

**SOME THOUGHTS ON  
THE SPANISH ECONOMY AFTER  
FIVE YEARS OF CRISIS**

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Eloísa Ortega and Juan Peñalosa (\*)

BANCO DE ESPAÑA

(\*) We gratefully acknowledge the valuable technical assistance of José Luis Fernández in this work.

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## **Abstract**

This paper briefly describes some features of the situation of the Spanish economy after five years of crisis, a task which is easier now that this period can be analysed from a certain perspective. The crisis prompted a substantial readjustment of the main Spanish macroeconomic aggregates, affecting the level and composition of GDP, employment and the balance sheet position of the institutional sectors. During this period some of the imbalances that built up during the upturn have been corrected and several key variables are currently at around the average European levels. All told, the legacy of the crisis, in terms of the magnitude of unemployment and of the still high levels of indebtedness, makes for a complex outlook and suggests that the recovery will be gradual and not free of uncertainty. This uncertainty mainly affects the functioning of the economy's adjustment mechanisms, particularly those working through the channels of competitiveness and of private sector balance sheets. Despite the depth of the crisis in Spain, the progress made in the reforms on various fronts is, on balance, significant. From the perspective provided by the analysis of the crisis in this paper, supply-side policies will have to play a major role in the current phase of the cycle to enable the recovery to proceed firmly.

**Keywords:** Spanish economy, economic crisis, adjustment, rebalancing, internal devaluation, competitiveness, balance sheet position, indebtedness, reforms.

**JEL classification:** E60, E65, F32, G01, H12.

## Resumen

En este trabajo se trata de recapitular algunos rasgos de la situación de la economía española tras cinco años de crisis, ejercicio que se beneficia de poder analizar este período con cierta perspectiva. La crisis ha supuesto un sustancial reajuste de las grandes cifras macroeconómicas españolas, tanto en términos del nivel y la composición del PIB y del empleo como en términos de la posición financiera de los sectores institucionales. Durante este período se han corregido algunos de los desequilibrios que se acumularon durante la etapa expansiva, y diversas variables clave se sitúan en la actualidad en unas cotas similares a las europeas. Con todo, el legado de la crisis en términos de la magnitud del desempleo o de los todavía elevados niveles de endeudamiento configura un panorama complejo y apunta a una recuperación gradual de la actividad, que no está exenta de incertidumbres. Estas afectan, principalmente, al recorrido pendiente de los mecanismos de ajuste de la economía, en particular el que transcurre a través del canal de la competitividad y el que lo hace mediante el ajuste de la situación patrimonial del sector privado. A pesar de la profundidad de la crisis, el recuento de los avances de las reformas adoptadas en diversos frentes ofrece un balance significativo. Desde la perspectiva que suministra el análisis realizado en este trabajo, las políticas de oferta deben desempeñar un papel fundamental en la fase cíclica actual, con el fin de consolidar la recuperación.

**Palabras clave:** Economía española, crisis económica, ajuste, reequilibrio, devaluación interna, competitividad, posición patrimonial, endeudamiento, reformas.

**Códigos JEL:** E60, E65, F32, G01, H12.

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## 1 Introduction

The first half of 2013 marked the fifth year of economic crisis in Spain against a background characterised by the difficulties of developed countries in overcoming the legacy of the great recession and by the vicissitudes besetting the euro area, partly due to the deficiencies of its institutional framework which became apparent in this period.

The crisis at global level began to manifest itself from 2007, particularly in the United States and other countries directly affected by the subprime mortgage crisis. At that time the Spanish economy was in its fourteenth year of continuous growth, had lowered its unemployment rate to 8% and was running a budget surplus. However, that long period of expansion had been overly reliant on increasing private-sector debt – largely financed with funds from abroad – and on a concentration of resources (both financial and material) in the construction sector, and had given rise to a significant external deficit and high external debt, signalling a gradual loss of competitiveness of Spanish production. Moreover, the continual recourse to debt concealed, in the boom years, the failure of Spanish market structure and institutions to conform to euro area requirements. The gradual correction of those imbalances marked the development of the crisis in Spain and, together with the scope and depth of the reform programme under way, will influence the extent and pace of the return to growth.

Based only on economic activity data, the first fall in the level of GDP in Spain was in 2008 Q2 and the last in 2013 Q2. The latest information points to a steadying of activity in the second half of the year, although the basis for a sustained recovery still continues to be weak and remains surrounded by a high degree of uncertainty. In this period of 21 quarters, the Spanish crisis passed through a number of phases of varying intensity and nature.

The world financial crisis hit the Spanish economy when it was already showing symptoms that the growth pattern which had prevailed for more than a decade was petering out. The sudden tightening of financial conditions and the rising perception of risk triggered a severe real estate crisis which confronted over-indebted economic agents with drastically changed expectations and marked falls in the value of their wealth. The standstill in real estate activity and the decrease in employment in the construction and the construction materials sectors were accompanied by a wider decline in domestic demand, which the Spanish economy was unable to counteract through an increase in external demand, given the problems of competitiveness which had been building up.

The extraordinary fiscal and monetary stimuli used in many industrialised countries after the Lehman Brothers bankruptcy in September 2008 helped to detain the global depressionary spiral, although in Europe the expansionary momentum of public debt in some countries posed uncertainties as to the adjustment capabilities of some euro area economies and as to the deficiencies of the euro area's institutional framework when faced with bouts of instability of



that nature and severity. These deficiencies, which were eloquently reflected in the dramatic developments of the Greek crisis, hampered the recovery of activity because they focused the attention of international investors on the sustainability of public finances, penalising the countries perceived as more fragile, which had to implement fiscal adjustment measures when the cycle continued proving to be very weak. In Spain the sharp growth of the budget deficit from 2008 and the resulting dynamic induced in public debt despite GDP ratios initially below those of the euro area, put Spain in the group of vulnerable economies.

