1 OVERVIEW

1 Introduction

In 2012 the euro underwent a serious confidence crisis that affected the behaviour of the world economy

In 2012 there was an increase in the contractionary pressures that had first become discernible in the world economy in the second half of the previous year. Aggregate growth fell to 3.2% and the divergence between the emerging and developed economies remained in place, with the latter posting a rate of increase of only 1.3%. The decline in activity was singularly severe in the euro area, whose GDP fell by 0.5% (see Chart 1.1). The contraction affected most of its 17 economies, and in the remainder output slowed, by almost 2 pp in the case of the largest countries. The growth of world trade also fell significantly, while inflation eased in most countries.

Notable among the factors behind the loss of momentum in global activity was the worsening of tensions in the euro area which, after two years of instability, experienced the most serious confidence crisis since the creation of the single currency, to the extent that the irreversibility of Economic and Monetary Union was called into question.

At the source of the euro crisis were the lack of adaptation of domestic economic policies to the stability requirements of a monetary union…

At the source of the euro confidence crisis was the fact that in an increasingly extensive group of economies a series of imbalances were becoming manifest. Ultimately, this reflected a lack of adaptation in the management of their domestic economic policies to the standards of stability required in a monetary union. When the perimeter of the problems spread to encompass some of the larger economies, such as Italy and Spain, the crisis took on a systemic dimension which tended to exacerbate the scope of its potential consequences.

… and a series of weaknesses in the institutional design and governance of EMU

In any event, the nature and generalisation of the tensions highlighted significant weaknesses in the architecture and governance of EMU, which strongly constrained the European authorities' response capacity and called into question the soundness of the euro project. It was thus evident that the mechanisms for coordinating and overseeing economic, fiscal and supply-side policies had been clearly unable to prevent and, in the circumstances, redress imbalances capable of endangering the sound functioning of the area. And it was likewise clear that the institutional framework was lacking the mechanisms needed to manage a crisis situation as deep-seated as that which ultimately took shape.

To overcome the situation, far-reaching decisions have been adopted in both the national economies and in the euro area as a whole

To respond to the challenges of this serious crisis situation, major decisions have been taken in two domains. Regarding domestic economic policy management, greater impetus and depth have been given to fiscal consolidation and to financial and structural reform aimed at correcting imbalances and making the economies more flexible, most particularly in countries where tensions have tended to concentrate to a greater extent. The European authorities have likewise set in train a review and reform of the institutional design and governance of the euro area, following the roadmap defined in the "Four Presidents' Report".

The response – despite its partial and in many cases hesitant nature – both at the European level, including in particular the ECB's announcement of its Outright Monetary Transactions (OMT) programme, and in the member countries allowed the most acute episodes of tension to be overcome, paving the way for the strengthening of the project and for ensuring its viability. However, as the events associated with the outcome of the Italian general elections and with the difficulties in agreeing on a financial assistance programme

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

CHART 1.1

SOURCES: Eurostat and national statistics.

for Cyprus show, sizable challenges remain. The nature and scope of the euro crisis, and the steps taken to overcome it, have decisively influenced the behaviour of the Spanish economy in 2012 and are a leading conditioning factor of the challenges it faces. Accordingly, Chapter 2 of this Report is dedicated exclusively to analysing in depth the various facets of this crisis.

The Spanish economy faced the rising tensions in the euro area from a position of great vulnerability, as a result of the depth of its imbalances…

The Spanish economy faced the euro confidence crisis from a vulnerable position. The severity of the great recession of 2009-2010 had had far-reaching repercussions in terms of a sharp contraction in household and business spending and a forceful increase in unemployment, which accelerated the deterioration in public finances and eroded the balance sheets of the banks most exposed to the real estate excesses of the expansionary phase.

The depth of the imbalances that had emerged and the need to correct them prevented the Spanish economy from joining in the pick-up in the world economy in the two years spanning 2010 and 2011. The persistence of the underlying problems and the difficulties the necessary adjustment processes faced confined this reaction to very modest growth in the second half of 2010 and early 2011, which was lacking the underpinnings needed to take root.

… and in which the economic policy action taken had not sufficed to dispel uncertainty

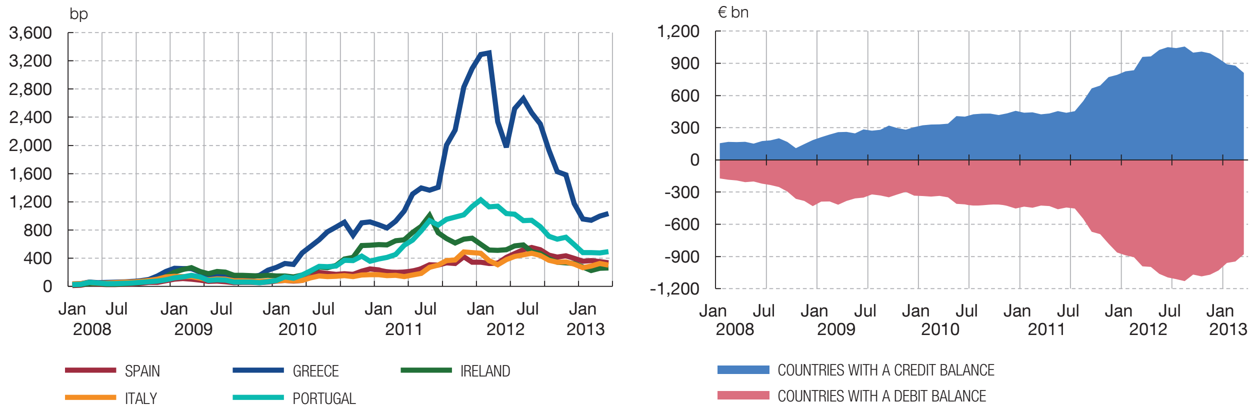
The economic policy action taken from the time the sovereign debt crisis began had not been sufficient to counter the doubts over the soundness of the Spanish banking system, the sustainability of public finances and the capacity to restore growth and absorb the high unemployment that had built up during the first recession. In 2012, market doubts heightened as it

SPREAD OVER GERMANY OF THE 10-YEAR GOVERNMENT BOND YIELD
AND AGGREGATED TARGET2 BALANCE OF THE NATIONAL CENTRAL BANKS IN THE EUROSYSTEM

CHART 1.2

SPREAD OVER GERMANY OF THE 10-YEAR GOVERNMENT BOND YIELD

AGGREGATED TARGET2 BALANCE OF THE NATIONAL CENTRAL BANKS IN THE EUROSYSTEM (a)



SOURCES: ECB and national central banks.

a Estimated from statistics published by national central banks. The difference between the credit and debit balance of the aggregate of all the countries reflects the ECB position.

emerged that the public finances figures for the previous year involved slippage in the general government deficit of more than 2 pp the from the objective of 6.3% set under the Excessive Deficit Protocol (EDP), while the Bankia crisis revealed the persistence of fragilities in the Spanish banking system. And this against a highly adverse macroeconomic background in which the absence of growth meant that headway in fiscal consolidation and the restructuring of the private sector was considerably more complicated.

The euro credibility crisis severely impacted the Spanish economy and gave rise to a serious external funding crisis

The emergence of redenomination risk within the euro area in the summer months, strongly linked to growing speculation about the possibility of a Greek exit from the Monetary Union, increased financial instability in the more vulnerable economies (see Chart 1.2). In Spain the perception of the dangers inherent in a growing feedback loop between sovereign risk and banking risk worsened, sovereign debt yields reached their highest levels since the creation of the euro area (7.5% on the 10-year bond at end-July) and there was a notable acceleration in net capital outflows, rising from already-high figures in the second half of 2011. The confidence crisis scourging the Spanish economy in this period ultimately became a severe balance of payments funding crisis, the first since joining the euro area (see Chart 1.3). This was an unprecedented event, laden with unknowns and challenges, that required a pressing and extraordinary response that would help restore credibility to the Spanish economy within the broader framework of action pursued by the European authorities to redress the complex problems underlying the euro crisis and to curb the risks of redenomination.

Generous liquidity provision by the ECB helped ease the effects of the external funding constraint

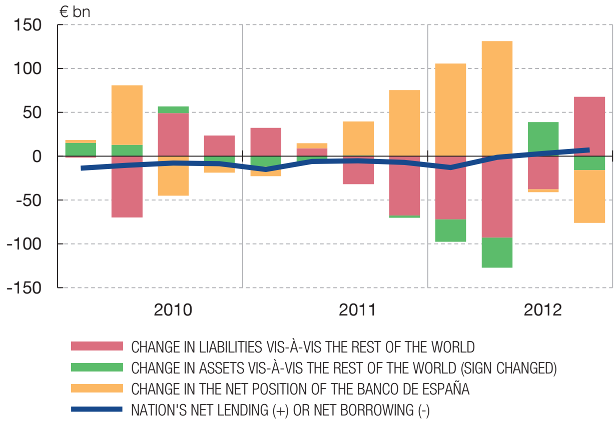
The generous liquidity provision policy pursued by the ECB since the onset of the crisis and some of the unconventional measures it adopted in response to the worsening situation helped compensate for the lack of external funds and circumvent the possibility of the financing of domestic spending being choked off. More specifically, credit institutions substantially increased their recourse to the Eurosystem, making use in particular of the opportunity provided by the two exceptional three-year liquidity tenders held in late 2011 and early 2012.[1]

1 These long-term refinancing operations (LTROs) thus complemented the policy to lengthen maturities (six months, one year and, now, three years) and to increase the amount injected through this means that the ECB has been implementing since the start of the crisis.

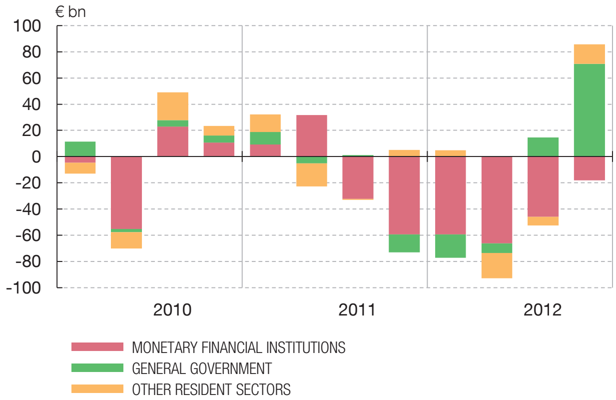
BALANCE OF PAYMENTS FINANCIAL ACCOUNT

CHART 1.3

NET TRANSACTIONS



NET CHANGE IN LIABILITIES, BY SECTOR (a)



SOURCE: Banco de España.

a Excluding the Banco de España.

This easing benefited also from a fresh bout of tensions being overcome in Greece, from the announcement of the OMT and from the design of a roadmap for the reform of the euro area and its governance

The easing in tensions also benefited from the fact that a fresh rise in the perception of a risk of reversal associated with the vicissitudes of the Greek economy was overcome. Moreover, the ECB stepped up its unconventional measures aimed at restoring the monetary policy transmission mechanism, following the further deterioration in this mechanism prompted by the emergence of the risk of reversibility of the euro. In August it announced a programme of conditional purchases on the sovereign debt markets, which provided strong protection against such redenomination risk. In parallel, the June European summit discussed the key elements for a reform of the euro area and its governance, a process which received additional impetus following the decisions adopted in December on moving towards a European banking union, which should help loosen the link between sovereign and banking risks in the area.

