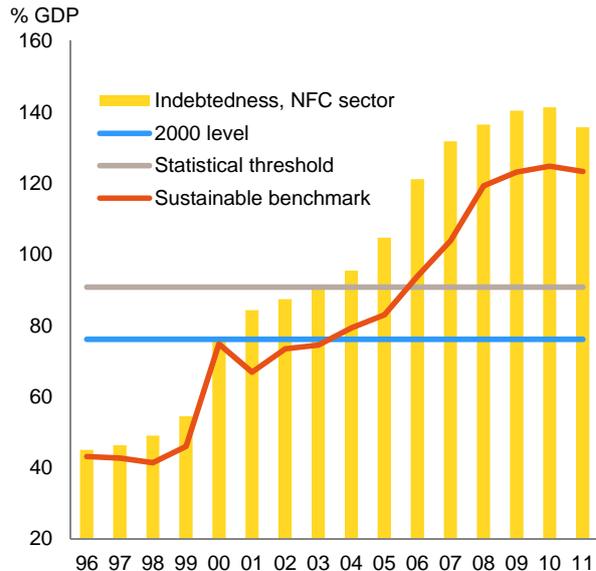
²¹ When considering debt-to-assets, valuation effects on assets and liabilities are also important.

considered sustainable if the notional leverage is stationary²² - i.e. if deflated debt were to evolve in line with deflated assets. Graphs 13 and 14 show that, between 2001 and 2007, the gap between actual debt and its balanced or sustainable path increased rapidly, especially for households. In the case of households, this was due to a significant extent to the expansion in liabilities associated with rapidly rising house prices. Taking into account the recent correction, the gap between actual debt-to-GDP ratios and their balanced paths is 29 and 12 pps. for households and non-financial corporations respectively. The following sub-sections look at the household and non-financial corporation sectors in greater detail.

Graph 13: Debt sustainability, Households (HH)²³ **Graph 14: Debt sustainability, Non-financial corporations (NFC)²⁴**



Source: Commission services (Eurostat)



Source: Commission services (Eurostat)

3.1.2. Households

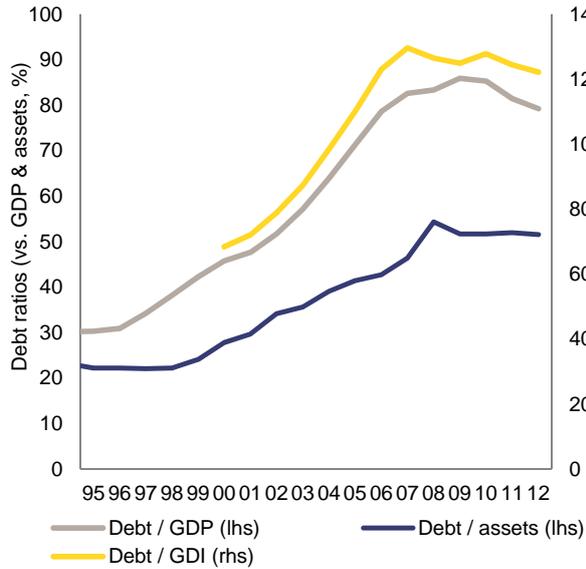
Spanish households' leverage grew at a very fast pace in the run up to the financial crisis in 2008. Driven mostly by low interest rates, abundant credit availability, and easy financing conditions, the household debt-to-GDP ratio increased to 86% of GDP in 2010, more than twice the level in 2000 (see Graph 15). As a share of gross disposable income, household debt surged to 131% in 2007, from 69% in 2000. Much of the increase in household debt was linked to residential mortgages. Consumer credit also contributed to the increase, although to a much lesser extent (see Graph 16).

²² The 'notional leverage' is the ratio of debt-to-assets adjusted for valuation effects. It represents an indication of the ability of households and non-financial corporations to incur liabilities.

²³ Sustainable benchmark: Private debt is considered "sustainable" whenever it implies that debt evolves in line with deflated assets (i.e. assets corrected for valuation effects). In technical terms, the debt-to-assets ratio adjusted for valuation effects (i.e. "notional leverage") should be stationary. Statistical threshold: This is the debt-to-GDP ratio corresponding to the third quartile of the 1995-2008 distribution of this variable for EU27 Member States.

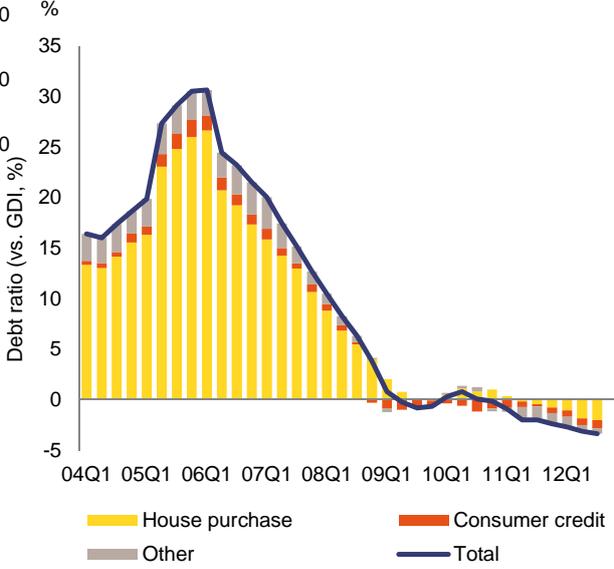
²⁴ See footnote 23.

Graph 15: Household indebtedness indicators



Source: BdE, INE

Graph 16: Decomposition of rate of change of household debt

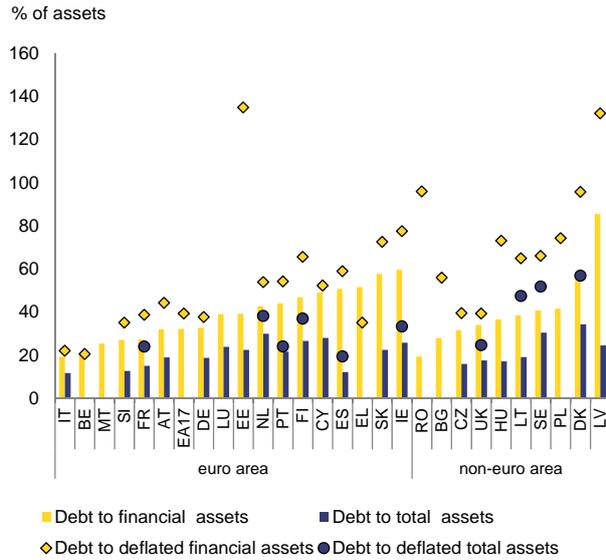


Source: BdE

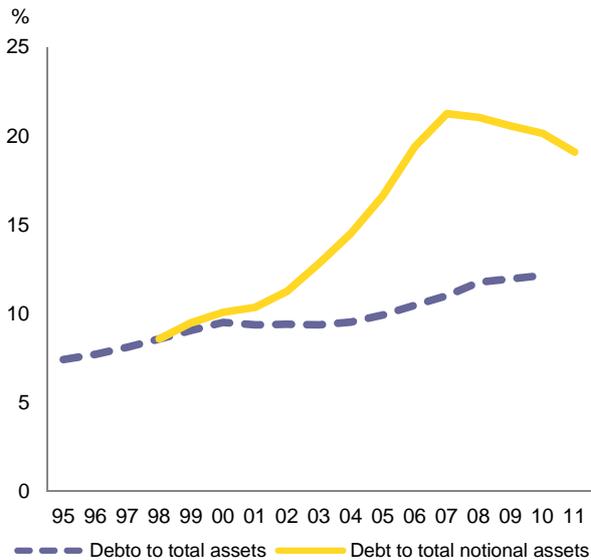
The increase in household debt went hand-in-hand with the accumulation of non-financial assets. Non-financial assets represent the bulk of Spanish household wealth.²⁵ Compared to most other Member States, the gap between household debt-to-financial assets and debt-to-total assets ratios in Spain is relatively higher. This can be explained by the fact that the proportion of housing assets in household balance sheets is also higher in Spain than in other Member States (see Graph 17). As such, the household balance sheet expansion in the boom period gave rise to a mild increase in the leverage ratio as debt grew broadly in line with an expanding value of non-financial assets (see Graph 18). However, if adjusted for valuation changes, where valuation effects on debt-generating instruments are minor compared to those on assets (in particular considering the large increase in house prices), household debt grew much faster than deflated assets, implying a sharp increase in notional leverage. Even on this metric, the debt total asset ratio remains below 20%, which is relatively low by international standards.

²⁵ Indeed, 87% of household total net wealth is related to housing, reflecting a high ownership ratio and a significant degree of ownership of secondary houses, while the remaining 13% constitutes financial wealth.

Graph 17: Household indebtedness, EU 27 countries, 2010 **Graph 18: Household notional leverage²⁶**



Source: Commission services (Eurostat)

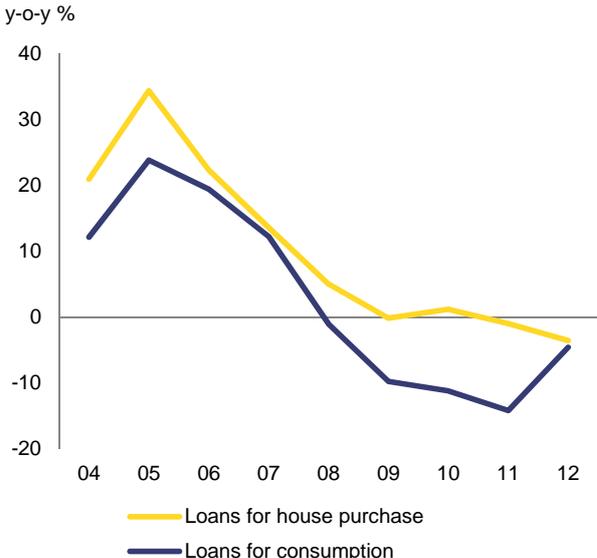
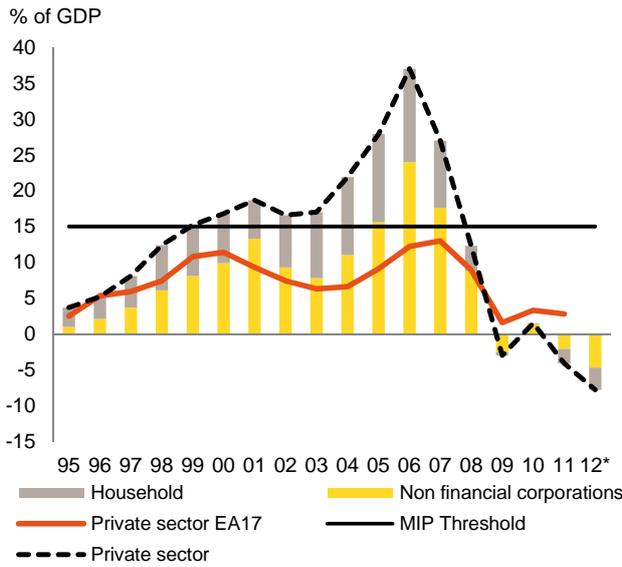


Source: Commission services (Eurostat)

The household debt-to-GDP ratio is on a mild downward path, driven by an adjustment in the flow of credit. When GDP growth contracted following the outbreak of the crisis, the debt-to-GDP ratio continued to increase. Subsequently, the debt ratio stabilized and moved on a downward path from the second half of 2010 onwards, falling from 87% of GDP to around 80% of GDP in the third quarter of 2012. As a share of gross disposable income, debt fell to 123%, despite falling disposable incomes in 2010-12. These ratios remain high from both historical and cross-country perspectives. Household borrowing has been contracting since 2009 (see Graph 19). The contraction was faster in consumption loans than mortgages, but the former account for a small part of total debt (see Graph 20).