The macroeconomic crisis together with the superposed sovereign debt crisis gave rise to a vicious circle of tightening financial conditions and deteriorating confidence which aggravated the situation of demand and employment, and prompted an additional weakening of bank balance sheets which affected credit institutions unevenly. This phase of the crisis became particularly serious in 2012 when the emergence of redenomination risk in the euro area exacerbated the Spanish public debt tensions and accelerated the net outflow of funds, triggering a balance of payments financing crisis. To address the lack of confidence in the Spanish economy and break the vicious circle between banking and sovereign risk, it was necessary to resort to an EU financial assistance programme to recapitalise the segment of credit institutions showing most weakness.

The European financial support, the acceleration of adjustments and reforms in the Spanish economy and the commitment by the ECB to address the risk of break-up of the euro through the outright monetary transactions programme contributed to stabilising the situation from summer 2012. A year later, Spain's GDP has stopped falling, after a year and a half of continuous decline, and net inflows of financing from abroad have been recorded again.

The economic policy actions over these five years have been numerous and large-scale. At national level, measures have been taken in the financial, fiscal and structural spheres.<sup>1</sup> In the monetary policy field, the ECB has gradually adapted its monetary policy stance to the exceptional challenges posed over these years and has made intensive use of its non-standard tools.<sup>2</sup> Finally, the euro area crisis has required a thorough revision of the euro area's institutional framework and governance, which has affected numerous aspects of the functioning of the area. Notable for its broad scope is the decision to set in train a banking union, which will foreseeably help to re-establish confidence in the soundness of the banking system and overcome the fragmentation of the financial markets.<sup>3</sup>

Among the numerous lines of analysis and thought engendered by such a turbulent period, many reported in different works,<sup>4</sup> this article seeks to recapitulate certain features of the

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1 See, inter alia, tables in the annex to and Box 1.3 of the 2012 Annual Report of the Banco de España

2 See Malo de Molina (2013).

3 See De Grauwe (2011), Malo de Molina (2011), Pisany-Ferry (2012), Banco de España (2013), Fernández de Lis (2013) and Gual (2013).

4 See, for example, Banco de España annual reports (2009-2012), FEDEA (2010), Blanchard et al (2012), Ortega and Peñalosa (2012) and Viñals (2013).

situation of the Spanish economy after five years of crisis. Obviously it has the benefit of being able to analyse this period from a certain perspective hitherto inaccessible given the profusion of impacts and spillovers produced by this crisis and the unpredictability of many of those developments.

This article is structured in five sections including this introduction. Section 2 below describes some stylised facts on the development of the crisis. Section 3, which is not intended to be exhaustive, analyses the adjustment of the construction sector, the balance sheet position of the private sector, the external imbalance, the labour market, the public finances and the relative level of economic welfare. Section 4 looks at the management of economic policy over this long period from the standpoint of its contribution to correcting imbalances and, lastly, some conclusions are drawn which place emphasis on the challenges awaiting us.

## 2 Stylised facts on the development of the Spanish economic crisis

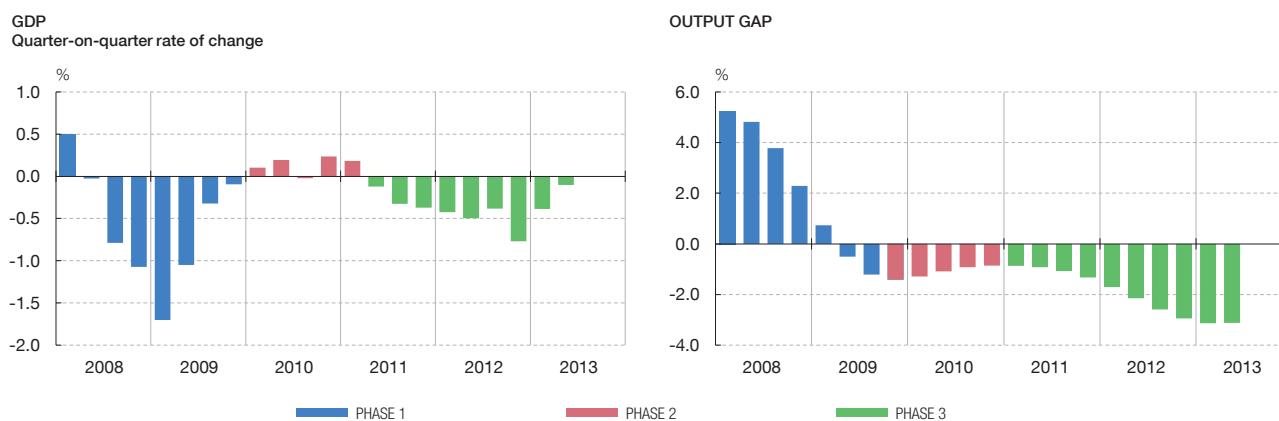
The economic crisis in Spain has been severe. In the euro area, it has only been harsher in the countries subject to international assistance programmes (such as Greece, Ireland and Portugal). Thus, in this five-year period, Spanish GDP has decreased by 7.5 pp, although perhaps the measure best illustrating the seriousness of the crisis is to be found in labour statistics: employment has decreased by 19% since 2008 and the unemployment rate has tripled to stand currently at 26% of the labour force.