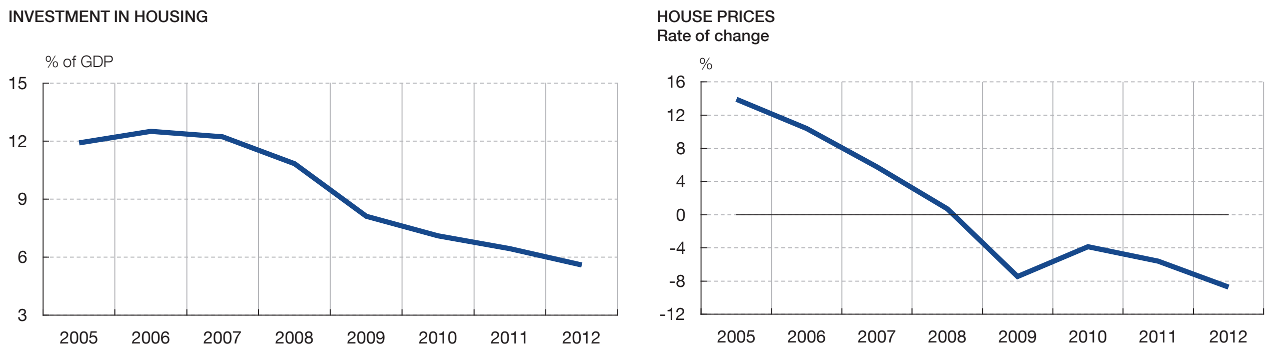
In Spain, economic policy measures in the financial, fiscal and structural areas were stepped up

Substantial steps were taken in Spain to speed through the clean-up, restructuring and recapitalisation of vulnerable Spanish banks. These included a financial aid programme for bank recapitalisation, which was requested by the Spanish government and agreed with the European institutions in July. There was also significant progress on public finances, following the approval of the Organic Law on Budgetary Stability and Financial Sustainability, which substantially strengthened the budgetary discipline framework by setting balanced-budget objectives for all levels of general government, caps on public debt, and requirements on transparency and the correction of slippage. In addition, the need to tackle the correction of a swollen deficit called for the adoption of various adjustment packages. These complemented the measures included in the State budget for 2012, including most notably the health and education reforms in April, the revision of the regional government re-balancing plans in May and the application of the extensive package of measures in July, which included an increase in indirect tax, a cut in public-sector wages and the elimination of house-purchase tax relief as from 2013.

July also saw the entry into force of the Law on Urgent Labour Market Reform Measures, which broadened the possibilities for the decentralisation of collective bargaining, increased internal flexibility at firms and rationalised the conditions for the determination of permanent contracts. Lastly, various measures were adopted during 2012 aimed at

INVESTMENT IN HOUSING AND HOUSE PRICES

CHART 1.4



SOURCES: INE and Ministerio de Fomento.

liberalising certain sectors and promoting competitiveness, and a Plan for the Payment of Suppliers was introduced which contributed to easing corporate sector liquidity constraints.

This response managed to halt the negative spiral in the summer, although uncertainty remains very high

In combination, this broad set of measures managed to halt the negative spiral in the summer. The easing of financial tensions surrounding the euro and the advance of reforms helped reduce the pressures on the cost of Spanish public debt, and external funding markets reopened. Both processes have continued in 2013 to date, although the situation has not normalised in full, meaning that domestic interest rates do not yet fully reflect the expansionary stance of the single monetary policy. Credit, meantime, continues to contract.

2 The double-dip recession in the Spanish economy

The Spanish economy went into a second recession…

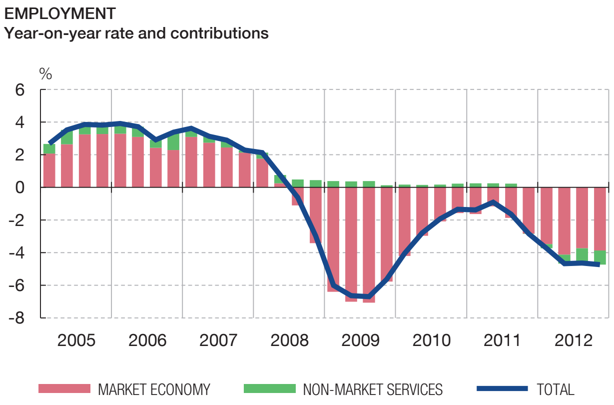
Against this enormously complex background, the Spanish economy went in late 2011 into a second recession, one less acute but more protracted than the first (between the second half of 2008 and late 2009). This double-dip in output, which spans the entire period under analysis in this Report, is unprecedented and poses major challenges. GDP shrank by 1.4% over the year on average, after its rate of decline had stepped up in the final quarter, when a series of temporary factors – linked chiefly to the greater budgetary consolidation drive undertaken in these months – combined with other more persistent ones. In this respect, the adverse funding conditions and the downturn in confidence exacerbated the fall-off in domestic demand, which dropped 3.9%, owing to the continuing real estate correction, the adjustment in private-sector balance sheets and the impact of fiscal consolidation. All these factors, present since the start of the crisis, bore down on private-sector demand, whose determinants were in a position of great fragility. Net external demand continued to be the only underpinning of activity, contributing 2.5 pp to output, although the weakening in the euro area during the year limited this cushioning effect, especially in the final months.

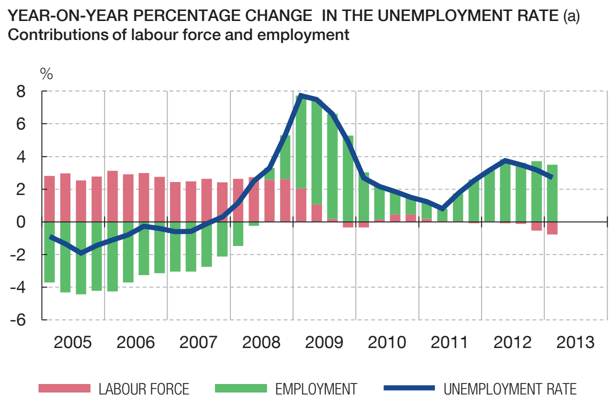
… as a result of a generalised and sharp decline in all domestic demand components

The decline in domestic demand affected all its components: consumption and investment, in public and private sector alike. The climate of uncertainty, the difficult financial conditions, the bleaker outlook for the labour market, the decline in disposable income and the fall in financial and non-financial wealth reduced household spending, in terms both of consumption and residential investment. Only the saving ratio, which fell once more to 8.2% of disposable income, less than half its level in 2009, helped soften to some extent the pattern of adjustment of household consumption. However, the abrupt decline in the saving ratio since the start of the crisis reflects the difficulties of household spending being sustained in the immediate future, in a setting in which the still-high level of household debt must continue to fall. Residential investment remained restricted by the

EMPLOYMENT AND UNEMPLOYMENT

CHART 1.5





SOURCES: INE and Banco de España.

a The EPA (Spanish Labour Force Survey) series are linked on the basis of the 2005 Q1 control survey.

depth of the correction of past real estate excesses and fell for the fifth year running, against the backdrop of weak housing demand, the continuing decline in real estate prices and the persistently high stock of unsold housing, which set back the start of new construction (see Chart 1.4). Business investment was likewise affected by an adverse financial environment and by a relatively unfavourable outlook for domestic and external demand.

The considerable effort made to respond to fiscal consolidation requirements exerted an inevitable contractionary impact on spending and activity. The fall in government consumption reflected the decline in purchases and in public-sector employment, for the first time since the crisis began, in response to the application of the regional government financial re-balancing plans, adding to the adjustment previously begun by central government. The collapse in public investment (38% for the year on average) was impacted by civil engineering work grinding to a halt, which affected the projects jointly undertaken with non-financial corporations. Under the restrictive fiscal policy stance in 2012, mention should however be made of the counter-effect of other measures (mainly the Payments to Suppliers Plan which, conceived to settle outstanding local and regional government payables to firms and sole proprietors, entailed the injection of €27 billion mid-year).

Activity and employment reacted forcefully to the contraction in spending

On the supply side, the figures for all the productive sectors worsened in relation to 2011, except for agriculture. The increases in value added in industry and in market services of the past two years turned negative in 2012, while the contraction in construction increased, owing to the marked decline in the non-residential segment. Employment fell by 4.4%, partly as a result of the above-mentioned decline in public procurement. But employment in the remaining productive sectors also fared very unfavourably (with a decline of 4.9% for the year on average), a figure much influenced in any event by the poor performance in late 2011 and early 2012. The unemployment rate rose sharply to 26% of the labour force in 2012 Q4, in a slightly contractionary demographic setting (27.2% in 2013 Q1). Indeed, in 2012 the labour force fell for the first time since the start of the crisis, as a result of the decline in the working-age population, caused in turn by the fall-off in the foreign population (see Chart 1.5).

The unfavourable performance of employment is having very adverse repercussions on structural unemployment, it amplifies the contractionary trend of expenditure and it hampers the attainment of speedier headway in the correction of certain imbalances, such as the fiscal maladjustment and private-sector indebtedness. However, the persistence of the recessionary environment is, along with the reforms undertaken, giving impetus to the adjustment of costs and, to a lesser extent, of prices, bringing about the necessary internal devaluation and the elimination of the external deficit. The results obtained on both fronts, whose significance and scope are analysed in depth elsewhere in this Report, have been better than expected and evidence the progress in the adjustments of the economy, though these are still incomplete.

Labour costs eased further…

The pattern of containment of labour costs begun two years earlier made further inroads. Economy-wide compensation per employee fell by 0.3%, after having increased at rates of 0.3% and 0.7% in 2010 and 2011, respectively. The fall in public-sector wages, owing to the elimination of the extra December payment, also played a key role here, although remuneration in the market economy likewise moved on a moderating course, posting a rate of increase of 0.6%. The progressive containment of wage settlements in new collective bargaining agreements, in which the weight of past inflation has been substantially lessened as has too the percentage of agreements with an inflation indexation clause, reflects the incipient impact of the labour market reforms on collective bargaining dynamics (see Box 1.1). Unit labour costs declined for the third year running, as a result also of the increase in productivity, prompting a further correction of the differentials with the euro area. It is crucial for this trajectory to firm if employment is to begin to be generated.

… but inflation quickened in the second half of the year owing to the impact of the rise in indirect tax and in administered prices

Inflation showed greater volatility during the year owing to the impact of the rises in energy prices and of the hike in VAT and in administered prices, which prompted an acceleration in the inflation rate in the second half of the year, taking the end-year annual rate to 2.9%. It is estimated that the impact of the rise in VAT from 1 September was only partly reflected in final prices, which is consistent with the ongoing extreme weakness of spending. Yet underlying inflation adjusted for these effects remained at relatively moderate levels. In April this year, the year-on-year rate of CPI inflation was 1.4%, and that of the CPI excluding unprocessed food and energy was 1.9%, with both rates still being affected by the aforementioned temporary factors. As these effects are progressively erased, inflation should resume a more moderate path, as should the inflation gap with the euro area (see Chart 1.6).

The external deficit narrowed substantially in 2012

In turn, the decline in the nation's net borrowing intensified in 2012, finally standing at 0.2% of GDP for the year as a whole (3.2% in 2011), following a second half of the year in which net lending capacity was generated for the first time since 1995. From the standpoint of the institutional sectors, this improvement was due exclusively to the surplus of non-financial corporations' saving over investment, which increased their financing to 3.5% of GDP (compared with a deficit of 10.7% of GDP in 2007). By contrast, the declining trajectory of households' net borrowing continued for another year and general government net borrowing increased, ending the year with a deficit of 10.6% of GDP. However, the budget deficit narrowed to 7% of GDP once the impact of the financial aid was stripped out.

Despite the sharp reduction in the nation's net borrowing, the demand for funds to roll over maturities on the burgeoning external debt was most substantial and difficult to meet on the markets. In 2012 as a whole, net outflows accounted for 17% of GDP, which made recourse by the banking system to Eurosystem liquidity vital, as earlier indicated. This trajectory reversed as from September last year.

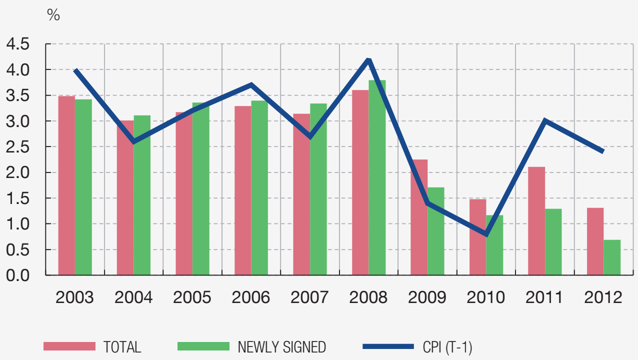
One of the most important characteristics of the economic expansion experienced by the Spanish economy before the current crisis was the gradual loss of competitiveness, as measured, for example, by the growth of unit labour costs relative to the average for the euro area countries (see Panel 4). During the crisis, however, this imbalance has been partially corrected, which means that a significant part of the cost competitiveness losses accumulated since 1998 have been reversed. The gap, however, remains considerable in relation to the most competitive euro area countries, reaching 18 pp in 2012 in the case of costs relative to Germany.