²⁶ See footnote 22.

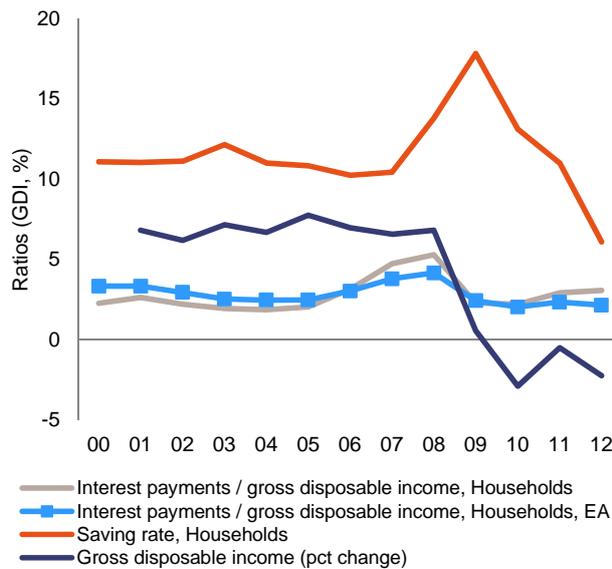
Graph 19: Sectoral decomposition of credit flows



Source: Commission services (Eurostat) Source: Commission services (Eurostat)
 * estimation based on quarterly data

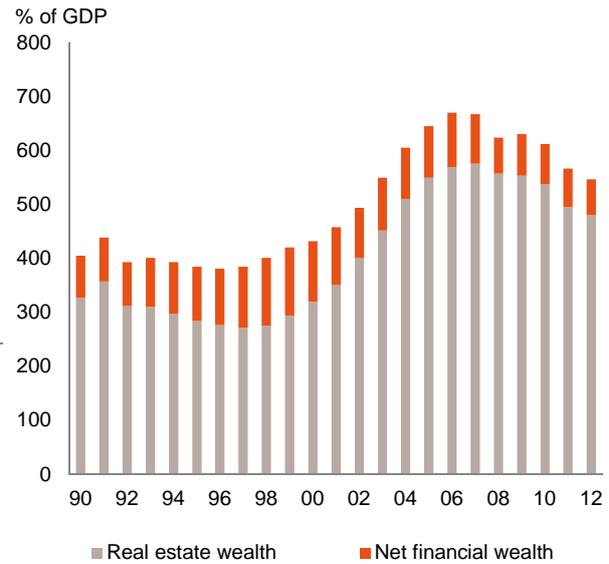
Households appear to have gradually exhausted their financial asset buffers. During the crisis, the composition of household financial assets has shifted towards less risky and more liquid instruments, in particular deposits. As discussed earlier, the household saving rate has already fallen below its pre-crisis level. Debt servicing burden has risen somewhat from the low levels seen in the first period of the financial crisis, as disposable income has been diminishing (see Graph 21). Real disposable incomes are being squeezed by rising unemployment, wage moderation and relatively persistent inflation due to the impact of hikes in indirect taxes and tariffs. Household net wealth has also declined (see Graph 22), mainly due to the fall in real estate prices, which has gathered pace in recent months. Total wealth remains high by international standards but near-term prospects for both incomes and wealth are negative as unemployment continues to rise and house prices are expected to decline further. Moreover, the predominance of non-financial assets reduces the degree of liquidity of household wealth. All in all, the household capacity to repay debt has been weakened and is subject to risks going forward.

Graph 21: Financial position of households



Source: Commission services (Eurostat)

Graph 22: Households' total wealth



Source: BdE

The household sector has moved into a net-lending position since 2008. Falling employee compensation, wealth losses on financial and non-financial assets and increased uncertainty spurred a sharp increase in the saving rate to around 19% in 2009. Subsequently, the saving rate declined to a historical low of 8.8% of gross disposable income (GDI) in the third quarter of 2012, well below its long-term historical average level of 11%. Households are expected to remain net lenders over the coming years, but the saving rate is expected to remain subdued due to the combination of falling disposable income and already low per capita consumption expenditure. This will limit the ability of households to rapidly reduce their debt ratios.

The pace of household deleveraging is also constrained by the high share of mortgage debt. More than 90% of household debt consists of mortgages, almost all of which have variable interest rates linked to the 12-month Euribor rate. These mortgages have maturity periods of over 20 or 30 years. The burden on households has been mitigated by the fall in euro-area short-term interest rates, as well as by refinancing programmes offered by many credit institutions.²⁷ Recently, the government has taken measures to protect the most vulnerable mortgage borrowers. In addition, Spain has relatively complex and lengthy bankruptcy procedures for both households and non-financial corporations. As a result, bankruptcy procedures are rarely undertaken by households and the personal insolvency rate is very low.²⁸ Finally, tax incentives for owner-occupied housing, now discontinued for new purchases, may be discouraging households from earlier repayment of outstanding mortgages.

The rate of non-performing mortgages is low (3.5% in the third quarter of 2012) but its rise has accelerated recently. This low rate is partly explained by generally prudent loan-to-value ratios²⁹ and the legislation that makes borrowers liable for all their assets in the event of

²⁷ It is estimated that households save as much as 30% of monthly mortgage payments when compared to the initial date when the loan was taken (S. Gonzalez, 2012).

²⁸ Insolvencies in Europe', CreditReform, February 2012

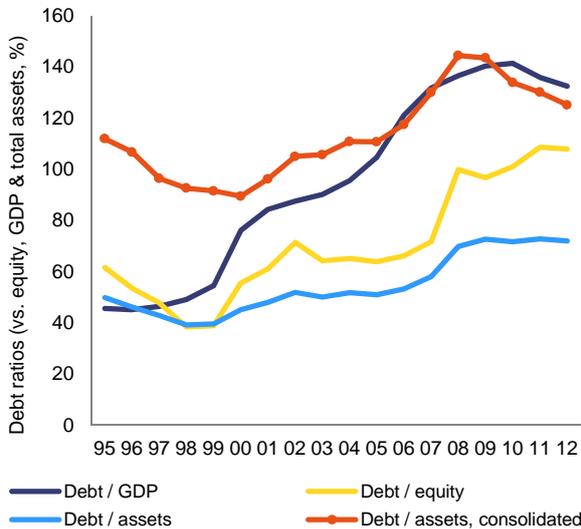
²⁹ According to the 2011 European Banking Authority's EU-wide stress test, the mortgage loan-to-value ratio was slightly below 55% in 2010.

the risk of default. The current recession, if prolonged, could additionally strain household balance sheets and hamper orderly deleveraging efforts.

3.1.3. *Non-financial corporations*

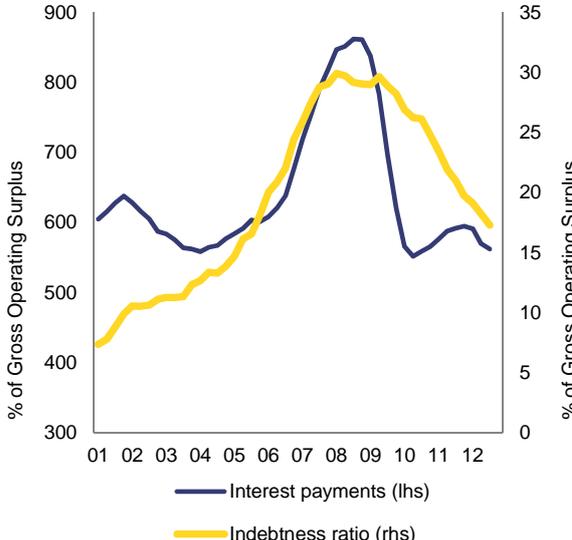
Non-financial corporations are highly indebted relative to other EU countries as well as by historical standards. Their debt increased from around 45% of GDP in 1996 to around 140% in 2010 (see Graph 23). The debt-to-asset ratio is also high, in particular if assets are measured on a consolidated basis (excluding intra-sector incurrence of debt). The ratio stands at 133% of GDP, vis-à-vis a euro-area average of 76%. Similarly, when measuring leverage with respect to gross operating surplus, a proxy for firms' capacity to generate income and thus repay the debt, non-financial corporations appear to be highly leveraged, as debt is six times higher than the gross operating surplus (see Graph 24). All in all, Spanish non-financial firms appear over-indebted with respect to both their assets and their capacity to repay debt.

Graph 23: NFC leverage indicators



Source: BdE, INE

Graph 24: NFC indebtedness and financial burden

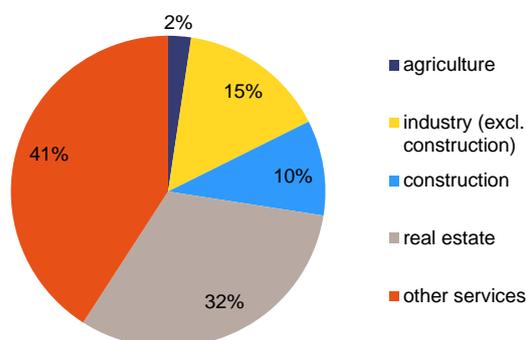


Source: Commission services (Eurostat)

The increase in indebtedness of non-financial corporations was to a large extent driven by the real estate boom. During the years of strongest growth of credit to non-financial corporations (2004-08), credit to construction and real estate activities accounted for 54% of the overall credit growth. As a result, the bank debt³⁰ of the construction and real estate sectors represents 10% and 32% of total bank lending to non-financial corporations respectively in the third quarter of 2012 (see Graph 25). Other sectors appear relatively less indebted and in line with EU and euro-area averages (except for sectors like hotels and restaurants whose leverage is slightly higher than in most euro-area countries).

