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Macroeconomic Imbalances Spain 2014

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Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Spain is experiencing *macroeconomic imbalances which require specific monitoring and decisive policy action*. In several dimensions, the adjustment of the imbalances identified last year as excessive has clearly advanced and the return to positive growth has reduced risks. Yet, the magnitude and inter-related nature of the imbalances, in particular high domestic and external debt levels, mean that risks are still present. The Commission will continue a specific monitoring of the policies recommended by the Council to Spain in the context of the European Semester, and will regularly report to the Council and the Euro Group. This monitoring will rely on post-programme surveillance.

More specifically, the adjustment has been supported by decisive policy actions at the EU level and by Spain. In particular, the recapitalisation and restructuring of weaker banks have dispelled systemic concerns about the financial sector and allowed a smooth ending of the financial assistance programme at the beginning of 2014. The current account has turned into surplus, as a result of a combination of import compression and strong exports, supported by competiveness gains. The housing market has approached stabilisation. Employment destruction appears to be coming to an end. On the policy front, the comprehensive agenda of structural reforms outlined in the 2013 NRP is mostly completed from legislative point of view, and attention is shifting to a challenging implementation phase. These positive developments have led to a strong return of confidence, manifest in the fall in market risk premia, the return of foreign capital inflows and the rise in business and consumer confidence.

Yet, the adjustment is far from complete and vulnerabilities persist. More specifically, the very high stock of private and public debt, both domestic and external, continues to pose risks for growth and financial stability. Despite its recent contraction, unemployment remains at alarming levels. The re-orientation of the productive system towards exporting sectors and the recovery in international competitiveness will have to be maintained to reduce the very large stock of external liabilities and the burden that it causes in terms of negative flow of incomes towards the rest of the world. The adjustment of private sector balance-sheets is advancing, but high unemployment and falling incomes have limited the pace of deleveraging of households. Non-financial corporations have reduced debt at a somewhat more sustained pace. Going forward, the challenge is ensuring that deleveraging will go hand in hand with positive credit flows to financially healthy borrowers. Removing hindrances in the functioning of the product and financial markets and efficient insolvency procedures could reduce the drag on growth from deleveraging. In the labour market, building on the positive effects of recent reforms on internal flexibility and wage settings, additional reforms could be envisaged. Finally, significant revenue shortfalls, higher social expenditure and costs of bank recapitalisation have led to a substantial pressure on government deficits and a steep rise in government debt to high levels. The 2013 fiscal deficit target might have been missed, although the improving macroeconomic prospects should allow Spain to meet the 2014 headline target. Ensuring a reduction in government debt in the medium-term will require sustained fiscal efforts.

Excerpt of country-specific findings on Spain, COM(2014) 150 final, 5.3.2014

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EXECUTIVE SUMMARY AND CONCLUSIONS

In April 2013, the Commission concluded that Spain was experiencing excessive macroeconomic imbalances, in particular as very high domestic and external debt levels continued posing risks for growth and financial stability. In the Alert Mechanism Report (AMR) published on 13 November 2013, the Commission found it useful, also taking into account the identification of excessive imbalances in April, to examine further the persistence of macroeconomic risks and to monitor progress in the unwinding of imbalances. To this end, this In-Depth Review (IDR) provides an economic analysis 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:

- **The correction of macroeconomic imbalances has progressed, allowing a return to positive economic growth and prospects of a stabilisation in the labour market.** Spain entered the financial crisis with high external debt, poor cost competitiveness, high private sector debt, a fragile financial sector and an overheated housing market. The burst of the housing bubble triggered a sharp adjustment, aggravated by the drying up of external capital inflows as the crisis progressed. A number of policy measures were taken to reinforce the financial sector, restore competitiveness and shore up public finances. The third quarter of 2013 marked the end of Spain's longest recession in decades and employment interrupted a long decline in the fourth quarter of 2013 (in quarterly terms). The return to positive growth occurred as domestic demand started to exercise less of a drag on growth amid recovering confidence and gradually easing financing conditions (although still relatively onerous for smaller borrowers). Going forward, the recovery can be sustained only if it does not result into a halt or reversal of the adjustment process, as the ongoing correction of the original imbalances still has a long way to go and new areas requiring close attention have emerged.

- **The current account has adjusted swiftly and is now in surplus (1.1% of GDP in 2013), while indices of competitiveness have recovered a significant part of the deterioration during the pre-crisis boom.** While cyclical factors explain a share of the improvement in the trade balance behind the turnaround in the current account, this latter appears to also have firm structural roots. In particular, exports, which remained resilient despite the loss in cost competitiveness in the years preceding the crisis, accelerated considerably in 2012 and 2013, with expansion both at the intensive and the extensive margins as the pressure for internationalisation increased amidst contracting domestic demand. Exports of services have been particularly dynamic. The import performance has been more mixed, as Spain has a high import intensity of final demand and higher oil prices countered the reduction of import volumes of non-oil goods. Yet, as a significant part of the slump in domestic demand during the crisis is likely to be permanent, imports will remain correspondingly lower. The current account balance is projected to increase further in the coming years, to 1.6% of GDP in 2014 and 1.8% of GDP in 2015 according to the 2014 Winter Forecast.

- **The banking sector has been bolstered by the recapitalisation of weaker banks, the transfer of problematic assets to Sareb (the asset management company) and overall positive earnings results in 2013.** In January 2014 Spain successfully exited the financial sector recapitalisation programme initiated in July 2012, having met all bank-specific and horizontal policy conditionality. However, despite favourable overall leverage ratios, the banking system is still exposed to challenges from the ongoing restructuring process, weak macroeconomic prospects, possible further adjustment in the construction sector and in the real estate markets and shrinking business volumes.

- **The adjustment of the construction sector and housing market appears to be approaching stabilisation.** Between 2006 and 2013 the share of residential investment in total GDP fell by around 8 pps. to 4.4%, below the previous historical low of 7% in 1997. Both residential investment and construction are still falling. The fall in house prices accelerated in 2012, and by the third quarter of 2013, the cumulative decline since the peak in the third quarter of 2007 was 36.2% in nominal terms and 43.8% in real terms. While there are indications of a slowdown or even stabilisation in the price correction at the end of 2013, given the still weak demand for housing and the remaining large stock of unsold houses some further adjustment cannot be excluded.

- **Despite the progress achieved, the economy remains vulnerable given still large stocks of accumulated imbalances.** The turn-around in flow variables is impacting stock variables only slowly, also due to the contribution from denominator effects are forecasted to remain contained in the short to medium run due to subdued nominal GDP growth. Large domestic (private and public sector) and external debt will weigh on demand and keep the economy vulnerable to shocks. The large pool of unemployed - a large share of which are long-term unemployed - will likewise require a sustained pace of job creation and effective activation policies over time to be reabsorbed.

- **Driven by valuation and denominator effects, the negative net international investment position deteriorated further in 2013, in spite of the positive net lending position.** The NIIP was -97.8% of GDP in the third quarter of 2013, down from -91.4% of GDP in 2012. The positive impact of net external lending of 1.9% of GDP was more than offset by negative valuation and denominator effects – the former linked also to the recovery in prices of Spanish financial assets and the appreciation of the euro exchange rate. Even disregarding valuation effects, it could still take a decade of large current account surpluses to reduce the NIIP significantly. Beyond the magnitude, the liability composition of the NIIP adds to external vulnerability, given the large share of loans and fixed income instruments.

- **Private sector deleveraging is advancing gradually.** The total stock of non-financial private sector debt was 210% of GDP in the third quarter of 2013 in non-consolidated terms (189% of GDP if consolidated). This is some 22 pp. of GDP lower than the peak in the second quarter of 2010, but still high. Most of the decline is due to non-financial corporation debt, which is down by 16 pp. of GDP since the peak. Based on historical evidence and considering the magnitude of the debt overhang, deleveraging pressures will take still time to work out and continue to weigh on domestic demand and on the financial sector.

- **The imbalances accumulated in the private sector have spilled over to the public sector.** General government debt has increased by almost 60 pps of GDP since 2007 and is forecast just below 100% of GDP in 2014. Worries about the banking sector, high budget deficits and the rapid increase in public debt, together with wider concerns about the stability of the euro area, all contributed to a brisk rise in Spanish risk premia, especially in 2012. Risk premia have narrowed considerably since the peak in mid-2012 (the 10-year sovereign bond yield spread has fallen from above 600 bps. in summer 2012 to less than 200 bps. in February 2014) and nominal yields are currently historically low. Due to the exceptional macroeconomic conditions, in July 2013 the Council extended the deadline for correcting the excessive deficit by two years to 2016. At present, the achievement of the 2013 budget deficit target appears still subject to risks.

- **Structural inefficiencies have magnified the fall in employment.** Limited firms internal flexibility in the use of resources, duality, unresponsive wages and the sharp contraction in the labour-intensive construction sector, have intensified labour shedding as a response to the economic contraction. The concentration of fixed term contracts among youngsters and low skilled, moreover, has led to a disproportionate burden of adjustment on these groups of workers. The labour reforms have contributed to enhance firms' internal flexibility and the responsiveness of wage bargaining to economic conditions. A positive impact on labour market duality is much less clear at this stage, but this may also be partly due to the high level of economic uncertainty, which may make companies favour temporary employment. However, a persistence of duality and lack of workers mobility when the recovery is more consolidated would be an obstacle to allocative efficiency and productivity growth. The labour market is also characterised by mismatch of labour demand and supply – both from a skill and a geographical perspective.

- **As the Spanish economy is tightly interconnected with the rest of the euro area, developments in Spain could have a significant impact on the other economies, and vice-versa.** The contraction of domestic demand impacted on Portuguese exports, almost one fourth of which are directed to Spain. The Spanish market is less important for other euro area economies, but nevertheless significant. Moreover, large flows of intermediate and final goods in some sectors (e.g. in transport equipment) show that Spain's production structure is closely integrated in particular with France and Germany. While the large share of exports directed to the euro area shelters Spain from movements in the euro exchange rate, an appreciation of the euro would impact on Spain's exports outside the euro area exports, which have been playing a growing role in recent years. Financial links between Spain and the rest of the euro area are also intense. The high reliance of Spanish banks on loans from the rest of the euro area (in particular France and Germany) implies that financial shocks in other large euro area Member States could impact on the funding of Spanish banks.

The IDR also discusses the policy challenges stemming from these imbalances and what could be possible avenues going forward, in particular to promote the allocative efficiency of the Spanish economy and support the on-going macroeconomic adjustment. A number of elements could be considered:

- **The structural reform agenda has been advanced decisively in the last year, although there are still some important outstanding items and full implementation of ongoing reforms will be essential to reap the expected economic benefits.** Beyond the measures to restructure the financial sector, many structural measures have been taken in accordance with the priorities identified in the National Reform Programme and the 2013 Country Specific Recommendations by the Council. The recent pension reform has improved the long-term sustainability of public finances, while public administration reforms are aiming at a rationalisation in competencies and a leaner administration. Public finance management has been reinforced by the internal stability pact between the central state and the regions, which is already delivering fruits and could be used to full potential, and by the new independent fiscal institution soon to become operational. The forthcoming reform of the tax system, still to be elaborated, could contribute to make the tax system more growth-friendly and tax revenues less volatile. The labour market reforms and social partners' agreements have increased flexibility and tempered the fall in employment. Measures in product and services markets are important to enhance competition, thereby bringing down profit margins and strengthening productivity, but they are still in the implementation phase in some cases while the reform on professional services has been delayed. The success of measures adopted to balance the electricity tariff system will be fully tested in 2014, the first full year of implementation, while competition in the retail and transport sector could be increased further. Going forward, the delivery on the ground of the reform strategy will be essential to the prospects of a sustained recovery. Such delivery depends often on joint implementation efforts by various tiers of government. Furthermore, as experience with the rebalancing process and reforms accumulates and is analysed, there could be scope for complementary policy measures to smoothen the adjustment and stimulate growth.

- **Easing the reallocation of capital and labour would underpin both potential growth and the external adjustment.** Effective competition in product and services markets and in network industries, as well as an enhanced business environment, would contribute to growth and to export potential and could also help to reduce the relatively high import content of final demand. Dealing with legacy debt and the restructuring of viable companies, allowing them to increase investment, would be facilitated by effective corporate insolvency and pre-insolvency frameworks. Incentives to consolidating the financial position of firms, and thus their resilience to shocks could come from removing the debt bias in corporate taxation. A review of the personal insolvency framework could provide a modernised legal framework for lending to individuals and reduce risks of permanent financial distress amongst households. In the face of the evidence of higher competitiveness and stronger export capabilities in larger companies, reviewing administrative and tax provisions that discourage small companies from growing could usefully be explored. Tax and other policy measures that would act to lower the high oil intensity and dependency of the economy would also contribute positively to the external equilibrium.

- **Ideally, access to finance for valuable projects and a reduction in aggregate debt levels should go hand in hand.** This would happen if valuable companies and creditworthy individuals have access to external funding, while overextended borrowers continue to work out their overhang. While this healthy discrimination in lending appears to be occurring to an extent, credit conditions for smaller borrowers have been easing only slowly and remain relatively onerous. The coming into full operation of the measures to strengthen access to non-bank financing will probably help, but asymmetric information between banks and SMEs could remain an obstacle to overcome in the light of widespread bank restructuring. Furthermore, there could be merits in close monitoring and further reinforcing banks' capital positions (as the Bank of Spain has been recommending in its supervisory role), in view of the ongoing rise in NPLs, still adjusting real estate and construction sectors and the bank balance sheet comprehensive assessment in 2014.

- **Reabsorbing the very large unemployment over time rests on markets for labour, product and capital and a business environment that support the reallocation of resources towards the most productive sectors of the economy.** The strong correlation between work status and measures of material deprivation suggests that reducing unemployment is critical to addressing social difficulties in the medium term. While a recovery in demand will help reabsorbing the cyclical part of unemployment, the behaviour of the labour market before and during the crisis points to deep structural shortcomings, which the recent reforms have started to tackle. Moreover, the adjustment that the Spanish economy is undergoing emphasises skills and geographical mismatches between labour demand and supply. Recent labour market reforms have increased internal flexibility and enhanced the responsiveness of wages to prevailing market conditions, while several new measures aim specifically at facilitating the entry of young and unqualified workers in the labour market. Mismatches could be alleviated by an intensification of Active Labour Market Policies (ALMP), the strengthening of public employment services and the extension of vocational training. The dual VET system aims at a greater employability of future generations; enhanced coordination between education and labour market policies could help to rationalise the offer of formal education vocational training and work-based training. Close cooperation between central and regional authorities would help to make best use of scarce financial resources and avoid fragmentation. Also relevant from an allocative efficiency point of view is the limited mobility of resources currently employed under contracts of indefinite duration, which could be related to the partly job-related protection legislation rules. Containing labour costs, via wage moderation and productivity increases, remains important to bridge the gap between labour demand and supply. Reducing non-wage costs for companies, possibly as part of a revenue-neutral tax shift from labour to consumption and other taxes (e.g., environmental or recurrent taxes on property), could provide a contribution to employment and cost competitiveness.

- **With continued fiscal discipline in line with EU commitments and rules Spain can reverse the rise in general government debt during the crisis.** Meeting the budgetary targets set out in the Council 2013 EDP recommendation and moving speedily thereafter towards the medium-term objective of a balanced budget would set public debt on a steady decline. Should growth turn out above expectations, accelerating correspondingly the reduction in the headline deficits would further underpin confidence and resilience to shocks. The credibility of the consolidation strategy is reinforced when this is underpinned by structural measures, of which significant ones have already been taken recently, such as in the area of pensions, public administration reform, des-indexation of public sector contracts. The forthcoming tax reform could contribute to solid public finances by reducing the volatility of revenue and by taking into account the need for alignment between revenues and expenditure in the medium-term.

1. INTRODUCTION

On 13 November 2013, 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. The AMR serves as an initial screening device helping 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 in the sense of the legislation and what type of follow-up in terms it will recommend to the Council.

This is the third IDR for Spain. On the basis of the previous IDR, published on April 10 2013, the Commission concluded that Spain was experiencing excessive macroeconomic imbalances, in particular as very high domestic and external debt levels continued posing risks for growth and financial stability. Overall, the Commission finds it useful, also taking into account the identification of excessive imbalances in April, to examine further the persistence of macroeconomic risks or their unwinding. To this end this IDR provides an economic analysis of the Spanish economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

Against this background, Section 2 provides an overview of the general macroeconomic developments. Section 3 looks more in detail into the main imbalances and risks, focussing in particular on (3.1) competiveness and the sustainability of the external position; (3.2) indebtedness and deleveraging and, (3.3) the performance of the labour market. Section 4 discusses policy challenges.

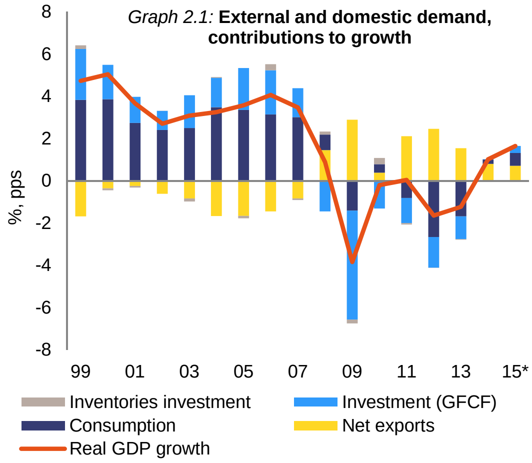
2. MACROECONOMIC DEVELOPMENTS

Return to positive output growth and stabilising financial markets amidst further adjustment of imbalances

The correction of imbalances is advancing, with some variables adjusting at a higher speed than others. The recapitalisation and restructuring of weaker banks has contributed to restoring financial stability and confidence and set the ground for a relaxation of financial market stress. On the external side, the current account has turned into a surplus, with exports fuelled by a growing internationalisation of companies and improving cost competiveness. It will nevertheless take a long series of current account surpluses to narrow the large net negative external investment position and reduce substantially external debt. Private sector deleveraging has continued, with corporations reducing debt levels more rapidly than households, but also in this case the current trends in flows will need to be sustained over time to reduce the still elevated debt stocks. Meanwhile, reversing the fall back from the crisis on the labour market and on public finances have become major economic challenges. General government debt has reached high levels and is still increasing. In the labour market, the fall in employment appears to be finally bottoming-out but reabsorbing the large number of unemployed, many of them long-term and low-skilled, will be a major undertaking.

The third quarter of 2013 marked the end of the longest recession in decades. After a first dip between Q3-2008 and Q4-2009, the Spanish economy recorded anaemic growth in 2010, entering again in recession in the second quarter of 2011 with soaring unemployment. Following the GDP stabilisation in Q3, growth picked up in Q4-2013 on the back of a less negative contribution from internal demand, confirmed by a generalised improvement of economic sentiment indicators. Private consumption and investment are set to accelerate further in 2014 contributing positively to growth, while the contribution from the external trade position is expected to decline (Graph 2.1). Key macroeconomic indicators covering 2007 to the current forecast horizon (i.e. 2015) are summarised in table 2.1.

Graph 2.1: **External and domestic demand, contributions to growth**



Source: Commission services

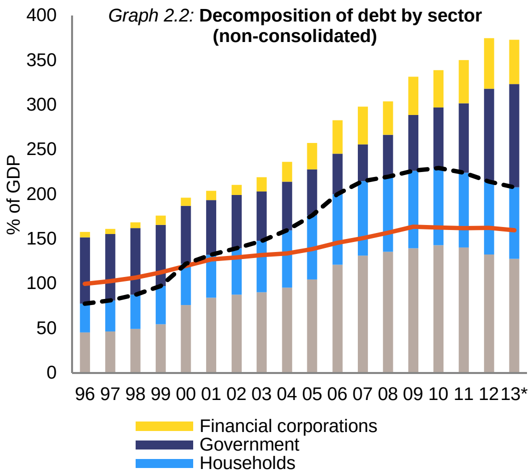
Financial markets have stabilised. A marked return of market confidence on Spain was manifest in the narrowing of sovereign debt yields spreads vis-à-vis the core euro area Member States, surging stock market prices and the resumption of foreign financing. Domestic deposits also increased, allowing Spanish banks to reduce their reliance on the Eurosystem. The financial sector recapitalisation programme ended successfully in January 2014, leaving banks much stronger than one and half year earlier. Yet, the restructuring and downsizing of the financial sector is set to continue.

Financing conditions for the non-financial private sector have been gradually easing, most notably for large borrowers. The reinforcement of banks' balance sheets and recovering confidence on Spain in financial markets have led to greater availability and a lower cost of financing for larger companies. At the same time, in spite of recent signs of easing and differentiation across companies, lending standards and terms for SMEs remain on average relative onerous, pointing to market fragmentation and the impact of the weakening or cutting of historical links between banks and customers. The financial sector is discussed in greater detail in section 3.2.

House prices have adjusted sharply and appear to be approaching stabilisation. The cumulative fall between Q3-2007 and Q3-2013 was 36.2% in nominal terms and 43.8% in real terms. Even though prices were still falling at a 7.9% year-on-year rate in Q3-2013, they increased by 0.7%

compared to the previous quarter, the first positive quarterly growth rate since Q2-2010. The market is also characterised by much differentiation across locations. However, given the large stock of unsold houses, it cannot be excluded that the adjustment may have somewhat further to run, and price developments going forward might also be influenced by the sale strategies of Sareb (the asset management company) and commercial banks. The housing market and the construction sector are discussed in detail in section 3.2.

Graph 2.2: **Decomposition of debt by sector (non-consolidated)**



Source: Commission services

Deleveraging pressures remain a drag on growth. The strong contraction of credit has been the main driver behind the reduction in private sector indebtedness, but the contraction of GDP has impeded a more rapid stabilisation of indebtedness ratios (Graph 2.2). The gradually improving economic outlook can be compatible with a continuation of deleveraging. Both households and non-financial corporations are expected to maintain positive net lending positions even as consumption and investment, as well as demand for credit, pick up.

Whereas the private sector is on a path of deleveraging, general government debt is still expanding. Rising social expenditure, the disappearing of a rich tax base linked to construction and stabilisation interventions in the financial sector have put general government debt on an increasing trend: from 2007 to 2012 it increased by almost 60 pps. and it is set to approach 100% of GDP in 2014. Deleveraging pressures in the private and in the public sector are discussed in section 3.2.

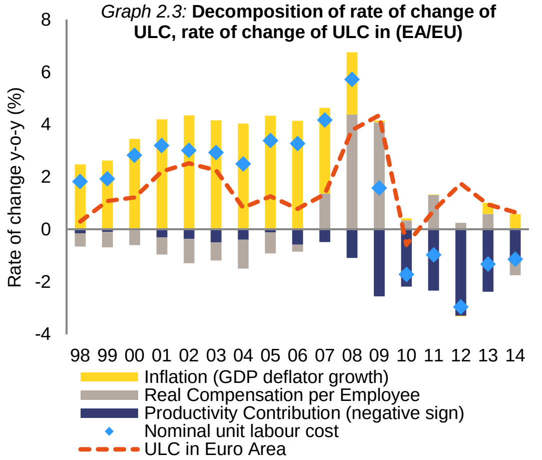
Strengthening current account and competitiveness, but not reflected yet in the net international investment position

The current account has turned into surplus (1.1% of GDP in 2013), after almost two decades of negative balances. The improvement was driven by the trade balance, with exports accelerating considerably in 2012 and 2013, while import volumes continued to contract. The current account balance appears set to increase further in the coming years, according to the 2014 Winter Forecast.

The process of internal devaluation advances, resulting in low inflation and a recovery in price and cost competitiveness. During the boom period Spain registered a protracted positive inflation differential with the euro area and the EU that entailed a strong deterioration in cost and price competitiveness. With the fall in domestic demand and surging unemployment during the crisis, inflationary pressures eased, first narrowing and then reversing the differential with the euro area and the EU. Headline and core inflation have fallen to around zero in late 2013 and are expected to remain very contained during 2014. The real effective exchange rates (REERs) and nominal unit labour costs (ULCs) have fallen by 12.0% and 6.8% respectively since 2009 (Graph 2.3).([1]) Productivity gains (largely associated with labour shedding) together with moderate wage developments in later years explained the recovery in competitiveness. The successful implementation of ongoing structural reforms in product and services markets would support competitiveness. In particular, measures aimed at overcoming regulatory fragmentation in the internal Spanish market and at instilling better regulation principles across all general government levels should enhance competition and reduce economic rents in sheltered sectors.

([1]) The REERs figures are deflated by unit labour cost.