Most of the correction of accumulated competitiveness losses has been based on the increase in productivity arising from the intensity of labour shedding. Indeed, at the start of the crisis the rate of growth of compensation per employee continued to exceed the average euro area rate, and in 2012, after two years of wage moderation, it was still only three points below the relative level observed in 2008. Against this background, it is essential that the contribution of wage restraint to the fall in unit labour costs should be stepped up to ensure a sustainable recovery in the Spanish economy.

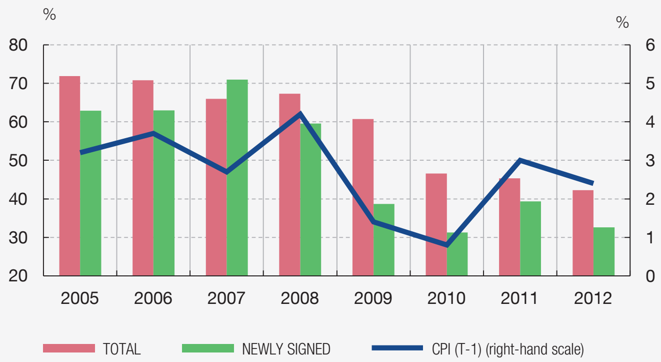
The various labour-market reforms adopted in recent years have sought to make the wage-determination process more flexible. In particular, firms have been afforded greater opportunities to adapt their wage and non-wage conditions to changes in the economic environment or in their own particular conditions, so as to reduce the need to adjust employment in response to adverse shocks. The functioning of the labour market in recent months is analysed below, to see to what extent changes can be detected in wage and employment behaviour during the double-dip recession in the Spanish economy. However, it is still too soon to make a definitive diagnosis of the effectiveness of the different reforms, and in particular to distinguish the effect of cyclical factors on the evolution of the labour market from effects arising from legislative changes.

With regard to wage developments, although a certain delay has built up in the collective bargaining conducted in 2012 and in the first few months of 2013, which may limit the representativeness of the available data, there would appear to be signs of greater wage moderation, with increases in compensation per employee

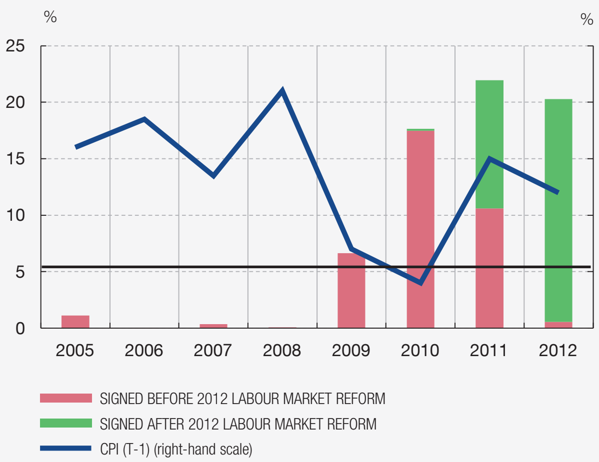
1 WAGE SETTLEMENTS



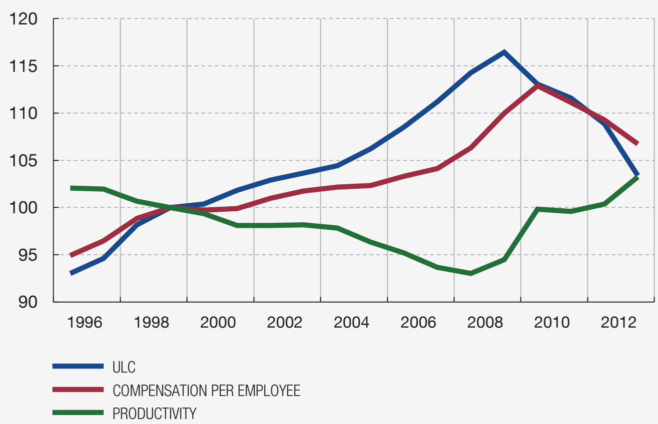
2 PERCENTAGE OF WORKERS WITH WAGE INDEXATION CLAUSES



3 PERCENTAGE OF NEWLY SIGNED AGREEMENTS WITH WAGE FREEZE OR REDUCTION



4 UNIT LABOUR COSTS RELATIVE TO THE EURO AREA
1998 = 100



SOURCES: Ministerio de Empleo y Seguridad Social and Eurostat.

of practically zero in the private sector in the last three quarters and less nominal inertia in collective bargaining. In fact, wage settlements fell to 1.3% in December 2012, from 2.5% a year earlier, while the data available for 2013, albeit still very unrepresentative, show a reduction in the average wage settlement to 0.6%. Analysing the data for 2012 in greater detail, the wage moderation was observed both in revised agreements and in newly signed ones, but especially in the latter kind, in which the wage settlement stood at 0.7% in December 2012. This wage settlement is close to the recommendations agreed by the social agents at the beginning of the year (0.5%) and is well below the rate of inflation. Also, in these new agreements, a certain increase in wage dispersion[1] can be seen, as well as a higher proportion of agreements with nominal wage reductions or freezes, despite the rise in inflation at the end of 2012 (see Panel 3). In relation to 2013, the information for the period to April shows very low wage settlements in newly signed agreements (0.2%), which would indicate further wage moderation in this year's collective bargaining, although these agreements still only affect a small group of workers (383,000).

1 Measured by the coefficient of variation of wage settlements in newly signed agreements.

At the same time, a gradual decline is observed in the extent of wage indexation, as measured by the percentage of workers covered by indexation clauses. This percentage, which has traditionally stood between 60% and 70%, fell to 45% in 2012. The reduction was more pronounced in the case of newly signed agreements, the percentage of those with indexation clauses falling to 33%. Among these newly signed agreements, it can be seen that around 75% of them observe, at least partially, the recommendations of the Employment and Collective Bargaining Agreement (AENC) signed by the social agents at the beginning of the year. In particular, an analysis of newly signed agreements since the beginning of 2012 shows that around half only provide for activation of indexation clauses from 2%, while around 25% use European instead of Spanish inflation as their nominal reference, which further reduces the indexation of wage increases. According to the first available data, these developments have translated into a considerably lower impact of indexation clauses in 2012 (0.25 pp), when, given the rise in inflation at end-2012 (2.9%), an impact of close to 1 pp would have been expected if the behaviour of previous years had remained unchanged. All in all, wage developments are beginning to reflect a greater response to the specific situation of firms and sectors of activity, in line with the objective pursued by the labour reform. However no significant changes are observed in the structure of bargaining, the relative weight of firm-level

EMPLOYMENT AND UNEMPLOYMENT OUTFLOWS, IN DIFFERENT PHASES OF THE CRISIS (a)

	2008 Q2 - 2010 Q1	2010 Q2 - 2011 Q1	2011 Q2 - 2012 Q1	2012 Q2 - 2012 Q4
Employment outflows (% employment in t - 1)				
Total	7.8	7.4	7.8	7.8
Market	8.5	8.0	8.4	8.4
Non-market	4.3	4.7	5.3	5.1
Employment outflows by type of contract (% employment in t - 1)				
Permanent	1.8	1.5	1.7	1.9
Temporary	12.8	14.5	15.8	17.1
Employment outflows by type of contract and sector (% employment in t - 1)				
Permanent-market	2.1	1.9	2.1	2.3
Temporary-market	14.1	15.8	17.1	18.6
Permanent-non-market	0.2	0.2	0.2	0.3
Temporary-non-market	7.1	9.4	10.6	11.3
Unemployment outflows (% unemployment in t - 1)				
Total	39.7	32.7	30.4	28.7
To employment	23.0	18.4	16.8	15.7
To temporary employment	18.2	15.0	13.7	12.8
To permanent employment	1.7	1.3	1.3	1.2

SOURCE: INE (EPA).

a Average for each period of quarterly rates of employment and unemployment outflows calculated drawing on EPA flows.

agreements being very similar to that observed previously. Also, the information to assess the effectiveness of the set of measures adopted to facilitate opt-outs from sectoral agreements and to modify the labour conditions agreed in collective agreements is still very limited.

By contrast, in the employment sphere no changes are observed in recent patterns of employment creation and destruction. In particular, outflows from employment (see adjoining table) have remained at very high levels and are characterised by significant numbers of temporary employees, both in the public and in the private sector. As regards workers' characteristics, outflows remained higher for foreign employees, partly owing to the greater intensity of job losses that continued to be seen in the construction sector. With regard to employment creation, the downward trend in the rate of outflow from unemployment has been maintained. In this respect, it might be thought that more time is needed to begin to detect changes in the labour market adjustment dynamics, since the different changes introduced, in relation to both collective and individual dismissals, and their interaction with the wage bargaining process should lead to a more balanced division of adjustment between temporary and permanent workers, reducing the high degree of duality that characterises the Spanish labour market. The information available is still very preliminary, although it suggests that changes in the definition of dismissal on economic grounds would have permitted around 40% of the individual dismissals to be carried out on these grounds (as against 10%-15% in the first phase of the crisis), while the data on the composition of collective dismissals show that most of them are not redundancies, but reductions in hours worked (22%) and temporary lay-offs (61%).

In short, in recent quarters a pattern of wage moderation has been observed, the continuation of which is vital to accelerate the reversal of competitiveness losses in the Spanish economy and, thereby, establish the foundations for higher economic growth in future, permitting a lasting reduction in the rate of unemployment.

The double-dip recession reached its nadir in the transition from 2012 to 2013, and this episode may be expected to be gradually overcome during the present year. The prospect of a recovery taking root depends on the external setting and on progress in the adjustments under way in the Spanish economy, which are pivotal to confidence being restored and external funding being maintained.

3 Progress in adjustment processes

The economy is in the midst of an adjustment process under very strict financial conditions, in which supply-side and structural reform policies must play a key role in restoring confidence and boosting growth

The Spanish economy is immersed in a far-reaching adjustment process under highly adverse circumstances. Financial conditions remain very strict despite the receding of tensions in the euro area, and there is no significant leeway to resort to demand-stimulating macroeconomic policies other than that potentially stemming from the normalisation of the monetary policy transmission mechanism, which at present is still impaired. It will fall on supply-side and structural reform policies to play a decisive role in restoring domestic and external confidence and in boosting medium and long-term growth, helping ease the short-term effects of the adjustment process.