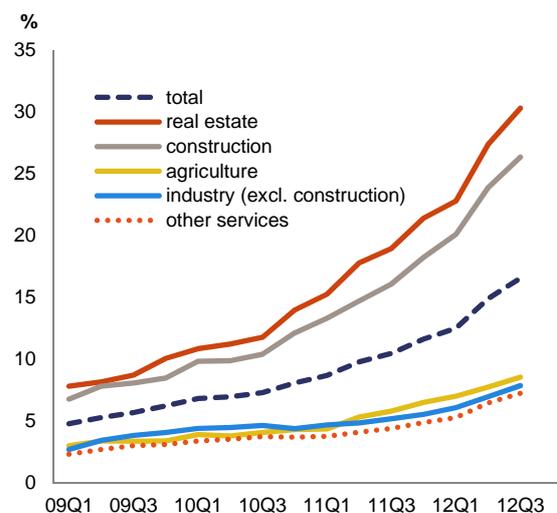
³⁰ Debt is defined as the sum of loans and securities other than shares. Loans (banks debt) represented 98% of the overall debt in the third quarter of 2012.

Graph 25: Breakdown of NFC bank debt by sector (3Q 2012)



Source: BdE

Graph 26: Evolution of share of doubtful loans in total loans by non-financial corporate sectors



Source: BdE

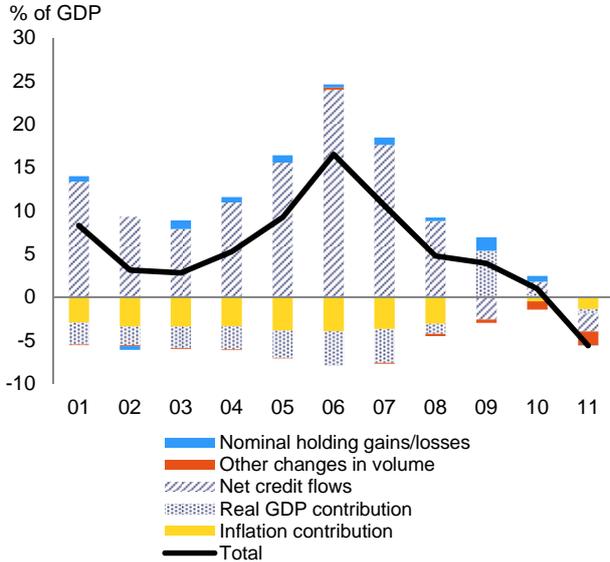
The very weak financial position of the construction and real estate sectors will continue to impact on the evolution of corporate deleveraging. These two sectors have the highest leverage (measured by the debt-to-asset ratio) and account to a large extent for the increase in non-performing loans in the corporate sector (see Graph 26). While the ratio of NPL to total loans is around 8% for industry and services not related to real estate or construction, it is 26% for construction and 30% for real estate activities. According to the latest Bank of Spain (BdE) data (Q3 2012), 74% of total NPL are linked to real estate and construction activities. A scenario of higher defaults in the construction and real estate sector has been considered in the bottom-up stress test exercise of the Spanish banking sector aimed at establishing the necessary recapitalisation amounts under the financial assistance programme.

The deleveraging of non-financial corporations has accelerated in recent quarters. A rapid adjustment of credit flows started when the Spanish economy entered into a recession in 2009 (see Graph 19). Since then, nominal debt has been on a declining path. By the third quarter of 2012 it had decreased by around 6% from its peak in 2008, although the pace of deleveraging has been uneven across different sectors. In particular, while credit to the construction sector has adjusted significantly, credit to real estate activities has been adjusting in line with the non-financial corporation sector average (see Graph 29).³¹ This different speed of adjustment of flows is also impacting the adjustment of the stock of accumulated debt (-41% for construction sector vs. -12% for real estate activities). Due to the contraction in GDP (denominator effect), the debt-to-GDP ratio started to decrease only in 2010 (see Graph 27). The adjustment in the corporate sector tends to be faster than in the household sector. This is largely due to the greater importance of debt write-offs, mainly as regards construction and real estate loans, and the shorter maturity of debt. By the third quarter of 2012, the non-financial sector debt-to-GDP ratio had decreased by 8.4 pps. from its peak. The adjustment with respect to consolidated financial assets has been much more significant,

³¹ Anecdotal evidence suggests that big construction companies, which are also present on the international market, have started divesting their assets abroad thus helping to reduce their indebtedness.

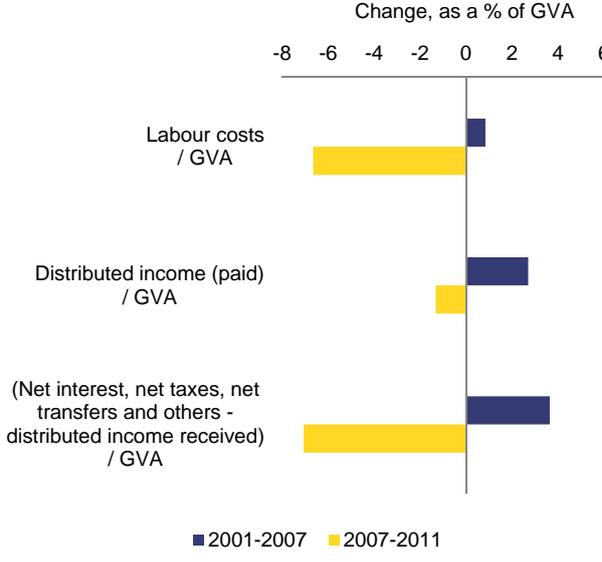
nearly 14 pps. However, when measured against equity or financial assets (non-consolidated), leverage is still on an upward path due to negative valuation effects.

Graph 27: Decomposition of change in ratio of NFC debt to GDP



Source: Commission services (Eurostat)

Graph 28: Change in selected ratios from income accounts, NFC



Source: Commission services (Eurostat)

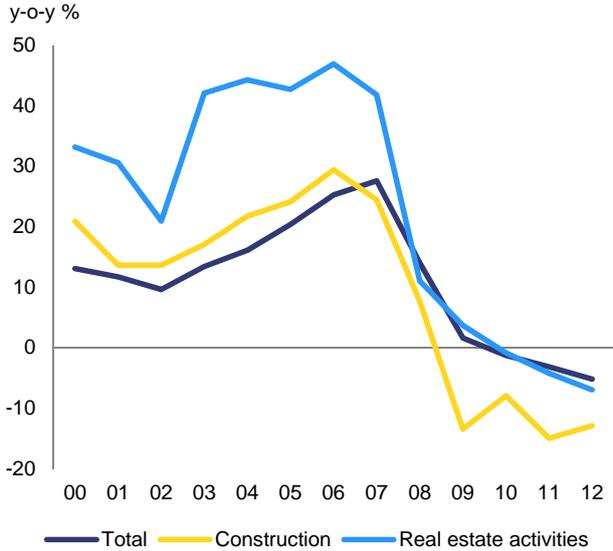
Encouragingly, companies and sectors that were highly indebted at the start of the crisis have been deleveraging faster. A recent study by the Bank of Spain (see BdE Economic Bulletin, January 2013) looks at the evolution of corporate indebtedness between 2007 and 2011 at firm level and by sector. The results show that companies and sectors, which were highly indebted at the onset of the crisis, have been reducing debt faster than the average, while firms that started from a low level of debt have actually increased their leverage over the period. The pattern has been similar for large companies and SMEs. The findings suggest that deleveraging can be compatible with a healthy reallocation of lending.

The non-financial corporate sector has moved to a positive and increasing NLB position since 2010, as savings have increased and investment has fallen. The increase in gross savings has been the main driver behind the increasing net lending position. In particular, corporations increased their gross savings through two main channels: a decrease in the compensation of employees and a significant fall in taxes and interest rate payments (see Graph 28). In a context of turbulence and tight borrowing conditions, companies have been building up internal financing buffers by maintaining high profit margins instead of fully passing the wage moderation on to lower (export) prices³² (see Section 3.2 for more details) as well as by restructuring and reducing investment. In the near term, the adjustment in non-financial corporation balance sheets is expected to continue as corporate savings increase on the back of improved profitability, while investment in real estate and construction continues to shrink.

³² The need to deleverage and rebuild balance sheets and the associated maintaining of high profit margins suggests that improvements in external cost-competitiveness may be slower than reductions in unit labour costs for as long as the deleveraging process continues.

The rise in the corporate net lending position observed since the beginning of the crisis seems to reflect a lasting balance-sheet adjustment. The factors that have triggered the balance sheet restructuring such as changes in risk premia, lower asset prices, and lower growth expectations, are likely to shape firms' behaviour in the years to come, while the impact of the sudden disruption of private foreign capital flows, which have also contributed to the rise in the net lending position, should progressively fade out. This points to a protracted balance sheet adjustment process.

Graph 29: Rate of change of credit to NFC



Source: BdE

3.1.4. Conclusion

The analysis above shows that the adjustment of private sector debt imbalances is progressing but it is far from complete. Deleveraging has taken place so far mainly through negative credit flows, against the background of difficult economic conditions. Households and non-financial corporations continue to be highly indebted and the deleveraging dynamics are likely to prevail over the short-to-medium term as credit is contracting, house prices are still correcting and overall economic activity is deteriorating. Both households and non-financial corporations are highly exposed to interest increases and income shocks.

Private sector deleveraging has significant repercussions on growth, financial stability and, via these two channels, on public finances. Deleveraging weighs on domestic demand and thus growth through negative wealth effects and constrained consumption and investment. The process is further exacerbated by deleveraging in the financial sector and the necessary fiscal consolidation, which prevents the government from implementing demand-management policies to offset the adverse macroeconomic effects. The recent easing of financial market conditions, if maintained and fed through the economic system, will support an orderly deleveraging process.

Model simulations illustrate the importance of market flexibility.³³ A fall in household debt-to-GDP ratio by 9 pps. over a six-year period would lead to a marked contraction in output by 5 to 6 pps. due to a significant contraction in housing investment and consumption.

³³ The simulations were run with DG ECFIN's QUEST model.