Graph 2.3: **Decomposition of rate of change of ULC, rate of change of ULC in (EA/EU)**



Source: Commission services

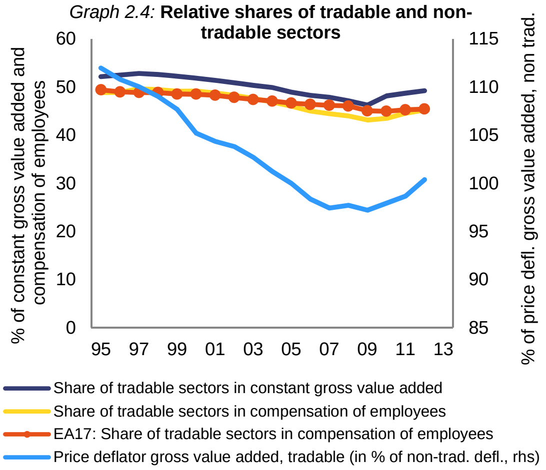
Several indicators suggest a structural improvement of Spain's export capacity. The analysis of cyclically adjusted current account suggests that the non-cyclical balance could be somewhat lower than the headline figure. Exports have increased both at the extensive and the intensive margins. Considering the fixed costs associated with penetration in foreign markets, it is unlikely that these gains will be reversed in the future. A part of the real import decline is also likely to be permanent, as domestic demand and growth expectations are not expected to return to pre-crisis levels.

In spite of the current account surplus, the NIIP has continued to deteriorate as a ratio of GDP, on account of contracting GDP and negative valuation effects. The latter reflect positively increased confidence in the perspectives of the Spanish economy. Yet, a high external debt (especially in the form of loans) exposes the economy to vulnerabilities – as it became evident in the wake of the crisis. The external performance is discussed in detail in section 3.1.

Ongoing reallocation of resources

The adjustment process has produced a sharp alteration of the composition of employment and value added. The contraction of value added and employment relative to the pre-crisis level has concerned all branches of the economy. In relative terms, the share of tradable sectors in value added has interrupted its long declining trend and the same applies when looking at the share of tradable sectors in the compensation for employees (see Graph 2.4). The change in the relative composition was mainly driven by the collapse of the construction sector and real estate development and to a lesser extent by the downsizing of the financial sector (this mainly in value added terms).

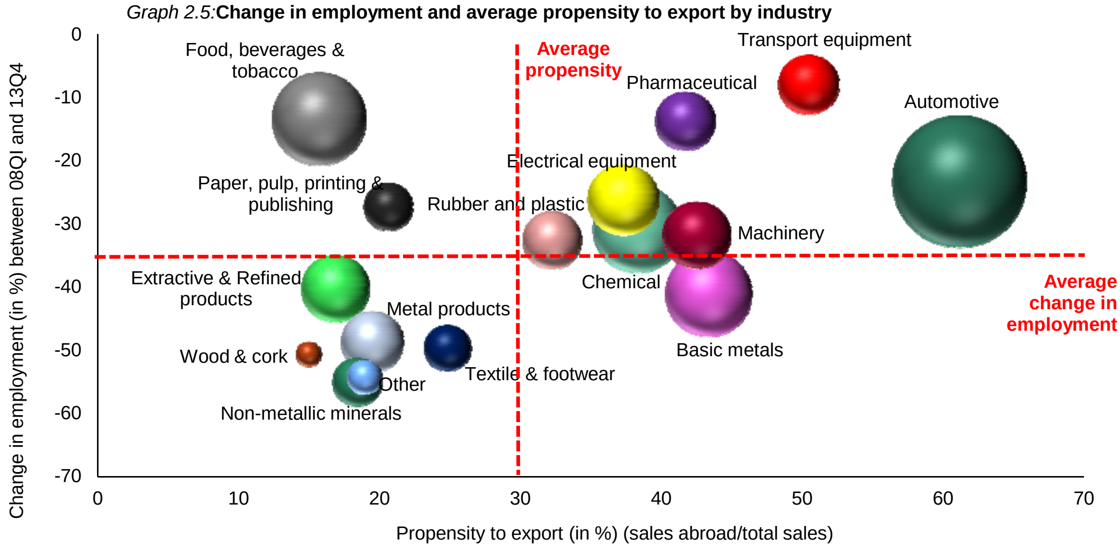
Graph 2.4: **Relative shares of tradable and non-tradable sectors**



Source: Commission services

Export-oriented firms have fared better. Micro-level data shows that exporting firms recorded better performance index of industrial production and higher profitability rates (based on firms' balance sheet data). Furthermore despite low rates of aggregate capital utilisation, investments in equipment have registered a significant increase in the last months of 2013, whereas sub-branches of the tradable sectors reported positive expectations about employment creation. The combination of this evidence suggests that a process of re-allocation of capital and labour is on-going despite the fact that it not yet visible at a high aggregate level (i.e. tradable versus non-tradable). This conclusion is also supported by a recent analysis of the Ministry of Economy. Since the onset of the crisis, as graph 2.5 depicts, exporting industries (e.g. automotive, transport equipment, chemicals and pharmaceuticals, machinery and equipment) have suffered much less than the average. A similar pattern is found with respect to credit: i.e. a much lower aggregate reduction in exporting industries.

Graph 2.5: **Change in employment and average propensity to export by industry**



Source: Kingdom of Spain, Ministry of Economy

Record high unemployment and worsening social indicators

The macroeconomic adjustment process in the context of a dual and rigid labour market resulted in unprecedented employment destruction, which is only starting to stabilise. The external rebalancing and the deleveraging pressures necessarily required an adjustment also in the labour market. However, in a dual and overly rigid labour market, the fall in aggregate demand produced an exceptionally high employment destruction (more than 4 million jobs were lost since the beginning of the crisis). The unemployment rate stood at 26.4% in 2013, below the record high of 27.2% in Q1 of 2013. The reduction was however mainly due to falling activity rates. Reductions in the labour force have mainly been driven by net migration outflows. The participation of the younger population also decreased, while the ratio of individuals not in education, employment, or training to total population in young cohorts (the NEET rate) has been increasing sharply.

There is an increasing risk that long term unemployment will cause hysteresis effects. Spain has historically witnessed sudden and extensive surges in unemployment in economic downturns. A sticky wage adjustment process and the significant share of fixed-term contracts contributed to a high elasticity of employment to GDP. While employment perspectives should improve as economic activity picks up, the structural transformations the Spanish economy is undergoing (and in particular the downsizing of the construction sector) accentuate the mismatch between labour demand and supply, and the large share of long-term unemployment (52.2% of total unemployment in Q4-2013) risks generating significant hysteresis effects with a negative impact on the structural rate of unemployment. Notwithstanding the positive impact of recent labour market reforms on internal flexibility and wage setting, future employment outcomes will also depend on improved matching in the labour market (to which ALMP and training and education can contribute) and on the success of reforms in product markets and business environment (see section 3.3).

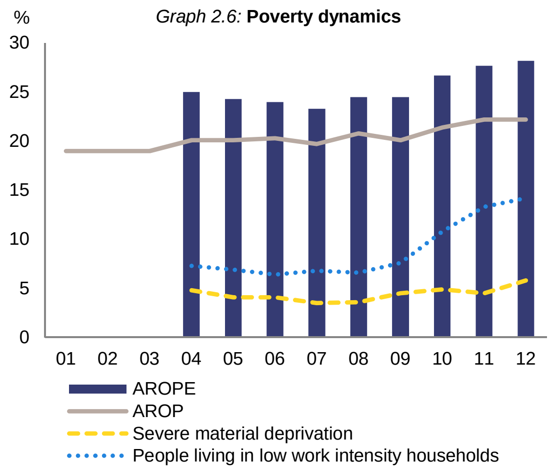
Social indicators have worsened substantially with the crisis and higher unemployment. With social indicators typically strongly correlated with the performance of the labour market, the surge in unemployment in Spain has had a direct impact on poverty (see Graph 2.6). Between 2007 and 2012, the population at-risk-of-poverty (AROP) ([2]) increased from 19.7% to 22.2%, whereas the percentage of the population of people at-risk-of-poverty or social exclusion (AROPE) increased

([2]) At-risk-of poverty rate (AROP): share of people with an equivalised disposable income below 60% of the national equivalised median income.

from 23.3% to 28.2%.([3]) The difference between the two measures is mainly driven by the increase in the number of households with very low working intensity (from 6.8% to 14.3%).([4]) Poverty has a strong gender profile, with poverty rates for single women well above the average. Families with two or more children are also particularly exposed to poverty risk, with the AROPE for household with three children or more being above 45%. Child AROPE rates, already high by comparative perspective, increased further to 33.8% - i.e. almost 10 pp. higher the euro area average.([5]) High poverty rates in households with children are consistent with a high average early school leaving rates, which at 24.9% in 2012 is amongst the highest in the EU. The rate has decreased in recent years, possibly also on account of lower employment opportunities for low-skilled workers.

Poverty has increased also amongst the employed, whereas the elderly have on average been relatively sheltered during the crisis. In terms of labour market status, recent years marked a strong increase of poverty amongst the adult unemployed population (from 49.5% to 62.3% between 2007 and 2012) and an increase in poverty rates amongst the employed population. The latter finding can be explained both in terms of falling earnings and of spill-over of labour market status of other members of the household. Retirees, on the other hand, appear to have been on average relatively sheltered over the crisis: the poverty rate for those aged 65 and more dropped from 27.9% to 16.6% between 2007 and 2012.([6])

Graph 2.6: **Poverty dynamics**



Source: Commission services

Higher social expenditure and intra-household solidarity have cushioned to some extent the rise in poverty levels. Expenditure on social protection in Spain increased from 20.8% of GDP in 2007 to 26.1% of GDP in 2011.([7]) However, a significant share of the increase is due to expenditure on pensions which rose from 9.2% of GDP to 11.4% of GDP. Moreover, over the same period the number of beneficiaries (all typologies) increased from 1,246,300 to 2,698,500, and the number of beneficiaries of social assistance from 400,500 to 1,184,100.

With falling disposable incomes, housing costs (including the repayment of mortgages) have become a heavier financial burden. The percentage of mortgage holders declaring to bear a heavy financial burden for the repayment of debts increased from 53.7% to 64.2% between 2007 and 2012.([8]) The situation of the labour market clearly

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([3]) People at-risk-of poverty or social exclusion (AROPE): are individuals who are at-risk-of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in household with zero or very low work intensity (LWI).

([4]) People living in households with very low work intensity: share of people aged 0-59 living in households where the adults (excluding dependent children) work less than 20% of their total work-time potential during the previous 12 months.

([5]) Number of children aged 18 or less living in poor household over total population aged 16 or less.

([6]) The poverty figures are higher when anchoring the poverty line at pre-crisis levels (2007 incomes). In this case the poverty rate for 2012 is above 28% - and it is likely to be higher in 2013, considering the further deterioration of employment in the last couple of years.

([7]) This corresponded to an increase from 5,237 pps (purchasing power standards) per inhabitant in 2007 to 6,031 pps in 2011. Expenditure on social protection include: social benefits, which consist of transfers, in cash or in kind, to households and individuals to relieve them of the burden of a defined set of risks or needs; administration costs, which represent the costs charged to the scheme for its management and administration; other expenditure, which consists of miscellaneous expenditure by social protection schemes (payment of property income and other).

([8]) The statistic on the financial burden of the repayment of debts from hire purchases or loans is asked to mortgage holders. Household can choose among the following answers: (i) “a heavy burden”, (ii) “somewhat a burden”, and (iii)“not a problem”. The question captures households’ perceptions about the influence of mortgage repayments and housing costs in particular, on their financial situation more generally.

Table 2.1:
Key economic, financial and social indicators - Spain

	2007	2008	2009	2010	2011	2012	Forecast 2013	Forecast 2014	Forecast 2015
Real GDP (yoy)	3.5	0.9	-3.8	-0.2	0.1	-1.6	-1.2	1.0	1.7
Private consumption (yoy)	3.5	-0.6	-3.7	0.2	-1.2	-2.8	-2.4	0.6	1.1
Public consumption (yoy)	5.6	5.9	3.7	1.5	-0.5	-4.8	-1.1	-0.9	-0.2
Gross fixed capital formation (yoy)	4.5	-4.7	-18.0	-5.5	-5.4	-7.0	-5.6	0.1	2.0
Exports of goods and services (yoy)	6.7	-1.0	-10.0	11.7	7.6	2.1	4.9	5.4	6.4
Imports of goods and services (yoy)	8.0	-5.2	-17.2	9.3	-0.1	-5.7	0.2	3.3	4.9
Output gap	2.0	0.5	-4.2	-4.7	-4.4	-5.2	-5.1	-3.1	-0.4
Contribution to GDP growth:									
Domestic demand (yoy)	4.4	-0.7	-6.6	-0.9	-2.0	-4.1	-2.7	0.2	0.9
Inventories (yoy)	-0.1	0.1	-0.2	0.3	-0.1	0.0	0.0	0.0	0.0
Net exports (yoy)	-0.8	1.5	2.9	0.4	2.1	2.5	1.6	0.8	0.7
Current account balance BoP (% of GDP)	-10.0	-9.6	-4.8	-4.5	-3.8	-1.1	.	.	.
Trade balance (% of GDP), BoP	-6.5	-5.5	-1.6	-1.9	-0.7	1.1	.	.	.
Terms of trade of goods and services (yoy)	0.5	-1.8	4.1	-2.2	-3.1	-2.3	0.7	0.9	-0.3
Net international investment position (% of GDP)	-78.1	-79.3	-93.8	-89.1	-90.3	-91.4	.	.	.
Net external debt (% of GDP)	68.5	76.2	88.3	92.0	93.5	90.4	.	.	.
Gross external debt (% of GDP)	145.3	153.7	167.9	164.0	166.7	167.8	.	.	.
Export performance vs. advanced countries (5 years % change)	.	.	.	.	.	.	.	.	.
Export market share, goods and services (%)	.	.	.	.	.	.	.	.	.
Savings rate of households (Net saving as percentage of net disposable income)	4.0	7.8	12.2	7.9	6.8	4.4	.	.	.
Private credit flow (consolidated, % of GDP)	26.9	12.6	-1.4	1.2	-4.6	-10.5	.	.	.
Private sector debt, consolidated (% of GDP)	200.1	205.8	213.2	213.8	206.5	195.3	.	.	.
Deflated house price index (yoy)	6.4	-4.8	-5.6	-3.6	-9.9	-16.9	.	.	.
Residential investment (% of GDP)	12.2	10.8	8.5	7.3	6.0	5.2	.	.	.
Total Financial Sector Liabilities, non-consolidated (yoy)	17.0	4.5	3.9	-2.0	3.7	3.5	.	.	.
Tier 1 ratio (1)	.	8.1	9.3	9.6	10.2	9.7	.	.	.
Overall solvency ratio (2)	.	11.3	12.2	11.9	12.2	11.5	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances) (2)	.	2.6	3.6	4.1	5.2	6.4	.	.	.
Employment, persons (yoy)	3.0	-0.1	-6.5	-2.2	-1.9	-4.2	-2.9	0.2	0.9
Unemployment rate	8.3	11.3	18.0	20.1	21.7	25.0	26.4	25.7	24.6
Long-term unemployment rate (% of active population)	1.7	2.0	4.3	7.3	9.0	11.1	.	.	.
Youth unemployment rate (% of active population in the same age group)	18.2	24.6	37.8	41.6	46.4	53.2	55.7	.	.
Activity rate (15-64 years)	71.6	72.6	73.0	73.4	73.7	74.1	.	.	.
Young people not in employment, education or training (% of total population)	12.2	14.4	18.3	18.0	18.5	18.8	.	.	.
People at-risk poverty or social exclusion (% total population)	23.3	24.5	24.5	26.7	27.7	28.2	.	.	.
At-risk poverty rate (% of total population)	19.7	20.8	20.1	21.4	22.2	22.2	.	.	.
Severe material deprivation rate (% of total population)	3.5	3.6	4.5	4.9	4.5	5.8	.	.	.
Persons living in households with very low work intensity (% of total population)	6.8	6.6	7.6	10.8	13.4	14.3	.	.	.
GDP deflator (yoy)	3.3	2.4	0.1	0.1	0.0	0.0	0.3	0.5	0.7
Harmonised index of consumer prices (yoy)	2.8	4.1	-0.2	2.0	3.1	2.4	1.5	0.3	0.9
Nominal compensation per employee (yoy)	4.7	6.9	4.2	0.4	1.3	0.2	0.5	0.6	0.6
Labour Productivity (real, person employed, yoy)	0.4	1.0	2.9	2.0	2.0	2.7	.	.	.
Unit labour costs (whole economy, yoy)	4.2	5.7	1.6	-1.7	-1.0	-3.0	-1.6	-0.4	0.0
Real unit labour costs (yoy)	0.9	3.3	1.5	-1.8	-1.0	-2.9	-1.9	-0.9	-0.7
REER (ULC, yoy)	3.6	4.1	-1.1	-3.9	-1.5	-6.6	-0.9	0.0	-1.1
REER (HICP, yoy)	1.6	2.5	0.5	-3.1	0.2	-2.3	1.8	0.2	-1.0
General government balance (% of GDP)	2.0	-4.5	-11.1	-9.6	-9.6	-10.6	-7.2	-5.8	-6.5
Structural budget balance (% of GDP)	1.0	-4.5	-8.5	-7.4	-7.2	-5.1	-4.3	-4.2	-5.8
General government gross debt (% of GDP)	36.3	40.2	54.0	61.7	70.5	86.0	94.3	98.9	103.3

(1) domestic banking groups and stand-alone banks.
(2) domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.
Source: Eurostat, ECB, AMECO.

drags on the process of deleveraging and weigh on prospects for banks' profitability. Whereas the NPL rate on mortgages has so far been contained, it remains on an upward trend. The increasing length of unemployment spell risks reducing the capacity of affected households to face their financial commitments.

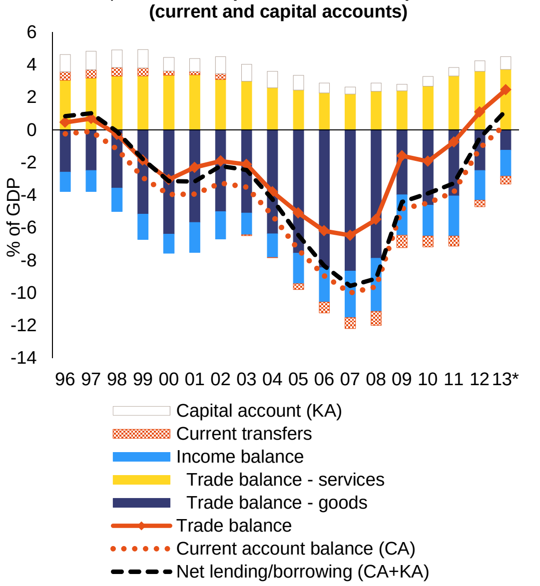
3. IMBALANCES AND RISKS

3.1. COMPETITIVENESS AND SUSTAINABILITY OF THE EXTERNAL POSITION

3.1.1. Overview

The bust of the housing bubble and the financial crisis has prompted a sharp current account adjustment. From a deficit of 10% of GDP in 2007, the current account registered a surplus of 1.1% of GDP in 2013 (Graph 3.1), which is forecast to widen to 1.8% of GDP by 2015. Indicators of competitiveness have also improved, reversing a good part of the losses accumulated in the boom period. ULC have been falling since 2010, on the back of labour shedding induced productivity growth, and – more recently – subdued wage dynamics.

Graph 3.1: **Decomposition of external position (current and capital accounts)**

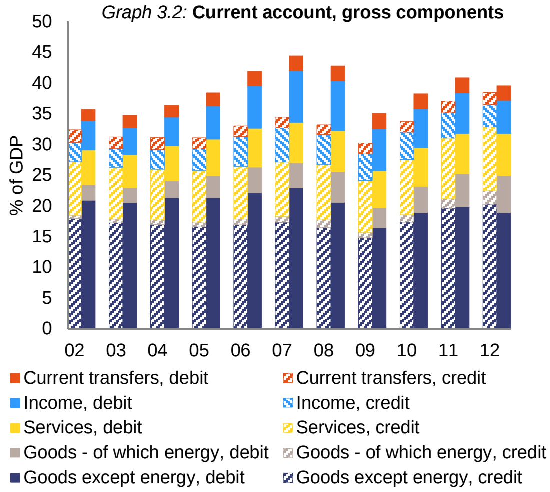


Source: Commission services

The export performance has been very robust, contributing to the re-balancing of the economy. Exports of goods and services increased from, respectively, 17.6% and 8.8% of GDP in 2008, to 23.5% and 10.6% of GDP in 2013 (Graph 3.2). Export of goods as a share of GDP is still well below the share of Germany (42.7% in 2013), but compares well with two other large euro area economies (21.4% of GDP and 25% of GDP in France and Italy respectively). Moreover, the share of services in Spanish exports is well above other large euro area economies (Germany, France and Italy are at 7.7% of GDP, 6.1% of GDP and 5.4% of GDP respectively) and comes close to the performance of the UK (12.3% of GDP).

The evolution of Spanish exports' market shares also compares well with other large euro-area economies (despite decreasing in relative terms due to globally increasing trade flows – see Graph 3.3). From 2008 to 2013 the export market share for goods decreased only marginally, from 1.8% to 1.7% (the corresponding values for other large euro area economies are: Germany: 9.0 to 7.8; France: 3.8 to 3.2; Italy: 3.4 to 2.8). Advanced countries' nominal shares tend to evolve relatively better than real shares. As competition in more standard products intensifies, these countries usually export more sophisticated and high-quality products characterised by higher unit-values. That was the case before 2007, also in Spain, where export shares fell more in real than in nominal terms due to high export prices. However, since 2007 real shares have performed better than nominal shares owing to price and wage moderation in advanced countries. The recent development of export market shares in Spain, particularly in real terms, points to structural competitiveness gains. The evolution of the real share in comparison with the nominal indicates the exporters' moderation of prices paves the way for a positive behaviour of exports in the medium term.

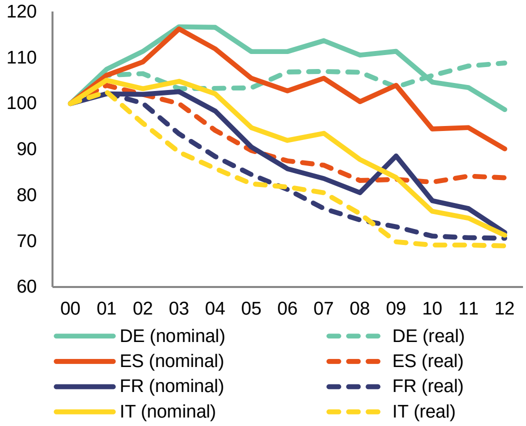
Graph 3.2: **Current account, gross components**



Source: Commission services

In spite of a sharp contraction in real imports, imports values proved quite resilient. Following the trade collapse of 2009, import of goods attained 24.7% of GDP in 2013 – i.e. not far from pre-crisis levels, whereas the import of services attained a ratio of 6.9% of GDP in 2013 – i.e. above pre-crisis levels. As discussed below this is largely due to the behaviour of import prices – in particular energy (for more details see discussion in section 3.1.3 and Graph 3.11).

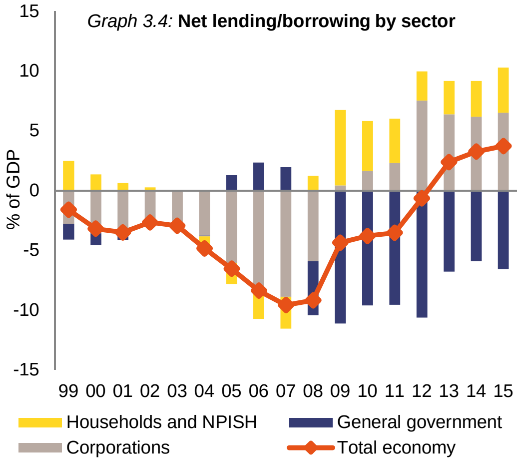
Graph 3.3: **Share in world exports of goods and services (2000=100)**



Source: Commission Services

The turnaround in the current account is the counterpart of deleveraging in the private sector (see Section 3.2)**.** Non-financial corporations and households have moved into very large net lending positions, more than compensating the large net borrowing position of the government (Graph 3.4). Going ahead, further reductions in the budget deficit would support a larger surplus in the current account even in the event of a stabilisation of private sector net lending.