During the course of this period, we can distinguish different phases in the rate of adjustment of activity and in the contribution of its determining factors. An initial characterisation of the successive phases through which the Spanish economy has passed in these last five years can be obtained from an analysis of the behaviour of the output gap with respect to potential GDP. As seen in Chart 1, from 2009 the output gap has been negative and has widened practically uninterruptedly, to around 3 pp in 2013. Only in 2010, coinciding with the slight recovery of activity in that year, was there a small turnaround in this process. However, it should be stressed that this approach is not free from problems because of the uncertainty surrounding the estimation of potential output in the context of the prolonged economic crisis.<sup>5</sup>

Alternatively, the stages of the crisis can be delimited by applying the standard definition of a recession based on the sign of the rate of change of GDP. Accordingly, this long period can be divided into three phases.<sup>6</sup> The first stage, running from 2008 Q2 to end-2009, saw activity

SPANISH GDP DURING THE CRISIS

CHART 1



SOURCES: INE and Banco de España.

5 The estimated growth of potential output has been sharply revised downward in Spain from levels exceeding 3% in the pre-crisis years to near-zero growth in the crisis years. An estimate of the potential growth of the Spanish economy can be found in Hernández de Cos, Izquierdo and Urtasun (2011) and a discussion of the effects of the crisis on potential output is given in European Commission (2013).

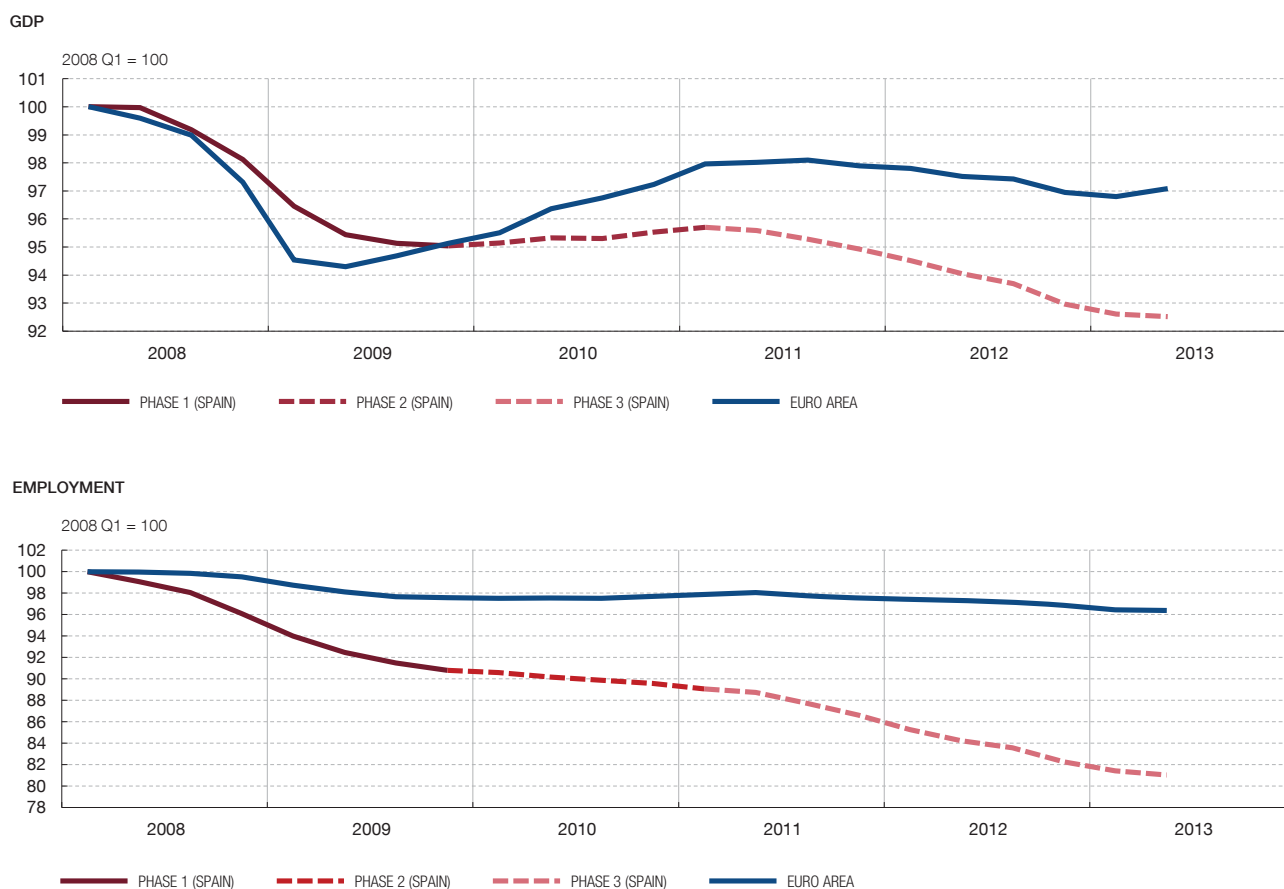
6 Successive revisions of the National Accounts time series have altered the starting date and length of the various recessionary periods. According to the original dates, the first recession began in 2008 Q3 and the second in 2011 Q4. The latest available estimates have brought forward these starting dates by one and two quarters, respectively.

fall sharply (the level of GDP decreased by 5 pp). The second stage, running from the beginning of 2010 to 2011 Q1, saw a certain stagnation of activity, since the level of GDP barely rose by 1 pp. From our present perspective of the period as a whole, this phase merely represents a pause before the subsequent recession. Indeed, the third phase is the second dip of the double-dip recession and, on the information currently available, lasted from 2011 Q2 to 2013 Q3 (see Table 1 of the annex), in which GDP again fell sharply (more than 3 pp in cumulative terms). These periods are fairly similar to those identified by analysing the behaviour of the output gap over these years. These phases are also observed in the euro area, with very similar timing, although, compared with Spain, the euro area recovered appreciably in the intermediate phase and its activity fell off more mildly in the final phase (see Chart 2). The differences between Spain and the euro area are much more significant as regards the behaviour of employment.