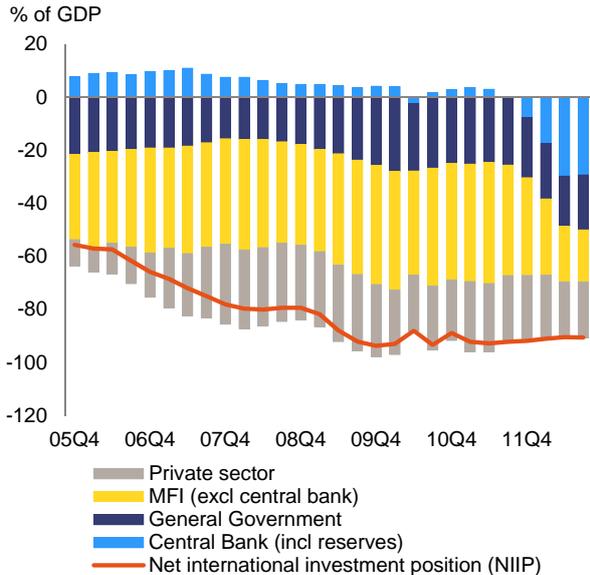
The high degree of real and nominal rigidities in the labour market implies a relatively contained fall in wages, while unemployment increases significantly. In contrast, employment, investment and production would fall significantly less if labour and product markets were more flexible. The results highlight the potential of structural reforms in labour and product markets to alleviate the impact of deleveraging on the economy.

Risks to financial stability have been mitigated by the ongoing bank restructuring and recapitalization programme. The recapitalization of the Spanish banking sector under the financial assistance programme and the transfer of problematic assets to Sareb aim at ensuring the stability of the banking sector - even in case of further defaults on real-estate development-related assets. Yet, bank asset quality will have to be kept under close monitoring, also in view of high deleveraging pressures.

3.2. External debt sustainability and current account adjustment

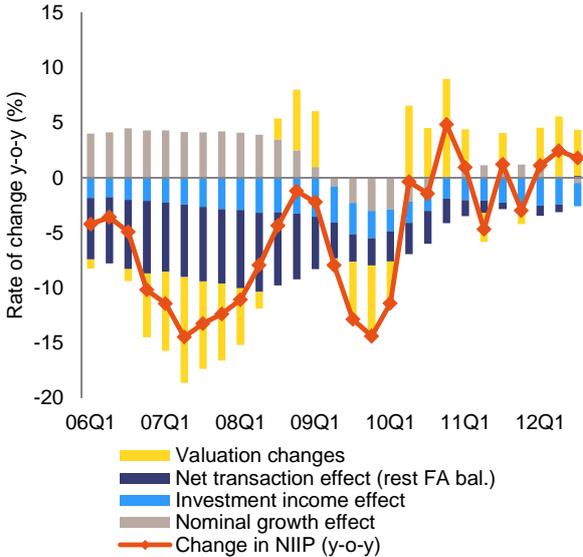
The current account deficit has fallen from 10% of GDP in 2007 to 0.8% of GDP in 2012. Adding the capital account, the external deficit³⁴ was 0.2% of GDP in 2012, down from a peak of 9.6% in 2007. This adjustment has contributed to the stabilisation of the NIIP in terms of GDP, although at a very high level.

Graph 30: Sectoral breakdown of NIIP



Source: Commission services (Eurostat)

Graph 31: Decomposition of rate of change of NIIP



Source: Commission services (Eurostat)

3.2.1. The net international investment position

Net external liabilities have stabilised since 2009 at around 90% of GDP (see Graph 30). This level has not significantly changed since the 2012 IDR and it implies continued vulnerabilities (the MIP scoreboard threshold is 35%). Inevitably, the adjustment of the stock of net external liabilities is slower than the adjustment in terms of flows as measured by the external deficit. With stagnating nominal GDP, interest payments and valuation effects have

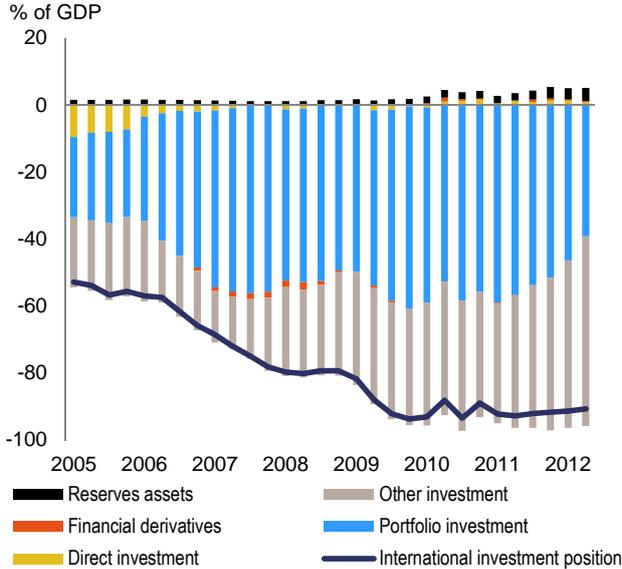
³⁴ The external balance (deficit or surplus) is defined as the sum up of the trade balance (goods and services), the income balance and the capital account balance.

become the main drivers of the NIIP ratio (Graph 31). Even though valuation effects have had a positive effect on NIIP since 2010, the estimated cumulative valuation effect since 2000 is still negative, around -20% of GDP (European Commission (2012b)). Interest payments will continue to contribute negatively due to the high net external liabilities, even though the implicit yields on Spain's external liabilities are slightly lower than those on external assets.

Some of the risks associated with this very high external exposure materialised in 2012.

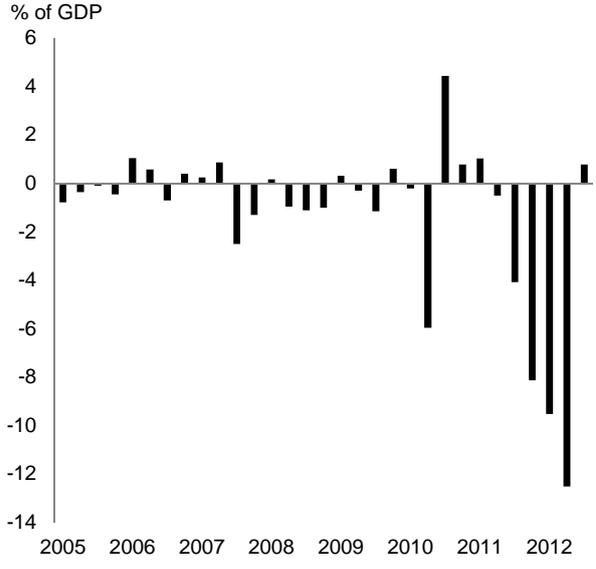
The 2012 IDR stressed that this large external imbalance exposed Spain to potential external financing problems (Graph 32). In the course of 2012, private external financing dried out and was to an important extent offset by increased Eurosystem flows. Already in spring 2010 and summer 2011 there were two episodes of private capital outflows, which could qualify as sudden stops.³⁵ In 2012, the magnitude of these outflows was much higher (Graph 33). Consequently, borrowing from the Eurosystem rose from around 6% of GDP in spring 2010 to 8% of GDP in the summer of 2011 and 12% of GDP in the second quarter of 2012. The Bank of Spain's NIIP moved from balance in the third quarter of 2011 to a deficit of 30% of GDP in the second quarter of 2012 (see Graph 30). This amount offset the reduction of external financing for other sectors, mainly monetary and financial institutions (-21% of GDP), the Spanish government (-6.4%), and the non-financial private sector (-2.8%). Private external financing resumed in the second half of 2012, following *inter alia* the ECB announcement of the Outright Monetary Transactions (OMT) and progress in addressing the crisis at euro-area level and with reforms at the national level.

Graph 32: Asset breakdown of NIIP



Source: Commission services (Eurostat)

Graph 33: Quarterly variation in BdE's assets against Eurosystem



Source: Commission services (Eurostat)

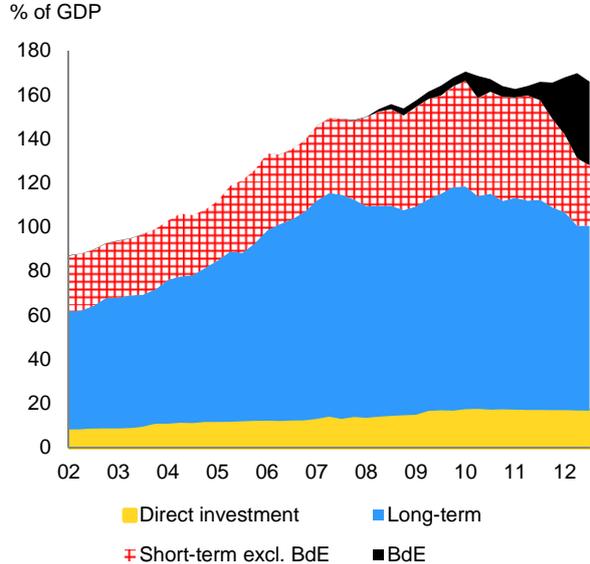
External gross debt is above 160% of GDP and the share of short-term external debt is significant.

Although the bulk of Spanish external liabilities is long-term (67% of total liabilities including direct investment), short-term debt is still sizeable. In the third quarter of 2011, short-term debt (excluding borrowing from the Eurosystem) was 45% of GDP. Even though it decreased to 27% of GDP in 2012 (Q3 2012), this fall was predominantly driven by

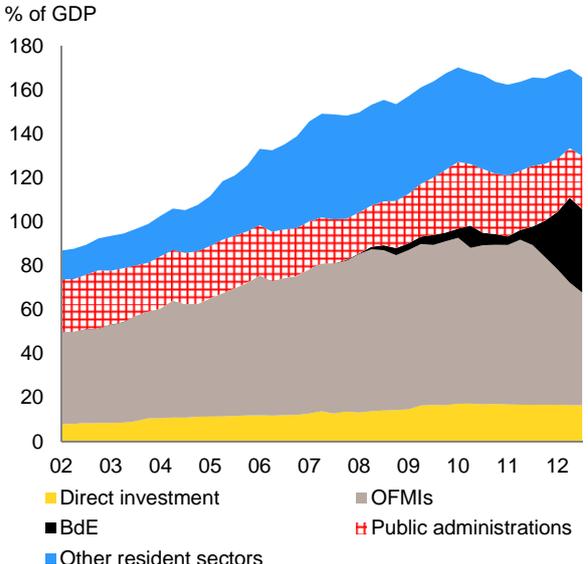
³⁵ Merler and Pisani-Ferry (2012).

the substitution of private financing (in particular to financial and monetary institutions) with monetary authorities financing (see Graph 34 and Graph 35).