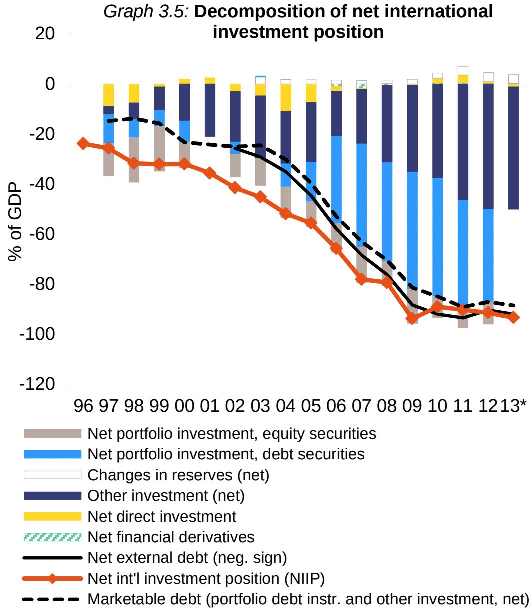
Graph 3.4: **Net lending/borrowing by sector**



Source: Commission services

In spite of the current account surplus, the Net International Investment Position (NIIP) deteriorated in 2013 on account of negative valuation effects. In Q3-2013 the NIIP stands at – 97.8 % of estimated GDP, i.e. more than 15 pps higher than before the crisis and more than 60 pps higher than the value in the early 2000s (Graph 3.5).

Graph 3.5: **Decomposition of net international investment position**



Source: Commission services

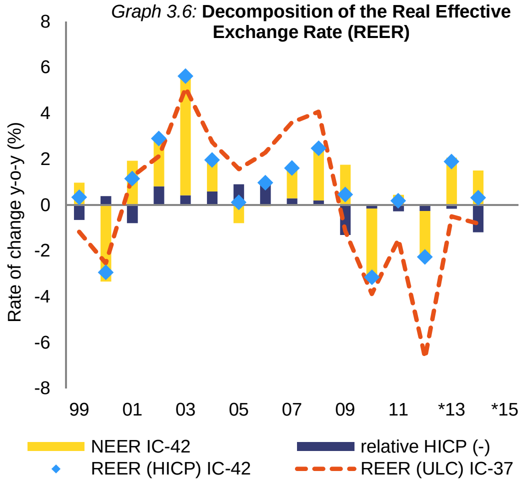
This section will continue with a discussion of the drivers of exports and imports, the level and the structure of the NIIP and trade and financial links with the rest of the euro area, before providing some conclusions.

3.1.2. Drivers of export performance

Spanish exports have been resilient in a medium-term perspective. Remarkably, this was the case also during the sizeable pre-crisis deterioration competitiveness indicators (Graph 3.6). This well-known phenomenon has been referred to as the 'Spanish paradox'. ([9]) Econometric evidence confirms the long-term positive relationship between relative-price-based competitiveness indicators and exports, but also suggests that other factors (non-cost determinants) may more than compensate the dynamics of relative costs and prices. ([10]) In empirical studies, the real exchange rate typically explains well below 10% of the change in (country-specific) exports; world (trade) developments explain about 80%, while the residual 15% is linked to a path dependency that implicitly captures other unspecified factors. Moreover, Spain stands out in these analyses in that the explicative power of cost competitiveness and path dependency are below the average of other countries.([11]) The higher explanatory power of foreign demand suggests that other factors have allowed Spain to benefit relatively more from the increase in global trade flows and thus offset the negative dynamic of aggregate losses in cost competitiveness.

The export mix (in terms of products and geographical markets) and the relative efficiency of exporting firms can help explain the export performance of Spain. Firstly, the concentration of exports in growing regions and/or growing markets contributes to determining the export performance of a country. Other factors include the extent of competition of other countries as well as the role of exporting industry in other sectors (i.e. high or low dependence). Secondly, the analysis of the behaviour of firms is key to understand the aggregate export performance of a country. ([12]) This analysis typically relies on micro-data at firm-level in order to capture the heterogeneity that exists both across sectors and across different enterprises of different size.

Graph 3.6: **Decomposition of the Real Effective Exchange Rate (REER)**



Source: Commission services

Spain has been successful in stepping up its export product and geographical specialisation. The change in goods export market shares can be decomposed through a shift-share analysis in four components, namely: (i) initial product specialisation; (ii) initial geographical specialisation; (iii) market share gains in product markets and (iv) market share gains in geographical destinations. Although the negative contribution of initial geographical specialisation (mostly the EU) was more sizable in the case of Spain than Germany (Graph 3.7), in recent years Spain has registered larger positive contribution from penetration in new geographical markets – mainly the Emerging And Growth Leading Economies (EAGLEs). The decomposition also shows a relatively favourable contribution (relative to Germany) of the initial product specialisation and market share gains signalling that, despite the lower technological content of its export, Spain was able to withstand relatively well increasing competition from developing economies.

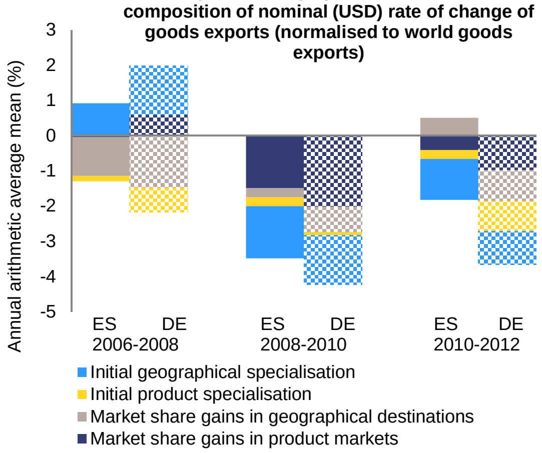
([9]) See Antràs et al. (2010) and Crespo-Rodríguez et al. (2012).

([10]) According to Correa Lopez and Domenech (2012), if Spain had experience the real effective exchange rate depreciation of, say, Germany, its export market share would have increased by 20 pp (equivalent to 6% of Spanish GDP).

([11]) See Crespo Rodríguez et al. (2012). The authors estimated an error correction mechanism model using a sample of ten countries for the period 1995 Q1-2011 Q3, in which the exports of each country are were modelled as a function of the volume of world exports (general world trade developments) and its relative price/cost competitiveness.

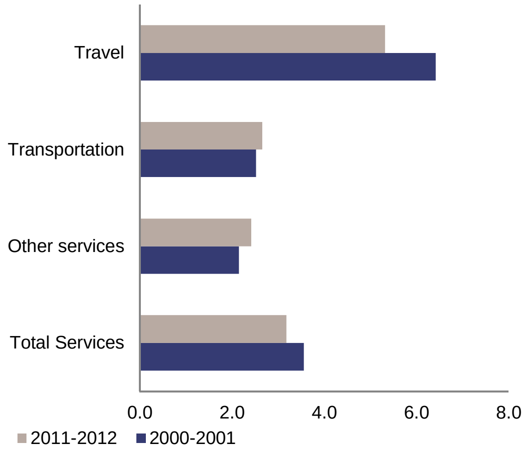
([12]) Indeed the emerging consensus in academic and policy circles is that aggregate external competitiveness is an expression of high firm-level productivity (Altomonte et al., 2012).

Graph 3.7: **Geographical and sectoral composition of nominal (USD) rate of change of goods exports (normalised to world goods exports)**



Source: Commission services

Graph 3.8: **World market shares for services**



Source: Commission services

A more granular analysis points to specific strengths of Spain's goods export mix. Spain fares well in terms of levels of global complexity and connectivity. ([13]) The average complexity of Spanish exports is more than double that of global exports, whereas its average industry connectivity is above the global average. Amongst the best performing industries are sectors with a high weight in Spanish exports such as machinery (33%), other chemical products (11%) and other metallic products (8.9%).

The performance of export of services has also been positive – both in quantitative and qualitative terms. Spain's share in world's service exports is significantly greater than its share in goods' export (3.3% versus 1.6% in 2012), mainly on account of its large tourism sector. While the share of Spain in world tourism has been decreasing in the last decade([14]), Spain has been able to expand its share in other services – mainly services to enterprises – characterised by higher value added and possibly higher future growth potential (see Graph 3.8). The share of turnover in foreign markets increased in most sub-sectors related to services to enterprises, especially in software publishing, computer programming, consultancy and related activities, engineering activities and related technical consultancy. Significant penetration in foreign markets also occurred in accounting, bookkeeping and auditing activities and tax consultancy as well as in management consultancy activities. Whereas the increase in the export markets for goods mainly occurred in the EAGLEs, the expansion of export of services was concentrated in North America and in the UK.([15])

At micro level, Spanish exporting firms are more efficient than non-exporting firms, and compare well to euro area competitors. The data point to higher productivity levels amongst

([13]) Hausmann et al. (2011). A sector's complexity index is higher the lower the number of countries capable of making the sector's goods and the higher the extent of product diversification of those countries. Sectoral proximity or connectivity is a measure of the average distance of a sector to each of the products that are exported globally. The higher the connectivity, the greater a sector's ability to extend exports to other sectors that may use its productive knowledge. Accordingly, countries with the highest international advantage in terms of product diversification will have a domestic distribution of exports geared towards more complex and more connected sectors.

([14]) Some concerns have been voiced about the risk that Spain remains locked into conservative tourism model, excessively reliant on costal seasonal tourism and increasingly subject from competition from cheaper destinations (see Valls and Perera (2012)).

([15]) IMF (2013).

Spanish exporting firms (typically bigger than non-exporting firms) ([16]) and to broadly comparable export propensity at the extensive margins to peers in other euro area countries. ([17]) This is consistent with the economic literature that has highlighted the importance for international competitiveness of firm-level factors (capacity to specialise and exploit new and dynamic markets) besides structural conditions prevailing in the individual countries including labour- and product-market functioning, the degree of technological diffusion, innovation, taxation and financing constraints.([18])

The relative strength of exporting firms appears to have offset part of the deterioration in aggregate competitiveness measures. Productivity performance at the firm level is the result of improvements in product quality and processes, but also relative strengths in relation to the management of the firm, distribution channels and after-sales services. ([19]) Antrás et al. (2010) find that when firm-level ULC developments are considered (instead of aggregated ULCs), Spain's export performance is less paradoxical. Productivity growth in the largest firms has outperformed that of smaller firms over the past decade and, in turn, the exports of those firms increased faster than those of other smaller firms. It thus appears that the behaviour of Spanish companies has in some instances allowed them to overcome structural weaknesses vis-à-vis their peers in other countries: the proportion of high-skilled employees is lower in Spanish firms, although the presence of managers with international experience and of employees participating in training courses is high; the proportion of Spanish firms that invest in R&D is lower, but Spanish score better in the generation of process innovations; the participation of Spanish firms in global value chains is lower and predominantly passive (by contrast, a higher percentage of Spanish firms import standardised inputs, in line with the Spanish economy's high import dependence).([20])

The export base is widening. The overall success of Spanish firm internationalisation strategy can be measured against the increase in export at the intensive and extensive margin. According to data released by ICEX (Spanish Institute of Foreign Trade), the number of Spanish exporting firms has grown significantly in recent years, at an annual average of 6.0% from 2008 to 2011. According to provisional data for 2013, the number of exporting firms further increased by 11.7% - a year-on-year rate similar to the record increase of 12.6% registered in 2011. ([21])

The size distribution of Spanish companies, skewed heavily towards micro companies, drags on the aggregate export capacity of the economy. Most of the variables positively contributing to export propensity and/or intensity are more frequently observed (or have higher average values) in larger firms. As pointed out in several early studies – there is a strong positive correlation between company size, productivity and export potential. ([22]) Interestingly, even when taking into account the contribution of the other variables discussed above, company size remains the single most significant factor explaining the

([16]) According to Correa Lopez and Domenech (2012), productivity in terms of value added per employee and output per employee is respectively more than 60% and more the 200% higher in exporting firms than in non-exporting firms.

([17]) According to Martín and Tello (2013), estimations suggest that Spanish firms, having controlled for their individual and sector characteristics, do not have a lower probability of exporting than German ones. Similar firms, in particular as regards size, have comparable propensity to export.

([18]) Altomonte et al. (2013) and European Commission (2013).

([19]) ECB (2012). Disentangling the weight of the two channels is empirically complicated, since the factors that generate productivity gains improve the competitiveness of the firm by lowering productive costs and increasing the quality of the final product.

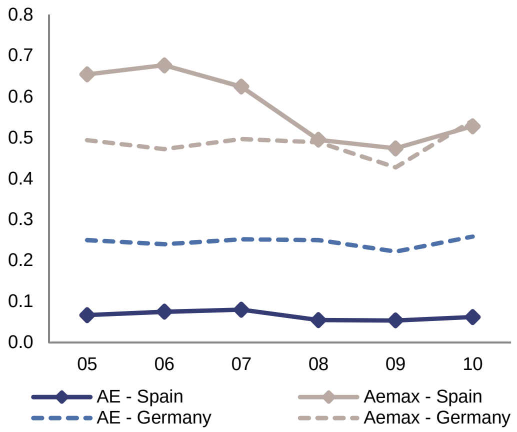
([20]) This discussion refers to the average characteristics of Spanish firms. Indeed some sectors (especially the automotive) feature an extremely high degree of participation in global value chains, resulting in high aggregate measures of integration.

([21]) It is noteworthy that the increase in the number of firms exporting less than EUR 5,000 was almost 70% between 2008 and 2012, whereas the number of firms exporting more than EUR 250 Mn (the second largest group in terms of increase) increase by 26%. Yet, the enterprises exporting the largest volumes registered the highest increase on the intensive margin. These indicators can be taken as signals of the still significant export potential – especially considering the high fixed costs typically associated with penetrating in foreign markets.

([22]) Large Spanish companies are equally, or even more, productive compared to their European peers. A study of Fedea-McKinsey demonstrate that Spain would have a 30% higher level of productivity than Germany if it maintained current productivity levels, but changed its company-size mix to resemble that of Germany. In a similar vein, Altomonte et al. (2011) estimate that Spain's exports would be 25% higher if it had the same industrial fabric as Germany. See also European Commission (2012).

export performance. [23] This contributes to the high degree of concentration of exports. Despite the recent increase in the extensive margin, moreover, the increase at the intensive margin has been largest amongst largest companies. This has resulted in a further increase in the degree of concentration of exports. [24]

Graph 3.9: **Allocative efficiency - manufacturing sector**



Source : Commission Services

Structural factors, and in particular low allocative efficiency, appear to constrain firms' growth and hamper the export potential. The above evidence suggests that low aggregate productivity was less rooted in micro-level determinants, but rather in structural features that prevent an efficient allocation of resources and more productive firms to grow faster. This view is supported by a recent study by the Bank of Spain which shows that (i) the loss of competitiveness during the boom did not occur among the largest firms with the greatest presence in international trade and (ii) the aggregate slow-down in productivity is the result of a lack of flexibility, which prevented resources from being efficiently reallocated between sectors and firms.[25] Commission services estimates further confirm this result. Allocative Efficiency (AE) for the manufacturing sector is defined in Graph 3.9 as the percentage increase in manufacturing productivity in Spain and in Germany connected with the actual allocation of employment across firm size classes, relative to a baseline scenario in which employment is allocated randomly (according to a uniform probability distribution) across the different firm size categories. The slightly positive value means that resources are allocated in a more efficient way relative to the baseline. The maximum attainable level assumes that the size class with the highest labour productivity has a 100% market share, while maintaining the observed labour productivity level per size class and unweighted average labour productivity level for the calculation of the index. Lower figures for allocative efficiency point to forces in the economy preventing competition to work properly, such as excessive regulation, rent-seeking and ineffective procurement. The gap with respect to the optimal allocation is much larger for Spain than for Germany. [26]

3.1.3. Drivers of imports

A significant part of the fall in imports is likely non-cyclical. In constant prices, total imports fell by almost 17% between 2008 and 2013. Regressing imports on final demand components confirms that this fall was mainly driven by contacting private consumption and investment in equipment and in construction, whereas the pick-

(23) According to Correa Lopez and Domenech (2012), an increase of 10 employees in the median firm size (specifically, from 50 to 60 employees) would increase the probability of exporting by 1.69%. An increase of 10 percentage points in the median of white collar workers or an increase in foreign ownership (induced by a 10 percentage point increase in the average share of foreign ownership) would increase the probability of exporting by about 0.6%. By contrast, raising average expenditure on R&D and technology adoption by 50% would increase the probability of exporting by 0.24%.

(24) According to ICEX, the largest 100 companies (in terms of exporting volumes) were exporting 37.3% of total exports in 2010. Preliminary data for 2013 suggest that this percentage could have gone up to 40.2%.

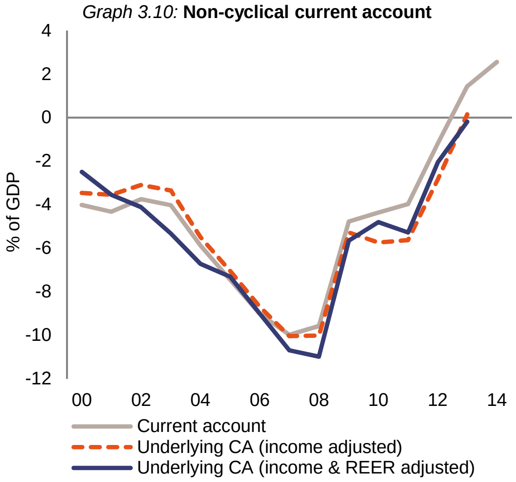
(25) The authors of the study also rely on firm-level microdata, but propose a different methodology. Specifically changes in ULCs are decomposed into three main components. The first component fixes the domestic market share of each firm and multiplies it with improvements in ULC. The second component fixes the ULC at the beginning of the period and multiplies it with the change in market shares (i.e. a measure of re-allocation capacity of the economy). The third component is a residual interaction effect. The authors conclude that "[…] changes in ULCs at the firm level play an important role in explaining the changes in ULCs relative to Germany, but the capacity to reallocate resources between firms within a single economy is even more important. In other words, lower resource reallocation, in comparison with Germany, towards firms that initially had lower ULCs explains more than 50% of the relative aggregate changes in ULCs", Crespo-Rodríguez et al. (2012).

(26) For more details on the methodology refer to European Commission (2013).

up of exports contributed positively to imports.([27]) As part of the fall in demand is itself structural, the corresponding fall in imports can be considered as permanent. In particular, the downsizing of construction (explaining around 30% of the fall in imports) can be assumed to be lasting and revised expectations and higher risk premia are likely to have lowered the expected trajectory of private investment and consumption.

At the same time, the cyclical component of the current account remains important. According to Commission services estimates, the cyclically corrected current account features only a marginal surplus in 2013 (Graph 3.10). Moreover, these estimates are subject to the uncertainty related to the estimation of potential output and might underestimate the potential for a rebound in in imports when demand picks up and/or potential output growth reverts to normal values. ([28])

Graph 3.10: **Non-cyclical current account**



Source: Commission services

The relative high use of foreign inputs by Spain's industries limits the capacity to compress imports. Preliminary evidence suggests that despite an initial reduction in the import content of exports, as trade volumes resumed, the import content of exports returned to its historical high levels. The latter was estimated by Commission Services at almost 30% in the years before the crisis.([29]) Importing intermediate goods raises the probability of exporting, probably because of the accessibility to a greater variety of inputs at a lower cost, and it could thus signal the efficiency of exporting sector in leveraging the benefits of international specialisation. ([30]) The Spanish economy is also more specialised than other euro area economies in sectors featuring relatively higher import content. Moreover, for several industries (and especially for the large automotive industry), import dependence may be explained by the relative weight in production of subsidiaries of foreign firms. Indeed, there appears to be a positive relationship between FDI and import intensity and Spain shows by far the highest ratio of stock of FDI to GDP amongst large euro area economies (almost 48% in 2012). However, FDI have not all gone into productive activities – much of it went into real estate - and the generalised high import content in all branches of the economy might also be linked to inefficiencies in the domestic markets. ([31]) ([32])

Import values, moreover, resumed relatively quickly, on the back of increasing oil prices and the high structural dependence of the Spanish economy on fuel products. The import of goods in terms of GDP could have been almost 1 pp lower between 2008 and 2012, had the index price of fuels and lubricants remained at the value of 2008.([33]) The high dependency of Spain on energy products represents a weakness for its external position (Graph 3.11).

([27]) European Commission (2013).

([28]) See also box I.3 in the Commission Services winter Forecasts. European Commission (2014).

([29]) Estimates are based on input-output tables using the World Input-Output Database (WIOD).

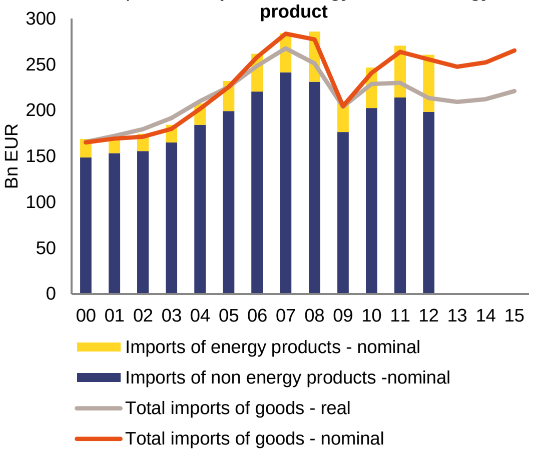
([30]) See Martin and Tello (2013).

([31]) Spain ranks particularly low in the UNCTAD FDI Contribution Index introduced in the 2012 World Investment Report. The latter ranks economies on the basis of the significance of FDI and foreign affiliates in their economy, in terms of value added, employment, wages, tax receipts, exports, research and development (R&D) expenditures, and capital formation.

([32]) Cabrero and Tiana (2012) suggest that as in the case of limited penetration in foreign markets, high import dependence may be linked to insufficient size of enterprises and limited investment in R&D

([33]) This figures is based on the COMEXT data, under the assumption of inelastic demand for fuels and lubricants.

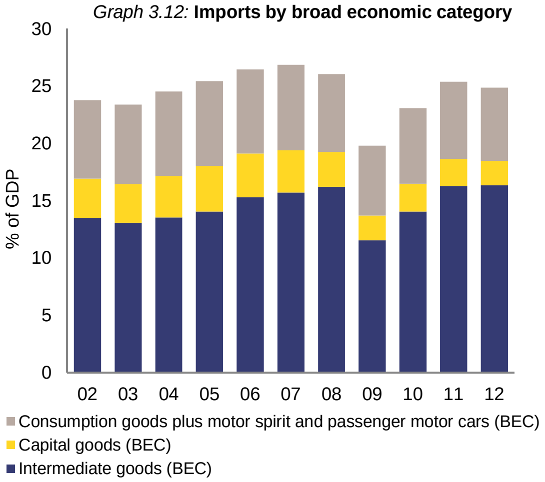
Graph 3.11: **Imports of energy and non energy product**



Source: Commission services

The process of internal devaluation could foster import substitution. In particular, if restored competitiveness translates into lower prices on domestic markets, import substitution could occur – at least for import goods that are subject to greater price elasticity. The impact is therefore likely to occur more with respect to consumer goods, which however have limited weight in total imports (Graph 3.12).([34])

Graph 3.12: **Imports by broad economic category**



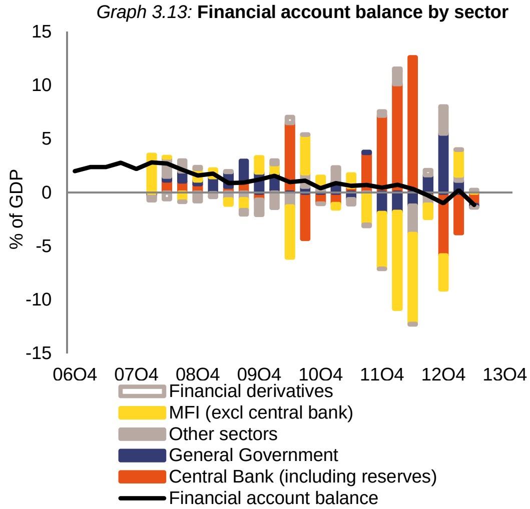
Source : Commission Services

3.1.4. Income balance and capital transfers.

High net external debt implies a significant negative income balance. The evolution of the income balance is closely linked to the composition of the debt – both in terms of instrument and in terms of borrower. Net financial flows will remain sensitive to variations in risk premia on Spanish assets. In recent times, official flows not only cushioned the withdrawal of private capital, but also allowed to contain interest payments, despite mounting debt (Graph 3.13). In 2013, the flow of income to remunerate foreign capital was in the order of 1.1% of GDP and it is set to increase to 1.8% of GDP in 2015.

The balance of current transfers and of capital account should nearly offset in the coming years. The balance of current transfers (or secondary incomes) is mainly made of transfers between public administrations and remittances. Transfers to the EU budget should remain broadly in line with the evolution of GDP. Remittances from foreign workers working in Spain have fallen significantly as many immigrants have returned to their countries of origin in the wake of the crisis, and there has been an increase in remittances from abroad. The contribution of current transfers from the EU budget is likely to reduce slightly. All in all, the balance of transfers will likely maintain over the medium term a negative, but decreasing contribution to the net financing position. As per the balance of capital transfers, it has traditionally been positive (about ½ pp. of GDP between 2008 and 2013) on account of capital transfers from the EU. However, these transfers are also likely to decline in absolute and relative terms in the years to come.