The sustainability of the recovery will depend on the pace and scope of the adjustments pending

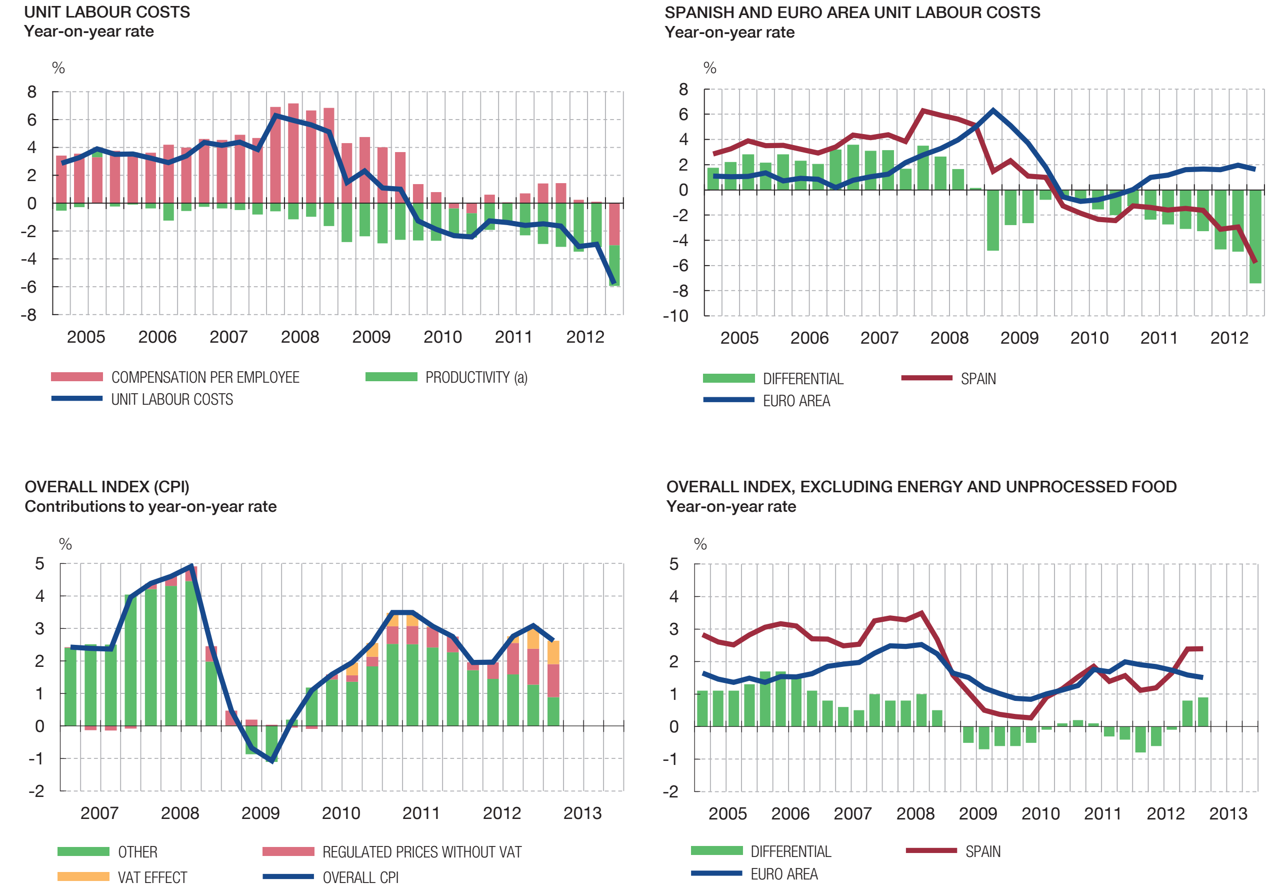
The pace and scope of adjustments will be the chief determinants of the strength and sustainability of the recovery. Assessing these processes is the most important aspect of the analysis of current economic conditions and of the outlook for growth. There follows a selective analysis of these adjustments, successively addressing external re-balancing, budgetary consolidation, private-sector deleveraging and, lastly, the restructuring of the banking system.

3.1 RESTORING COMPETITIVENESS AND EXTERNAL RE-BALANCING

The loss of competitiveness, the swollen external imbalance (driven, in part, by the pressure of domestic spending) and high dependence on external saving were key ingredients in the deterioration in the Spanish economy once the international financial crisis, the great recession and the sovereign debt crisis changed investors' attitude to risk and prompted

LABOUR COSTS AND INFLATION

CHART 1.6



SOURCES: Eurostat and Banco de España.

a Year-on-year rates with sign changed.

Improved competitiveness and the correction of the external imbalance are central objectives of economic policy

a major redeployment of cross-border financing. In these conditions, improved competitiveness and the correction of the external imbalance have become fundamental requirements for recovery in the Spanish economy.

Headway in competitiveness will make the external sector the engine of growth and will help in the difficult task of attaining a lasting improvement in the external accounts

Achieving substantial improvements in competitiveness is vital for ensuring that the external sector can continue to cushion the impact of domestic demand, which will be subject, for some time, to the effects of private-sector deleveraging and of budgetary consolidation. Looking ahead to the medium term, a more export-oriented productive model in which the weight of tradeable activities is greater will promote a more balanced allocation of productive resources and this, in turn, will be conducive to less import dependence. In addition, to resolve the problem of excessive external debt, it is vital to sustainably redress the balance of payments situation.

Restoring competitiveness within the euro area requires adjustments, in comparative terms, of wages, productivity and margins

Within the euro area, and without the possibility of using the exchange rate as an economic policy instrument, the only means of restoring competitiveness and reabsorbing the misalignments of relative prices to countries belonging to the euro area is by means of an adjustment of costs and prices, along with productivity gains, derived from more efficient economic functioning.

The price-competitiveness indices show improvements,

In Spain, the losses in competitiveness were most sizable during the first decade of euro area membership, against a background in which the characteristics of product more markedly so in terms of unit labour costs

and factor markets prevented the adjustment channel of relative prices and costs from operating properly. This lack of response by nominal variables to cyclical requirements continued during the initial years following the international financial crisis, contributing to deepening the job destruction process. That meant that the incipient improvements in the competitiveness indices resided solely on the productivity gains generated by such job reduction. Subsequently, wages moved onto a path of moderation, which became steeper in 2012, while productivity continued to increase over these years, in tandem with the prolongation of the negative labour market trajectory. Margins, for their part, have followed a countercyclical path, partly owing to the aim of companies to restore health to their balance sheets and be better placed to withstand the difficult financial situation, although increases in margins also reflect the persistence of a lack of competition in certain sectors.

Overall, the various indices approximating developments in price-competitiveness encompass improvements of differing degrees of intensity, which are more pronounced when unit labour costs (ULCs) are used. For the market economy as a whole, ULCs have shown a 7 pp decline since 2009 Q3 (when they began their declining course), which entails a correction of two-thirds of the difference with the euro area that had built up since the start of EMU. In turn, the correction of the difference in terms of ULCs for the whole economy was already completed in 2012, although behaviour in this latter year was much influenced by the decline in public-sector wages.

The reduction of the external deficit quickened in 2012, to the point of its virtual elimination

The correction of the external deficit that began mutedly in 2007 was much more forceful in 2012, with the balance of this item standing at -0.2% of GDP. The projections available suggest that the surplus on the balance of payments in the final stretch of last year will firm, and that this trajectory will run into 2014.

Since 2007, only investment income and the energy bill have checked the improvement in lending capacity

A component-by-component analysis shows that the reduction in borrowing requirements since 2007 (of 9 pp of GDP) has been chiefly based on the improvement in the trade balance of non-energy goods, the deficit on which has been cut by 6.5 pp to turn into a surplus in 2012. Foreign trade in services has contributed in the same direction, albeit for a lesser amount (1.5 pp), owing to the change of sign in the balance of non-tourist services and to the maintenance of a surplus on tourist services corresponding to pre-crisis levels, albeit with some oscillations over the course of these years. Conversely, the considerable weight accounted for by the energy deficit and the income deficit act as a brake on the room available for lending capacity to improve.

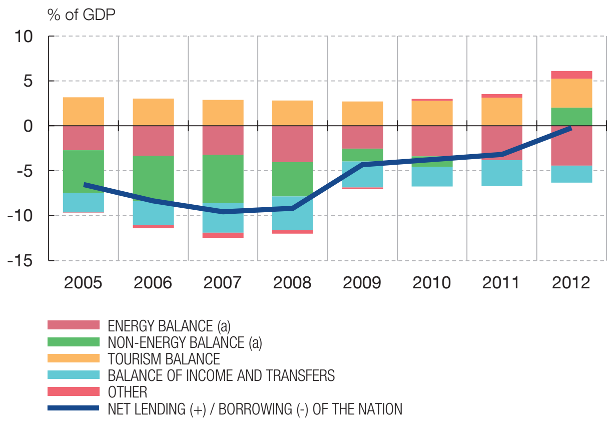
The reduction in net borrowing in 2012 followed a similar pattern to that described for the period as a whole, except as regarded the investment income deficit, which fell as a result of lower interest rates and the change in the composition of the International Investment Position (IIP), both of which factors are essentially temporary in nature (see Chart 1.7).

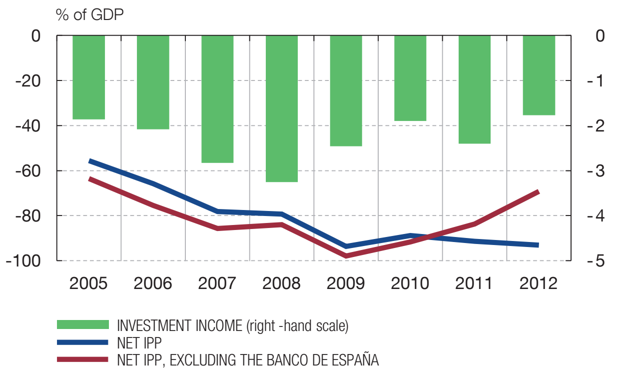
The external sector adjustment has been underpinned by the weakness of domestic spending but also by the gains in competitiveness

From the standpoint of the relative contribution of exports and imports to the improved foreign trade balance, somewhat more than two-thirds of this reflects the increase in exports (with an increase in the intensive margin but also in the export base), and the remainder the fall in imports, chiefly as a result of weak demand. This development, combined with the information provided by indicators of the more or less structural nature of the adjustment, indicates that cyclical factors have played a key role in this adjustment, although the weight of the gains in competitiveness is acquiring increasing significance in the correction of the external imbalance.

NET BORROWING OF THE ECONOMY AND INTERNATIONAL INVESTMENT POSITION

CHART 1.7





SOURCES: INE, Customs and Banco de España.

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

The increase in net external debt has been halted, but its reduction in a phase of higher growth must be ensured

The reduction in the external deficit has provided for a halt in the expansionary dynamic of the external liabilities position, which peaked at almost 94% of GDP in 2009, one of the highest in the euro area. However, in 2012 the IIP was still at over 90% of GDP. The foreign trade balance, once the income deficit was stripped out, posted a surplus of around 1.6% of GDP, placing the Spanish economy in a sound position to begin to correct the debit balance. Nonetheless, given the foreseeable course of the energy and income sub-balances in the short run, and the fact that their deficit may only be corrected gradually, it is vital to continue generating gains in competitiveness that boost net goods and services exports and increase the primary balance of payments.

In sum, despite the sharp correction in the external imbalance, the sector shows a series of fragilities that must be overcome to ensure that the surplus and the reduction in the international debit position can be maintained in a higher growth phase.

3.2 FISCAL CONSOLIDATION

Budgetary consolidation progressed in 2012, in a process that is proving costly…

The fiscal consolidation process that had begun in 2010 continued in the Spanish economy in 2012. General government borrowing amounted to 10.6% of GDP, though it should be borne in mind that this figure includes the impact arising from the aid granted to financial institutions, which increased public spending through the capital transfers item, by 3.6% of GDP. If this effect is stripped out, the general government deficit fell from 2009 by 4.2 pp to 7%, while the public debt ratio climbed by 50 pp, from its 2007 minimum to 84.2% of GDP in 2012 (a rise of 30.3 pp since 2009) (see Chart 1.8).

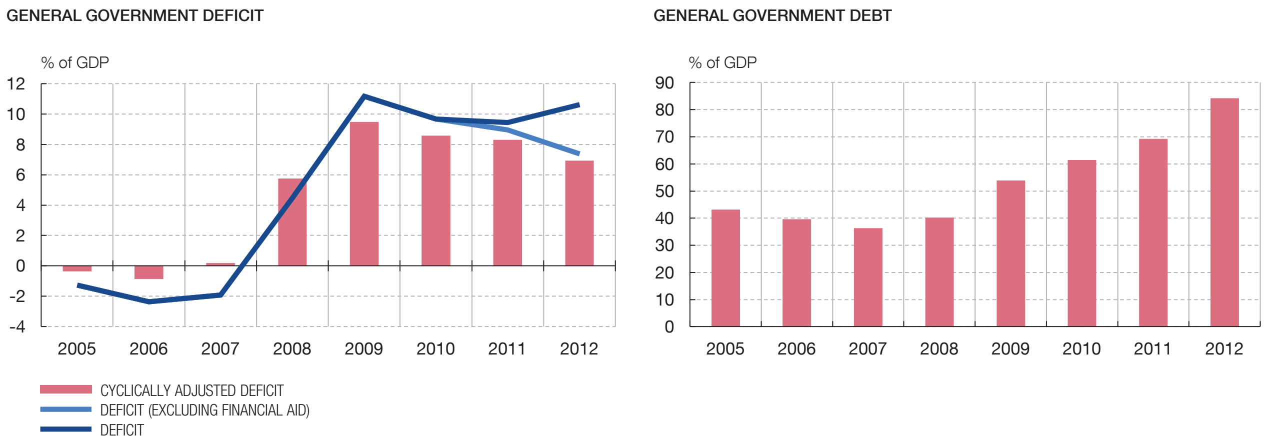
Reducing the budget deficit is proving costly, as shown by the fact that the major measures adopted, both in terms of the range of budgetary items affected and of the scale of the adjustments implemented, have translated into limited advances, with a still-high deficit figure (see Box 1.2). The reduction since 2009 in the primary structural deficit, totalling 6.5 pp when the financial aid is not included, illustrates most clearly the magnitude of the fiscal effort made.