Graph 34: Maturity composition of external debt **Graph 35: External debt by issuer**



Source: BdE, INE



Source: BdE, INE

3.2.2. External debt sustainability

External debt will have to shrink significantly in order to reduce financing risks and ensure long-term sustainability. Even though there is no consensus on what constitutes a 'safe' or 'sustainable' level of either the NIIP or gross external debt, available studies generally point to the order of magnitude of around 50% of GDP (also depending on the composition of liabilities and other country specific factors³⁶). This is also the level recorded in Spain in the mid-2000s, before the near doubling of the negative NIIP in the second half of the 2000s. The current crisis has provided further evidence that large negative NIIP can expose countries to severe financial shocks and is not compatible with a smooth long-term growth path.

The reduction of external debt requires a shift to recurrent external surpluses. There are four main channels through which the adjustment of NIIP can take place: i) a shift of liabilities from debt to equity (while keeping the overall level of NIIP unchanged it implies an improved composition of the external position and a reduction of the external debt, ii) higher nominal GDP (denominator effect), iii) positive valuation effects, and iv) an external surplus. The first channel depends mainly on the decisions of private foreign and domestic agents, who react to relative risk-adjusted returns on assets. Given the subdued outlook for nominal GDP growth, any significant contribution from the denominator effect on reducing the NIIP is unlikely in the short-term. As noted above, interest payments will continue to add to the debt

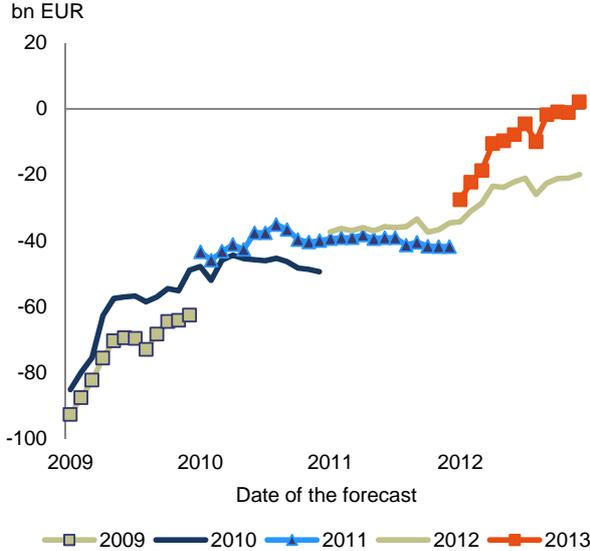
³⁶ European Commission (2012b).

burden, while the impact of valuation effects is difficult to predict. This leaves a sustained current account surplus as the main pathway to achieve a reduction in net external liabilities.³⁷

3.2.3. *Progress in the adjustment of the external deficit*

The adjustment of the external deficit has accelerated in the course of 2012. The external deficit fell to 0.2% of GDP in 2012, a reduction of 3 pps. with respect to 2011 (see Graph 37). The evolution of the different components of the external deficit has been uneven. Overall, the improvement in the current account balance has surpassed expectations (see Graph 36), driven by the trade balance, which turned into a surplus at the end of 2012. The income and capital balances have been broadly stable. The rest of this section analyses the evolution of the different components and the outlook.

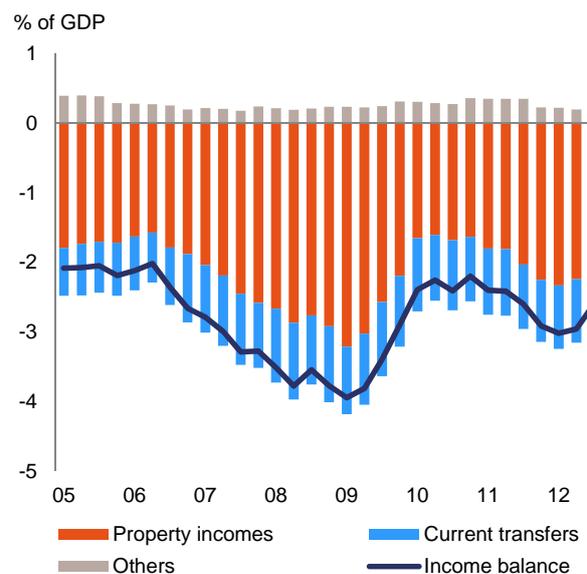
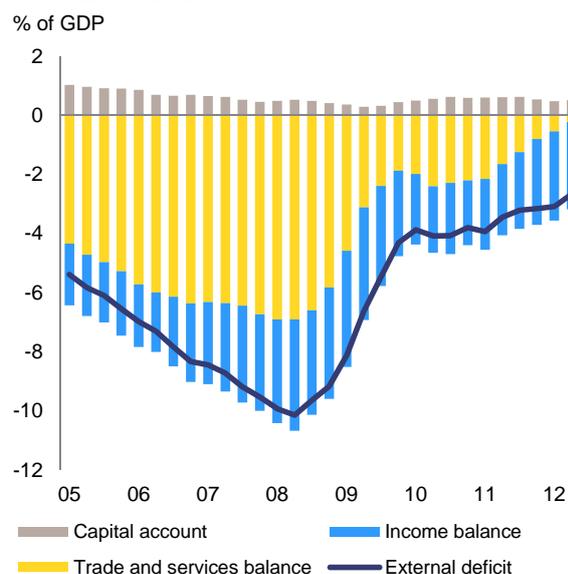
Graph 36: Evolution of forecasts of current account balance



Source: Consensus Forecasts

³⁷ Estimates of the required current account adjustment are sensitive to the target level set for the NIIP and to assumptions concerning in particular valuation effects, interest rates and GDP growth. For instance, with a cautious set of assumptions, Goldman Sachs (2013) estimates that Spain's current account needs to improve by 10-15 pps. of GDP from the current (estimated) cyclically-adjusted level of about -5% of GDP in order to reduce the NIIP to -25% of GDP over a 20-year horizon.

Graph 37: Trade, income and capital account balances



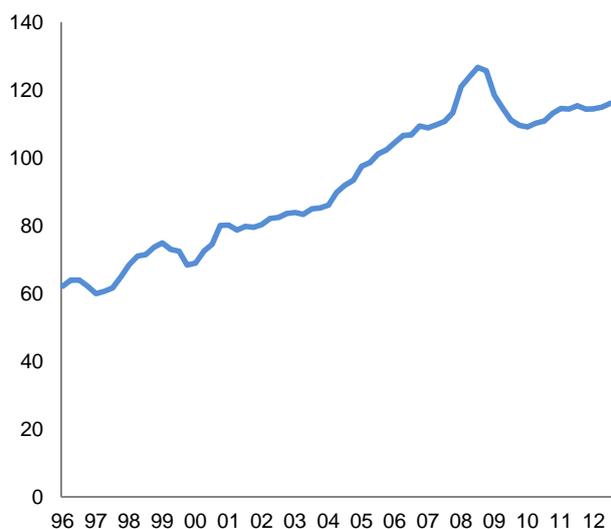
The high level of net external debt implies a significant and persistent negative contribution of the income balance to the external account. The income balance deficit was on average 2.5% of GDP in the last years driven by interest payments, the main component of property incomes (see Graph 38). Current transfers have also been negative, averaging 1% of GDP. A certain reduction in current transfers is foreseeable in the future, as immigrant remittances (0.7% of GDP) could fall given the high unemployment rate of immigrants. However, due to the high interest rate burden, no major shifts in the income balance are expected in the short-term.

The negative energy balance weighs on the trade balance. Net external energy dependence remains high and has been on an increasing path, although with some correction in the last years (see Graph 39). Advances in domestic generation of energy, mainly renewable energy sources, have not translated into a substantial reduction of energy imports. The energy balance has contributed 3.6 pps. of GDP to the external deficit (see Graph 40) in 2012, also as a result of an increase in energy import prices by 10% on average.

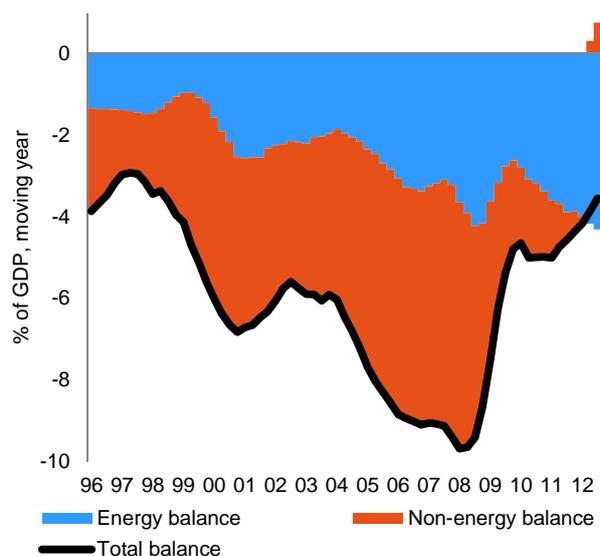
The capital balance has contributed positively to the total external deficit, in line with historical evidence. This contribution has been relatively stable in the last years, around ½% of GDP (see Graph 37). The future development of the capital balance will depend to a large extent on the financial flows from the EU (these flows constituted 70% of the overall balance in 2011), and as such it is mostly exogenous to the economic situation.

Graph 39: Energy imports, volumes, 12-month moving average **Graph 40: Goods trade balance: energy and non-energy component**

2005 = 100



Source: Ministerio de Economía y Competitividad



Source: Ministerio de Economía y Competitividad

3.2.3.1. Assessing the cyclical/non-cyclical nature of trade balance adjustment

It is challenging to assess the cyclical versus non-cyclical nature of the on-going external deficit adjustment. Permanent adjustment may come from (i) changes in the relationship of exports and imports with their corresponding determinants (prices and demand) and/or (ii) from permanent shifts in these determinants. In the case of exports there is evidence of growing diversification of destinations and product specialisation (see also 2012 IDR), which would raise the sensitivity of Spanish exports to changes in world trade. On the import side, the responsiveness to final demand would be reduced by a permanent rebalancing of demand towards exports. As discussed below, the evidence is not conclusive about these changes.