Graph 3.13: **Financial account balance by sector**



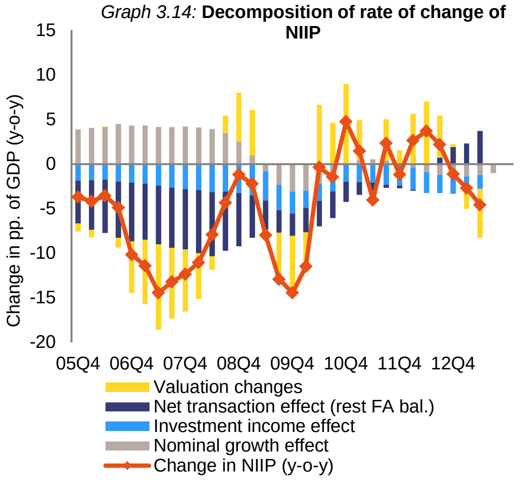
Source: Commission services

([34]) Econometric evidence suggests that consumption goods are more responsive to relative prices than are aggregate imports, while intermediate goods are typically less responsive, due to lack of readily available domestic substitutes.

3.1.5. Medium-term evolution of net international investment position

The re-absorption of the NIIP will require a prolonged period of significant current account surpluses. A prolonged period of large trade deficits and negative income transfers contributed to the sizable deterioration of the NIIP (Graph 3.14). Going ahead sizable trade balances surpluses will be needed to offset the negative contribution of the balance of primary income. Even if the current account were to reach a record level of 3.4% of GDP, it would take about 10 years for the NIIP to reach -35% of GDP. This would imply a surplus in the trade balance and balance of current transfers of about 6.5% of GDP. A more realistic scenario would be to attain by the end of 2023 a NIIP of -50% of GDP. This would require still sizable average current account balance and a balance of trade and current transfers of 1.7% of GDP and 5.1% of GDP respectively –i.e. a figure in line with current forecast for 2014 and 2015. Note however that such projections are extremely sensitive to the underlying hypotheses.([35]) The projections moreover neglect the impact of valuation effects.

Graph 3.14: **Decomposition of rate of change of NIIP**



Source: Commission services

The weight of loans and bonds increases vulnerability to external shocks. With regard to the structure of its NIIP, Spain has a large net external debt (-88.1% of GDP, mostly due to liabilities related to bonds and loans), while its equity position improved sharply in the last few years and turned positive in 2010.([36]) Measures to reduce the corporate debt bias, i.e. favouring a shift in companies financing towards equity, would at the same time strengthen the competitive positions of Spanish enterprises, and impact favourably on the composition of NIIP.

3.1.6. Euro area dimension

Spain is tightly interconnected with the euro area through trade and financial linkages. Spain's GDP is about 10.6% of overall euro area output and the Spanish market is the destination of a significant share of other euro area's exports. At the same time, in spite of an increased geographical diversification of exports in recent years, Spain is directing about 50% of its exports in goods and more than 40% of its services to other euro area Member States. The main euro area destinations are the large euro area economies. France, Germany and Italy account respectively for 17.2, 10.3 and 8.2% of total export of goods in 2011. Portugal also accounted for 8.2% of the total exports of goods in 2011. Germany is the largest euro area exporter to Spain: 11.8% of Spanish imports come from Germany. Germany is closely followed by France (10.8%), while a significant share is also represented by imports from Italy (6.6%) and the Netherlands (4.1%). Outside the euro area, about 7% of Spanish imports come from China, and around 4% from the US and from the UK. From the perspective of the exporting countries, Portugal features the highest link, with exports to the Spanish market constituting more than a fifth of total exports (graph 3.15). Exports from France and Italy to Spain make up around 7% and 6% respectively of these countries' total exports.

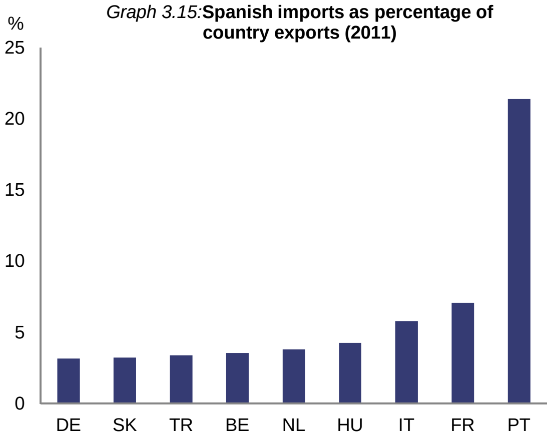
The extensive trade linkages within the euro area are also a reflection of Spain's participation in international value chains. A significant share of the imports and export linkages

([35]) These simulations are based on the following hypothesis: average GDP growth of 1.8%, average inflation of 1.9%, average domestic yield at 4.3% and average foreign yield at 3.9%. For example if inflation were to remain subdued over the whole next decade (e.g. 1%) the average current account needed to attain a NIIP of -50% would increase from 1.7% of GDP to 2.3% of GDP.

([36]) These instruments are more volatile and sensitive to changes in investors' confidence – as shown by instances of capital stops during the crisis. Moreover fixed income instruments are non-state-contingent (i.e. they have to be serviced whatever the economic situation of the debtor) unlike equity (i.e. dividends are paid only if the economic situation of the "debtor" allows it).

between Spain on one side and France and Germany on the other side are related to the high degree of integration in specific industries, particularly the automotive sector. Due to these interdependences, fluctuations in domestic demand or other types of shocks, that originate in one of them is likely to be transmitted to the other. Portuguese exports to Spain, on the other hand, are diversified as no industry captures more than 10% of total exports.([37])

Graph 3.15: **Spanish imports as percentage of country exports (2011)**



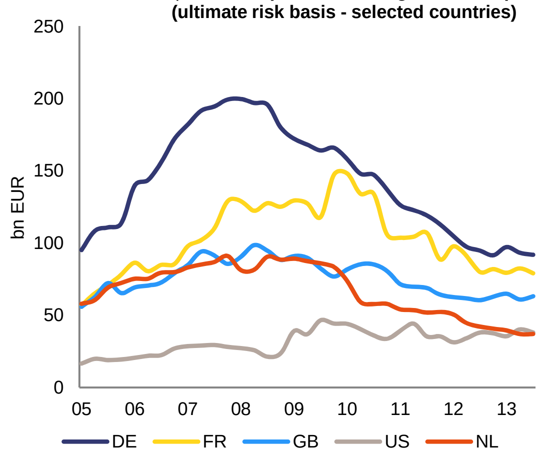
Source: WIOD Input-Output tables

Whereas concerns about Spain's financial and macroeconomic stability and the on-going adjustment process have had contractionary effects on other parts of the euro area, the direct role of trade linkages is likely not to have been major. To assess the extent to which economy activity in one country spillover across border, inter-sectoral and inter-regional links need to be taken into account. The spillover effects from low growth in Spain can be quantified by simulating a 1% reduction in domestic final demand in Spain.([38]) The results show that the spillover effects generated by the domestic final demand changes tend to be small in a static perspective. Portugal is impacted the most, followed by France and Italy. The impact on Portuguese exports, a decrease by 0.16 percent, is almost 3 times larger than the impact on French exports. French and Italian exports decrease by some 0.06% and 0.05% respectively. This impact is in contrast with the sharp contraction in trade witnessed in the years following the crisis. It is indeed likely that simultaneous contractionary effects lead to more than addictive results. In this respect, the simultaneous adjustment of several euro area peripheral countries might have a stronger impact than what suggested in a single country simulation. In the case of Portugal, moreover, even the static simulation suggest a sizable negative impact, considering that the magnitude of the contraction of final demand in real value between 2007 and 2013 was in the order of 10 pp.

([37]) Trade in transport equipment constitutes a large share of the trade between Spain and Germany and between Spain and France. Transport equipment makes up for the largest share of Spanish imports from Germany, 22%. Imports of chemical products and metals make up for 15 and 11% of Spanish imports from Germany respectively. Some 26% of Spanish exports to Germany are made up of exports of transport equipment. The flows of intermediate and final goods produced by this industry shows how well integrated countries are in each other's value chains. While intermediate goods account for 60% German exports of transport equipment to Spain, final goods account for 72% of Spanish exports of transport equipment to Germany. French exports to Spain also comprise to a large extent of goods produced by the transport equipment industry, 23%, and 22% of Spanish exports to France are in transport equipment. The second largest share of French exports to Spain is occupied by the chemical products industries whose exports constitute 13% of total French exports.

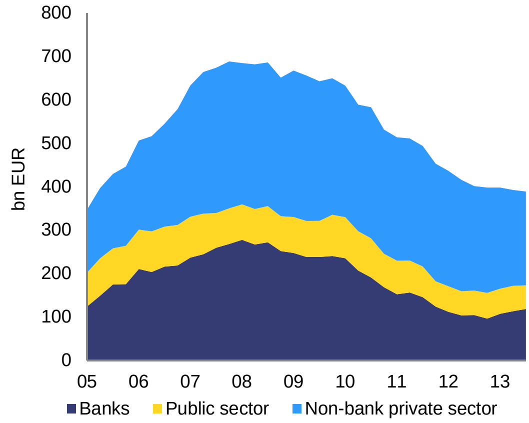
([38]) For that purpose we consider, in a multiregional setting (using the WIOD Input-Output table), a decrease of 1% in domestic final demand in Spain. Note however that the I-O analysis captures the spillovers through sectoral interrelation within and beyond a country's borders. This approximation to spillovers has some shortcomings, particularly those stemming from the assumption of a Leontief production function (no substitution between factors). Estimations using general equilibrium approaches (e.g. QUEST), though more aggregated in sectoral terms, do involve more complex transmission channels. The increase in exports is calculated using the WIOD multi-regional Input-Output table. The table for 2011 is used. A new vector of final demand, in which final demand in Spain is decreased by 1%, is used to calculate sectoral output in all countries and industries and, ultimately, new export figures by country. The model used is the standard Leontief expression: $X = (I - A)^{-1} FD$ where, X: output vector; A: matrix of technical coefficients; FD: new final demand consisting of final consumption expenditure by households, final consumption expenditure by non-profit organisations serving households (NPISH), final consumption expenditure by government, gross fixed capital formation and changes in inventories and valuables. Exports in country 'i' are sales of each industry to intermediate demand and to final demand in the rest of the countries.

Graph 3.16: **Exposure of foreign MFIs to Spain (ultimate risk basis - selected countries)**



Source: BIS, Commission services

Graph 3.17: **Exposure of foreign MFIs to Spain by sector (ultimate risk basis)**



Source: BIS, Commission services

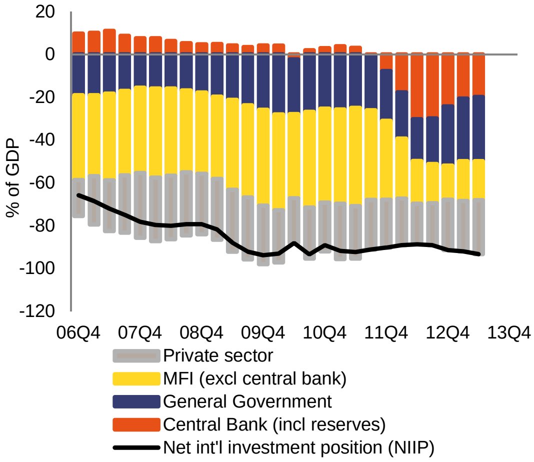
Spain would be to a limited extent be affected by an appreciation of the euro. The discussion in section 3.1 has highlighted the resilience of the Spanish export sector, which suggests that moderate exchange rate variations should not alter fundamentally exports prospects. Moreover the growing contribution of non-tourism service exports should also reduce the risk of negative spillovers from an appreciation of the euro, considering that services tend to be less price elastic.

The external private sector has significantly reduced its exposure towards the Spanish financial sector. Graphs 3.16 and 3.17 highlight the substantial reduction of the exposure of foreign banks towards the Spanish private sector and especially the banking system. The reduction has been particularly significant for German banks, which had significantly increased their exposure in the boom years. The exposure of the French banking system was also sizable. Recent data show a comparable exposure of Germany and France of about EUR 90 and EUR 80 billion respectively. The exposure of the UK is in the order of EUR 60 billion, whereas the exposure of the Dutch and US banks is below EUR 40 billion.

This reduced private sector exposure has been offset to a large extent by the official sector. Private capital outflows were compensated by an increased recourse to Eurosystem financing by Spanish banks, and Spain also drew EUR 42 billion from the financial sector assistance programme. With the stabilisation of financial markets, Spanish banks have been able to reduce their Eurosystem borrowing. The net claims of the Banco de España vis-à-vis the Eurosystem decreased from a peak of EUR 406.3 bn in Q2-2012 to EUR 263.7 bn in Q3-2013, while recovering confidence on Spanish assets led to an increase in the share of public debt owned by foreigners. Consequently in Q3-2013, the external liabilities of the Bank of Spain and of the General Government amounted to 26.3% of GDP and 37.0% of GDP respectively. The net liabilities were somewhat less, given the reserves of the Bank of Spain and other assets held by the Government, yet the joint net liabilities represent more than half of the Spanish NIIP.

Spain exposure to the euro area is relatively limited, but risks could come from its exposure to foreign markets. According to BIS data, Spanish exposure to foreign banks is estimated at EUR 1,118 bn in September 2013 (i.e almost 110% of GDP). Almost EUR 500 bn correspond to exposures with EU Member States, of which however exposure to euro area is less than EUR 200 bn. The highest exposure within the euro area is with Portugal (about EUR 50 bn), followed by Germany and France (EUR 44 bn and EUR 31 bn respectively). Outside of the euro area, exposure with the UK is almost EUR 300 bn. At present, the risk of negative spillover could rather come from Spain's significant exposure with Latin America (more than EUR 350 bn, concentrated in Mexico and Brazil).

Graph 3.18: **NIIP by sector**



Source: Commission services

3.1.7. Conclusions

A significant part of the current account adjustment is likely to be of permanent nature. This permanent component is however the result of both 'good news', i.e. the very positive export performance, and 'bad news', i.e. the likely longer-lasting reduction in domestic demand and potential output. More granular analyses points to elements of intrinsic strength at firm level that have supported the export performance, as well as to a dynamism. Moreover, there is growing internationalisation of companies and geographical diversification has also increased. Considering the fixed costs of entering foreign markets, these trends are unlikely to reverse. Exports are thus set to remain a main growth driver, in particular if supported by policy measures that prioritise higher allocative efficiency through better functioning labour and capital markets and enhanced access to technology while removing all hurdles to company growth.

A significant reduction in the large negative external liabilities will take many years. Meanwhile, the large external financial dependence will remain a source of vulnerability. The external adjustment will need to be supported by cost dynamics, via higher productivity and appropriate wage dynamics. A contribution could come from a tax shift geared to increasing employment (see Box 3.4). The process of internal devaluation would also support increased import substitution**.** Some structural weaknesses on the import side – in particular the external reliance on imported energy products – could be mitigated by reforms and tax policies geared to reduce energy intensity and the high oil dependence.

The risk of direct negative spillover from the rest of the euro area appears limited. Spain in particular has benefited from broadening its geographical markets. The high share of non-tourism exported services and the demonstrated performance in non-cost competitiveness provides a protection from the risks posed by an appreciating euro. The financial exposure of Spain is spread globally, and overall limited towards euro area Member States, with the exception of Portugal. With still visible financial fragmentation affecting Spanish lending markets, financial and economic prospects in Spain remain however sensitive to the progress in the ongoing reinforcement of euro area governance.

3.2. INDEBTEDNESS AND DELEVERAGING

3.2.1. Overview

Private sector deleveraging has accelerated since the end of 2012, in particular for non–financial corporations. Households and non-financial corporations' debt more than doubled in terms of GDP in the decade following the introduction of the euro, on the back of loose financing conditions and overoptimistic income expectations. Credit flows were above 20% of GDP on average and annual credit growth rates averaged 18% during 2000-2007. With debt of 230% of GDP (non-consolidated data) in 2010 (215% of GDP in consolidated terms), the Spanish private sector became amongst the most indebted across the Member States. The deleveraging process started in 2010 and gained momentum as of the second half of 2012. By the third quarter of 2013, the stock of debt amounted 210% of GDP in non-consolidated terms (189% of GDP in consolidated terms), some 22% of GDP lower than the peak reached in the second quarter of 2010, out of which almost 15 pp. were registered since the second quarter of 2012. The distribution of the correction is uneven, most of which being due to the fall in debt of non-financial corporations by 19% of GDP since the peak (consolidated data).

This process has gone in parallel with restructuring in the banking sector and a sharp correction in the real estate market and construction. Spanish banks suffered considerable funding and capital stress with the implosion of the real estate bubble, which caused a sharp deterioration in their asset portfolio and systemic concerns about the banking sector and the capacity of the sovereign to support it, culminated in the summer of 2012. While credit demand was falling in line with economic activity, banks also had an incentive to shed risks to rebuild their capital ratios, in an environment of heightened risk aversion. The recapitalisation and reform process undergone in the last couple of years have all but eliminated such systemic concerns, and set an essential basis for a renewed capacity of banks to provide lending to the real economy at more favourable conditions. Meanwhile, the fall in both prices and activity indicators in the housing market has continued apace, bringing this market closer to an inflection point.

In contrast to the private sector, general government debt has continued to increase. The expansion of aggregate social expenditure and the disappearing of a rich tax base linked to construction coupled with stabilisation interventions in the financial sector have led to a sharp increase in government debt, which is set to reach nearly 100% of GDP in 2014, about 60 pps. of GDP higher than in 2007.

This section will continue with an overview of development in the financial sector and the housing market, and then move to analyse sectoral debt development in the household, non–financial corporations and government sectors before providing some conclusions.

3.2.2. Financial sector developments

The Spanish banking sector has been adversely affected by the burst of the real estate and construction bubble and the economic recession that followed. Several Spanish banks have accumulated large stocks of problematic assets. With the exception of a few large and internationally diversified credit institutions, Spanish banks lost access to wholesale funding markets on affordable terms, thus becoming highly dependent on Eurosystem refinancing. Moreover, the borrowing capacity of Spanish banks was severely limited by the impact of rating downgrades on collateral availability. Concerns about viability of some of these banks became a source of market stress and eventually led to the Spanish government requesting external financial assistance from EFSF/ESM in June 2012. The Programme, as agreed by the Eurogroup on 9 July 2012, covered a period of 18 months([39]) and entailed an external financing by the euro area Member States of up to EUR 100 billion. Eventually, the total amount of funds disbursed was limited to EUR 41.3 billion.

By the end of the financial assistance programme, the resilience of the Spanish banking sector had improved considerably. In particular, the solvency position of banks has been bolstered after the recapitalisation of parts of the banking sector, the transfer of assets to Sareb and overall positive earnings results over 2013. On average core tier 1 capital ratio stood at 10.5% while total own funds ratio was at 12% at the end of September 2013. Compared to their peers, Spanish banks are not amongst the banks with the highest capital ratios, but rank favourably in terms of overall leverage.

The exposure of the Spanish banking sector to the construction and real estate development sector has been significantly reduced. According to the Banco de España, the total exposure amounted to EUR 308 billion at the end of December 2011. By the end-2012, the exposure of Spanish banks to the construction and real-estate development sector had decreased by around 50% of the total (net of provisions). Somewhat more than half of the reduction is explained by the transfers to the Sareb, while 40% of the reduction derives from the provisions made by institutions as a consequence of RDL 2/2012 and RDL 18/2012.([40]) These two Royal-Decree Laws established new provisioning requirements to cover asset impairments related to the banks' real estate activity

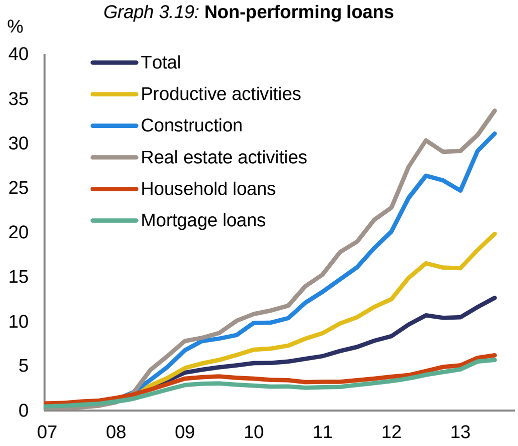
([39]) However, the restructuring of the banks receiving public support under the State aid rules is expected to take up to five years.

([40]) According to the Banco de España's Financial Stability Report (May 2013).

Some recent policy measures will contribute to shore up banks' core capital. This is also important in view of the new EU Regulation on capital requirements ([41]) and the comprehensive assessment to be carried out by the ECB in 2014 along with the entry into force of the new single supervisor. First, the Banco de España issued a recommendation on a maximum 25% of paid-in-cash dividends for 2013 and, more recently, also for 2014. Second, the tax legislation on deferred tax assets (DTAs) was amended and it will allow banks to avoid the deduction of an amount which has been initially estimated at around EUR 30 billion from the fully loaded common equity tier 1.([42])

The liquidity situation and the financing structure of the Spanish banking sector have been strengthened. In particular, banks are shifting towards more stable sources of finance such as deposits and the repo market. The annual growth rate of household and non-financial corporate deposits reached about 4% and 7%, respectively as of December 2013, reversing a declining trend recorded in most of 2012. In turn, the liquidity generated by the fall in the loan-to-deposit ratio is being used by banks to reduce their reliance on the Eurosystem and on the wholesale market.

Graph 3.19: **Non-performing loans**



Source: Commission services, Banco de España

Notwithstanding the advanced stage of the cleaning up of balance sheets, the ongoing restructuring of banks might continue to weigh on credit conditions for smaller customers. The ratio of non-performing loans (NPLs), which typically lags the cycle, continued to increase in recent months and reached 13.6% at the end of December 2013 (Graph 3.19).([43]) This rise has been driven by the higher stock of impaired assets but also, increasingly, by the denominator effect, i.e. shrinking total loan portfolio. While the stock of impaired assets rose by EUR 20 billion between June and December 2013, total loans declined by EUR 71 billion during the same period. In addition, most recent increases have been also driven by the reclassification exercise of the restructured loans portfolio performed by banks on guidance from Banco de España.([44]) Going forward, the increases in NPL ratio at system level are expected to be more limited. Nevertheless, the risk stemming from increasing NPLs is mitigated by a comfortable coverage ratio.

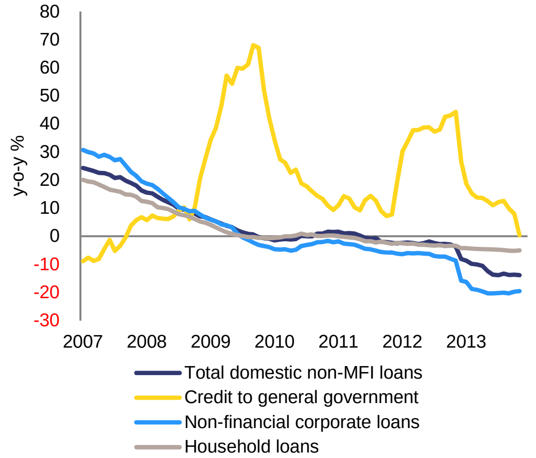
([41]) Regulation No. 575/2013 on prudential requirements for credit institutions and investment firms and amending Regulation No. 648/2012 (Official Journal of the European Union 27.06.2013).

([42]) The amendment is applicable to all companies and covers all DTAs stemming from provisioning for (i) credit insolvencies, (ii) foreclosed assets and (iii) pension funds for the company's employees. The fiscal impact of the new regulation is limited to three specific cases (i.e. the company is not able to generate enough profits to offset remaining DTAs within the 18-year period, insolvency or liquidation procedure of the company, and accounting losses at the end of a concrete year) and depends on the probability of occurrence of those events. As the new rules apply to all companies, the total fiscal impact will also depend on the possible effects materialising in the non-financial sector (See Box 2 in the 5th Review Report for more details).

([43]) The upward trend in NPL has been only interrupted by two transfers to Sareb in December 2012 and February 2013. As a result of these transfers the overall share of construction and real estate sectors in the overall stock of non-performing loans decreased from 58% in Q3-2012 to 45% in Q3-2013.

([44]) According to preliminary data published by the Banco de España in November 2013, banks reported a total amount of EUR 181.3 billion of restructured loans (based on balance sheet data as of March 2013), with the bulk of these loans (roughly 73%) being classified as substandard and non-performing.