… as a result of the growing weight of the interest burden, adverse cyclical conditions and the characteristics of the process of adjustment in the economy

Among the difficulties the budgetary consolidation is facing, mention should first be made of the growing weight of the interest burden, which has doubled as a percentage of GDP (up to 3% in 2012). Secondly, the fact that this process is unfolding under highly adverse economic conditions entails an acceleration in the spending items most linked to the business cycle (essentially unemployment benefits) and a reduction in

GENERAL GOVERNMENT DEFICIT AND DEBT

CHART 1.8



SOURCES: IGAE and Banco de España.

revenue-raising capacity. And it is along these same lines that the characteristics of the process of adjustment in the Spanish economy are acting; as indicated, the external sector is proving to be the only source of improvement in activity, which limits the expansion potential of tax receipts.

The adjustment has been greater on the expenditure than on the revenue side, albeit with a sizeable bias towards capital spending

Fiscal consolidation has to date been concentrated to a greater extent on the side of public spending than on that of revenue, with a very high weight of the adjustment in capital spending (in particular in public investment and, to a lesser extent, in employee compensation, which stood in 2012 at 40% and 90%, respectively, of their 2009 levels). In the case of tax, there were across-the-board increases under all headings, albeit with a bias towards indirect as opposed to direct taxation.

In terms of agents, the reduction in the general government deficit was the outcome of the drive to contain the various sub-agents, except the Social Security system

The adjustment drive was initially concentrated on central government, and in particular in 2012 this extended to regional and local government, which significantly reduced their imbalances that year following the doubts raised about their adjustment capacity in the previous years. Conversely, there has been a gradual deterioration in the Social Security balance, which went into deficit in 2012 (-1% of GDP, or -3.2% net of transfers received mainly from the State), as a result of the combination of the upward dynamics in pension spending – determined essentially by demographic trends – and the impact of adverse labour market developments on social security contributions and unemployment benefits.

The new Law on Budgetary Stability and Financial Sustainability was applied for the first time in 2012

The new Law on Budgetary Stability and Financial Sustainability contributed in its first year to reinforcing transparency in respect of the information on regional governments' budget outturns, which should facilitate the application of the law's preventive arm. The latter includes procedures to correct marked budgetary slippage, which have not been applied yet.

Regional governments' difficulties in obtaining funding on the markets and the delays in payments to suppliers have been addressed by setting in place various central government-intermediated financial support funds for regional and local government (the Regional Government Liquidity Fund and the Plan for Payments to Suppliers), whose use entails complying with the agreed adjustment plans. The balanced implementation of the mechanisms provided by law in cases where there is observed slippage from the objectives set in the aforementioned adjustment plans is vital for preventing this type of aid from generating inappropriate incentives.

The deterioration of the fiscal position has been one of the most widespread consequences of the economic and financial crisis among the developed countries. In the specific case of the euro area, this deterioration, along with doubts about growth prospects, uncertainty about the costs of bank system restructuring and shortcomings in euro area governance, was the event that triggered the sovereign debt crisis which commenced in Greece and subsequently spread to the other peripheral countries. The European authorities understood from the outset that a number of measures would be required to overcome the crisis, including, as a priority, the monitoring of fiscal consolidation, which most countries started in 2010 to regain the confidence of international markets and ensure that public debt dynamics do not become unsustainable.

The implementation of fiscal consolidation has been subject to difficulties, resulting in many cases in repeated failure to achieve the fiscal targets initially set. Against this background, there has been an intense debate over the appropriate speed and extent of fiscal adjustment. An important part of this debate has focused on analysis of the value of so-called "fiscal multipliers". This box analyses this question, providing empirical evidence for the case of Spain and discussing its implications for the pace of fiscal consolidation.

The high degree of uncertainty regarding the macroeconomic effects of fiscal policy should be recognised. In particular, the short-run impact of the budget deficit on the growth rate depends on a very broad set of conditions, such as the composition of the adjustment (how it is distributed between spending cuts and tax increases), the cyclical position, the initial levels of debt, the behaviour of monetary policy and the exchange rate regime. The literature has emphasised the possibility that the so-called "fiscal multipliers" are greater in macroeconomic situations like the current ones, of economic recession and/or financial crisis, as there are more idle resources in the economy and/or agents may be more constrained, or in which monetary policy is unable to offset the effects of the fiscal contraction, because nominal interest rates are close to the zero lower bound. For the specific case of Spain, these fiscal multipliers have been estimated under different circumstances (see accompanying table). In general, the importance of taking macroeconomic conditions into account when anticipating the effects of fiscal policy is confirmed. In particular, it can be seen that public spending multipliers (consumption and public investment) are higher at times of economic recession and financial stress, although the differences in their value compared with expansionary phases are lower than those estimated for the United States.[1]

Likewise, Blanchard and Leigh (2013), in a recent influential paper, provide evidence to show that during the economic crisis the IMF's macroeconomic projections have been systematically optimistic and that these errors are correlated with the magnitude of the planned fiscal adjustment. This would suggest that the restrictive effects of fiscal consolidation are proving to be greater than those derived from the multipliers used in the macroeconomic projection models (which, although it depends on the fiscal instrument used, would generally be less than 0.5). However, the evidence provided seems to suggest that these conclusions cannot be extrapolated to all the countries analysed. In this respect, a similar analysis has been performed for Spain, in which, first, the forecast errors observed for the Spanish economy in the Eurosystem forecast exercises are calculated, correcting them for the impact of the observed changes in the external assumptions, including the fiscal ones, with respect to those used at the time the forecasts

1 When estimating the multipliers for states of economic expansion/recession, financial stress/no financial stress and fiscal stress/no fiscal stress shown in the table below, such states were approximated on the basis of the output gap, the aggregate default rate and changes in the level of public debt, respectively. The states of expansion/recession were alternatively approximated on the basis of real GDP growth and the unemployment rate, the financial crisis/no financial crisis ones on the basis of the flow of credit to the private sector and the fiscal stress /no fiscal stress ones on the basis of the ratio of public debt to GDP and the budget deficit, and the results did not change significantly. On the other hand, the differences between regimes in the multipliers presented in the table are, generally, statistically significant.

	Multiplier for a negative public spending shock (a)	
Regime	four quarters after shock	eight quarters after shock
Expansion	-0.47 *	-0.25 *
Recession	-1.15 *	-1.67 *
No fiscal stress	-0.73 *	-0.31 *
Fiscal stress	-0.12	-0.16
No financial stress	-0.61 *	-0.06
Financial stress	-0.96 *	-0.89 *

SOURCES: Hernández de Cos and Moral-Benito (2013).
NOTE: * statistically significant to 5%.

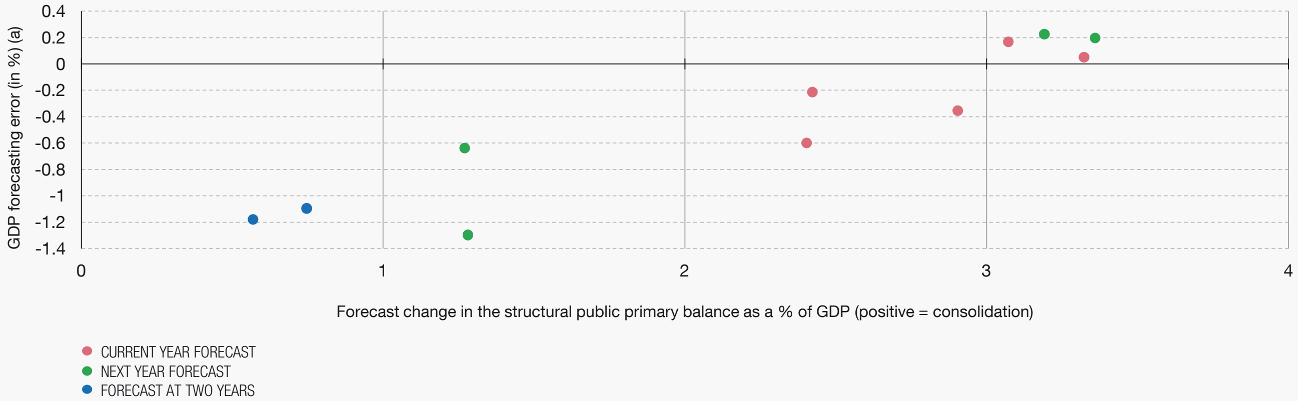
a The multipliers in the table show the response by GDP to a €1 reduction in public spending.

were made (see Panel 1). The conclusions of this analysis are, first, that the forecast errors have not always had the same sign and, second, that these forecast errors are not negatively correlated with the fiscal consolidation initially planned, which does not provide support, in the Spanish case, for the idea that the multipliers may be significantly higher in the current situation than the ones incorporated in the forecast models.

Given the possible effect of fiscal policy on agents' confidence, the literature has also emphasised the possibility that multipliers may be lower, or even negative, in situations of fiscal stress, which may also be relevant in the current situation given the observed increases in public debt-to-GDP ratios and risk premiums. In this respect, evidence is found, for the Spanish case, that multipliers are lower in situations of fiscal stress identified by abnormally large increases in the level of government debt (see accompanying table).

The determination of the level of fiscal stress is related to the concepts currently being discussed in the economic literature of

1 REAL GDP FORECASTING ERRORS AND FISCAL CONSOLIDATION. THE SPANISH CASE

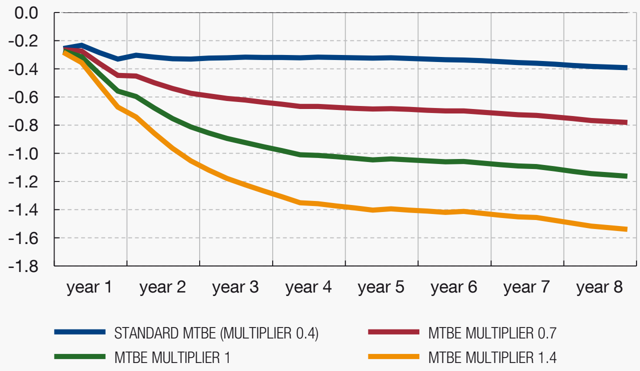


SOURCE: Banco de España.

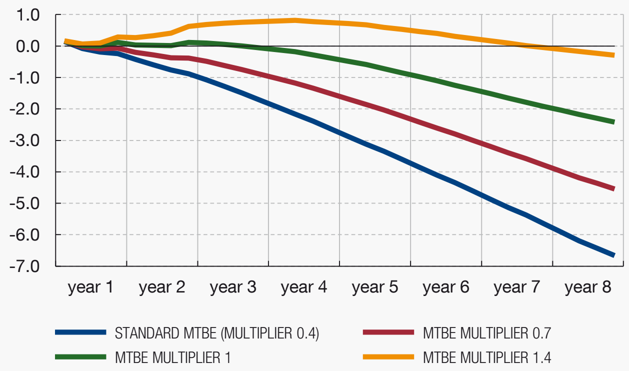
a Adjusted for slippage in the exogenous assumptions: the MTBE is used to approximate how the forecast would have changed had correct assumptions originally been available for the external sector, interest rates, and the amount and composition of the fiscal consolidation finally observed. The results are similar if this adjustment is not applied.