Top-down analyses based on the historical relationship between the current account and the output gap suggest a still significant role of cyclical factors in the external adjustment. This overall conclusion is consistent with the persistence of an external deficit so far in spite of a growing output gap and soaring unemployment.³⁸ However, estimates of the cyclical versus non-cyclical factors in the external balance adjustment vary substantially. For instance, Deutsche Bank (2012), applying estimated short-term coefficients to the cyclical component of determinants of exports and imports, concludes that the non-cyclical trade balance improved by around 2 pps. of GDP (2007-11) compared to a total reduction of around 6 pps. – i.e. around one third of the total adjustment would be non-cyclical. Goldman Sachs (2013), based on a cyclical adjustment of current account balances, shows a non-cyclical improvement of around 5 pps. out of an overall 7 pps. reduction. Commission services' model estimates also point to a small cyclical component. Overall, the wide range of estimates demonstrates the limitations of these approaches and the need to complement them with more detailed analyses.

³⁸ According to IMF (2012c), in the presence of more flexible product and labour markets, Spain could have moved to an external surplus already in 2011, compared to the observed deficit of 3.2% of GDP.

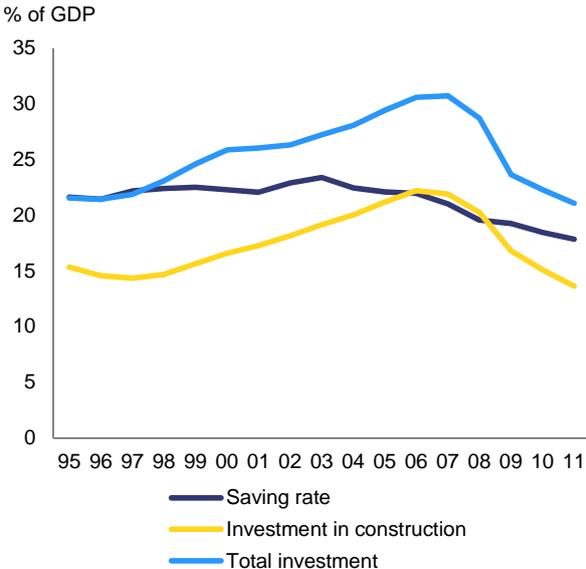
The apparent improvement in cost competitiveness is largely due to demand factors. As noted in Section 2, in the period 2007-2012 cost competitiveness has recovered a part of the cumulated losses between 2000 and 2007. The positive development in cost competitiveness results from a sizeable increase in apparent productivity and slower wage growth. These improvements are tightly linked with labour shedding, partly reflecting the downsizing of the construction sector, and the slump in domestic demand. To an extent, however, they also reflect efforts by companies to improve underlying productivity, some belated movement towards realigning wage dynamics with underlying economic trends and shifts in the composition of output away from construction-related activities with low productivity.

A saving-investment perspective points to a sizeable non-cyclical component in the external adjustment. The reduction in the current account deficit over 2007-2011 was 6.3 pps. of GDP. In terms of the saving and investment counterparts, there were two main drivers (see Graph 41). On the investment side, the downsizing of investment in housing, 5.8 pps. of GDP in the period 2007-11, is unlikely to be reversed fully in the coming years, and in fact, as noted in Section 2, it has not ended yet. However, in the same period the saving rate (as a percentage of GDP) fell by 3.1 pps. and part of this reduction may also be of a permanent nature, which would reduce the net permanent adjustment of external deficit.

3.2.3.2. The role of exports in the adjustment of the external trade balance

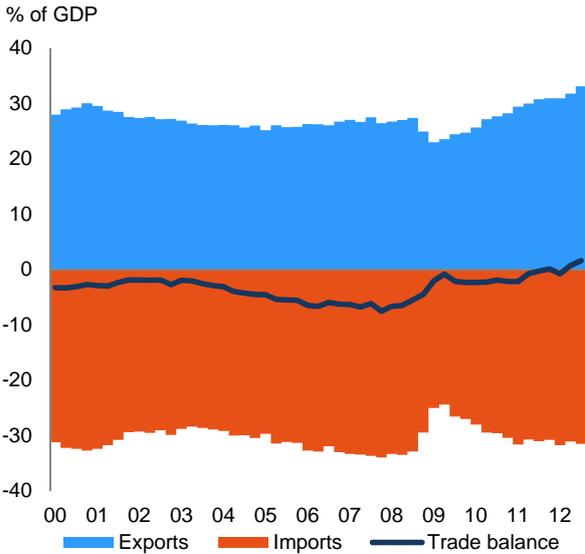
Exports have driven a large part of the trade balance adjustment but volume data show that the fall of import volumes has been more rapid than shown by nominal data. The trade balance adjusted from a deficit of 5.8% of GDP in 2008 to a surplus of 1% of GDP in 2012 (6.8 pps. adjustment, see Graph 42). This sharp adjustment was predominantly driven by the increase of the share of total exports in GDP (around 80% of the overall adjustment) and, to a lesser extent, by the reduction of the share of total imports in GDP (the remaining 20%). However, these shares are significantly influenced by different behaviour of export and import prices. In real terms, exports grew by 11% between 2008 and 2012, while imports fell by 15%.

Graph 41: Saving and investment rates



Source: INE

Graph 42: Total exports and imports (current prices)

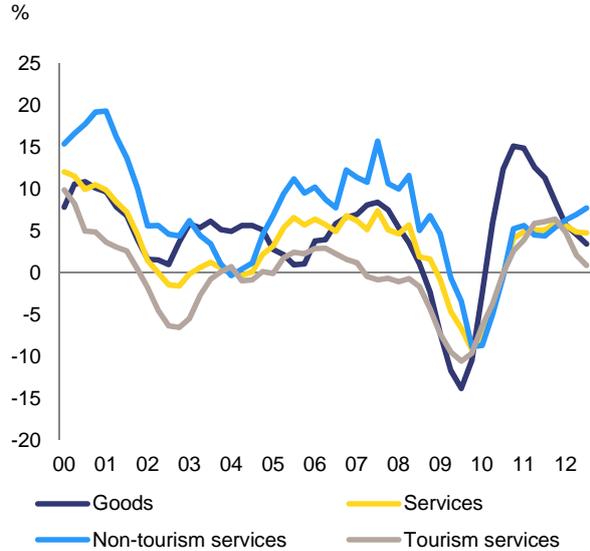


Source: INE

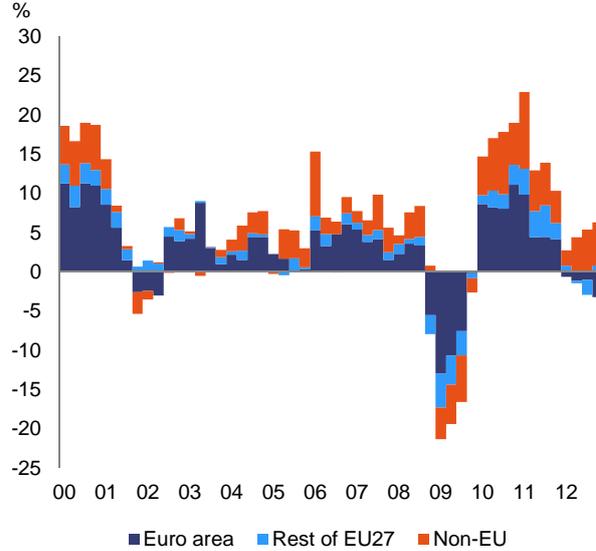
The resilience of Spanish exports is manifest in a relatively modest loss in export market shares compared to other European countries. As outlined in the 2012 IDR, between 1996 and 2011, Spanish exports of goods and services expanded only slightly below the trend for world exports, with the total Spanish export market share decreasing from 2.2% to 2.0%. This relatively good performance of exports was driven by both exports of goods and services. While services have been less dynamic than goods in the period 2010-11 (see Graph 43), they surpassed the growth rate of exports of goods in 2012, predominantly driven by non-tourism services (more than compensating for the deceleration of tourism services). The rise in non-tourism services exports can be related to the increase in direct investment abroad by Spanish firms during the expansion period, and as such is expected to persist in the coming years.

The relatively good historical performance of export market shares does not match with the evolution of price competitiveness. As shown in Section 2, the REER deflated by consumer prices appreciated by 20% in the period 2000-08 and has since adjusted by around 7%. This combined evidence of good performance with respect to world market shares and significant losses in terms of price competitiveness has fuelled a debate about this apparent 'Spanish paradox'. The two main factors which may explain the relative resilience of Spanish exports despite competitiveness losses are the duality of the Spanish economy and other factors related to non-price competitiveness.³⁹

Graph 43: Exports of goods and services, y-o-y growth (12-month moving average) **Graph 44: Exports of goods by destination, contribution to y-o-y growth**



Source: INE



Source: Ministerio de Economía y Competitividad

The expansion of exports of goods during the crisis has been supported by some strong underlying fundamentals:

- **Increasing geographical diversification** (see Graph 44). The share of non-EU-27 countries in Spanish merchandise exports increased from 27% in 2000 to 30% in 2009 and 33% in 2011, according to Eurostat's data. Exports to emerging markets have

³⁹ See Cardoso et al. (2012).

registered very dynamic growth, especially to Latin America, North Africa and some Asian emerging markets. This has broadened the traditional export base of the Spanish economy.

- **Growing diversification of exports by products.** On some measures, the Spanish export sector is one of the most diversified both in terms of products and client countries.⁴⁰ Furthermore, the weight of more complex sectors in Spanish exports is above the world average. These characteristics allow Spanish exports to achieve an international advantage in terms of product diversification.⁴¹

Going forward, it will be crucial to continue strengthening both price and non-price competitiveness. The implementation of the reform agenda should increase the relative attractiveness of tradable activities by reducing rents in sheltered sectors, facilitate the reallocation of resources, reinforce the link between wages and economic and firm conditions and remove obstacles to firms' growth (see Box 1).

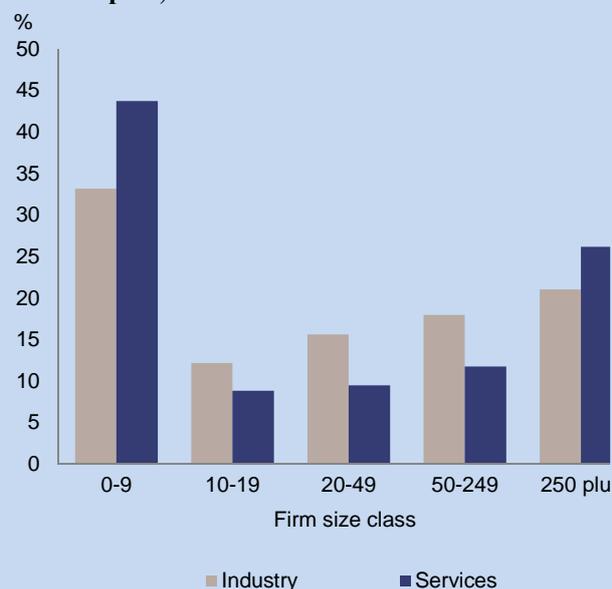
⁴⁰ Hausmann et al. (2011).