Graph 3.20: **Bank loans**



Source: Commission services

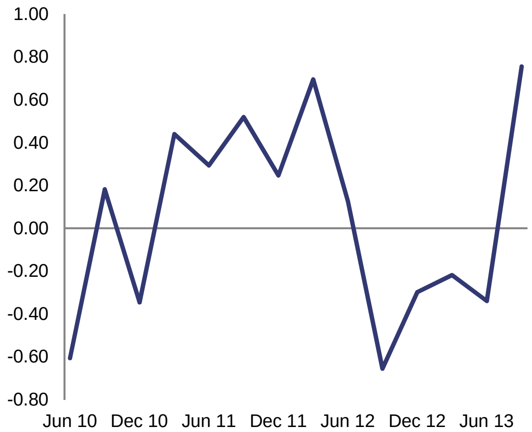
Sustaining profitability will remain a challenge given the modest medium-term GDP growth outlook and the low policy interest rate environment. The third quarter of 2013 has confirmed the positive trend for bank profitability in 2013, which is on average above both the baseline and significantly above the adverse scenario of the 2012 stress test by Oliver Wyman. For the vast majority of banks the net interest incomes have declined compared to the first three quarters of 2012 due to both the impact of low interest rates on assets with floating rates (i.e. mortgages) and shrinking business volumes. The latter trend is expected to continue in the medium-term as households and non-financial corporation continue to deleverage. In spite of this and of the significant contribution from non-recurring items in some cases (including revenues from the burden sharing exercises for some state-aided banks, incomes from the carry trade activity and sales of assets), pre-provisioning profits demonstrate the banks' capacity to generate internal resources. Furthermore, although provisioning requirements are still high, they are on a clear declining trend, and operating costs are being reduced rapidly.

Bank lending has been on a declining path since 2007 but a stabilisation may be approaching. Recent data shows some deceleration in the contraction of domestic bank private credit (Graph 3.20). Adjusted for the effect of the asset transfer to Sareb, private domestic credit declined by around 7.7% y-o-y in December 2013. Whereas the decline in domestic credit to households accelerated to about 5.3% y-o-y, the contraction in bank credit to non-financial corporates decelerated to around 10% in the last three months of 2013, and was also alleviated by increasing market issuance by larger companies.

The biggest annual contraction in lending took place in the construction and real estate sectors. This was also partly due to the transfers of assets to Sareb, while lending to other economic sectors contracted at a slower pace. This shows that the reallocation of resources in the Spanish economy continues. Despite ongoing contraction in stock of loans to NFCs, 'credit impulse' defined as the change in new credit issued as a percentage of GDP, is pointing to a turnaround in activity (Graph 3.21). This is confirmed by the most recent data on new lending to NFCs, which recorded an annual increase of around 7% in December 2013. These data are consistent with banks' funding and capital plans, in which private sector lending is expected to bottom out in 2015 driven by lending to NFCs.

Going forward, lending conditions are expected to improve. Standards for approving loans have stabilized in the second half of 2013. In the fourth quarter bank lending survey, there was a slight easing of credit conditions for SMEs, for the first time since the first quarter of 2010. Therefore, the tightening trend observed since the beginning of the crisis appears to be bottoming out, in particular as banks expect some credit standards relaxation for loans to NFCs and consumer credit in the next three months.

Graph 3.21: **Credit impulse to NFC**



Source: Commission services, Banco de España

While banks continue to consider weak solvent demand as the main contributor to the ongoing decline in lending to the private sector, frictions

on the supply side have also played a role, affecting in particular SMEs. These frictions relate to the on-going restructuring process, regulatory changes (i.e. reinforced capital requirements) and persisting euro area financial market fragmentation. In particular, the restructuring of the financial sector might have weakened or broken long-term lender/borrower relations. Asymmetric information is particularly harmful to SMEs. While larger companies can access non-bank financing sources (i.e. by issuing bonds or raising equity), SMEs rely predominantly on bank financing and, hence, are disproportionally affected by the on-going restructuring. Despite the recent reduction in the banks' cost of funding, lending rates remain elevated, especially for SMEs and households.

There is encouraging evidence showing that lenders are effectively differentiating between companies. According to the Banco de España, on average, most indebted companies and sectors at the start of the crisis have been deleveraging faster.([45]) By contrast, firms that started from a low level of debt have actually increased their leverage over the period, indicating that credit continues to flow to companies in a stronger financial position. The pattern has been similar for large companies and SMEs. However, in general the latter have reported difficulties in accessing credit.

The evolution of the real estate market remains important for banks' future profitability. In recent quarters the Spanish banking sector has become a key player in the real estate market, including housing. In the first half of 2013 the five largest Spanish banks and Sareb sold around 35,000 properties, amounting to 25.5% of all the transactions in urban properties (houses and other properties attached to them) according to the Spanish Official Association of Notaries.([46]) Banks have incentive to sell the properties as their net accounting value was drastically reduced after the new provisioning requirements for non-performing loans and repossessed properties introduced by RDL 2/2012 and RDL 18/2012. At the same time, they continue their accumulation of real estate assets, which implies that the number of repossessions exceeds the number of sales. Therefore, the on-going adjustment in the housing market and construction sector needs to be carefully monitored.

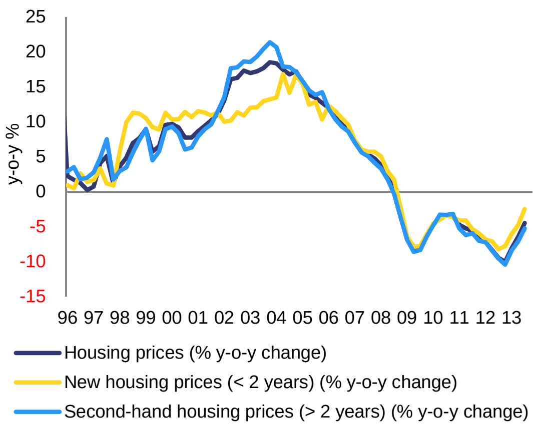
3.2.3. Adjustment in the housing market

The Spanish housing market has adjusted sharply following the burst of the housing and lending bubble. The share of residential investment in total GDP fell from 12.5% of GDP in 2006 to 4.4% in 2013, below the previous historical low of 7% in 1997, and the adjustment is still ongoing, with residential investment falling by 8.3% y-o-y and investment in construction by 10.3% in the third quarter of 2013. Employment in the construction sector fell by around 1.8 million between Q3-2008 and Q3-2013, and continues to fall even though the weight of construction in employment, at 5.8%, is below its historical average.

The fall in house prices, which accelerated in 2012 and the first half of 2013, might be approaching an end. The cumulative fall in house prices between Q3-2007 and Q3-2013 was 36.2% in nominal terms and 43.8% in real terms. While nominal prices were still falling in annual terms by 7.9% Q3-2013, they increased by 0.7% compared to the previous quarter, the first positive quarterly growth rate since Q2-2010 (Graph 3.22). Another sign that the housing market might be approaching stabilization are recent statistics on home sales, which tend to react faster to changes in supply and demand than house prices. After declining continuously since 2007, annual home sales have stabilized at around 320,000. For the first ten months of 2013, 235,000 houses were sold, 11.3% more than in the same period last year. This stabilization comes on the back of increasing foreign demand (foreign investment in the Spanish real estate sector grew by 28% in December 2013, y-o-y, according to Banco de España). However, domestic demand for housing remains weak given high unemployment and tight credit conditions.([47]) Similarly, there are also preliminary signs of stabilization in building permit applications, albeit at a very low level of around 35,000 a year (compared to a record 866,000 in 2006).

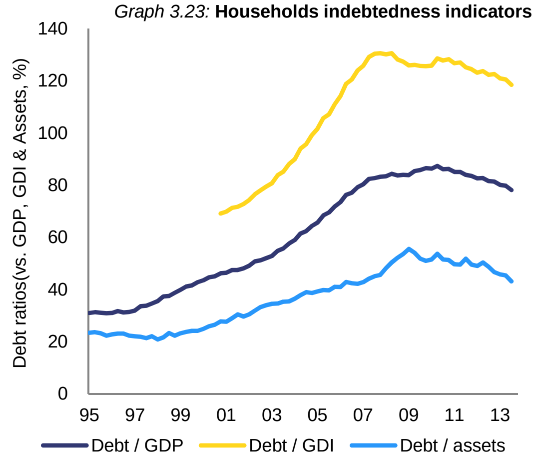
([45]) See Menéndez and Méndez (2013).
([46]) This figure is likely underestimated as banks do not disclose separately some urban properties.
([47]) While credit conditions remain relatively tight, the proportion of home buyers who pay in cash has increased significantly. Depending on the estimate, 55-70% of all houses bought in 2013 were purchased without mortgage according to J. G. Montalvo (2013).

Graph 3.22: **Housing prices**



Source: Commission services, Ministerio de Fomento

Graph 3.23: **Households indebtedness indicators**

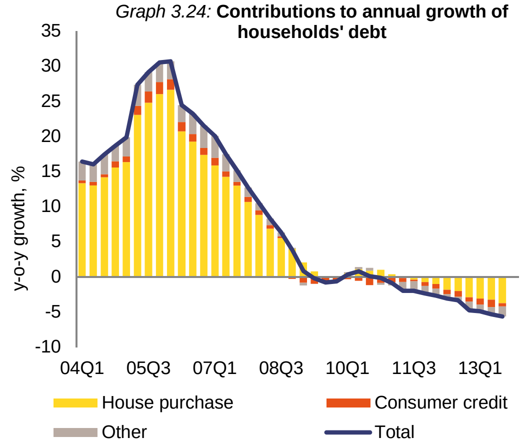


Source: Banco de España. INE

Yet, further adjustment in house prices cannot be excluded. Demand for housing is still weak and the stock of unsold houses, estimated at around 400,000-580,000, very large.([48]) The acceleration of business activities of Sareb and of sales of real estate assets by Spanish banks could also contribute to bring forward any further price adjustment. While it is difficult to forecast future house price developments, on balance, available studies suggest that the degree of overvaluation is much reduced, although some undershooting of prices cannot be ruled out.([49]) Declining house prices negatively affect household wealth, as over 80% of total wealth is real estate related.

Housing market policy distortions contributed to the housing boom. Spain is characterized by high home ownership rate of 85% compared with 72% for the whole EU. Apart from cultural factors placing a strong preference on house ownership, a housing policy skewed towards promoting home ownership (i.e. tax deductions) was one of the factors that contributed to the housing bubble in Spain. The high incidence of home ownership in Spain is mirrored by the underdevelopment of the rental market. Only 11% of houses are rented compared to 28% for EU average. This lack of viable rental market may have aggravated the adjustment process in the years following the burst of the bubble to the extent that it has limited labour mobility.

Graph 3.24: **Contributions to annual growth of households' debt**



Source: Banco de España, INE

Spain has taken measures to remove tax and regulatory distortions in favour of house

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([48]) According to the latest government estimates (Ministerio de Fomento), there were 583,453 of empty new dwelling at the end-2012. This number is estimated to be lower, at around 400 000, by Tinsa (private appraisal company).

([49]) See for instance Cuerpo and Pontuch (2013) and the OECD Economic Outlook 2013.

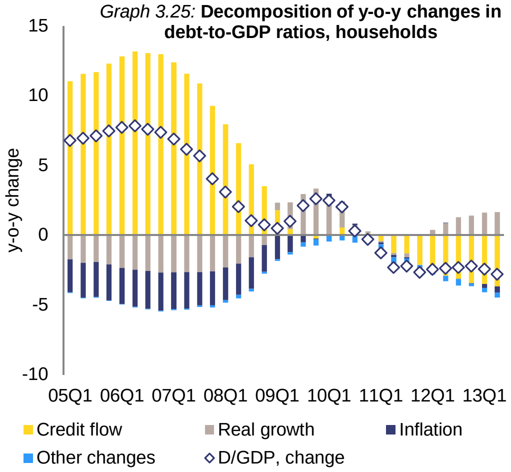
ownership and hindering the rental market. Apart from the elimination of a general tax deduction on new house purchases in December 2012, most recent measures have improved the institutional framework of the rental market. The Law on liberalisation of the rental market (Law 4/2013 ([50])) adopted in May 2013, increased the flexibility of the regulatory regime and strengthened incentives for landlords and legal certainty. In addition, social housing policy has been also recently redirected towards support for tenants, i.e. rented accommodation. While it is too early to see any impact of these recent changes on the share of households living in rented accommodation in Spain, some encouraging signs can be observed. In particular, 11 new real estate investment trusts have been set up and listed on the stock market since the reform. In addition, further development of rental opportunities is also one of the strategic goals of Sareb. In this context, Sareb is also working with several regional governments to assist them in their social housing policies by temporary leasing up to 2 000 homes.

3.2.4. Drivers of indebtedness and deleveraging in the households sector

Acquisition of dwellings has been the primary driver of households' rise in indebtedness. The household debt-to-GDP ratio more than doubled since 2000, to peak at 87% of GDP in 2010 (Graph 3.23). Debt as a share of gross disposable income or as a share of assets displays a similar picture. Such brisk increase in indebtedness was mostly explained by the credit demand for housing purchases. Total credit to households grew by some 20% on average between 2004 and 2007. Residential mortgages' contribution to annual credit growth stood well above 10 pps. until 2007, recording highs above 20 pps. in 2005 and 2006, whereas the contribution of consumer credit was much lower. The sharp deceleration of credit growth to households at the onset of the crisis and the contraction of credit growth thereafter has naturally been led by a negative contribution from credit for dwellings purchases (Graph 3.24).

([50]) The Act on Flexibilization and Promotion of the Rental Housing Market was adopted by the Spanish Parliament on 23 May 2013.

Graph 3.25: **Decomposition of y-o-y changes in debt-to-GDP ratios, households**



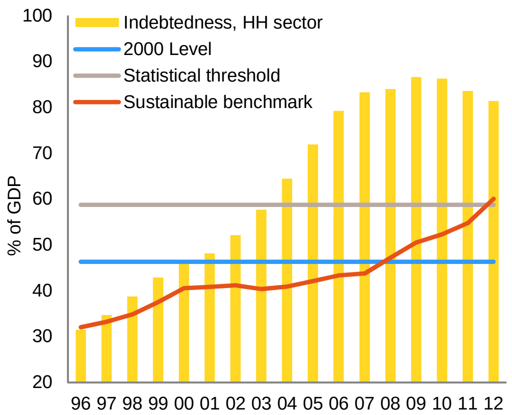
Source: Commission services

Household debt is falling gradually but it remains high. Household debt has fallen from a peak of 87% of GDP in 2010 to 78.2% of GDP in the third quarter of 2013.This reduction has occurred mostly through negative credit flows (Graph 3.25), whereas the long average maturity of the stock of outstanding mortgages has slowed down debt reduction. To gauge how far the correction has advanced, a first approach is to compare current debt levels to static benchmarks such as the MIP threshold ([51]) or the pre-boom debt ratio, e.g. in year 2000. According to this approach, the required remaining adjustment of the debt-to-GDP ratio for households would stand at 23 to 35 percentage points (Graphs 3.26). In an alternative approach private debt is considered sustainable if the notional leverage is stationary - i.e., if deflated debt evolves in line with deflated assets.([52]) Between 2001 and 2007 the gap between actual household debt and its balanced or sustainable path widened rapidly. However, the recent correction, together with the increase in the sustainable level since 2007, has significantly narrowed the gap, by almost 20 pps. to some 21 pps of GDP at the end of 2012.

([51]) The debt-to-GDP ratio corresponding to the third quartile of the statistical distribution using 1995 to 2008 data for the EU27 Member States.

([52]) The 'notional leverage' is the ratio of debt-to-assets adjusted for valuation effects. In the case of households these assets also include non-financial assets, notably dwellings. It represents an indication of the ability of households to incur liabilities. According to the stationarity benchmark approach, net worth must be (weakly) increasing in order for debt to be sustainable (see Cuerpo et al., 2013).

Graph 3.26: **Debt sustainability, households**

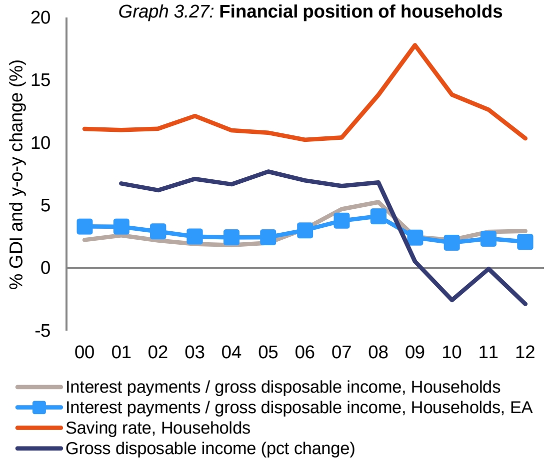


Source: Commission services , Banco de España

The interest burden has remained contained (Graph 3.27) as a result of the fall in the Euribor rate, to which most mortgages interest rates are linked, as well as of refinancing programmes offered by credit institutions.([53]) Yet, over-indebtedness is a heavy burden for lower income households that have contracted debt (about 15% of those in the lowest 20% of the income distribution according to ECB data), as debt service has absorbed an increasing share of their disposable income, in some cases above 100%. Nevertheless, the rate of NPLs on mortgages has remained until recently very subdued, owing to a strong paying back culture and limited recourse to personal default (see Box 3.1 for more details).

Household debt is expected to continue to fall in the coming years. Household deleveraging efforts will be eased by a recovery of the economy and of the labour market, leading to gradually higher incomes, and supported by the recent sharp recovery in financial asset prices, which has allowed households to recoup some of the wealth losses during the crisis. Easing financing conditions and a stabilisation of house prices, on the other hand, could result in a revival of new credit. These forces will impact on the behaviour of the savings rate. Wealth losses on financial and non-financial assets, increased uncertainty and the sharp increase in unemployment spurred a surge in the saving rate to around 16% in 2009 (possibly also suggest offsetting to an extent a fiscal expansion at the time) (Graph 3.27). Since then, consumption smoothing in a context of falling incomes has led the saving rate to decline sharply to below its long-term historical average level of 11%. A moderate recovery of the savings rate approaching to the historical average, as embodied in the Commission services' 2014 winter forecast, would be consistent with a mild increase in consumption and households maintaining a substantial net lending position. Together with more favourable denominator effects as GDP growth turns positive, the maturity profile of outstanding mortgages could also favour a more rapid decline in debt the coming years. A reform of personal insolvency could help speed up the restructuring of distressed household debt, but any such reform would need to carefully take into account financial stability considerations.

Graph 3.27: **Financial position of households**



Source: Commission services

([53]) Already in 2012, it was estimated that households' monthly mortgage payments have been reduced by as much as 30% when compared to the initial date when the loan was taken (Gonzalez, 2012).

Box 3.1: **Insolvency procedures in Spain**

Insolvency systems face a trade-off between the protection of creditors' rights and protection of debtors, including the protection of companies from unnecessary liquidation or ensuring a fresh start after personal insolvency. While a high degree of protection to creditors allows credit to flow at lower interest rates, it might negatively affect the number of potential entrepreneurs willing to take risks. By contrast, high protection to debtors may lead banks to request more securities and guarantees as collateral.

High disincentives to using insolvency frameworks can hamper an efficient re-allocation of resources by delaying recognition and work-out of unsustainable private debt or by unnecessarily pushing viable firms into liquidation. Hence, an effective insolvency system tries to allocate risks in a predictable, equitable and transparent manner, allow a quick return to normal business to viable firms and entrepreneurs and a winding-up of non-viable businesses, protecting the interest of all involved parties. The efficiency of the system is also linked to a balanced approach to debt discharge. In this respect, while debt discharges provide risk-averse agents with stronger incentives to undertake entrepreneurial activity, its absence minimizes the scope for moral hazard, thereby reducing risk premia for entrepreneurs.([1])

Corporate insolvency

Spanish corporate insolvency law is in line with international best practices. The Spanish bankruptcy code (Ley Concursal) grants relatively low protection to creditors, while protection of secured creditors is medium.([2]) The law includes mechanisms for reorganisation of viable firms, simplified restructuring procedures, pre-packaged insolvency plans, special priority for new financing, automatic stay on foreclosures to allow for restructuring, and cram-down provisions (a reorganisation imposed on creditors). Out-of-court settlements are also regulated by law.

However, while bankruptcy rates amongst SMEs and large companies in Spain are close to those in other countries, firms with less than 10 employees barely use the corporate insolvency framework in order to restructure their business. Insolvency procedures for the smaller companies are costlier and lengthier than mortgage foreclosure procedures. ([3]) Consequently, most insolvency proceedings end in liquidation rather than in restructuring, which suggests that bankruptcy arrangements do not generally lead to efficient decisions concerning the continuation or liquidation of the insolvent firm.

Moreover, protection of bankrupt entrepreneurs is low due to the absence of debt discharges, insolvency administrators lack expertise and courts dealing with bankruptcies are overloaded, thereby resulting in long judicial resolution periods. Furthermore, while the rate of success of out-of-court settlements is high (70%), the average duration is quite long (7.8 months). ([4])

These features may have negative economic implications. Firstly, the fact that the mortgage system is used as a substitute for bankruptcy may bias firms towards investing in assets that can serve as collateral, notably tangible fixed assets, and discourage innovation and investment in knowledge-based enterprises. Secondly, the absence of debt discharges may also deter innovation and risk-taking.

Some recent policy initiatives are aimed at remedying this situation. The Entrepreneurship Law (Law 14/2013) has strengthened the protection of entrepreneurs and facilitated out-of-court debt

([1]) See OECD (2012) and Liu and Rosenberg (2013).
([2]) See Mora Sanguinetti and Fuentes (2012).
([3]) In Spain, insolvency proceedings would take 1.5 years (Ireland is the best performer with 0.4 years), costs average 11% of the estate (Norway with 1% is the best performer), and creditors could recover 72 cents on every euro (93% in Japan). See World Bank (2013).
([4]) See European Commission (2011).

(Continued on the next page)

Box (continued)

refinancing agreements, but its impact is uncertain in the absence of reliable data. Specifically, the law has eased the procedure to appoint an expert in charge of the workout. The majority of creditors required for approval of the agreement has been reduced to 55%. This provision could help bigger firms to address problems of coordination between creditors, although the majority of Spanish firms with outstanding credit are small and have only one or two creditors. Moreover, the law has also introduced elements of "fresh start" for indebted entrepreneurs in order to shorten insolvency proceedings. A new out-of-court procedure has been established for debtors, according to which creditors have to participate in the mediation meetings to develop a payment plan if they do not want their debt to become subordinated.[5] *However, the procedure cannot be initiated if any of the creditors, who would be bound by the agreement, had been declared insolvent, which might limit the application of the procedure. The Entrepreneurship Law also created a limited liability company "in formation" with lower capital requirements. Under this regime, individual entrepreneurs can protect their housing (up to a certain value) from the insolvency proceedings. Finally, in October 2013, some tax disincentives to debt restructuring have been eliminated by providing that debt write-offs in the context of a refinancing are not taxable as profits.*([6])

While these measures go in the right direction, there appears to be still significant room for improvement, in particular to: i) improve the relative attractiveness of insolvency compared to the mortgage system; ii) strengthening the early warning signals in the insolvency regime; iii) establish centralised guidelines for out-of-court workouts between banks and firms;; iv) shorten the average duration of the voluntary out-of-court restructurings; and v) enhance the expertise of judges and insolvency administrators. Foreseeing a debt discharge for entrepreneurs could also help reduce business liquidations, although its application in the current context of high overall level of debt and with a high proportion of it held by firms in difficult financial situation should be balanced with measures encouraging re-payment plans in order to prevent that it negatively affects the banking sector and the supply of credit. ([7])

Personal insolvency

The current insolvency regime appears to be complex and costly for households and the current legal framework does not generally foresee the possibility of debt discharge for financially responsible personal debtors. To address debt distress of residential mortgage debtors, the authorities adopted the Law on Strengthening Protection of Mortgage Debtors, On Debt Restructuring and Social Housing (Law 1/2013). In particular, the law has tightened conditions to launch foreclosures, establishes a temporary 2-year moratorium on evictions of vulnerable debtors in primary residence mortgages, provides for a partial debt discharge and extends the application of out-of-court workouts. A limited partial discharge is possible after foreclosure of the primary residence. In addition, Spanish banks have voluntarily adhered to a Code of Good Practice, which establishes different measures or viable debt restructuring arrangements for mortgages applicable to families on the "threshold of exclusion".

Altogether, these emergency provisions try to strike a balance between providing relief to over-indebted insolvent households and the need to preserve financial stability. The law is a step in the right direction, but there is a risk its use will be limited. Further measures might be warranted with a view to introducing a personal insolvency regime with a fresh start, including establishing: i) centralised guidelines for out-of-court workouts between banks and individuals; ii) a system of mediation to support out-of-court debt restructuring for individuals; and, iii) introducing a broader conditional debt discharge mechanism for financially responsible individual debtors.

([5]) The plan can include transfer of property as settlement of debt or a partial debt discharge (up to 25% of debt with a three year discharge period) and needs to be approved by holders of at least 60% of liabilities affected by the agreement. If the plan is not approved, the mediator has to request a competent court to declare the debtor insolvent. In the meantime (and during a period up to three months) debtors' assets are protected.