2 FISCAL CONSOLIDATION, VALUE OF THE MULTIPLIERS AND CHANGES IN PUBLIC DEBT/GDP RATIO. THE SPANISH CASE (a)

2.1 MULTIPLIER (GDP RESPONSE TO FISCAL SHOCK)



2.2 PUBLIC DEBT RESPONSE TO FISCAL SHOCK (DIFFERENCE % OF GDP)



SOURCE: Banco de España.

a Response by GDP and by the GDP/debt ratio to a fiscal shock based on tax increases and spending cuts, simulated with different values for the fiscal multiplier (MTBE standard is the value habitually used, while the remaining results are obtained by adding to this simulation a negative response —of differing intensity— by household and business confidence to the fiscal shock, which generates higher multipliers).

"fiscal limit" and "debt threshold". The latter may be defined as the level of government debt that the markets implicitly take as a reference, above which an economy would begin to find itself having difficulty financing itself on the markets at costs compatible with its fundamentals, insofar as above that debt limit agents would begin to perceive risks to the sustainability of the country's public finances. The evidence available for Spain on this question [see Andrés et al. (2013)] suggests that the current level of public debt is close to this threshold, so that anchoring the expectations of agents to the stabilisation of debt at these or lower levels would help to mitigate the pressures on their financing costs.

Given these considerations, it may be concluded that the fiscal adjustment strategy should take into account not only the behaviour of economic activity, but also the costs of excessive delays in consolidation, in terms of risks to credibility and their impact on agents' confidence. In this respect, it is important to ask how high fiscal multipliers would need to be in order for fiscal consolidation to generate an increase in the public debt-to-GDP ratio, i.e. to have the opposite impact to that intended (known as a "self-defeating consolidation"). For this purpose a simulation exercise was performed using the quarterly model of the Banco de España (MTBE), in order to analyse the effect of a fiscal adjustment based equally on reductions in spending and transfers and increases in taxes, with different assumptions for the values of fiscal multipliers (ranging from 0.4 to 1.5). The results show that in all cases the debt-to-GDP ratio is reduced in the medium and long-term, although when the ex-ante multiplier reaches 1.5 (which is achieved by imposing a very negative reaction of agents to the adjustment),[2] the public debt ratio may temporarily rise in the short term (see Panel 2). The conclusion of this analysis is that, although multipliers are higher than on average in the past, they are still within reasonable ranges, so that in general self-defeating consolidations should not be expected in the case of Spain.

[2] The extreme nature of this simulation with a multiplier of 1.5 is apparent in the fact that the fall in activity is so marked that the ex-post budget deficit is hardly reduced, owing to the negative effect on taxes and benefits. The fact that in recent years a significant reduction in the budget deficit has been observed in Spain would be a further indication that the fiscal multiplier for the measures adopted has not reached such high levels.

Despite the effort made the size of the adjustment pending remains significant, but unavoidable

The fiscal assumptions used in the latest "Spanish economic projections report" in the March *Economic Bulletin* placed the budget deficit at around 6% of GDP over the projection horizon (2013 and 2014), figures which, should they materialise, would not allow the growing trend of the public debt/GDP ratio to be curbed in the immediate future. This fiscal scenario reveals that, despite the intense fiscal consolidation undertaken, the scale of the adjustment pending is still most significant if it is intended to initiate a lasting reduction in public sector debt that is consistent with the requirements of the Law on Budgetary Stability and Financial Sustainability and with the commitments entered into in the Stability and Growth Pact.

3.3 CLEAN-UP, RECAPITALISATION AND RESTRUCTURING OF THE BANKING SYSTEM[2]

The double-dip recession in the Spanish economy and the euro confidence crisis increased pressure on the banking system

The adjustment of the imbalances accumulated in the Spanish banking system during the economic upturn was adversely affected by the concurrence of the double-dip recession in Spain and the euro confidence crisis. The quality of banking assets was further impaired and the capacity of Spanish banks to gain access to international funding markets was severely constrained. As has been the case since the start of its banking crisis, the tensions exerted very different effects from bank to bank.

The ongoing clean-up, recapitalisation and restructuring of the system

The worsening of the situation meant that the clean-up, recapitalisation and restructuring of the banking system had to be accelerated. One significant course of action turned on the clean-up of bank balance sheets. Royal Decree-Laws 2/2012 and 18/2012 laid down a swift

2 For a more detailed analysis of the financial position of Spanish banks, see the 2011 Annual Report, the Financial Stability Report and the Report on Banking Supervision in Spain, published by the Banco de España, where these issues are addressed in greater depth.

was expedited by means of a strategy based on four pillars…

and transparent process of cleaning up potential capital losses associated with real estate assets, raising the levels of specific and general provisions. Subsequently, a detailed and rigorous stress test was conducted to evaluate the capacity of each individual bank to withstand reasonably extreme situations involving a further heightening of difficulties. Once the capital requirements to shore up each bank had been identified in this way, the following step of the strategy consisted of designing a mechanism and specific conditions for the recapitalisation and restructuring of the banks in question, and for the orderly resolution of those that were not viable. In parallel, procedures were set in place for the segregation and transfer out of banks under restructuring of assets and real estate loans. Finally, the finishing touches were provided by the launch of a substantial reform of current regulations. Box 1.3 sets out the key aspects of these measures in greater detail.

… which had the financial assistance of the ESM

Against an exceptionally fragile economic background in the euro area, dominated by the feedback loop between sovereign and banking risk, the Spanish economy's capacity to finance this strategy through its own means was very limited. The Spanish government requested the support of its European partners and, in July, a financial assistance programme for the recapitalisation of ailing Spanish banks was formalised. The programme was endowed with maximum resources totalling €100 billion and the conditions for the disbursement of the funds were set out in a Memorandum of Understanding (MoU), giving expression to the courses of action described above.

Major progress has been made

The MoU laid down a demanding timetable for compliance with the conditions established, which has been strictly followed. In 2012 Q4 and 2013 Q1, the programme was reviewed, as stipulated in the MoU. And on both occasions, the joint European Commission, ECB, European Stability Mechanism (ESM) and European Banking Authority (EBA) missions delivered a positive assessment of fulfilment of the conditions, thereby enabling the effective disbursement of the funds.

The funds contributed by the ESM ultimately amounted to slightly over €41 billion. Of this amount, €39 billion were earmarked for recapitalisation by the FROB of the banks that could not cover their capital needs by their own means (the so-called "Groups 1 and 2", following the MoU terminology). The remainder has financed the FROB's participation in Sareb, the company created to manage the real estate assets segregated from bank balance sheets.

Among the recapitalisation efforts made in this new phase are private capital increases and the sales of assets by the Group 3 banks[3] which, in this way, covered the capital shortfall estimated in the stress tests without resorting to public aid. The need for public injections also diminished as a result of the assumption of losses by shareholders and holders of hybrid instruments. Furthermore, the regulatory reforms undertaken include the requirement, for all banks, of a minimum core capital ratio of 9% from January this year.

Greater impetus was also given to the downsizing of banking activity as a result, among other factors, of the restructuring plans approved for the banks in Groups 1 and 2. In terms of offices, employees and assets, these plans envisage reductions for end-2017 which, on average, range between 40% and 60% compared to the situation in 2010. The same can be said regarding the clean-up process which, as a result of the various measures adopted, has entailed a reduction in just one year of at least half of Spanish banks' exposure, net of provisions, to the real estate sector.

3 Banks for which capital needs were identified, but which could be covered by their own means.

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

BOX 1.3

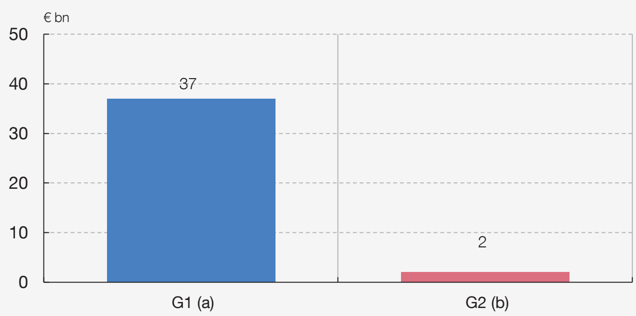
During 2012 and the first few months of 2013 very significant progress was made in the process of balance-sheet clean-up, recapitalisation and restructuring of the Spanish banking system, based essentially on four courses of action: identification of the individual capital needs of each bank; recapitalisation and restructuring (or in the event of non-viability, orderly resolution) of those institutions in situations of greatest vulnerability; write-downs, separation and transfer of assets related to the real-estate sector and, finally, a significant regulatory reform.

Given that this plan of action required the mobilisation of public funds and that the financial tensions and heavy financing requirements of the public sector limited the capacity to obtain funds at reasonable prices on the markets, the Spanish government requested financial assistance from its fellow EU members to carry it out. Specifically, the aid took the form of a financial assistance programme to recapitalise those banks that needed to be recapitalised, with funds available of up to €100 billion. The related conditionality for the financial system was contained in the Memorandum of Understanding (MoU) signed on 20 July 2012. This document established the specific measures that would have to be adopted in two spheres: that relating to those institutions that have required public aid and that relating to the sector as a whole. The final objective of all these measures is to increase the resilience of the financial system to adverse shocks.

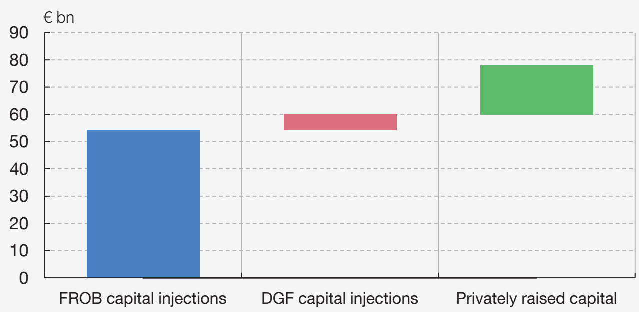
In order to determine capital needs, the authorities commissioned independent experts to perform two stress tests. The first one, carried out in June 2012 by two consultancy firms, was an aggregate top-down test in which Spanish banking groups that together accounted for around 90% of the assets of the sector participated. Two macroeconomic scenarios were considered: a so-called baseline scenario, assumed to have a high probability of occurrence, under which a core capital ratio (as defined by the European Banking Authority) of 9% was required to be met as at the end of 2014, and another adverse scenario, considered very unlikely to occur (its probability of occurrence was estimated to be less than 1%), under which the level of ratio had to be at least 6% as at the same date. According to the results, published on 21 June, the system was estimated to need additional capital of €16-26 billion under the first scenario, and €51-62 billion under the second one.

After this initial work, which served to put an upper limit on the system's overall capital shortfall, the second stress test was

1 PUBLIC CAPITAL AID AFTER THE STRESS TEST

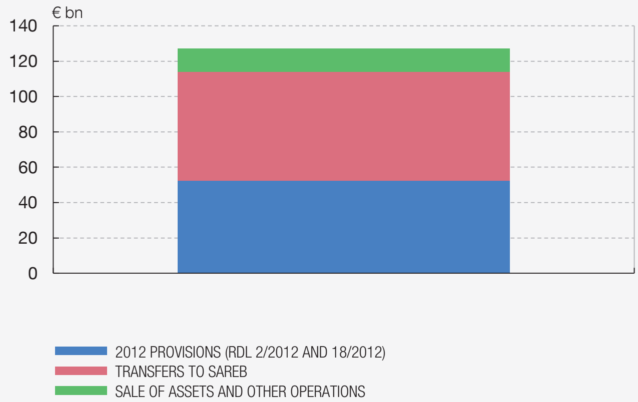


2 CAPITAL INJECTIONS DURING THE CRISIS



3 EXPOSURES NET OF PROVISIONS TO THE REAL ESTATE SECTOR

4 REDUCTION IN EXPOSURES TO REAL ESTATE SECTOR IN 2012



SOURCE: Banco de España.

a Banks with a FROB majority shareholding.
b Other banks with additional capital needs.
c Assets transferred to SAREB in February 2013 by Group 2 banks are not included.

carried out between July and the end of September, to determine the capital needs of each institution (bottom-up exercise). The scenarios, capital requirements and institutions considered were the same as in the first test and one of the consultancy firms that performed the first test was commissioned to conduct it, along with the four main Spanish audit firms and six domestic and international real estate valuation companies. The test was conducted very rigorously, using very exhaustive information, with strict control of the process, the governance of which involved both the Spanish authorities (Banco de España, Ministry of Economic affairs and competitiveness and the FROB) and international authorities (European commission European Central bank, European banking authority and the International Monetary Fund, in an advisory role). According to the results, which were published on 28 September, the maximum total capital needs were estimated to be €57 billion under the adverse scenario, which were distributed across the institutions very unevenly. More specifically, of the 17 groups analysed, seven (which accounted for 62% of the loan portfolio), had no need for additional own funds, while in the case of the other ten, the needs identified were concentrated (86% of the total) in four institutions in which the FROB already had majority holdings at the time.