⁴¹ Correa-López and Doménech (2012).

Box 1: Firm size and export potential

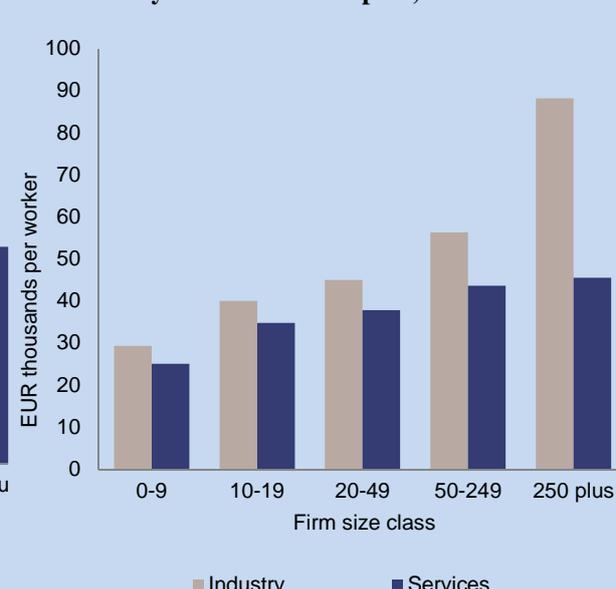
A small average firm size might limit the export potential. International comparisons show that differences in aggregate export performances by country can often be explained by differences in the size distribution of firms and the sectoral structure. For firms that are similar in size, but located in different countries, the probability that they export and the proportion of production exported are similar. But compared to companies oriented towards a domestic market, export-oriented firms have higher levels of productivity, are bigger and closer to the efficiency frontier than non-exporters (see Ahn (2001)). This is confirmed by analysis of Spanish companies. In Spain, firms with less than 10 employees represent around one third of employment in manufacturing and more than 40% in services (see Graph 45 and Ahn (2001), Banco de España (2013), and Galán and Martín (2012)). Productivity differences according to firm size are particularly pronounced in Spain (see Graph 46).

Graph 45: Employment distribution by firm size class in Spain, 2010



Source: Commission services

Graph 46: Labour productivity distribution by firm size. Industry and services in Spain, 2010



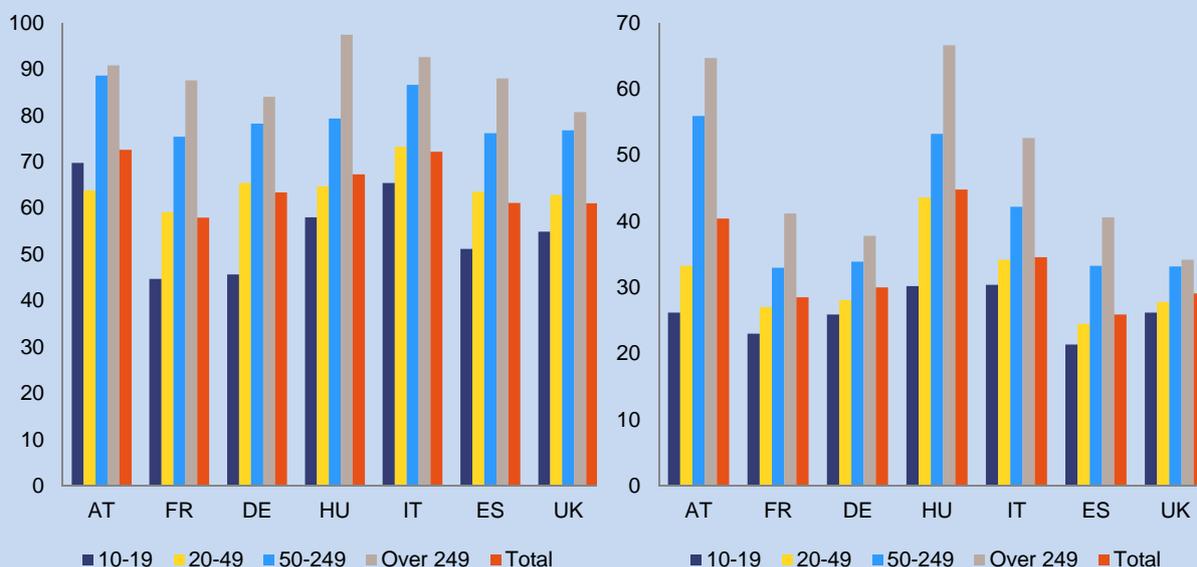
Source: Commission services

Labour market regulations, administrative burden, fragmentation of the internal market and fiscal requirements as well as transport costs may explain the atomization of Spanish firms. The different requirements in terms of labour regulations and administrative and tax burden for small firms might discourage the growth of small companies (see La Caixa (2012)). Thus, the distribution of workers according to company size shows a concentration of firms in the category between 20 and 49 employees. In addition to institutional factors, trade-related variable costs (i.e. transport costs) appear to be a key factor limiting the growth of Spanish firms when compared to other European countries (see Rubini et al. (2012)). The geographical position of Spain could explain this higher importance of transport costs, especially for exporting firms. However, non-export firms are also affected. In particular, the deficiencies in transport infrastructure (a lack of interoperable interconnections with other Member States and poor integration between transport modes (see European Commission (2012c)) may explain the significance of transport costs.

Limited access to financing for SMEs can compound small firm size as a limiting factor to the export potential. Public support can partially substitute for weak collaboration between SMEs in Spain, but it does not entirely help to overcome the barrier of sunk costs, which is especially high for small firms and firms that venture into foreign markets. Fragmented business structure and large numbers of micro firms increase firm dependency on bank financing, while alternative financing sources are

underdeveloped. The possibility of recourse to a wider range of financing sources could increase the firms' export propensity (see Martín et al. (2009)).

Graph 47: Extensive margin of exports, by country and company size, 2008 **Graph 48: Intensive margin of exports, by country and company size, 2008**



Source: EIFIGE

Source: EIFIGE

A relatively low overall extensive margin reflects the high number of SMEs and the significant gap in productivity between small and large companies. Spain has similar shares of exporting firms in some firm size categories as its European peers. However, given fragmentation of the industrial structure, the total extensive margin, i.e. the total share of Spanish companies engaged in export activities, has been relatively low (see Graph 47). The intensive margin (the proportion of overall production that firms export) also tends to be lower in Spain (see Graph 48). In 2010, the intensive margin was the major source of export expansion (as firms were recovering from the 2009 slump in international trade). More recently, many smaller companies also started to export and the extensive margin became an important export engine in 2011 and 2012. Weak domestic demand will continue to provide a strong incentive for firms to engage in export activity. However, the situation may reverse when domestic demand eventually recovers.

3.2.3.3. The role of imports in the adjustment of the external trade balance

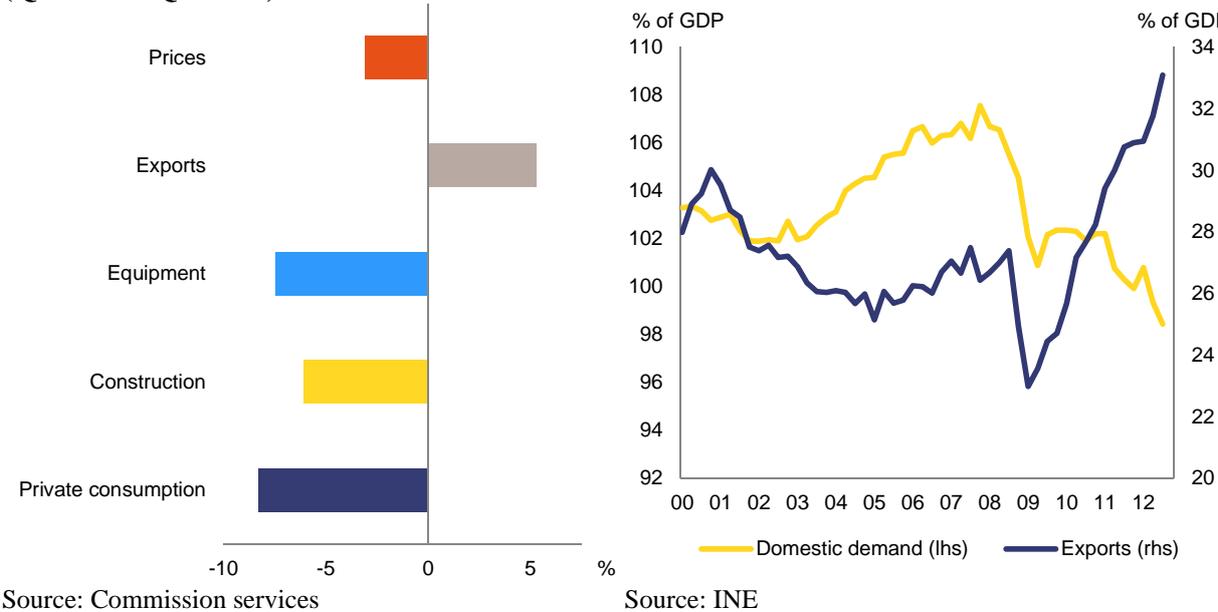
The large fall in imports reflects mostly cyclical factors, but also shifts in the level and pattern of demand. Total imports fell by 15% in constant prices between 2008 and 2012, which contrasts with a GDP fall of 5% in the same period. Econometric analysis confirms that the decline of imports was mainly driven by the fall of private consumption and reduced investment in equipment and in construction. Exports contributed positively to import growth (see Graph 49).⁴² While the contraction of private consumption and investment in equipment

⁴² With the target of disentangling the different contribution of final demand components to import adjustment, a regression for imports over the final demand components (private consumption, investment in construction, investment in equipment and exports) is estimated (all variables in constant price terms and logs). Additionally, import prices, seasonal dummies and other dummies are included in the regression, with sample period since Q1 1995 until Q3 2012.

were most likely largely driven by cyclical factors, the adjustment of investment in construction (explaining around 30% of the fall in imports) can be assumed to be largely permanent. If part of the adjustment in private consumption is also considered to be lasting (as households have revised downwards their income expectations and try to reduce their debt in a context of more limited availability of credit) about one half of the total fall in imports could be maintained over time.