These three periods have features in common, such as the persisting downward trend of domestic demand, the positive contribution of the external sector, the continuous job destruction or the downtrend in house prices, but others marked the differences in the trajectory of each stage (see Chart 3). Such is the case of the fluctuating support to activity provided by the public sector or by financial conditions, or of the varying sensitivity of prices

SPANISH AND EURO AREA GDP AND EMPLOYMENT DURING THE CRISIS

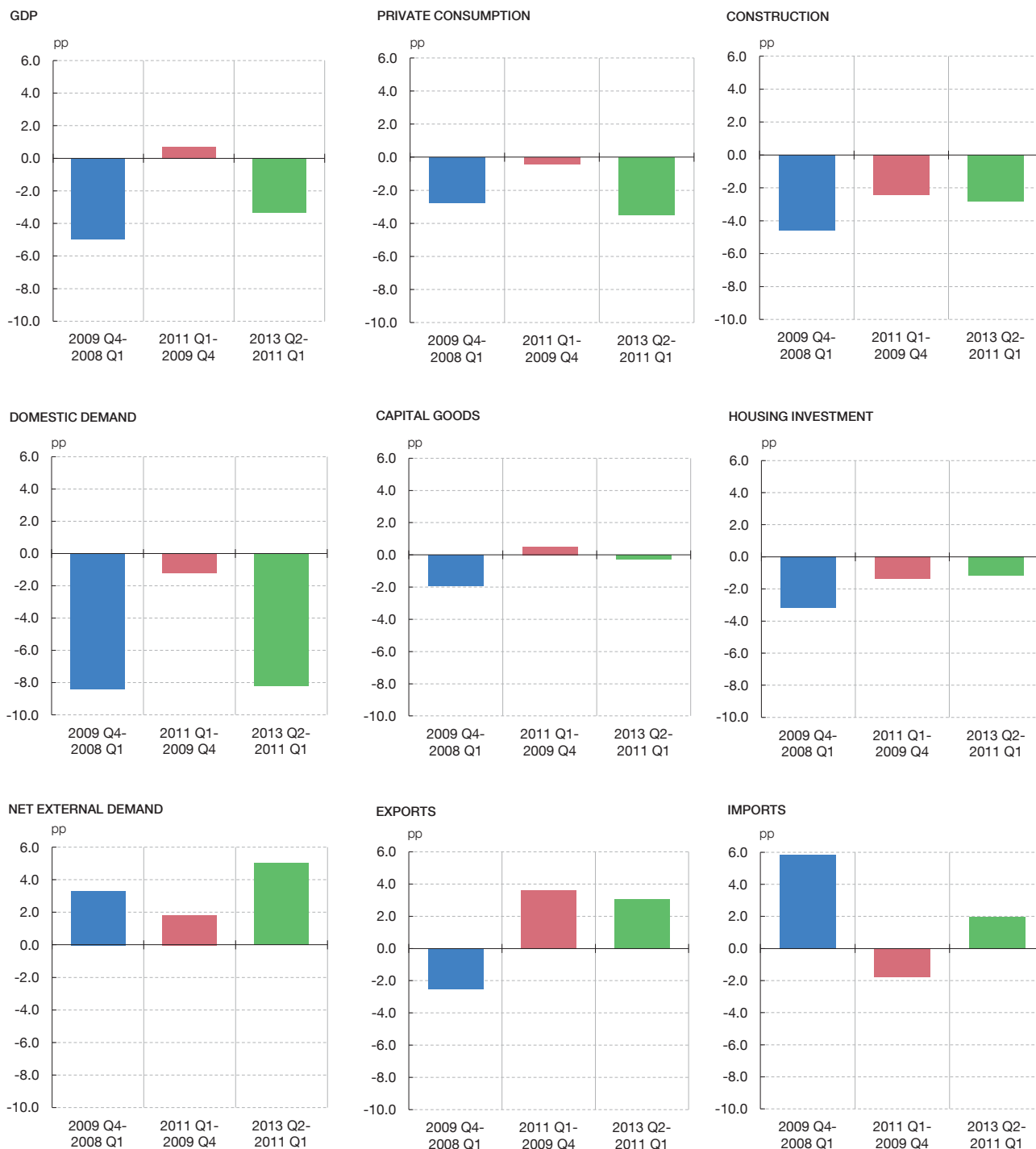
CHART 2



SOURCES: Eurostat, INE and Banco de España.

CONTRIBUTION OF DEMAND COMPONENTS TO GDP GROWTH

CHART 3



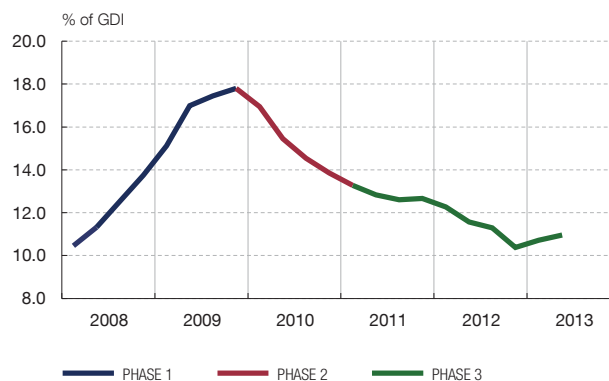
SOURCES: INE and Banco de España.

and wages to the unfavourable cyclical situation. The patterns of balance sheet adjustment and deleveraging by firms and households have also changed over these years.