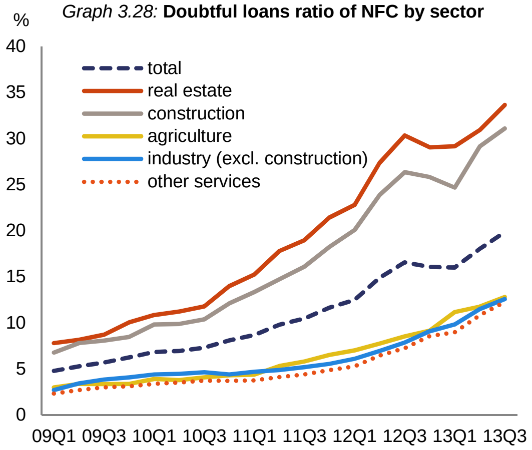
([6]) With the 'Ley de fiscalidad medioambiental y otras medidas tributarias'.

([7]) See IMF (2013).

3.2.5. Drivers of indebtedness and deleveraging in the non-financial corporations sector

Corporate deleveraging has accelerated in the recent quarters. The adjustment in the corporate sector tends naturally to be faster than in the households sector, as a result of larger debt write-offs, mainly on construction and real estate loans, and the shorter maturity of debt. In the run-up of the crisis non-financial corporation debt increased from around 45% of GDP in 1996 to above 140% (non-consolidated data) in 2010 largely in real estate and construction sectors. In consolidated terms, debt amounted to almost 130% of GDP. A decline was initiated thereafter, bringing down the debt/GDP ratio to 132% of GDP by the third quarter of 2013, still well above the euro area average of 97% (non-consolidated data).

Graph 3.28: **Doubtful loans ratio of NFC by sector**

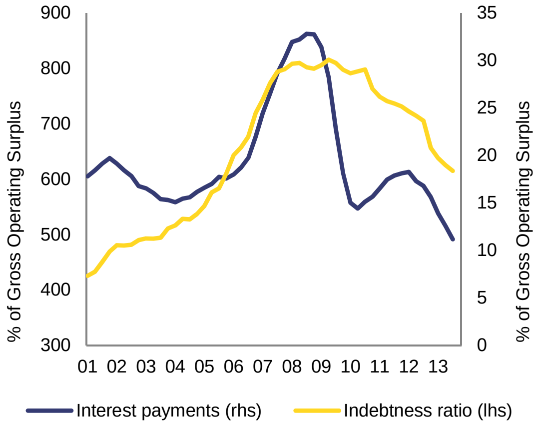


Source: Banco de España

Deleveraging is sharpest in the construction and real estate sectors. After being responsible for more than half of total credit flows between 2000 and 2007([54]), the construction and real estate sectors have seen a drop in bank debt by 13% of GDP (thereby representing around 36% of total bank lending to non-financial corporations in the third quarter of 2013). This adjustment also reflects the larger incidence of write-offs on lending to these two sectors and the transfer of assets to Sareb. While the ratio of doubtful loans to total loans is around 12% for industry and services non-related to real estate or construction, it reaches 31% and 34% in construction and real estate activities, respectively, with 60% of total doubtful loans being linked to real estate and construction activities (Graph 3.28). Non-performing loans in these two sectors have stepped up in the last quarters. More generally, disaggregated lending analyses by the Banco de España show that the reduction in debt is more intense in companies that very highly leveraged at the beginning of the crisis.

Despite the recent correction, non-financial corporations remain highly indebted both with respect to their assets as well as their capacity to repay debt. Beyond the debt-to-GDP ratio, the debt-to-asset ratio is also high, at above 110% in the third quarter of 2013 (consolidated data for both assets and debt) compared with around 80% in the euro area. Likewise, non-financial corporations debt is five times higher than the gross operating surplus (a proxi for firms' capacity to generate income), (Graph 3.29). Comparing to other benchmark (as explained in in the section on households) such as the MIP threshold or the debt ratio in year 2000, the required remaining adjustment would still be - 44 to 59 percentage points of GDP respectively (Graphs 3.30). With respect to the sustainable notional leverage the gap between current non-financial corporation debt ratio and their balanced path has remained broadly stable, amounting to some 19 pps. of GDP at the end of 2012.

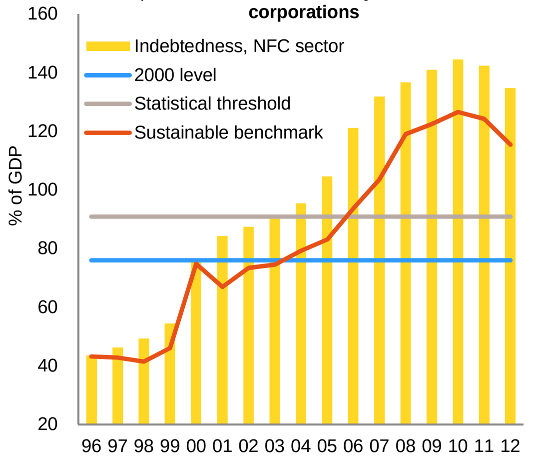
Graph 3.29: **NFC indebtedness and financial burden**



Source: Banco de España, INE

([54]) Here debt is defined as the sum of loans and securities other than shares.

Graph 3.30: **Debt sustainability, non-financial corporations**



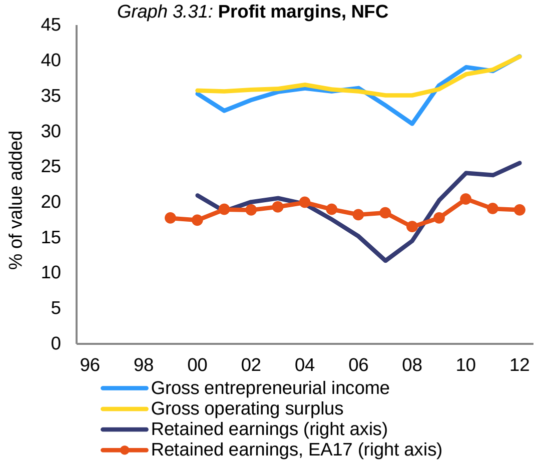
Source: Commission services, Banco de España

The evolution of profits will influence the pace of future adjustment. Net lending of the non-financial corporate sector has risen sharply, especially in the most recent quarters, as a result of increased savings and the fall in investment. The increase in gross savings has been mainly driven by the increase in gross operating surplus, related to a reduction in employment and real wages, and to a lesser extent from an increase in value added. Profit margins have also increased as tight credit conditions led firms to rely more heavily on own financing, mainly retained earnings (Graph 3.31), s in line with what has happened in other euro area countries recovering from high indebtedness, high cost of financing or both. With the stabilisation of the economy and of financial conditions, the adjustment in non-financial corporate balance sheet is expected to moderate in the medium-term. While corporate savings would be supported by improved profitability, investment would be expected to pick up amidst improved expectations and rising capacity utilisation.

3.2.6. General government debt

General government debt has reached high levels. Buoyant economic growth, a particularly tax-rich composition and sizeable revenue windfalls, especially linked to the housing boom, led government debt to decline significantly during the pre-crisis phase, to 36.3% of GDP in 2007. The outbreak of the economic and financial crisis reversed this trend. The collapse of tax bases, surging unemployment, fiscal stimulus in the early years of the crisis have caused large general government deficits and a rapid debt increase, also spurred by the bank recapitalisations and contributions to the EU and euro area financial assistance institutions. Government debt is expected to approach 100% of GDP this year and grow further in 2015.

Graph 3.31: **Profit margins, NFC**



Source: Commission services

Further fiscal consolidation in the medium term will be needed to bring government debt down. Model simulations (see Box 3.2) unveil an underlying upward trend in general government debt in the medium term in the absence of further fiscal consolidation, followed by a stabilisation at a high level. The high debt-to-GDP ratio makes government debt developments vulnerable to adverse shocks and imposes a high interest burden on public finances. The simulations show that only by complying with the structural adjustments path recommended by the Council to ensure the correction of the excessive deficit by 2016 and then progressing towards the MTO, Spain can ensure a reduction in the debt ratio after 2016 that allows it to reach 60% of GDP in 2030.

Box 3.2: **Long-term projections of general government debt**

The public debt trajectory has been simulated under alternative scenarios. The baseline scenario has been derived on the basis of the Commission 2014 Winter Forecast, where the short- and long-term interest rates have been set to be consistent with the forecasted implicit interest rate, on the shares of short-term and long-term public debt, and data on maturing debt. This baseline scenario embeds a number of technical assumptions. First, the structural primary balance is set constant at the value of 2014 beyond the forecast horizon. The cyclical component of the primary balance is calculated using the (country-specific) budget balance sensitivities to the cycle over the period until output gap closure is assumed (2018). Second, long-term and short-term interest rates are assumed to converge respectively to a value above and a value below 3% (in real terms). Third, the inflation rate of the GDP deflator is assumed to converge linearly to 2% in 2018 and remain constant thereafter. Fourth, a short-run temporary feedback effect on GDP growth is introduced in the consolidation scenario (a 1 pp. of GDP consolidation effort impacts negatively on baseline GDP growth by 0.5 pp. in the same year). Fifth, the stock-flow adjustment is set to zero after 2015. Finally, the projected increase in age-related expenditure is given by the AWG reference scenario from the 2012 Ageing Report, which does not include the effects from the last pension reform yet. The assumptions for GDP growth are also those in the macroeconomic scenario in the Commission 2012 Ageing Report. Hence, potential growth is assumed to average 1.3% between 2010 and 2020 and to increase to 2.6% on average between 2020 and 2030.

The alternative scenarios are: i) a permanent increase by 100 basis points in short-term and long-term interest rates from 2014; ii) a permanent increase by 100 basis points in short-term and long-term interest rates from 2014 accompanied by a 0.5 pp. decrease in GDP growth; iii) a permanent decrease by 100 basis points in short- and long-term interest rates linearly over 2 years from 2014; iv) a permanent linear decrease by 100 basis points in short- and long-term interest rates over 2 years from 2014 accompanied by a 0.5 pp. increase in GDP growth; v) a permanent decrease in inflation of 0.5 pp. as of 2014; and vi) an alternative scenario, similar to the baseline one but setting the structural primary balance constant at the value of the 2015 (the last year covered by the forecast) beyond the forecast horizon.

The simulations unveil an underlying upward trend in general government debt in the medium term unless further fiscal consolidation is undertaken. The debt ratio would be on an increasing path in the baseline scenario until 2022 and stabilize thereafter at about 113% of GDP. Favourable assumptions on interest rates and growth would allow just for a mild reduction after 2022 and a further stabilization at around 110% by the end of the projection horizon. By contrast, under unfavourable scenarios on interest rates or inflation debt would continue on a steady upward trend. In particular, when the structural primary balance is assumed to remain constant at the 2015 level according to the Winter Forecast, the debt ratio unveils the most unfavourable dynamics, peaking at almost 140% of GDP in 2030.

One further sensitivity scenario has been run on the structural primary balance (SPB) by assuming an additional annual budgetary effort, in structural terms, of 0.5 pp. each year starting from 2014 up to 2017. This would lead to a structural primary surplus from 2017 onwards, 2 pp higher than in the baseline scenario. The assumed additional consolidation effort would broadly stabilise the debt ratio in 2017 and put it on a slightly decreasing path thereafter, although it would be clearly insufficient to reduce public debt to the 60% benchmark over the projection horizon.

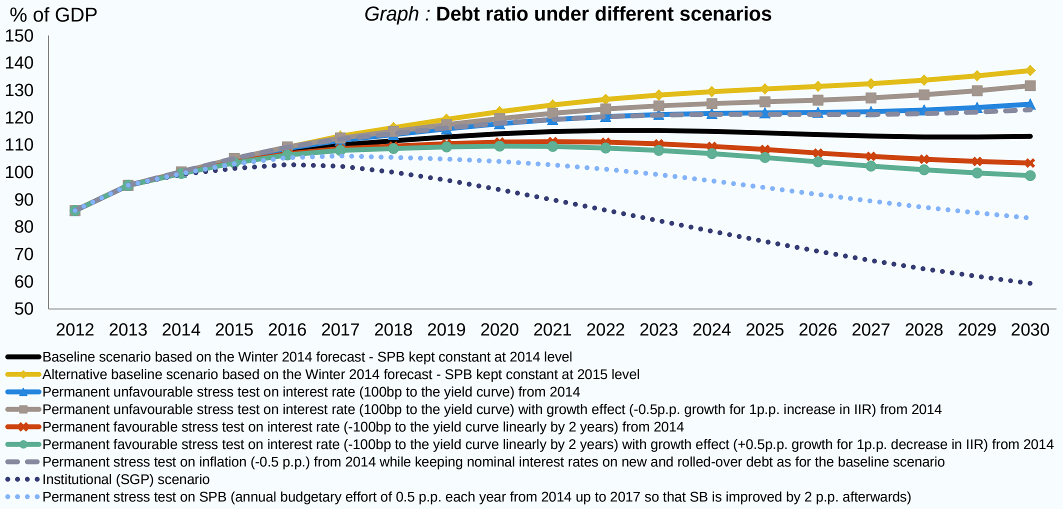
The so- called 'institutional (SGP) scenario' in the graph assumes that adjustments to the structural primary balance are set in compliance with the fiscal efforts recommended by the Council (which imply improvements in the structural primary balance by 0.8%, 0.8% and 1.2% of GDP in 2014, 2015 and 2016 respectively) until the excessive deficit is corrected, and thereafter an additional structural consolidation effort is maintained (+0.6 pp. of GDP) until the MTO is

(Continued on the next page)

Box (continued)

reached. Under this scenario, the debt ratio would start decreasing steeply after 2016 to reach 60% of GDP in 2030.

Graph : **Debt ratio under different scenarios**



Source: Commission services

3.2.7. Conclusions

Deleveraging by the private sector has advanced further but is far from complete and will continue to constrain growth. While the correction has accelerated, households and non-financial corporations continue to be highly indebted. Deleveraging has so far taken place mainly through negative credit flows, against the background of difficult economic conditions (negative growth, rising unemployment, low inflation and negative valuation effects). Large debt levels keep households and non-financial corporations exposed to interest rate increases and income shocks and limit their capacity to consume and invest. Overall, developments in Spain are consistent with the empirical evidence showing that deleveraging processes following banking and housing crises imply sizeable output losses.([55])

Deleveraging by households could progress faster in the medium term if the economy gains momentum, while a pick-up in investment could imply some scaling down of the net lending position of non-financial corporations from the current high level.

Effective structural reforms and well-working lending markets facilitate the deleveraging process. As reported in the 2013 IDR, both theory and model simulations point to reduced output and employment costs of deleveraging under flexible factors and product markets, that promote a reallocation of currently employed resources across sectors and firms and thereby support higher growth in both the short and medium run. The success of the structural reform agenda and restoring well-functioning bank lending and capital markets are essential in this respect. Beyond the measures already taken to reinforce the banking sector and foster access to non-bank financing, further measures aimed at limiting the negative impact of asymmetric information in bank-customer relations could be envisaged. Moreover,

([55]) 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 WEO, Sept 2009). Empirical evidence suggests that deleveraging episodes accompanied by a housing crisis took 5 years and a half 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, reducing debt to GDP by 30 pps on average and were accompanied by a considerable slower recovery in GDP (see e.g. Aspachs-Bracons, et al., 2011). Evidence presented by IMF (2012) 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%.

a more efficient regulatory framework for both personal and corporate insolvency could contribute to the deleveraging process and facilitate the allocation of credit to the viable sectors of the economy.

Despite a much more solid position, the banking sector will still deserve close attention. The continued increase in NPLs, a modest medium-term GDP outlook, and the low interest rate environment are challenges for banks profitability. A stabilisation in the real estate market, if confirmed, would remove a lingering source of concern, although exposures to this sector are highly provisioned. Particularly important seems to ensure continuous efforts to repair banks' balance sheets and maintain an adequate level of provisions and capital. This would avoid lending forbearance and contribute to strengthen the flow of new credit to the viable part of the economy.

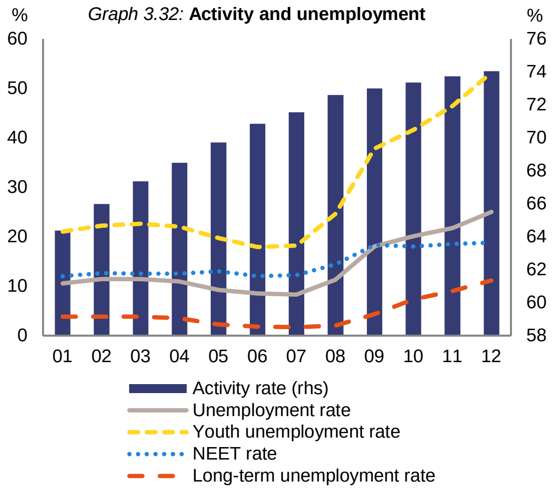
A critical challenge going forward is to stem and reverse the rise in government debt. Reversing the rise in government debt will be dependent on unfaltering fiscal discipline in the years ahead, concretised in high-quality measures that reduce structurally the budget deficit and are least harmful to short and medium term growth prospects. Given the high level of decentralisation in Spain, a combined effort by all levels of administration will be important for the success of such a strategy, starting from the effectively implementation of the ongoing reforms in the public administration.

3.3. LABOUR MARKET PERFORMANCE

3.3.1. Overview

The period between the second half of the 1990s and 2007 was characterised by an unprecedented surge in employment. Strong economic growth was accompanied by fast job creation, namely in labour intensive sectors such as residential construction, and a moderate increase in productivity. Overall, 7 million jobs were created. Yet, even at the peak of the boom in Q3-2007, employment and activity rates [56] stood at only 54.4% and 59.1% respectively, and the unemployment rate was 8%. Other indicators of dysfunctional labour market institutions were the high rate of structural unemployment and the high share of temporary employment (31.7% of the total).

Graph 3.32: **Activity and unemployment**



Source: Commission services

The breakout of the crisis in the context of a dual and rigid labour market and large sectoral shifts triggered a dramatic increase in unemployment (Graph 3.33)**.** While output fell by a cumulative 5.9% between 2007 and 2013, approximately 4 million jobs were lost since 2008 (19.5% of the total) and unemployment surged to a record high rate of 27.2% in Q1-2013. Labour market outcomes were heavily affected by the sharp downsizing of the construction sector since 2008. Notwithstanding the massive increase in unemployment, wages reacted very slowly to the changed economic conditions. The massive labour shedding hit first and foremost temporary workers. That the challenges facing the labour market in Spain had long-standing structural roots is also confirmed by the fact that Spain had approached unemployment levels close to 25% also during other economic downturns in the early 1980s and the first half of 1990s. [57]

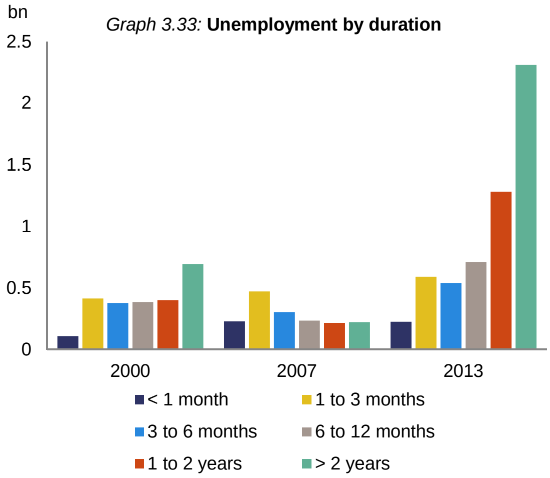
Notwithstanding recent encouraging signs in joblessness inflow, unemployment persistence remains the most pressing near-term concern. Both higher inflow rates and lower outflow rates contributed to the rise in unemployment at the beginning of the crisis, but, at this stage, where unemployment shows the first signs of stabilisation, the risk of persistence is largely determined by the evolution of the outflow rate,

[56] People aged 16 and over.

[57] See García Montalvo (2012).

which remains overall depressed, and depends on job creation and matching efficiency. After having increased in 2012, the job separation rate ([58]) has been trending downwards since the first half of 2013.

Graph 3.33: **Unemployment by duration**

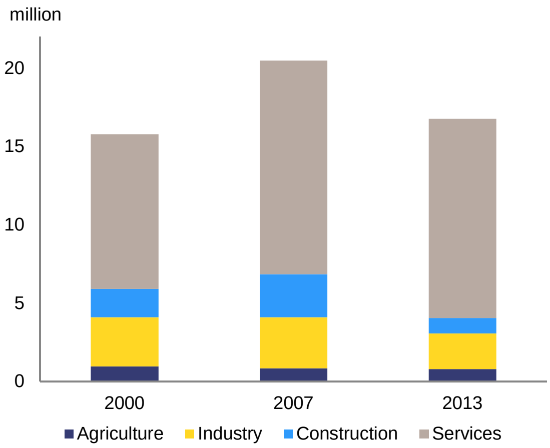


Source: INE, own calculations

Young people and the low-skilled are particularly exposed to high and prolonged unemployment rates (Graph 3.34). The high and rising share of unemployed workers facing long spells without a job (long-term unemployment rate: 52.2%) ([59]), points to a significant risk of hysteresis. Long-term unemployment has severe implications for job finding rates and labour market matching, and eventually results in widespread deterioration of human capital, discouragement and labour market withdrawal. The risk is strongest for youth and the less skilled workers, who have been disproportionately affected by the rise in unemployment. The fraction of young people not in employment, education or training increased from 14.4% in 2008 to 18.8% in 2012 ([60]), and their unemployment rate increased from 24.6% in 2008 to 55.7% in 2013. For low-skilled workers, the unemployment rate stands at 39.9% ([61]). All in all, these figures imply a high probability that the underlying structural rate of unemployment has shifted significantly upwards.

([58]) Measure of the probability that an employed person becomes unemployed in the next month.
([59]) Source: Eurostat, Q4-2013, for people unemployed for 12 months or more, expressed as a percentage of total unemployment.
([60]) Estimated at 900,000 in 2012 (Source: Draft Spanish Youth Guarantee Implementation Plan)
([61]) Source: INE, 2013, for people with primary education.

Graph 3.34: **Employment distribution by sector**



Source: Commission services. INE

This section will explore the drivers of the increase in unemployment and prospects and the contribution of labour market to rebalancing.

3.3.2. Drivers of labour market performance

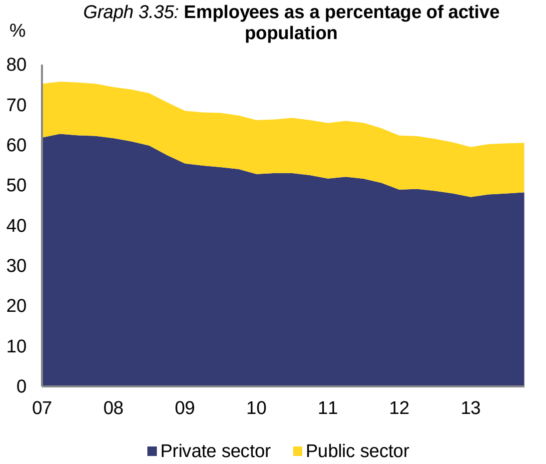
The crisis has hit employment across all sectors, but most strongly construction and some manufacturing sectors. Given the large share of low-skilled workers typically employed in construction, matching problems are likely to have been exacerbated by the sectoral concentration of job losses (Graph 3.35). There are also very large differences in the effects of the crisis on employment across regions, to a large extent explained by regional patterns of sector specialisation (as suggested by, among others, a high correlation between differences in employment losses across regions and employment losses in the construction sector) and, eventually, further aggravated by the lack of geographical mobility of workers. ([62])

Public sector employment has also been reduced significantly since 2011. The cumulative downsizing in public employment since the peak in 2011 has been 13.2%. In 2013, public employment decreased by 5.4%, faster than private employment, which declined by 2.3%. After the adjustment in the size of public administration in 2011 and 2012, the public sector accounted for 20.6% of the employment in 2013 (Graph 3.36).

([62]) Even before the crisis, internal migration rates in Spain were very low, leading to a mismatch between qualified workers and jobs (OECD, 2008a).

Most job cuts were carried out by the autonomous regions and municipalities, which are responsible, among others, for providing education and health services.

Graph 3.35: **Employees as a percentage of active population**



Source: Commission services, INE

Part-time employment withstood better the effects of the crisis than full-time employment, but it is still used less than in other EU Member States. The number of workers in part-time employment has increased by slightly more than 24% since 2007, and the percentage of persons working part-time reached 16% of total employment in 2013 ([63]), versus an EU-28 average of 19.9%. However, many of these are likely to be involuntary part-timers ([64]). Fostering stable part-time employment, as a tool against unemployment and duality, is also the main stated purpose of Royal Decree-Law 16/2013, adopted in December 2013, which is particularly addressed to young people.