The post-crisis composition of final demand points to a lower import content for a given level of final demand. The weight of domestic demand in GDP decreased by 6.8 pps. between 2008 and 2012 while the weight of exports increased by 5.7 pps. (see Graph 50). Econometric evidence points to an import elasticity to domestic demand more than twice as high as that to exports.⁴³ The rebalancing of the Spanish economy towards exports can be expected to continue in the coming years, even factoring in a modest recovery in domestic demand. The balance-sheet adjustment of households, corporations and the public sector will continue constraining the expansion of domestic demand.

Graph 49 Decomposition of import growth Graph 50: Domestic demand and exports (Q1 2008 - Q2 2012)



3.2.4. Conclusions

While the external deficit is adjusting at a fast rate, the stock adjustment of negative net external liabilities is, necessarily, much less advanced. The level of external debt remains very elevated. This high level of external debt and its composition increase the vulnerability of the Spanish economy to financing shocks. A lasting external surplus will be needed to bring about a reduction of external debt.

The recent improvement of the trade balance appears to have been driven by both cyclical and non-cyclical factors. A precise quantification of the relative weight of these

⁴³ The estimated elasticity of imports to domestic demand is 1.5 and to exports 0.6

factors is difficult. The sharp fall in employment, private consumption and investment suggest an important cyclical component behind the current account improvement and the measured improvement in cost competitiveness. This is corroborated by top-down analysis. There is, however, also evidence of robust fundamentals, such as greater geographical diversification of export markets and products and changes in the level and compositions of domestic demand. Stronger productivity improvements at firm level would consolidate and further deliver competitiveness gains

Supporting a further expansion of export potential is a key policy objective to underpin the rebalancing of the economy and the improvement in the current account. The incentive to reallocate resources towards the tradable sector and the ability of companies to compete on international markets depend crucially on the proper functioning of domestic markets. Opening up sheltered sectors, reducing barriers to firms' entry and exit and to their possibility to grow as well as reducing the administrative burden would support this process. There may also be failures and limitations in the market for bank loans, which could be relieved by developing non-bank financing sources and by specific measures to support access to finance by export firms (especially for SMEs). A contribution to exports would come also by lower export costs – i.e. resulting from a higher efficiency of the transport infrastructure efficiency or from export promotion strategies that alleviate the costs of export market entry for SMEs. In this respect, the Spanish authorities have taken, or announced, a number of policy initiatives aimed at export promotion. In particular, the measures included in the Royal Law Decree 20/2012, which enlarge the system of warranties to exports, and the plan to create an internationalization agency (expected by Q2 2013) with the objective of rationalising public export promotion instruments.⁴⁴

⁴⁴ International experience on measures to facilitate size growth of small firms, and their export profile, has been basically based on advice and information provision to those sectors and firms which have been identified with higher export potential. Other measures try to associate small firms with related large firms (their suppliers, partners or clients) for joint actions in the external markets (Ministerio de Industria, Turismo y Comercio (2011)).

4. POLICY CHALLENGES

Despite the measures already taken by Spain, several important and interconnected policy challenges are identified in this report. Spain needs to simultaneously reduce high levels of external and private sector debt, regain competitiveness and revive economic growth through a further rebalancing of the economy towards more export-led growth, taking into account the inter-linkages with financial sector restructuring and public sector consolidation. Developments since the 2012 IDR have confirmed the difficulties of balancing these different needs and the vulnerability of the economy and the financial system to shocks, notwithstanding progress in some areas and policy advances.

The complexity and severity of the challenges require a comprehensive policy response and close monitoring. The recent easing of wholesale funding costs has not yet fed through the real economy, and both financial markets and non-financial sector confidence remain very sensitive to economic and political news. With unemployment already at extremely high levels and growing, completing and implementing decisively the structural reform agenda is essential to support the rebalancing of the economy and hence growth and employment during the deleveraging process. A stronger economy would back up progress in the consolidation of public finances and the stabilisation of the financial sector.

Progress with respect to the timetable of the government structural reform plan of 27 September 2012 has been mixed. The plan intended to provide a concrete response to the country-specific recommendations under the 2012 European semester. It covered (i) structural fiscal reforms, (ii) labour market and education reforms and (iii) product market reforms and measures to improve business environment.

Further steps to strengthen competition in product and service markets (including network industries), improve the business environment, support the growth and internationalisation of firms, widen the sources of firm financing, and review the growth friendliness of tax system would contribute to a greater adjustment capacity of the economy:

- **The draft law on Market Unity adopted by the government on 25 January 2013 has the potential to reduce the fragmentation of the domestic market.** The first draft of the law covers two main dimensions: i) defining principles of better regulation and good governance to be applied at all levels of government and ii) laying down a general principle of 'mutual recognition', whereby any goods or services that have been authorised in one region can be marketed anywhere else. Once it enters into force, this law would reduce fragmentation and spur competition and allow reaping efficiency gains via economies of scale. The degree of ambition of the draft law and the timely adoption should be preserved.
- **Further measures to enhance competition in the network industries as well as to tackle the energy tariff deficit appear warranted.** It is important to ensure the effectiveness, autonomy and independence of the newly created supervisory and sectoral regulatory authority. The 'electricity tariff deficit' implies a considerable contingent liability for the budget as well as non-negligible macroeconomic risks and may negatively affect the debt dynamics in the future. Despite some recently adopted measures, further steps to contain its potential impact on the public finances are warranted.

- **Anti-competitive regulations and non-justified entry barriers, e.g. in professional services, remain a problem.** A draft law aiming at reforming professional services was to be adopted by the government by end-2012 but is still being finalised. Measures to facilitate entry and exit of firms - in particular to lower the administrative burden, widen the choice of company forms, review of insolvency laws, increase the availability of financing channels to reduce bank-dependency - would help businesses to reallocate resources and create jobs. Following up on the payment of large amounts of arrears to suppliers of regional and local administrations, avoiding the building up of public administration arrears in the future would support firms' liquidity and be an indication of improved public finance control. In addition, intensifying the fight against the informal economy would contribute to a level-playing field amongst companies.
- **The export potential would be boosted by the removal of barriers to firms' growth and by providing targeted support to internationalisation.** A review of size-dependent policies with lock-in effect in the area of labour regulations as well as administrative and tax burden could reveal their role in skewing firm composition towards SMEs. At the same time, SMEs may need assistance to enter and remain present in export markets, an area in which measures are being taken. In addition, targeted measures, facilitating access to finance for exporting firms, especially SMEs, as well as reducing transport costs, would also be useful to support internationalisation and firms' growth.
- **There has been progress in rebalancing the tax system.** VAT revenue and revenue from environmental taxes in Spain have been amongst the lowest in the EU.⁴⁵ Moreover, tax-to-GDP ratios have decreased considerably as part of the rebalancing of the economy towards a less tax-rich growth pattern. Some recent measures have gone in the direction of improving the efficiency of the tax system. These include an increase of VAT rates and a wider scope of application of the standard rate as well as measures aimed at reducing the tax-induced bias towards indebtedness and home-ownership. A number of environmental taxes have been increased or introduced. Going forward, the scope to further limit the application of reduced VAT rates (or to raise those rates), to further increase the role of environmental taxes, notably as regards energy and fuel taxes, and reduce tax expenditure could be explored.

The extent of the unemployment challenge warrants that the impact of the 2012 labour market reform be closely monitored and the reforms complemented by accompanying measures:

- **It is important to monitor closely whether the reform of the labour market is attaining its objectives.** Recognising that a well-working labour market is key to the correction of imbalances and to growth and employment, aims at greater efficiency and reduced labour market duality, higher internal flexibility, a wage bargaining mechanism that ensures a better alignment of wages to economic conditions, greater employability of young workers and greater use of permanent contracts. Further measures were adopted in July 2012 to phase out certain hiring subsidies and to link unemployment benefits better with job-search activities. A Royal Decree approved in November 2012 provided the basis for establishing a dual vocational training system.

⁴⁵ According to the latest available data (2011).

On 22 February 2013, the government adopted a Royal Decree-Law which contains part of the (short-term) measures included in the Youth Entrepreneurship and Employment Strategy 2013-2016. A first assessment of the labour market reform was to be carried out by the authorities before the end of 2012.

- **An overhaul of ALMP and public employment services would help to absorb the large number of unemployed and support competitiveness.** More effective ALMP, better collaboration between regional, national public and private employment services, as well as intensifying the implementation of education and vocational training policies would be important complements to the labour market reform in this respect. It is key to activate the unemployed and upgrade their skills through better targeting and provision of training opportunities (including on-the-job training) and to better link unemployment benefits with job search and training activities. These measures would also contribute to improving the cost competitiveness of the Spanish economy in the longer term, including by boosting productivity growth.

Completing the ongoing bank restructuring and recapitalisation is essential to support an easing of financing conditions for households and companies. As part of the financial sector programme, the banking sector is undergoing a deep restructuring. The restructuring plans endorsed by the Commission in November and December 2012 in line with State aid rules are designed to ensure a return to viability and thus to minimise the impact on credit to the healthier part of the economy⁴⁶, but smooth credit provision will also depend on the ability and willingness of the stronger banks to extend credit. Completing the recapitalisation and restructuring of banks in line with the banking sector programme, as well as strengthening of the regulatory and supervisory framework are essential in this respect. The authorities are complying with the deadlines and the programme is on track. The reallocation of resources within the economy would also benefit from the development of non-bank financing sources, so as to widen financing options for companies according to their needs and their stage of development. There appears to be scope to review the bankruptcy regulatory framework to make it more effective, while bearing in mind the possible impact on financial stability.

There has been progress in removing distortions in the housing market, which contributed to promote past disequilibria. In particular, the tax deductibility of interest rate payments on new mortgages has been eliminated and the institutional framework of the rental market is in the process of being strengthened. A larger, more efficient, rental market would also ease geographical mobility of workers and thereby improve the adjustment capacity of the economy.

Fiscal consolidation has further to go to secure lasting financial market confidence. The commitments under EU surveillance procedures provide the framework for fiscal consolidation. Putting greater emphasis on the medium-term strategy, basing consolidation on structural measures, as well as improving efficiency and quality of public expenditure at all government levels would contribute to confidence building and ensure reductions in the structural and headline deficits. In addition, there is scope to further strengthen the long-term sustainability of the pension system and of social security. Regarding the fiscal framework, implementation of the Budget Stability Law remains uneven. There have been important improvements in budgetary transparency through more timely and regular reporting on

⁴⁶ See European Commission (2013c), the programme's second review report.

monthly and quarterly budgetary developments at different levels of government. However, the monitoring instruments envisaged in the Budget Stability Law, including in particular early warning mechanisms, have not been fully effective. In addition, preparations for setting up an independent Fiscal Council have been delayed and it appears unlikely that this body will be operational in time to play an active role in the preparation of the 2014 budget law.

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