The first period saw the sharpest decrease in activity, and also in employment (-9%). In this period budgetary policy adopted an openly countercyclical stance, with notable increases in government consumption and investment, tax cuts and higher transfers to the private sector,

GROSS DISPOSABLE INCOME  
Contributions to the rate of change

SAVING RATE



SOURCES: INE and Banco de España.

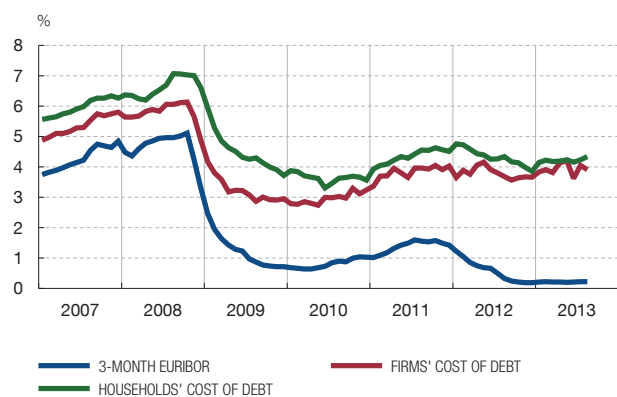
which temporarily sustained household disposable income. Employment in non-market services increased (by 3%), in contrast to the fall in employment in the market economy as a result of the inertia of the worker hiring mechanisms of general government. This fiscal policy stance, along with the sharp fall in the voluminous tax revenues from the real estate sector and, more generally, the significant cyclical impact of the recession, made for an exceptional surge in the budget deficit by 11 pp of GDP in less than two years.

Despite the expansionary budgetary policy, the notably higher uncertainty derived from the rapid deterioration of the labour market and of financial conditions substantially constrained the spending of agents (both business investment and private consumption), so the household saving rate soared to a historical high (see Chart 4). This development, along with the fall in residential investment, meant that households again became net lenders in 2009,<sup>7</sup> after having built up an excess of investment over saving over a long period. The balance sheet position of firms also changed radically because their traditional net borrowing was cut back markedly. Analysis on the non-financial private sector as a whole reveals that the turnaround in its net borrowing was sizeable, since it shrank by 17 pp of GDP in a period of a year and a half. The sharp decrease in private spending helped to reverse the upward trend in net borrowing of the nation, which diminished by nearly 6 pp of GDP between 2008 Q2 and 2009 Q4 in four-quarter cumulated terms (to 4.4% of GDP in 2009).

The second phase of the crisis witnessed the first steps to bring the public deficit back under control, against a background of change in the financial markets' perception of the vulnerability of some euro area countries (most of them on the euro area periphery) as a result of the Greek crisis, which broke out at the end of 2009 (see Chart 5). In this phase the Spanish budget deficit decreased by 2 pp of GDP, although the figure is larger if measured in terms of the implicit structural effort. To do this, some of the expansionary fiscal measures of

<sup>7</sup> Since these variables are usually analysed on an annual basis, we discuss here the four-quarter cumulated figures up to the start and end of each phase into which the crisis period is divided.

COST OF DEBT



10-YEAR BOND YIELD SPREAD OVER GERMANY



IBEX 35



BANCO DE ESPAÑA'S DEBIT BALANCE IN TARGET



SOURCES: Eurostat, ECB and Banco de España.

the previous phase were reversed and public-sector wages were cut substantially (see Table 2 of the Annex). Private-sector wages did not react to the same extent and the process of job destruction continued, albeit at a slower rate. Household disposable income fell substantially, but this fed through only partially to their consumption decisions, so the saving rate declined markedly. Firms continued cleaning up their balance sheets and, for the first time since the start of monetary union, began to generate financing capacity. This may have also been the result of their growing difficulty in obtaining foreign financing as the spread of the sovereign debt crisis heightened tensions in the wholesale finance markets. In this period, non-financial corporations reduced their debt for the first time, although, as in the case of households, the debt to GDP ratio remained at a level not far from that recorded at end-2009. The nation's net borrowing decreased, albeit very slightly, due to the rise in imports.

Many factors played a significant role in the double-dip recession in the Spanish economy from mid-2011. A basic element in that phase was the balance of payments crisis between the summers of 2011 and 2012. This development reflected, in turn, a severe loss of confidence in the Spanish economic outlook and led to a substantial tightening of the financing conditions of the private sector, against a broad backdrop of great uncertainty as to the viability of the euro area as an increasing number of countries required external financial support and the

	Cross-border financial flows (€bn)		
	Total	Excl. Banco de España	Banco de España
2008 Q2-2009 Q4	122	80	42
2010 Q1-2011 Q1	53	48	5
2011 Q2-2013 Q2	9	-234	243
2008 Q2-2013 Q2	184	-106	290
Last 12 months	-22	92	-114

	International investment position			
	€bn	Change	% of GDP	Change
2008 Q1	-849		-79.7	
2009 Q4	-982	-133	-93.8	-14.1
2011 Q1	-961	21	-91.8	2.0
2013 Q2	-955	6	-93.4	-1.7
Change 2013 Q2-2008 Q1		-106		-13.8

SOURCE: Banco de España.