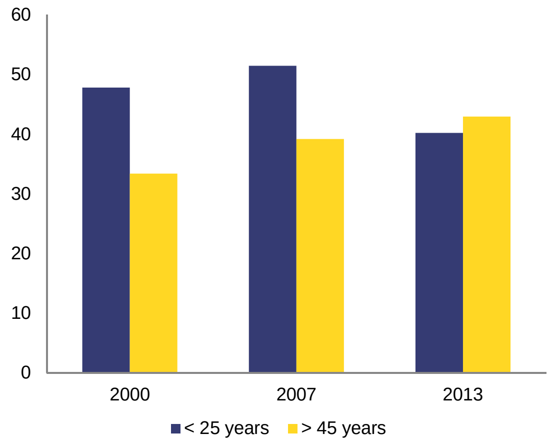
Activity rates in Spain were generally high, but have been falling lately due to demographic factors, migration and the extension of education and training. During 2007-2012, the proportion of the population aged between 15 and 64 in the labour force increased by about 2.5 pp, an unusual development in light of the sizeable increase in unemployment rate and the typically pro-cyclical behaviour of the participation rate. The activity rate stood at 59.6% in 2013 (or 22.7 million active persons). However, there is now some evidence of labour force withdrawals in specific groups, and the protracted slack in labour utilisation increases the risk that unemployed workers drift out of the labour force. ([65]) The withdrawals observed so far have been largely concentrated among youth, migrants and the low-skilled, who may be harder to bring back to the labour force. In general, a still limited, but growing trend is observed regarding discouraged workers.

Workers with an immigrant background are among those most strongly hit by the crisis in Spain and also those seeing the fastest fall in participation. The unemployment rate for workers with an immigrant background stood at 37.1% in 2013 (vs. 24.6% for Spanish nationals). These workers were disproportionately employed in construction, retail trade, and tourism, all sectors making an extensive use of temporary contracts. Discouraged workers from this group account for a large part of outward migration flows since the start of the crisis and more generally of withdrawal from the labour force. Nevertheless, their activity rate is still 16 pp higher than the Spanish nationals. ([66]) Much less noticeable, a limited exit of Spanish nationals as a result of the crisis has also taken place between 2008 and 2012. ([67])

Falling participation rates for youth partly reflect a prolongation of education and training. The activity rate of young people under 25 has fallen from 55% in 2008 to 41.3% in 2013 (Graph 3.37), partly reflecting more young people staying or going back to the education and training system, and, to a lesser extent, migration flows and demographics. In this regard, any negative effects on youth attachment to the labour market may have scarring effects on labour supply.

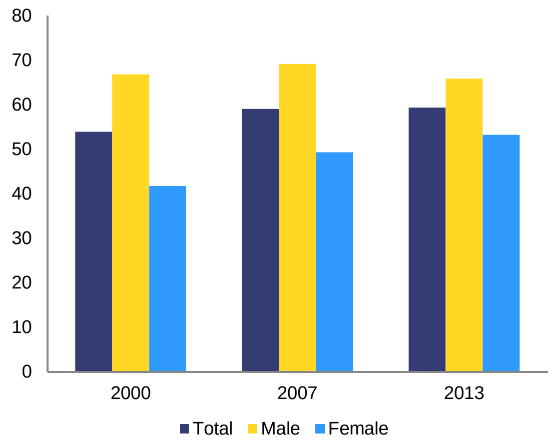
([63]) Source: INE.
([64]) 60.9% of total part-time employment of people between 15 and 64 years was involuntary in 2012 (vs. 27.6% in EU-28). Source: Eurostat.
([65]) Past evidence suggests that the peak effect of downturns on labour force participation could display a lag of up to 3 or 4 years. See OECD Economic Outlook (2011).
([66]) This difference in activity rates is largely explained by the different age structures of both population groups.
([67]) According to national data, 24.3% of the people leaving Spain in 2012 were people born in Spain. Of this, 59% were Spanish nationals aged 25-39 years, and 15.3% aged 15-24.

Graph 3.36: **Evolution of activity rates by age**



Source: Commission services. INE

Graph 3.37: **Evolution of activity rates by gender**



Source: Commission services. INE

At the same time, the crisis has led to an 'added worker effect' in labour participation. This materialises in a steep increase in the female participation rate from 48.9% in 2007 to 53.3% in 2013, Graph 3.38, possibly in response to increased first-earner, male unemployment. ([68]) In the case of older workers, the impact of the recession on their increasing participation has been affected by regulatory changes such as, among others, the increase in the legal retirement age introduced by the 2011 pension reform and the restrictions on early retirement adopted in March 2013, ([69]) which may have induced older workers to extend their active life in order to sustain prospective incomes. Relative to past recession episodes, all these factors point to diminished risks of labour force withdrawal among older workers despite the persistence of unemployment. ([70])

The labour market remains characterised by significant duality. Despite the different reforms and measures implemented since the 1980s (for instance, easing open-ended contracts with financial incentives), and most notably the labour market reforms of 2010 and 2012 (which have narrowed the gap in firing costs between temporary and open-ended contracts and promoted internal flexibility in firms)([71]), and in the context of the negative current economic situation and still uncertain outlook, labour market segmentation remains a feature of the Spanish labour market, with greater incidence on some groups of workers, namely the young and low-skilled. In Q4-2013, the temporary employment rate stood at 23.9% (Graph 3.38), up from 23.7% in 2012.

([68]) Partly related to national policies implemented before and in the first years of the crisis, which have supported female and elderly participation through, for example, child-care facilities and hiring subsidies.

([69]) An additional element to take into account is the outcome of past and recent reforms in pension and tax and benefit systems that contributed to the rise in the effective retirement age. These policy developments may help explain the increased participation of elderly workers.

([70]) See OECD (2010).

([71]) Since mid-1990s, Spain has both restricted the conditions under which temporary employees can be hired and sought to entice employers with incentives for increasing the hiring under permanent contracts.

Box 3.3: **Main features of the 2012 labour market reform**

The 2012 reform of the labour market took immediate effect by Decree in February; the subsequent Law has been in force since July 2012. The reform followed the pattern and direction of previous reforms, but took more decisive measures towards a wide set of objectives, including: favouring internal flexibility as an alternative to job destruction, modernising and decentralising collective bargaining, improving employability through training and effective labour mediation, promoting quality jobs and reduce labour market dualism, combating unjustified absence from work, strengthening the control and prevention of fraud.

The main novelties introduced by the reform were: i. changes in employment protection legislation (i.a. reduction of severance payment for unjustified dismissals from 45 to 33 days per year of service up to a maximum of 24 months([1]), ii. a more detailed definition of the economic conditions that apply for justified dismissals([2]), iii. the elimination of the "express dismissal"([3]), iv. suppression of worker's right to receive wages ("salarios de tramitación"), and v. removal of the prior administrative authorisation for collective dismissals. The reform also introduced a new open-ended contract for SMEs (with significant fiscal incentives and a longer probation period) and targeted subsidies, and reintroduced the prohibition of linking different temporary contracts further than 24 months. A major feature of the reform were the measures to enhance internal flexibility in relation to the working conditions for economic, organisational and technical reasons; and functional and geographical mobility. Firm-level collective agreements are made prevalent, ultra-activity reduced to one year, and the definition of opt-out was amended to flexibilise its use. Incentives were also introduced for training and apprenticeship contracts, an individual training account was introduced and temporary work agencies are now allowed to operate as recruitment and placement bodies.

The Spanish Government presented the main conclusions of its own assessment of the impact of the 2012 labour market reform on 29 August. An OECD assessment requested by the authorities was published in December 2013. Overall, there is a shared view that the reform has increased labour market resilience and contributed to wage moderation. However, the OECD points to lack of evidence of a reduction in labour market duality.

Some fine-tuning of the reform has already taken place, namely with the adoption of Royal Decree-Law 11/2013 on 2 August, which amended the procedural requirements for collective employment regulation measures and measures adopted in December 2013 ([4]) to promote stable part time jobs. The number of contract templates were also reduced from 42 to 4 (indefinite, temporary, training and apprenticeship and internship) in January 2014. At the end of 2013, the Government announced also the intention to systematise the current hiring subsidies into a single piece of legislation.

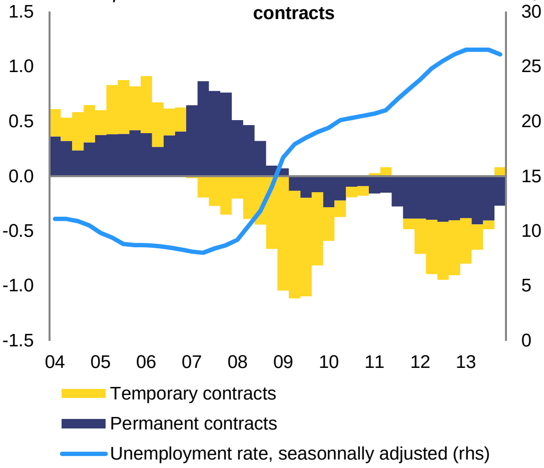
([1]) *The reform of severance pay applies to new hires, while current employees accumulate rights with the new regime, with no reduction in existing entitlements.*

([2]) *To the existing valid bases for individual and collective dismissals, the 2012 Law added "organisational reasons". The dismissal is justified when the firm experiences or expects a persistent reduction in the level of sales (previously only revenues were considered); a persistent reduction of revenues or sales occurs when sales or revenues fall for 3 consecutive quarters. Previously, only revenues were considered.*

([3]) *The employer could save the legal uncertainty of the process recognising that the dismissal was unjustified and accepting to pay the higher severance pay of 45 days per y.o.s. in case of unfair dismissal; before the reform, approximately 65% of all dismissals were "express dismissals".*

([4]) *Royal Decree-Law 16/2013.*

Graph 3.38: **Evolution of fixed-term and indefinite contracts**



Source: Commission services

The impact of recent reforms on duality will become clearer when the recovery is better established. The massive dismissal of (mostly) temporary workers from 2008 to date has resulted in an increased share of permanent workers in the total stock of employees. However, since the beginning of 2012, growth of permanent contracts among the new contracts has picked up ([72]), outpacing that of temporary contracts, which nonetheless still constitute about 92.4% of the total new labour contracts signed ([73]). The high share of new temporary contracts may be motivated by the broad economic uncertainty and the current productive structure (which determines the average life of contracts). Adding to the unstable economic context, some administrative difficulties and uncertainties persist in relation to the use of the new subsidised indefinite contract for SMEs. The simplification of the contract templates (effective from January 2014) and the announced streamlining of hiring subsidies will increase transparency and may reduce information costs for employers.

Segmentation raises the volatility of employment and has negative consequences on the labour market integration of young, low-skilled workers. ([74]) Negative externalities on the whole economy arise from low training incentives and productivity. ([75]) In addition, segmentation can condition decisions on the type of production and it can make it more difficult for companies to adapt quickly to technological or demand shocks. ([76]) Finally, the fact that protection is linked to the job tenure with current employers might be a disincentive to mobility and hence to allocative efficiency. ([77])

The rigidities in the labour market were manifest in the behaviour of wages and low productivity. Economy-wide labour productivity growth was weak in Spain compared to other advanced economies in the period 1996-2006, but has accelerated since 2007, most markedly in 2009. ([78]) However, the substantial hourly productivity gains are a consequence of, among others, a decline in total working hours, and also reflect composition effects, since job losses were largely concentrated in low-productivity sectors such as construction.

Before the 2012 labour reform, Spain's collective bargaining system featured an intermediate degree of centralization (at the sectoral and regional level), which did not allow for a sufficient adaptation to the macroeconomic conditions, nor to the microeconomic conditions of the company. ([79]) This rigid system was exacerbated by the so-called ultra-activity, i.e. the automatic indefinite prolongation of existing contracts in the absence of renewals. In addition, the conditions to opt out of the collective agreements were too strict and rendered its use very difficult. Thus, the bargaining structure largely prevented wages from being configured as an additional adjustment element, while also hindering their role as an incentive mechanism. ([80]) Partly explained by this nominal

([72]) The share of new open-ended jobs increased by 8.3% y-o-y in December 2013 (Source: Public Employment Service, January 2014).

([73]) The percentage of temporary employment is also boosted by the number of fixed-term contracts of very short duration, which may suggest the use of consecutive temporary contracts with the same person. In 2013, 84.9% of the temporary jobs had a duration of less than 3 months (source: INE).

([74]) See García Serrano and Malo (2013).

([75]) See OECD (2013)

([76]) See Bassanini et al (2006).

([77]) See Jimeno (2011).

([78]) Productivity per hour worked increased up to 31.5 euro/hour worked in 2012, close to the EU-28 average of 32, but still well below other large euro area economies (42.6 in Germany, 45.4 in France, 45.6 in the Netherlands and 39.4 in United Kingdom). Source: Eurostat.

([79]) According to the Calmfors-Driffill hypothesis (Calmfors and Driffill, 1988), the intermediate level of centralisation in collective bargaining generates worse results in terms of the unemployment rate.

([80]) See Estrada et al. (2011).

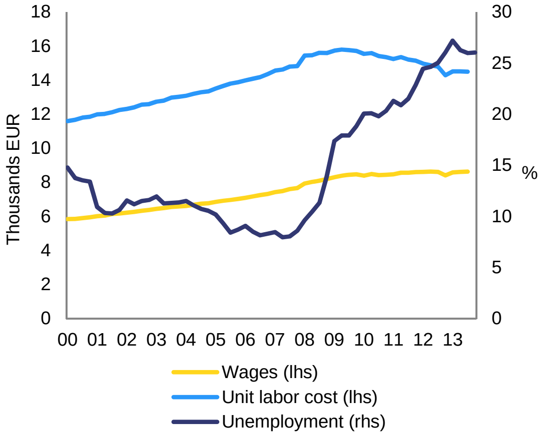
wage inertia and by the more frequent use of temporary contracts, labour shedding played a stronger role ([81]) in adjusting labour input in Spain than in other European countries, with adverse effects on employment.

A labour market improvement has followed swiftly the first signs of recovering economic activity in the second half of 2013. Unemployment stabilised at the end of 2013, largely due to the contraction of the labour force and to some seasonal factors, but also to a halt in the decline in employment levels (which showed a first positive increase in the registers to the Social Security in December 2013). Self-employment has progressed more favourably than average employment ([82]), seemingly partly fuelled by the new measures on entrepreneurship, in place since March 2013 (Youth Entrepreneurship and Employment Strategy 2013-2016) and September 2013 (Law on Entrepreneurship).

The enhanced internal flexibility brought about by the labour market reform and the social partners' agreement is likely to have had a positive effect on employment. The comprehensive labour market reform adopted in 2012, together with the social partners' agreement for wages, employment and growth 2012-2014, ([83]) set the basis for a more flexible and resilient labour market (see Box 3.3 for more details). The reform created the ground for working hours to react more flexibly to labour market shocks. ([84]) This could lead in the future to a reduction in labour demand fluctuations over the economic cycle, especially for temporary contracts. Without a downward adjustment of average working hours employment losses could have been even more severe. Different estimates suggest also that the reform has helped to limit job losses, although varying substantially between the 225 800 (estimated by the national authorities) and 60 000 (estimated by BBVA -Banco Bilbao Vizcaya Argentaria). ([85]) Conversely, there is no evidence to date of substantial impact on duality.

The 2012 reform is likely to have contributed to wage moderation, especially in new collective agreements. The agreed wage increase for 2013, calculated provisionally with the information on the collective agreements registered up to December 2013, stands at 0.57% (0.37% for firm-level agreements and 0.58% for higher-level agreements, in line with the social partners' agreement for 2012, 2013 and 2014 signed in January 2012). As for the collective agreements which start deploying their effects in 2013, the agreed wage increase is lower, 0.41% (0.39% for firm-level agreements and 0.41% for higher-level agreements). ([86]) According to 2013 Q3 data, the labour cost of companies increased 0.2% y-o-y, standing at 2,461 euro per worker. However, the wage cost per worker per month decreased 0.2%, standing at 1,801 euro on average. As working hours have also decreased by 0.3%, labour costs per hour worked have increased by 0.5%.

Graph 3.39: **Wages, ULC, unemployment 2000-2013**



Source: INE, own calculations

The surge in unemployment is a key factor to explain the deterioration in poverty and exclusion indicators in Spain. ([87]) The share of

([81]) See OECD (2010).
([82]) In Q4-2013, self-employment decreased by -0.30 y-o-y vs. a decrease of -1.35% for employees. (Source: INE)
([83]) Agreement on Employment and Collective Bargaining 2012-2014, signed by the main business associations and trade unions – CEOE, CEPYME, CCOO and UGT – in January 2012.
([84]) According to national data, the share of workers affected by adjustments in the working time varied between 15-25% in 2012 and 60.5% in 2013, although with great divergences in relation to the firm's size.
([85]) See Domenech (2013).
([86]) This information is provisional, covers only the data on agreements registered up to December 2013.
([87]) As in section 2, poverty is defined in relative terms, as the percentage of people with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income (after social transfers). Poverty is usually seen from the viewpoint of the individual household, when trends in household size affect the number and composition of the

people living in households with very low work intensity increased to 14.3 % in 2012 (from 6.7% in 2007). Poverty among the unemployed population has increased from 39% to 46% between 2007 and 2012, also in line with the increase in long-term unemployment. The fall in income among the long-term unemployed influences the increase in income differentials, since the long-term unemployed, having expired up their right to earnings- related unemployment allowance, are now protected under social assistance schemes, managed by the regions (whose replacement rate is significantly below typical poverty thresholds). This evolution is clearly visible in the decrease in total expenditure on contributory unemployment benefits by 16.4% between 2012 and 2013, reflecting a fall in the .number of unemployment benefit recipients (-17.4% y-o-y in December 2013) and unemployment benefit coverage rate (-4.1% y-o-y, to 61.4%). ([88])

In-work poverty has also increased, mainly as a result of lower household work-intensity. At 12.3%, the in-work poverty rate remained high in 2012 (18.8% for part-time workers, 10.9% for full-time workers)**,** reflecting the deterioration for some clusters of the employed population (notably young people, the low skilled and temporary workers) and the fact that the main social policies pertain to unemployment and non-contributory pensions for elderly and people with disabilities, not so much to households with economically active members. Poverty and social exclusion amongst employed workers are also related to the quality of employment, with temporary employment leading to a higher poverty risk not only in the short term, but also in the medium and long term.

3.3.3. Medium-term prospects

On the back of a further decrease in the labour force and stabilisation of employment, unemployment is projected to fall in 2014. The 2014 WF projects unemployment to fall from 26.4% in 2013 to 25.7% in 2014. While the recent evolution of labour market indicators suggest an approaching turning point, it is difficult to judge if they prelude a serious inroad into unemployment. The answer depends very much on the strength of the recovery in activity, in the face of headwinds from deleveraging, and the reactivity of employment. Employment has been traditionally highly reactive to output changes in Spain, with greater variation in unemployment in situations of GDP stagnation or growth near to zero. ([89]) Labour market developments during the crisis also confirm that significant dualism tends to increase the sensitivity of employment to fluctuations in output. ([90]) The recent reforms could have lowered the GDP growth level at which employment starts to react to GDP growth. At the same time, the large share of long-term unemployed complicates the challenge of a substantial reduction in the unemployment rate.

Spain needs to achieve internal and external equilibrium. The recovery in cost competitiveness to rebalance the economy externally and the reabsorption of unemployment (and the reduction in structural unemployment) might point to differing adjusting needs. While the external rebalancing is advanced and, as discussed in section 3.1, does not depend only on relative labour costs, mobility of workers across different sectors and occupations, in particular towards those with the highest growth and export potential, as well as compatible wage settings, would support the reabsorption of unemployment.

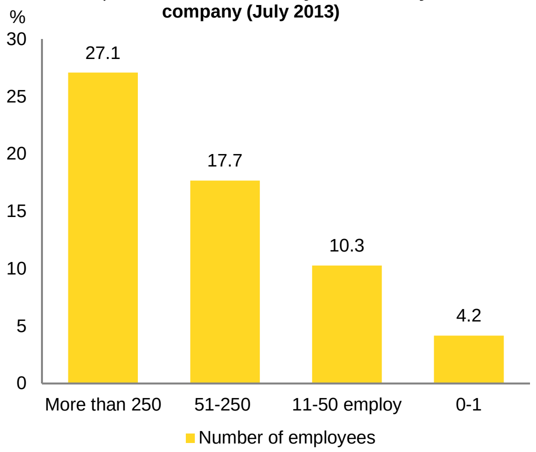
Duality limits productivity and medium-term growth potential. ([91]) The duality of the labour market, including the fact that protection is linked to tenure with current employers, is likely to be a hurdle to allocative efficiency, while the lower incentives to invest in human capital and building up skills of temporary workers reduce their productivity.([92])

‘poor’ category. The fall in the average number of children may explain the better situation in families.

([88]) Source: Public Employment Service, January 2014

([89]) See Estrada et al. (2011).
([90]) See IMF (2014).
([91]) See Crespo Rodríguez et al. (2012).
([92]) See Jimeno (2011).

Graph 3.40: **Use of flexibility measures by company (July 2013)**



Source: Ministerio de Empleo y Seguridad Social

The reabsorption of unemployment would be supported by further improvements in unit labour costs. This adjustment is at work. Overall, labour costs have been falling since Q1-2012, by a cumulated 3.6%, while the GDP deflator has risen by 0.4%. A continuation of wage moderation, along the lines of the 2012-2014 inter-confederal agreement, would contribute to a reduction of the current estimated high level of the NAWRU and promt its convergence towards the less cyclical structural unemployment rate (predicted solely on the basis of key policies variables such as the tax wedge, the unemployment benefits and the active labour market policies).

A tax shift away from labour could complement structural reforms and have a positive impact on both employment and cost competitiveness. A revenue-neutral reduction in social security contributions financed via consumption and/or other taxes could be considered in the framework of the up-coming review of the tax system.([93]) Model simulations (see Box 3.4) suggest that considerable tax shifts are needed to have large employment effects. Targeted reductions are likely to be more effective in reducing unemployment for a given amount of the tax shift, in particular if focussed on low skilled due to the higher elasticities of both low-skilled labour demand and supply. Moreover, the short-term employment impact can be expected to be larger when employers' social security contributions are reduced, as the impact on labour demand is more direct. The impact of a social security contribution cut targeted only to new additional and stable hires, as the government announced on 25 February to be planning, can only be assessed when the details on the actual design and implementation of such mechanism become available. In principle, this type of scheme can support employment creation, while the impact on competitiveness and on the trade balance is likely to be limited as the cost of the stock of existing employment is not affected and the amount of the associated tax shift (if any) would likely be contained. Introducing a flat social security payment would imply a larger reduction in the cost of higher wage new net employees.

In addition to the strength of aggregate demand and wage setting, a determinant of unemployment persistence is the efficiency with which jobseekers are matched with job openings ([94]). The structural transformations undergoing the Spanish economy are generating a mismatch between demand and supply of labour, which may require policies enhancing support to job-search and activation of unemployed. ([95]) This is one of the goals of the on-going revision of the active labour market policies framework in Spain, upon which resources are to be allocated among regions depending on results. ([96]) Persistent regional disparities in labour market conditions

([93]) The level of unemployment justifies considering such a measure even though Spanish labour tax rates are not particularly high by European comparison. The implicit tax rate on labour (33,5%) and the tax wedge (37% at 67% of average wage) for 2012 were lower than the EU averages.

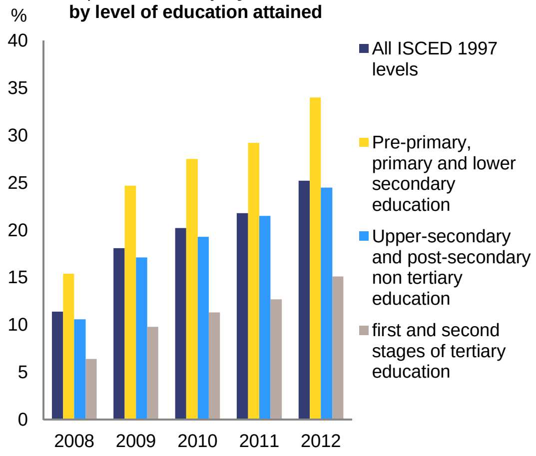
([94]) An often used gauge of matching efficiency is the relationship between open vacancies and unemployment (the Beveridge curve). Another source of unemployment persistence is the lower level of female labour market participation.

([95]) See OECD (2013).

([96]) The Spanish Government approved the Annual Employment Plan for 2013 in August 2013. On 8 November 2013 the first distribution of funds to the regions (totalling of €1,342.58 million) for the implementation of active labour market policies, corresponding to 2013. The PAPE 2013 contains 33 agreed structural and strategic/policy common objectives for all Public Employment Services (national and regional). The strategic objectives for 2013 are: (i) Improving the employability of young people and promote entrepreneurship; (ii) Improving the employability of other groups particularly affected by unemployment (people older than 55, long-term unemployed, recipients of PREPARA programme); (iii) improving the quality of the 'professional training for employment' system, and (iv) Strengthening the links between active and passive policies. In 2014, 40% of the funds will be distributed according to results achieved in 2013, 25% with respect to the strategic objectives and 15% responding to the structural ones.

also point to mismatch across regions. More could be done to improve the matching of workers and jobs, namely through measures to incentivise activation and mobility, and to strengthen public employment services and training programmes, including vocational training.