The second component of the strategy has been the recapitalisation of viable entities identified as having a capital gap. Of the ten institutions in that situation, two were capable of covering the gap on their own by means of capital increases, subordinated debt repurchases and asset liquidation. The others needed public aid provided by the FROB and financed through the MEDE, within the framework of the approved financial assistance programme. The volume finally injected was, however, lower than that estimated in the stress tests, as a result of the application of a number of measures, in line with the agreements contained in the MoU, including the assumption of losses by the holders of shares and hybrid instruments, the transfer of assets to the institution set up for their management and sale (asset management company for assets arising from bank restructuring (SAREB)) and the divestment of other assets. Following these adjustments, public aid was €39 billion (see Panel 1), of which €37 billion was given to the institutions in which the FROB had a majority holding (Group 1), and the rest, to those other banks that could not cover their capital needs on their own and that make up the so-called "Group 2". The injections were completed in December 2012, in the first case, and March 2013 in the second (except in the case of one institution, for which the injection was made in April). The institutions that received public aid have presented, in accordance with the provisions of the MoU, restructuring plans that contain commitments to make very significant reductions in the number of offices, employees and risk-weighted assets during the period 2010-2017 (of 60%, 50% and 60%, respectively, in the case of the Group 1 institutions, and 40%, 40% and 50% in that of the Group 2 institutions). These plans have already been approved by the Banco de España and the European Commission.

Following these new contributions from the FROB, the total amount of public aid provided in the form of capital since the start of the crisis amounts to €54 billion. In addition, the Deposit Guarantee Fund (DGF) had already carried out recapitalisations of €6 billion, to which must be added the private capital increases, which have involved a further €18 billion. In total, the recapitalisation of the financial system during this period exceeds €78 billion (see Panel 2).

The objective of the third pillar of the strategy was to clean up bank balance sheets and reduce their exposure to the real-estate sector. Royal Decree-Laws 2/2012 and 18/2012 introduced measures to ensure a rapid and transparent recognition of possible capital losses associated with real-estate assets, increasing the levels of the specific and general provisions and establishing the need for an additional capital buffer to cover possible losses associated with assets relating to land. With the application of the new rules, the coverage of assets relating to real-estate development would reach 45% of their total amount, and 80% in the case of land.[1] Subsequently, and in accordance with the MoU, in December 2012 the SAREB was set up, a company whose purpose is to manage real-estate assets, which currently has a capital of €4.8 billion, 44% of which is held by the FROB (the rest being mostly held by private investors, banks and insurance companies). The institutions that have received new public aid have been required to transfer to this company all their foreclosed real-estate assets and loans to developers with a net book value of more than €100,000 and €250,000, respectively, as well as controlling shareholdings linked to the real-estate development sector. The transfer price was calculated, following the conditions of the MoU, according to the economic value of the assets, to which some additional adjustments were applied, with an average cut of 65% in relation to the book value for the foreclosed assets and 48% of loans. In December 2012 and February 2013 the assets of the Group 1 and 2 institutions were transferred, respectively, with a total effective amount of €51 billion.[2] For the SAREB a business plan has been designed with a 15-year horizon and its management is supervised by the Banco de España, along with other domestic and international authorities.

As a result of all these measures and, to a lesser extent, the sale of assets and other actions, the total net exposure (after applying provisions) of the bank balance sheets to the real-estate sector has been reduced, during 2012, by €127.2 billion, as may be seen in Panels 3 and 4.[3]

Finally, the fourth component of the strategy was focused on regulatory reform. Specifically, RDL 24/2012, approved on 31 August

1 This limit was reached through the requirement for an additional capital buffer. However, as this requirement was lifted by RDL 24/2012, the coverage of land is now 60%.

2 The assets were recorded on the balance sheets of institutions with a gross amount of €106 billion.

3 In order to calculate this amount the transfer to the SAREB of the Group 2 assets, which took place in February 2013 has been taken into account.

PROGRESS MADE IN THE BALANCE-SHEET CLEAN-UP, RECAPITALISATION AND RESTRUCTURING OF THE SPANISH BANKING SYSTEM (cont'd) BOX 1.3

2012, established a modern framework for the management and resolution of banking crises (with more rapid intervention by the Banco de España in the event that difficulties are detected at an institution), delimited the competencies of the FROB and of the DGF and strengthened the tools of the former in all phases of crisis management. In addition, the Banco de España assumed the power to authorise and sanction credit institutions (a function previously performed by the Ministry for Economic Affairs and Competitiveness), and a more demanding capital requirement was established that credit institutions had to meet from 1 January of this year, a minimum level being set for core capital[4] of 9%. This royal decree also addresses other aspects, such as placing limits on the remuneration of the directors of institutions that have received financial support and improving the mechanisms for protecting retail investors, by requiring greater transparency in the marketing of products not covered by the DGF. More recently, Circular 6/2012 was approved, which introduced greater transparency into the financial reporting of institutions, especially in relation to real-estate exposures and refinanced and restructured loans. In the coming months new legislation is expected to be approved to convert savings banks, whose activity is now carried out through commercial banks in practically every case, into foundations, which will have significant incentives to reduce their holdings in such commercial banks below controlling levels, thereby completing the process of reform of the model of governance of this type of institution that was commenced in 2010. Finally, work is currently done to improve the supervisory methods of the Banco de España and the system of provisions for loan impairment.

4 As defined by the European Banking Authority.

In any event, challenges remain; and these must be tackled to entrench the success of the process

In an economy such as Spain where banks are so prevalent and strongly established, the successful culmination of the clean-up, recapitalisation and restructuring of banks is a vital condition for being able to raise under reasonable conditions the external funds needed and for these funds to be efficiently channelled towards private-sector spending projects. Precisely for this reason, the significant progress in recent months should serve to further the strategy adopted and to address the challenges remaining, including most notably those associated with the uncertainty over the future course of the fragile macroeconomic environment.

3.4 THE DELEVERAGING OF HOUSEHOLDS AND FIRMS

The double-dip recession weighed down on household and corporate deleveraging, which continued to reside essentially on the fall-off in credit

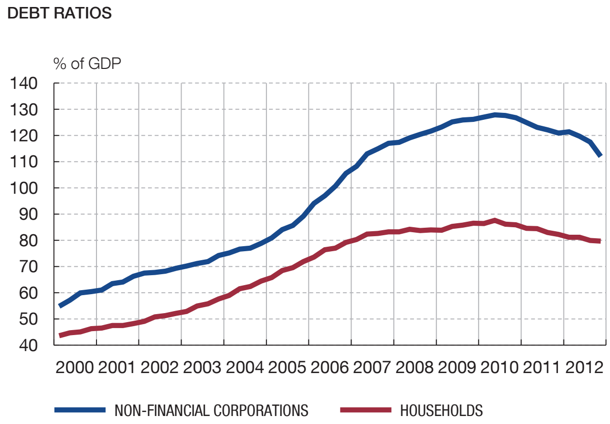
The unfavourable course of Spanish household and corporate income weighed down for yet another year on the ongoing reduction of their related debt ratios, a process which continued to be relatively slow. In the current settings of the Spanish economy, which is immersed in a double-dip recession and in the process of restoring lost competitiveness and reinforcing the banking system, neither growth, inflation nor the restructuring of debt offer viable alternatives in the short term to cutting the non-financial private sector's leverage ratios. Their reduction, therefore, is drawing in the main on the contraction of credit flows, which restricts the speed at which the process may advance, particularly in the case of household mortgage debts.

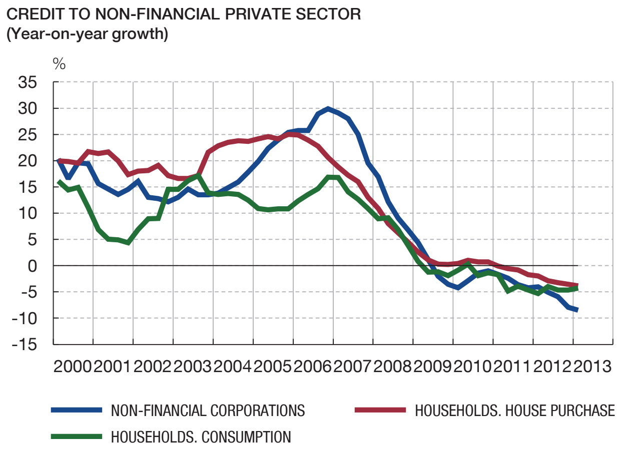
The financing received by households and firms fell, in fact, by around 5% over the year as a whole (see Chart 1.9). Along with the need for the sector to deleverage, other factors also influenced financing. On one hand, the weak economic outlook had a negative effect on the demand for new loans and on the creditworthiness of borrowers. On the other, the strict funding conditions for Spanish banks on international markets, though mitigated in part by the ECB's decisions, were reflected in their lending policies, thereby shaping a markedly restrictive setting for the granting of loans. As is habitual in these circumstances, the effects of these developments have tended to be asymmetrically distributed among the different borrowers, particularly affecting those which, as is the case with SMEs, face greater structural difficulties in overcoming such effects.

The implementation of the bank restructuring plans might, in principle, accelerate the contractionary trend of credit, although their quantitative influence need not, a priori, be very

DEBT RATIOS AND CREDIT GROWTH

CHART 1.9





SOURCES: INE and Banco de España.

significant. The banks affected account for only around one-third of the system's total credit portfolio and the remaining banks could absorb and offset part of this impact. However, and above all, the bank restructuring plans, under the overall strategy of placing the economy back on a normal footing, will contribute to restoring investor confidence in Spanish banks as a whole, thereby broadening their possibilities of raising, under accessible conditions, the funds that they can then lend to the private sector.

The short-term costs of the necessary aggregate deleveraging will also depend on how this is distributed among individual debtors

Correcting Spanish households' and firms' excess indebtedness is, in any event, a necessary step for upholding the sustained recovery in domestic demand, although in the short run it may restrict the sector's spending potential. This effect will, in any case, depend on how the aggregate contraction in credit is distributed across the different sectors and types of debtors. The data on the distribution of debt show that there is a high degree of heterogeneity among both households and firms. And some recent studies suggest for example that, in the case of corporations, the deleveraging observed at the aggregate level in recent years has been compatible with an increase in the credit received by corporations starting from a healthier position.[4]

4 The role of economic policy

Economic policy has a key role to play in laying the foundations for a sustainable recovery

Economic policy has a pivotal role to play in seeing through the adjustments, dispelling uncertainty and laying the foundations for a sustainable recovery that allows for an increase in the economy's growth capacity in the medium and long term. Restoring confidence and overcoming the current tensions, which have a significant external component linked to the euro crisis, depends on the progress made towards a more complete and sustainable economic union, which is beyond the scope of the national authorities. But the speedier the adjustment of the Spanish economy and the headway on reforms, the greater will be the protection afforded against external shocks and the possibility of benefiting from European progress.

As highlighted throughout this chapter, the adoption of extraordinary economic policy measures helped stave off the dangers of the serious confidence and external funding crisis undergone by the Spanish economy amid the most acute tensions experienced by the euro area since it was founded. There has been progress on fiscal consolidation and

4 See, for example, A. Menéndez and Méndez, M. (2013): "Spanish non-financial corporations' debt since the start of the crisis. A disaggregated analysis", Economic Bulletin, January, Banco de España.