first decision was taken on Greek debt restructuring. The balance of payments in this period was close to equilibrium, but in the resident sectors other than the Banco de España there were large outflows of financing (€200 billion, almost 20% of GDP), which were offset by an increase in the Banco de España's liabilities for a similar amount, due to the greater recourse by Spanish banks to Eurosystem liquidity tenders (see Table 1).<sup>8</sup> The tensions eased from September 2012 once the European financial assistance programme for Spanish banks was approved and the ECB announced it stood ready to intervene in the markets through outright monetary transactions (OMT) to forestall any doubts over the irreversibility of the euro.<sup>9,10</sup>

This external financing crisis weakened Spanish banks' balance sheets and also affected the availability of funds to the private sector, particularly at the banks whose solvency had been most seriously damaged, as was the case of savings banks. Consequently, the process of deleveraging, which had begun timidly in 2010, accelerated sharply (corporate debt was reduced by €195 billion and household debt by €74 billion).<sup>11</sup>

In this stage fiscal policy was tightened, and more rigorous procedures to control budgetary slippage in the various general government sub-sectors (such as the new Budgetary Stability Law<sup>12</sup> or the obligations derived from the Supplier Payment Plan) were implemented. The aim was to redress the unsustainable path of the budget deficit.

<sup>8</sup> See Merler and Pisani-Ferry (2012).

<sup>9</sup> Thus, in the most virulent period of the balance of payments crisis in Spain, which ran from July 2011 to August 2012, outflows of financing in other resident sectors amounted to €356 billion, equal to one-third of Spanish GDP.

<sup>10</sup> Gros and Alcidi (2013) compare the adjustment of euro area economies to a "sudden stop" with the experience of Central and Eastern European countries.

<sup>11</sup> It should also be noted that a portion of that deleveraging was effected by cleaning up bank balance sheets through the recognition of bad loans.

<sup>12</sup> See Hernández de Cos and Pérez Garcia (2013).



Employment decreased considerably in the second dip (9%), especially if the adjustment already made previously is taken into account, with job losses in all sectors, including, for the first time since the crisis began, in non-market services. The fall in employment and the greater drain of resources by general government through higher taxes and lower transfers led to a further drop in household disposable income, which substantially reduced private consumption. Despite this, the saving rate again decreased and at end-2012 stood at its lowest level in recent years, signalling the gradual erosion of households' resilience to income shocks without radically changing their consumption pattern [see Arce et al. (2013)]. This reduction in saving also meant that households' net lending decreased. By contrast, firms resorted, as in the previous stage, to internally generated funds to clean up their balance sheets, reduce their debt and raise their financing capacity. Once again, the adjustment of domestic demand favoured the correction of the external balance, which at mid-2013 swung to net lending for the first time since the end of the last century, in an amount equal to 1.4% of GDP in four-quarter cumulated terms.

### 3 Some features of the readjustment of the Spanish economy between 2008 and 2013

As noted in the preceding section, the crisis prompted a substantial readjustment of the main Spanish macroeconomic aggregates, affecting the composition of GDP on the demand and supply sides and impinging on the financial position of the institutional sectors. In particular, it changed the composition of activity, in that the dynamism of domestic demand moderated significantly (above all in construction investment) and the continuous recourse to external saving was reversed. This section summarises the process of readjustment and its impact in terms of employment, public finances and the relative level of economic welfare.

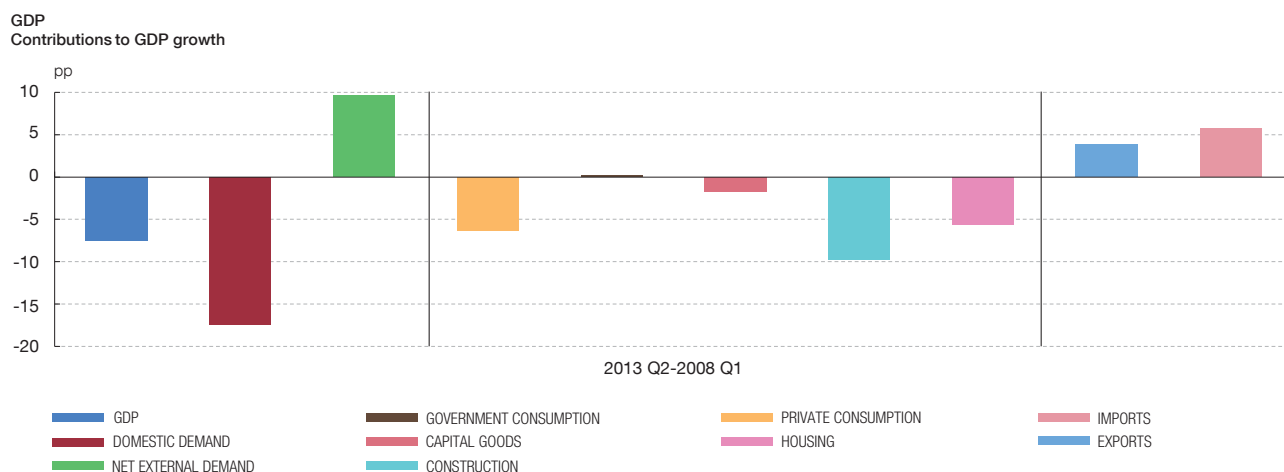
#### 3.1 Changes in the composition of GDP

The behaviour of GDP, as estimated using its demand-side determinants, indicates that the crisis brought a sharp fall in domestic demand, with a corresponding rise in net external demand (see Charts 6 and 7). Thus, over these five years, domestic demand dropped by 16% in real terms, with decreases in all items. The decline was most significant in investment, but also sizeable in private consumption, which fell by 10%. In terms of the structure of output, the most substantial change was in construction investment, whose weight in GDP expressed in current prices dropped to half, i.e. a ratio of around 10% of GDP, similar to that for the euro area as a whole.