Graph 3.41: **Unemployment rate, by level of education attained**



Source: Commission services

In the medium term, the success of recent reforms tackling shortcomings in Spain's education systems that have contributed to high youth and low-skilled unemployment will be important. ([97]) Although on a fast declining trend, Spain still stands out for a high early school leaving rate (24.9% in 2012). Further declines are likely in the light of the economic context and the ongoing reform of the education and training system. The high rate of early school leaving is not incompatible with the improved educational attainment registered during the last three decades (40.1% tertiary educational attainment in 2012). However, Spain's investment in human capital has not enabled convergence with the EU in relation to the population with higher secondary education, mainly vocational education and training. The polarisation of Spain's educational attainment has given rise to high levels of unemployment among the low skilled, but also to an imbalance between the supply and demand for qualified work, resulting in high levels of graduate unemployment, and a significant underemployment or *overqualification* (Graph 3.41). Spain ranks as one of the countries with the highest degree of qualification mismatch in the EU, showing also great variations in the share of over-qualified and non-employed university graduates over the business cycle. ([98]) Estimates show that 26% of the Spanish labour force is overqualified for their job, with higher proportions for young people (44%).([99]) The fact that this trend has been sustained over recent years, is at odds with human capital theory. ([100])

3.3.4. Conclusions

Reducing unemployment is the most urgent challenge facing Spain. Recent polices have helped to avert even worse outcomes and are expected to deploy further positive effects as the recovery gathers speed. Nevertheless, the urgency of the labour market and social situation magnifies the need for a swift and adequate implementation and close monitoring of all the measures adopted and planned. A number of critical structural problems, as emerged from the preceding analysis, would need to be fully addressed in order to achieve a sustained decline in unemployment, accompanied by better prospects for sustained productivity gains.

([97]) See García (2011).

([98]) See Dolado et al. (2013).

([99]) See OECD (2012).

([100]) See García Montalvo (2013): According to human capital theory, anticipation of lower returns to education, lead future workers to invest less in education. In the long run, any excess supply of highly educated entrants to the labour market will be reduced.

Box 3.4: Model simulation of the possible impact of a tax shift in Spain

Spain plans to review its tax system during 2014, with the key aims of simplifying it, increasing its growth-friendliness and reducing the debt bias. A Committee of experts tasked by the Government with developing reform proposals is set to deliver its report by end-February 2014. In the context of the reform, the authorities could explore the possibility of shifting taxation away from labour, so as to reduce labour costs and stimulate employment. When enacted via an increase in consumption taxes, such shift in tax-bases is often referred to as 'fiscal devaluation', as it permits a country to mimic the effects of exchange rate depreciations/devaluations and improve its trade balance. Both objectives are highly relevant for Spain, as it needs to maintain large current account surpluses to bring down net external liabilities from the current high levels and at the same time has a high unemployment. However, putting emphasis on employment rather than the external balance has implications for the design of the tax shift. Model-based simulations, including those presented below, suggest that (i) targeted labour tax reductions are comparatively more effective in stimulating employment than reductions across the board and (ii) that reductions in employers' social security contributions – while equivalent to reductions in employees' social security contributions in the long run – are more effective in the short-run.

Generalised tax cuts tend to have a limited impact on employment due to low aggregate labour demand and supply elasticities. Literature relying on macro and/or computable general equilibrium models warns against overly optimistic expectations to lower persistently high unemployment rates by decreasing social security contributions across the board. Indeed, the tax shift required to achieve even a marginal decrease in the unemployment rate (for example by 1pp), is substantial. Such a large tax shift moreover implies a significant increase in the consumption tax and equally significant reductions in the tax rate on labour. Both changes work to improve the current account balance. Lower labour taxation has a positive impact on competiveness and thus on exports, while the increase in the consumption tax delivers a contraction in imports.

When a tax-cut is targeted on low-skilled workers, achieving the same impact on unemployment requires a much smaller tax shift. Labour demand for the low skilled, in fact, tends to be more elastic to labour costs (due to larger labour-capital substitution effect). Labour supply is also more elastic for the low skilled as the pool of unemployed and/or inactive is greatest amongst the low skilled. On the other hand, the impact on current account tends to be smaller than in the case of generalised tax cuts, due to the limited increase (decrease) in the consumption (labour) tax rate.

The Commission Services' model QUEST was used to estimate the impact of two alternative reform scenarios[1]: (i) a generalised reduction of employees' social security contributions and (ii) a reduction targeted to the low skilled. In both scenarios, taxes on consumption (VAT or other indirect taxes) are raised so that the reform is budgetary neutral (other tax components, such as property taxation, could also contribute to the financing but this is not modelled). Both scenarios are calibrated to achieve a reduction in the unemployment rate in the medium run by around 1 p.p. The simulations confirm that more revenue has to be shifted from labour to consumption taxes when all workers are affected by the reform (2.6% of GDP compared to 0.7% of GDP in the targeted scenario), the reason being that low skilled workers in the model are characterized by a higher elasticity of labour supply compared to medium and high wage earners.

Under the first scenario, in order to reduce unemployment by 1pp, taxes on labour must decrease by 6pp and consumption taxes must increase by more than 4pp; the current account balance improves by almost ½pp of GDP. Employment increases across all skill groups. GDP remains almost unaffected in the first year but increases by around 0.8% in subsequent years. The

[1] Neither of the scenarios presented here corresponds to the introduction of a flat social security rate for new stable employment announced by President Rajoy in the State of the Nation speech of 25 February 2014 (the cut-off date for this IDR).

(Continued on the next page)

Box (continued)

aggregate consumption response is negative mainly driven by a reduction in consumption of non-liquidity constrained households as this tax shift effectively shifts the tax burden away from labour towards others sources of income, including profits. However, consumption of liquidity constrained households increases significantly. The trade balance improves as the lower labour income taxes combined with an increase in consumption taxes reduce the relative price of exports to imports.

Under the second scenario, in order to reduce unemployment by 1pp, taxes on labour decrease by more than 7pp for low skilled only and consumption taxes increase by only 1.2pp; the current account balance improves by almost 0.2pp of GDP (less than in the non-targeted scenario as the tax shift is smaller). GDP, consumption and trade balance effects are smaller in this scenario which is a consequence of the smaller overall tax shift. Proportionally, the effects are larger for a targeted tax shift.

Long term equilibrium is not affected by reducing labour taxes paid by employees or employers, but reducing taxes on employers leads to a quicker reduction in unemployment. With frictions in the adjustment of nominal variables, a decrease in employees' social security contributions would have an immediate impact on after-tax nominal (and real) wage. A reduction of employers' social security contributions, on the other hand, would have an immediate impact on profit margins. Considering the current adjustment needs of the Spanish economy, a reduction in the latter appears a more appropriate instrument and would accelerate the pace of adjustment in the short to medium run.

Equity concerns (regressivity of consumption tax) should be mitigated. Whereas it is generally accepted that a tax shift from labour to consumption improves efficiency and leads to higher levels of output and employment, equity considerations are often raised to oppose such tax reforms. The argument relies on the regressive nature of consumption taxes and on the adverse effect of households receiving social transfers. There are however offsetting forces that tend to mitigate equity concerns. Firstly, in the long run the tax reform also shifts part of the taxation from wages to income from distributed profits and financial wealth. Secondly, the targeting of the reform both in terms of social security contributions' cut and VAT increases (changes standard rate, reduced rate or super-reduced rate) would alleviate the overall distributional impact. Thirdly, many households receiving social transfers, specifically retirement incomes, are not systematically found at the bottom of the distribution in Spain. Moreover, in the simulations discussed above, social transfers are indexed to the real wage, so the impact of higher prices is partially offset. Fourthly, to the extent that a significant share of unemployment is involuntary, a reform that reduces the number of constrained households would have a clear welfare enhancing effect. Finally, the larger the second round effects (in terms of additional output), the lower will be the necessary compensating increase in consumption tax. Said that, targeted compensating measures might still be considered ([2]). These measures would act to reduce the size of the overall impact, but not alter the overall qualitative conclusion of a positive impact from the tax shift.

([2]) A tax shift from labour towards more growth friendly tax-bases (VAT, property taxes, environmental taxes, etc.) has been advocated in the frame of the Annual Growth Survey 2014. Such a shift is also supported on the basis of lowering risks of tax evasion (EC, 2013).

Absorbing displaced workers from permanently downsized sectors and facilitating the shift towards a more export-led economic growth implies a large-scale sectoral reallocation of labour over time. This process would be accelerated by appropriate developments in labour costs, enhanced mobility of workers both across sectors and geographically, and enhancing skill-match. There is a role to play for labour market policies, including strengthening ALMP and employment services, education and training and other flanking policies, such as a tax shift bringing lower labour costs and easier access to rental accommodation. Measures are being taken in all these areas, but their effects will be visible only over time, also due to the longer implementation lags related to the division of responsibilities between the centre and the regions, in particular for ALMP and employment services. Effective cooperation will be paramount also to ensure the swift implementation of the national Youth Guarantee Implementation Plan in 2014.

There is a strong complementarity between measures directly geared to the labour market and other policy areas. In particular, it is essential to increase competition, removing barriers to entrepreneurship and growth and facilitating the allocation of resources towards more efficient sectors and firms. The competitiveness gains from lower unit labour costs would benefit the whole economy only if not absorbed in the medium term by higher firms' margins. A rapid and thorough implementation of ongoing reforms in product and services markets (such as the market unity law and the professional services law), together with measures to modernise public administration, will thus be critical for employment prospects. The same goes for the reforms of education and training, which have an important role to play to address skill mismatches and increase human capital.

4. POLICY CHALLENGES

The analysis in Sections 2 and 3 shows clear progress in the adjustment of imbalances but it also highlights that winding down the large stocks of domestic and external debt will require sustained efforts, and that unemployment and government debt have grown into major policy challenges. In particular, risks to banking sector stability have been put under check; the external lending position is now in surplus; the housing market contraction seems to be approaching stabilisation; confidence has improved significantly and the economy has started to grow again. Yet, both the private and the public sectors remain highly indebted on a number of indicators, with government debt still on an ascending trajectory. External liabilities also remain very large, while the labour market situation, in spite of recent signs of stabilisation, is critical. Until these imbalances are corrected, the economy remains vulnerable to external or domestic shocks, including policy setbacks, which could cast doubts on the continuation of the ongoing adjustment.

These significant economic challenges warrant close monitoring and policy attention. Against this background, this section discusses different areas of intervention that could contribute to address the above challenges. The adjustment was supported by intense policy action over the last year, driven by the commitments in the 2013 National Reform Programme and Stability Programme, the country-specific recommendations issued by the Council in July 2013 and for the financial sector by the conditionality under the financial sector assistance programme.([101]) The scale and interrelated nature of the remaining economic challenges call for a determined continuation of this policy response. A few key reforms are still in the pipeline, and many of the reforms recently adopted will deliver their results only upon full and effective implementation. The effective cooperation of all tiers of governance (central, regions and local administrations) is a key ingredient to the success of many reforms. In addition, additional policy measures to underpin further the adjustment process might be considered as further experience and insights are gained.

The following paragraphs discuss policy challenges in relation to the macroeconomic imbalances and risks identified in section 3. Most related policy measures are nevertheless cross-cutting and likely to contribute to the broader adjustment process, despite being more relevant for specific dimensions thereof. Often these policies are complementary, making their combined implementation important to reap the expected economic benefits.

Enhancing competitiveness and reducing external vulnerabilities

Reducing the large negative NIIP requires sustained external net lending surpluses, in turn requiring sizeable positive trade balances over time. On current and forecasted net lending positions, and abstracting from valuation effects, it will take a number of years to bring the NIIP to levels generally considered as compatible with the absence of vulnerabilities. Moreover, a rebalancing of external liabilities towards equity and away from debt would also strengthen the resilience of Spain to external financial shocks.

Structural factors have underpinned the buoyant performance of exports in recent years. Spanish exports shares were relatively resilient even during the boom period, in spite of unfavourable aggregate ULC and REER dynamics, suggesting a role for other competitiveness factors. More recently, exports volumes have grown on the back of rapidly increasing export propensity of Spanish firms both at the intensive and extensive margins. The number of exporting firms is now larger and the range of countries toward which Spain exports is broader. Considering the fixed costs associated with export activity and in particular with entering new markets, this trend is unlikely to reverse as internal demand picks up. Moreover, the gains in relative cost competitiveness spurred by the internal devaluation process will support firms' internationalisation efforts. There are instead risks that imports might rebound strongly once activity picks up, due to the high external dependence on oil and the relatively elevated import content of final demand.

There is scope to increase further the export potential of the Spanish economy. In going

([101]) The assessment of progress in the implementation of the CSRs will take place in the context of the 2014 European Semester.

forward further labour cost moderation and increased competition on product and service markets would contribute positively to aggregate productivity growth and international competitiveness. The recent experience has however also shown that non-cost competitiveness explains a significant share of the Spanish export performance. Exporting firms in particular have adopted efficient production and marketing strategies and maintained high levels of productivity (both by national and international standards). In this respect, the fragmentation of the Spanish production system, where the dominance of micro and small companies point to obstacles to firms' growth, appears as a bottleneck to expanding the export potential. Improving the allocation of resources across firms and sectors, requires efficient labour and capital markets, but also a friendly business environment, without unjustified entry and growth barriers, and competitive service and product markets.

Recent reforms in capital and product markets support competitiveness but there could be scope for further deepening. The 2013 law on the market unity aims at removing measures that may directly or indirectly obstruct the free movement of goods and services and the establishment of economic operators throughout Spain – and could allow firms to grow in size and exploit economies of scale. The planned reform of professional services and associations could increase competition in an important sector, which is also a large input to other activities. The reform is nevertheless met with strong opposition and has not yet been approved. Efficiency gains and lower prices could also derive from more competition in the retail sector, where there could still some scope to streamline authorisation schemes in spite of recent reforms. Tackling capital constraints and administrative and tax provisions that discourage companies from growing and becoming more competitive would enhance productivity and competitiveness. Larger firms can reap benefits of scale and scope (through product differentiation and/or vertical integration in markets up or down the value chain), and this could also contribute to lower import dependence. Energy policy could play a role in reducing the dependence on external energy sources.

The foreseen reform of the tax system offers an opportunity to contribute to the external adjustment process. A more environmental friendly taxation could support the reduction of the oil intensity of the economy, with a positive impact on imported volumes. A well-engineered tax shift could support employment and be beneficial to external competitiveness by reducing the cost of labour and at the same time making imports relatively more expensive. Sizable effects on the trade balance, however, tend to require very large tax shifts.

Sustaining the deleveraging process and strengthening the financial sector

The high deleveraging pressure on the private sector continues to drag on growth and to pose challenges to financial stability. The economy would likely benefit from a speedier debt reduction amongst non-financial corporations. A return to positive growth coupled with the right incentives could create the necessary space for frontloading the debt reduction. Some measures have already been taken to reduce the debt bias – e.g., the entrepreneurship law has introduced a tax break to foster SMEs' re-investment of profits on fixed assets or on real estate assets linked to the company's economic activities. In spite of recent measures, significant shortcomings still appear to limit the application and the effectiveness of insolvency procedures. An effective insolvency (including the pre-insolvency stage) framework would contribute to allocative efficiency by (i) reducing incentives to invest in tangible assets as collateral, (ii) freeing-up resources locked in low productivity investments and (iii) promoting the debt restructuring of insolvent firms with solid growth perspectives.

Debt reduction could accelerate in the household sector as income starts recovering and older mortgages come to maturity. The elimination of the tax deductibility of mortgage payments as of the beginning of 2013 has greatly reduced the bias towards home-ownership. To address debt distress of residential mortgage debtors, the government has adopted measures to strengthen the protection of mortgage debtors, facilitate debt restructuring and tightened conditions to launch foreclosures. While these measures have proved helpful, an organic revision of the personal insolvency framework could provide legal stability, help the work out of distressed household debt and rebalance creditor/borrower relationships.

The medium-term resilience of the Spanish economy requires putting government debt on a declining path. Meeting the targets set out in the context of the Excessive Deficit Procedure (EDP) until 2016 and abiding by the provisions of the Stability and Growth Pact (SGP) thereafter is essential to reverse the rise in the government debt/GDP ratio. The fiscal adjustment would be more effective and less costly if based on structural fiscal measures. The government has already adopted a number of measures with a view to generating efficiency gains and budgetary savings. A careful follow-up of the implementation of the recent reforms of the public administration (including at the regional and local levels) would ensure the planned savings actually materialise. The stated aims of the forthcoming tax reform are to make the tax system more growth-friendly and tax revenues less volatile. As such, it can play an important stabilising role for public finances, for which the volatility of tax revenues has been a major challenge during the crisis. Moreover, positive growth surprises may offer the opportunity to accelerate the reduction in the headline budget deficit and consolidate the regained confidence of investors in Spanish assets.

The ongoing restructuring of the banking sector improves its capacity to finance economic growth. The financial assistance programme for the recapitalisation of financial institutions that ended in January 2014 has contributed to restoring banks' health and stemming concerns about financial stability. Despite the considerable progress achieved, the restructuring process in the savings banks will still take time to be completed and the system remains exposed to possible adverse international and domestic developments. Maintaining or increasing robust capital positions would boost further the resilience of Spanish banks and strengthen their lending capacity. The new rules on deferred tax assets and the continuation of prudent dividend policies, as recommended by the Bank of Spain in its supervisory role, would support the building-up of capital buffers.

The development of the rental segment contributes to the stabilisation of the housing market. Notwithstanding large specific provisions, the speed and nature of the adjustment in the housing market continues to be an important factor for banks' profitability going forward and for the success of Sareb, the asset management company created in the context of the recapitalisation of Spanish banks in 2012. In this respect, it is encouraging that there are first tentative signs of an approaching stabilisation, to which the recent reform of the regulation of the rental market seem to have contributed by increasing the attractiveness of this market segment also for specialised investors. A bigger offer of rental accommodation would also support geographical mobility.

Spain needs to find a path where the financing of valuable projects and further reduction in aggregate debt levels go hand in hand. Ideally, the deleveraging process should be concentrated in overstretched companies and households, while other borrowers should be able to finance ongoing and new productions at competitive rates. There is encouraging evidence that healthy Spanish firms with solid growth perspectives were able to increase their external finance even as aggregate credit was falling. Yet, credit access conditions for smaller borrowers, while improving, are still much tighter than in other Member States, partly due to persisting financial fragmentation. Efforts have been made to develop non-bank financial intermediation and alleviate credit shortages for SMEs caused by supply frictions. Considering the significance of SMEs in the Spanish productive system, additional measures could be envisaged. As difficulties in accessing credit for SMEs are traditionally linked to information asymmetries, measures to foster the availability and comparability of information for the assessment of creditworthiness of SMEs (e.g., via the use of standardised credit scores) could be explored.

Tackling unemployment

The macroeconomic adjustment process has weighed heavily on the labour market. Spain is not new to episodes of sharp employment destruction. However, the severity of the current economic downturn and its sectoral nature (with the sharp contraction of the construction sector), combined with structural weaknesses in the labour market caused an unprecedented fall in employment. The duality of the labour market, the lack of reactivity of wages to the economic context and mismatches between demand and supply increased the cost of adjustment. At present, large-scale reallocation of labour across sectors and companies still appear needed for both internal and external equilibrium, so as to provide the preconditions to absorb displaced workers from permanently downsized sectors and facilitate the shift towards a more export-led economic growth.

Even though the fall in employment appears to be coming to an end as the economy starts to recover and the impact of the labour market reforms to be felt, unemployment remains the most urgent policy challenge to address. The unemployment rate is down from the peak registered in 2012 but still very high at 26.4%. While this decline has been mostly due to a drop in the active population – driven by net migration outflows, ageing population and incipient discouragement effect, employment grew in the fourth quarter of 2013 for the first time since early 2008 and in spite of a still muted rate of output growth. Building on previous reforms in 2010 and 2011, a comprehensive labour market reform was passed into law in July 2012. The social partners' agreement for wages, employment and growth for 2012-2014 complemented the reform. The reforms have set the basis for a more flexible management of human resources at firm level and modified bargaining procedures, and likely even worse outcomes in terms of employment. Yet, the challenge of bringing down the high structural rate of unemployment is huge, as long-term unemployment is high, skill mismatches pervasive and geographical mobility low.

Containing unit labour costs, building on recent progress, remains important to close the gap between supply and demand of labour. The reforms and social partners' agreement have contributed to a reduction in real labour cost and to restoring cost competitiveness, although this process started late in the crisis. A positive shock to employment could come from a revenue-neutral tax shift from labour to consumption and/or other taxes, such as environmental taxes or recurrent property taxation. The short term impact would be stronger if the reduction was applied on labour employer social security contributions – due to sticky wage adjustment. Moreover, targeted reductions for groups most affected by unemployment or inactivity would likely have a stronger impact than a generalised cut in labour costs. Competitive product and services markets are required to ensure that the lower labour costs result in expanded investment and production and lower prices. A social security contribution cut for new additional and stable hires, as the government announced on 25 February to be planning, would go in the direction of cutting the cost of labour for companies (proportionally more for higher wage workers if implemented via a flat social security payment) and thus stimulating labour demand. The impact on cost competitiveness would likely be limited as the labour cost of existing employment is not affected. The details of the measure are however not available at the time of writing.

Effective activation policies could contain hysteresis effects from the large share of long-term unemployment. The 2013 Annual Employment Plan strengthened the incentives for a more effective use of ALMP funds by regions starting from 2014. The new active labour market policy approach will be complemented by the launch of the single job portal, planned to gather all central and regional government public employment services' information for jobseekers and employers and to be linked to the modernisation of employment services. Yet, there is scope for better working public (and private) employment services to improve individualised guidance and labour market intermediation, and reduce information costs, stimulating inter-regional mobility and skill adaptation. A Youth Guarantee Implementation Plan, to be implemented in the second half of 2014, complements on-going initiatives to combat youth unemployment. It includes actions targeting people below 25 years not in employment, education or in training (NEET). It is important that the rather complex institutional set up for these policies does not delay progress or undermine effectiveness in these critical areas.

In the long-run, skill mismatches can only be fully addressed by reforms in the education and training systems. The recently approved law on the quality of education aims, among other objectives, at improving the links between the labour market and the education system and at reducing the percentage of early leavers from education and training in Spain, currently among the highest in the EU28. Particularly important in this respect is the reform of the VET system (including the development of a dual vocational training system). Effective cooperation between regions and the central administration would enhance the effectiveness of the reform, while closer coordination between education and labour market policies could rationalise the supply of formal education vocational training programmes and work-based training, reducing information costs and supporting the up-skilling of youngsters.

Reducing duality in the labour market over time would support an efficient allocation of resources and productivity. Addressing duality is an area where the success of recent reforms is less clear relative to other objectives, although more reliable conclusions will be possible only when the economic recovery will be more firmly established. At the moment, new contracts are still dominated by fixed-term contracts and there has been a significant increase in part-time – part of which likely involuntary. While temporary contracts are useful in specific circumstances and facilitate the transition in and out of unemployment, they have negative effects on the acquisition of skills and on productivity. A less commonly highlighted sign of a dual market is that job-to-job mobility of workers with undetermined spell contracts tend to be relatively low. This could be related to dismissal protection being linked to tenure with current employers - a significant disincentive to mobility (in particular of skilled-workers, more likely to have indefinite contracts) in times of high economic uncertainty. Both elements, the negative impact on individual productivity of temporary workers and the lack of mobility of permanent workers, act as obstacles to an efficient use of human capital. Recent initiatives that the authorities expect to lower duality are the administrative simplification of contract templates (rendering information on contract categories more user-friendly) and measures to incentivise stable part-time employment. However, there could still be a need for more determined actions to close the gap in the relative attractiveness of indefinite and temporary contracts and review disincentives to mobility.

Increasing employment is crucial to buffer the social cost of the on-going macroeconomic adjustment process. Beyond efficiency, also equity considerations call for a rapid reabsorption of unemployment and a reduction in labour market duality in the medium term. The burden of the macroeconomic adjustment has weighted heavily on the household sector, and within the household sector, certain segments (young and low skilled) have suffered disproportionately from unemployment and/or in work poverty. The high poverty rate recorded amongst household in working age and in particular younger households are in sharp contrast with the decreasing poverty rates amongst the elderly population. Also child poverty rates are particularly elevated by international standards. The sizeable increase in total social expenditure during the crisis could not offset the impact of the crisis and of surging unemployment on social indicators.

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