MAIN INDICATORS OF THE SPANISH ECONOMY (a)

TABLE 1.1

	2007	2008	2009	2010	2011	2012
DEMAND AND OUTPUT (b)						
GDP	3.5	0.9	-3.7	-0.3	0.4	-1.4
Private consumption	3.5	-0.6	-3.8	0.7	-1.0	-2.1
Government consumption	5.6	5.9	3.7	1.5	-0.5	-3.7
Gross capital formation	4.2	-4.2	-17.9	-5.5	-5.5	-8.7
Equipment investment	10.2	-2.9	-23.9	2.6	2.3	-6.6
Construction investment	2.4	-5.8	-16.6	-9.8	-9.0	-11.5
Housing	1.4	-9.1	-23.1	-10.1	-6.7	-8.0
Other construction	3.6	-1.6	-9.1	-9.6	-11.0	-14.6
Exports of goods and services	6.7	-1.0	-10.0	11.3	7.6	3.1
Imports of goods and services	8.0	-5.2	-17.2	9.2	-0.9	-5.0
Contribution of national demand to GDP growth	4.3	-0.6	-6.6	-0.6	-1.9	-3.9
Contribution of net external demand to GDP growth	-0.8	1.5	2.9	0.3	2.3	2.5
EMPLOYMENT, WAGES, COSTS AND PRICES (c)						
Total employment	3.0	-0.2	-6.3	-2.5	-1.7	-4.4
Employment rate (d)	66.6	65.3	60.6	59.4	58.5	56.2
Unemployment rate	8.3	11.3	18.0	20.1	21.6	25.0
Compensation per employee	4.7	6.9	4.2	0.3	0.7	-0.3
Apparent labour productivity	0.5	1.1	2.7	2.3	2.2	3.2
Unit labour costs	4.2	5.7	1.5	-2.0	-1.4	-3.4
GDP deflator	3.3	2.4	0.1	0.4	1.0	0.1
Consumer price index (12-month % change)	4.2	1.4	0.8	3.0	2.4	2.9
Consumer price index (annual average)	2.8	4.1	-0.3	1.8	3.2	2.4
Consumer price differential with the euro area (HICP)	0.7	0.9	-0.5	0.4	0.3	-0.1
NET LENDING (+) OR NET BORROWING (-) AND FINANCIAL BALANCE (e)						
Resident sectors: domestic net lending (+) or net borrowing (-)	-9.6	-9.2	-4.3	-3.8	-3.2	-0.2
General government	1.9	-4.5	-11.2	-9.7	-9.4	-10.6
General government (without aid to financial institutions)	1.9	-4.5	-11.2	-9.7	-9.0	-7.0
Households and NPISHs	-2.7	1.2	6.6	3.9	2.4	0.9
Companies	-8.8	-5.9	0.2	2.0	3.8	9.5
Financial institutions	1.9	1.8	1.3	0.9	2.0	6.1
Non-financial corporations	-10.7	-7.7	-1.1	1.1	1.8	3.5
Net international investment position	-78.1	-79.3	-93.7	-88.8	-91.3	-93.0
General government gross debt	36.3	40.2	53.9	61.5	69.3	84.2
MONETARY AND FINANCIAL INDICATORS (f)						
ECB minimum bid rate on MROs	3.9	3.9	1.2	1.0	1.3	0.9
Ten-year governemnt bond yield	4.3	4.4	4.0	4.2	5.4	5.8
Synthetic bank lending rate	5.7	6.2	3.8	3.3	4.1	4.1
Madrid Stock Exchange General Index (Dec 1985 = 100)	1.631.8	1.278.3	1.042.4	1.076.5	971.8	767.5
Dollar/euro exchange rate	1.4	1.5	1.4	1.3	1.4	1.3
Nominal effective exchange rate vis-à-vis developed countries (g)	101.9	103.3	103.4	101.9	101.7	100.3
Real effective exchange rate vis-à-vis developed countries (h)	114.9	119.1	116.3	112.8	109.8	102.8
Real effective exchange rate vis-à-vis the euro area (h)	112.7	115.1	111.8	110.3	107.5	102.1
Households: total financing	12.5	4.4	-0.3	0.2	-2.4	-3.7
Non-financial corporations: total financing	17.7	8.2	-1.4	0.6	-2.0	-6.2

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

a Spanish National Accounts data, base year 2008.
b Volume indices. Rate of change.
c Rate of change, except the unemployment rate, which is a level.
d Employment rate (16-64).
e Levels as a percentage of GDP.
f Annual average levels for the Madrid Stock Exchange General Index, interest rates and exchange rates, and rates of change for finanancial assets and liabilities.
g 1999 Q1 = 100.
h 1999 Q1 = 100. Measured with unit labour costs.

labour market reform, and important steps have been taken to restructure the credit system, although there are adjustments outstanding and the culmination of the process will not be free from difficulties. Elsewhere, the reforms in the goods and services markets have made less impact. Against this background, restoring growth foundations in a lasting way requires furthering the effort expended and finalising the adjustments under way, in line with the recommendations of the European Commission for Spain under the Macroeconomic Imbalances Procedure. The aim is to prevent the risk of the imbalances detected proving excessive. The high dependence on external funding is a factor of vulnerability that requires the careful handling of all the economic policy instruments available to prevent new bouts of financial instability from exerting adverse effects on confidence and on the availability and cost of funding in Spain.

Economic policy should ensure that equilibria, the financing of the economy and the flexible functioning of the markets for factors, goods and services that growth within the Monetary Union requires are all restored.

It is vital to complete the bank restructuring process

Notable among the many economic policy requirements is the need to complete the restructuring of the banking system, under the strategy adopted, to normalise the necessary financing of domestic expenditure.

It is imperative to persevere with supply-side and structural reform measures…

Maintaining adjustment and growth-boosting policies via supply-side and structural reform measures, in an economic setting of high unemployment and flat income, is very costly in the short term and entails considerable risks of fatigue that may erode the capacity to act. The types of measures needed to restore the foundations of growth require time for their effects to work through, and they should not be judged against the weakness of the economy in circumstances still dominated by the problems built up in the past and the uncertainty surrounding the European project. The experience of previous critical episodes taught us that perseverance with adjustment measures, even though initially costly, managed to contain investor and market mistrust and to redress complex and dangerous situations.

… so that the adverse trajectory of the labour market may be reversed…

After five consecutive years of job destruction, the unemployment rate has reached unacceptable levels and the risk of long-term unemployment becoming chronic is a very serious concern, all the more so if the high incidence of youths and the least-skilled in this group is considered. The achievements of the labour reform in respect of internal flexibility and wage restraint are encouraging, but the results obtained in fomenting new hires are still not sufficient, although this is probably one of the areas in which the measures need time to work through in full. Nonetheless, the seriousness of the labour market situation advises maintaining and intensifying reform momentum through the adoption of additional measures to promote job creation in the short term and to facilitate wage flexibility. Here it would be worth exploring the possibility of establishing new formulas that would allow, in special cases, temporary departures from the conditions laid down in collective bargaining agreements, or exceptional mechanisms to prevent the minimum wage from acting as a constraint on specific groups of workers with most difficulties in terms of employability. Further steps should also be taken to ensure that the diminished scope of the wage indexation clauses is not reversed in phases of economic growth.

… so that competitiveness is boosted through the greater adjustment capacity of relative

Improving competitiveness is a fundamental objective for boosting growth. Economic policies should promote a greater sensitivity of prices, margins and wages to cyclical conditions to smooth the reallocation of resources towards projects and sectors with more prices, margins and costs and genuine productivity gains…

growth potential. Likewise, policies geared to promoting productivity gains arising from genuine improvements in productive efficiency are essential for ensuring that gains in competitiveness are lasting and lay the foundations for growth in the medium and long term. It should be borne in mind that gains in competitiveness must come about in a contractionary setting for domestic spending and at the same time as the high levels of debt of various institutional sectors are being reduced, which underscores the leading role supply-side and structural reform policies must play here.

In this area, however, reforms have been less penetrating or are at a more incipient stage, although the National Programme of Reforms (NPR), approved on 30 April, sets out a series of measures and a timetable for their implementation in 2013 that may resolve some of the most pressing issues outstanding. Indeed, as the NPR acknowledges, the bodies entrusted with overseeing competition and with regulating the network industries are under review. The new law, envisaged for June this year, should shore up their independence and improve their functioning, in order to ensure competition and to push through further sectoral liberalisation. In this respect, certain liberalising measures have been adopted in the services sector. These include most notably the substitution of prior communications for authorisations or licences in the case of small retail outlets, the extension of trading hours and the liberalisation of retail trade sales periods, and the lifting of obstacles to the setting up of service stations, among other measures, in the case of oil and fuel retailing. The draft bill for ensuring a single market envisages a single licence throughout Spanish territory for access to business activity, which would help significantly lessen the administrative burden on corporations, and which should be completed by making the array of regulations from one region to another uniform in relation to the carrying out of economic activities. Also pending is the liberalisation of professional services, though it does feature among the reforms envisaged by the NPR over the next 12 months. In the case of the energy industry, despite the various measures adopted to reduce the tariff deficit, a far-reaching reform of the electricity sector is needed to ensure sustainability and the degree of competition. Finally, regarding the housing market, recent tax changes have contributed significantly to bringing the tax treatment of owner-occupancy and rentals onto an equal footing. In combination with the new Law on Urban Rentals in passage through Parliament, which adds flexibility to contractual terms and the setting of rents, this should contribute to achieving a more balanced mix between owner-occupancy and rentals.

… and so that the credibility gains achieved in the fiscal field become entrenched

The reduction in the deficit in 2012 by more than 2 pp of GDP, against a background of economic recession and a strong increase in the public debt interest burden, has significantly enhanced the credibility of the fiscal consolidation process; not only because of the scale of the adjustment made, but also because the effort has been across all tiers of government, in particular local and regional government, where doubts had arisen concerning their capacity to make the adjustment required.

However, in a setting such as the present, in which economic agents and financial markets remain highly sensitive to fiscal and macroeconomic developments in the different economies, it is very important to entrench the gains in credibility attained. What would contribute to this would be the setting of a medium-term budgetary horizon that provided sufficient details on the necessary measures which, in a lasting way, were to allow the fiscal consolidation process to be culminated. Such measures should furthermore be based on a deep-seated review of the size of the public sector, of the different spending programmes and of the tax system, so as to ensure not only the success of the process but also an improvement in the quality of public finances. The rigorous and transparent application of the instruments included in the Stability Law, for instances in which non-compliance with the objectives set are observed, would likewise help attain this objective, all the more so following the approval of various funds supporting the financing of local and regional government by the State. The budgetary framework should also emerge stronger following the setting up of an Independent Fiscal Responsibility Authority, before the end of the year, under the commitment entered into in the latest Updated Stability Programme 2013-2016 sent by the government to the European Commission on 30 April. The mandate, resources and governance of this Authority should be defined in keeping with international standards.

Additional measures should be taken to ensure the sustainability of the pensions system

The foregoing measures should be accompanied by new ones aimed at ensuring the sustainability of the pensions system, measures that would complement those needed in the labour market. Such measures would be very powerful in terms of the sustainability of public finances and would afford great certainty as to the reformist resolve of economic policy, without an appreciable impact on current labour and social conditions. In particular, and as envisaged in the Updated Stability Programme, an appropriate definition of the so-called "sustainability factor" should be approved so as to enable automatic modifications of the parameters of the system that guarantee its sustainability in the medium and long term. It would further be advisable to bring forward the entry into force of the later retirement age and the lengthening of the period for calculating the regulatory base, both of which were approved in the last pensions system reform. This is because, in light of the heightening of the problem since the last reform was enacted, the phase-in period agreed is overly long.

Foreseeably, furthering the scope of these priority economic policy measures will allow a gradual recovery in internal and external confidence, and the normalisation of the funding of the economy. It will also lay the foundations for resuming economic growth in the medium term, thereby providing for improved expectations, the clean-up of private-sector balance sheets, the soundness and profitability of the banking system and the sustainability of public finances.