The share of residential investment in GDP fell from 12% in 2007 to 4.4% in 2013 Q2, its lowest for the last three decades.<sup>13</sup> The decrease in the number of housing starts was even sharper, since in the twelve months up to June 2013 the construction of 40,000 houses was started, scarcely 5% of those commenced in 2006.<sup>14</sup>

CHANGE IN GDP DURING THE CRISIS: BREAKDOWN BY COMPONENT

CHART 6

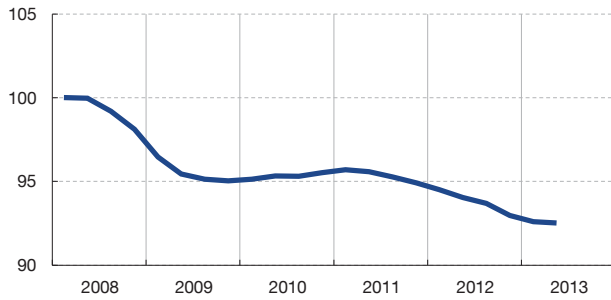


SOURCES: INE and Banco de España.

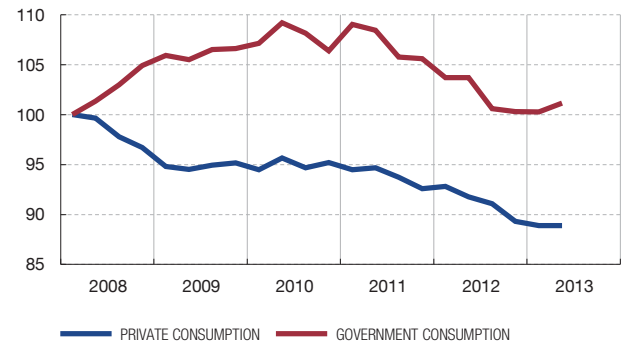
<sup>13</sup> This ratio is even lower than that for the euro area, which is understandable because the large housing overhang requires residential investment to remain for some time below what is probably its medium- and long-term level.

<sup>14</sup> This means that a relatively high percentage of residential investment currently consists of its housing rehabilitation component, which has been less affected by the economic crisis.

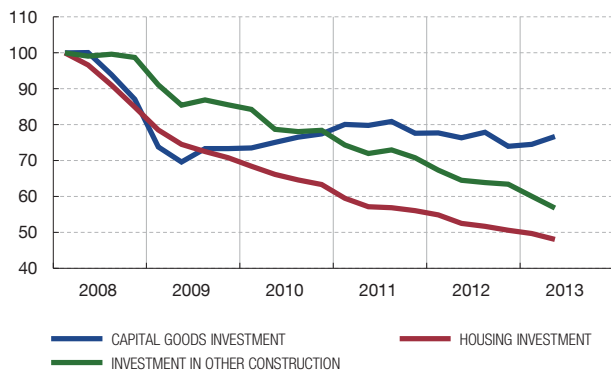
GDP



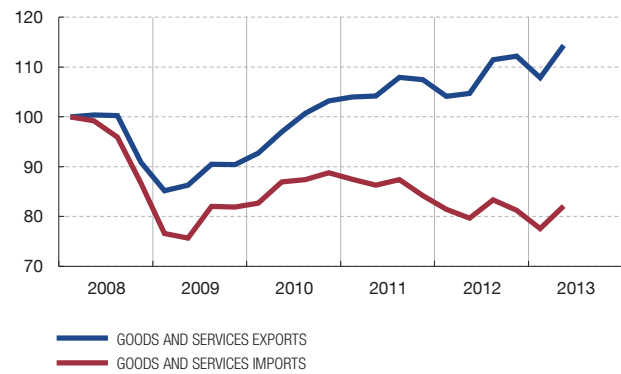
CONSUMPTION



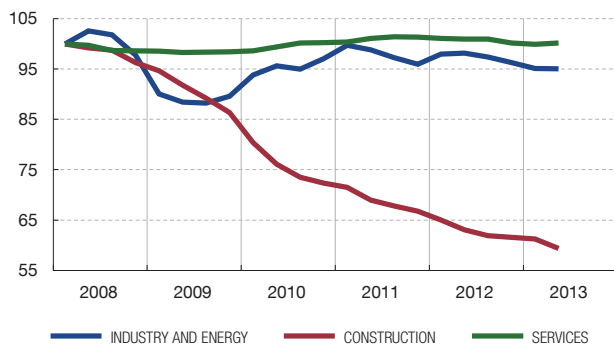
GROSS FIXED CAPITAL FORMATION



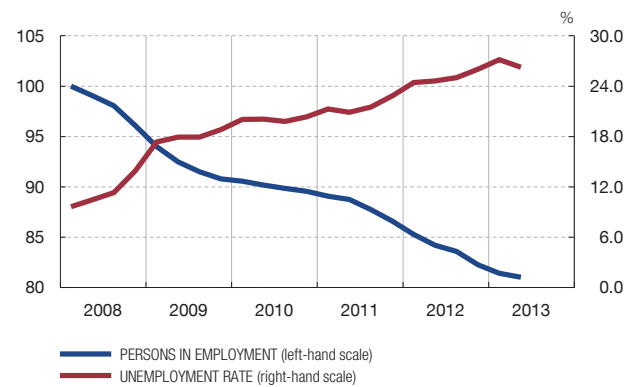
EXTERNAL DEMAND



GROSS VALUE ADDED



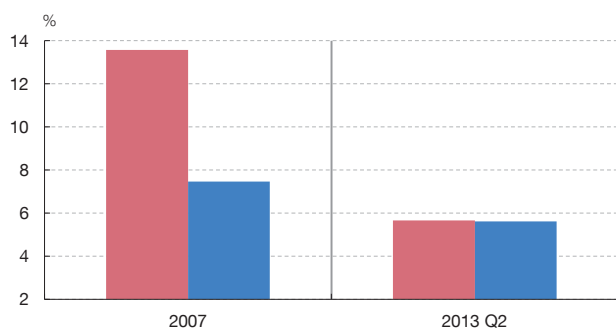
LABOUR MARKET



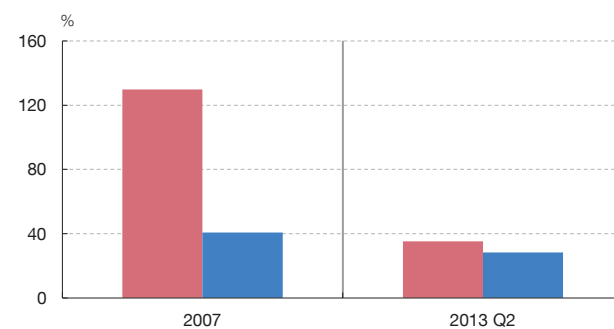
SOURCE: INE.

The real estate collapse substantially affected house prices, which in nominal terms fell by nearly 30% from their peak until 2013 Q2. In real terms, the size of the adjustment is 36%, which far exceeds those in previous real estate cycles. As shown by Chart 8, this means that the gap which opened up between house prices in Spain and in the euro area in the boom period has closed considerably. Household wealth has been affected by this price correction, since housing wealth in mid-2013 was around four times GDP, compared with nearly six times GDP

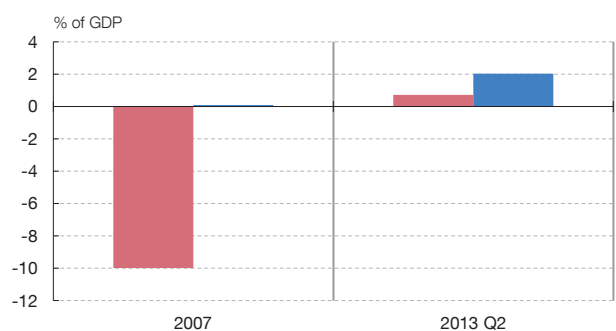
SHARE OF CONSTRUCTION EMPLOYMENT IN TOTAL EMPLOYMENT



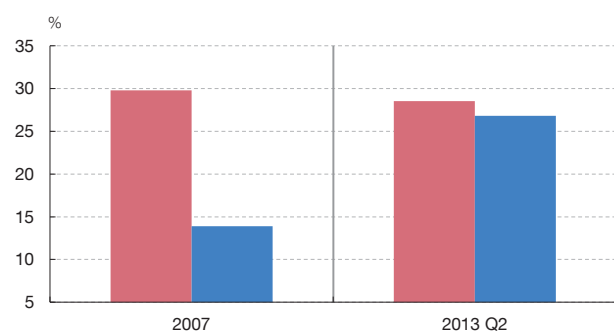
INCREASE IN HOUSE PRICES IN REAL TERMS SINCE 1998



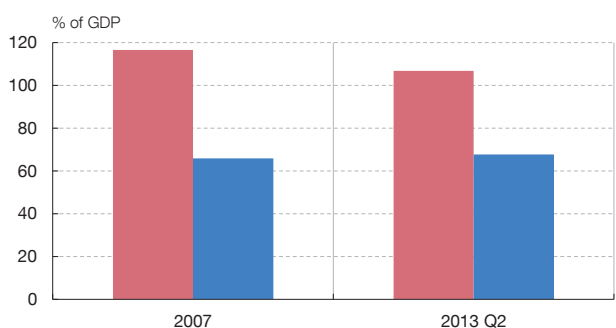
CURRENT ACCOUNT BALANCE



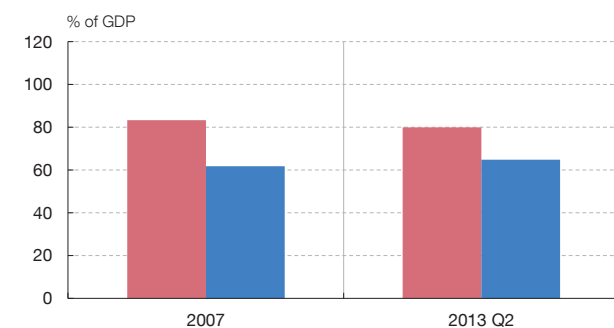
INCREASE IN UNIT LABOUR COSTS SINCE 1998



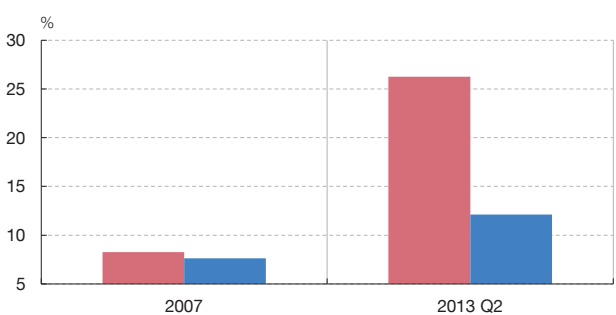
CORPORATE DEBT



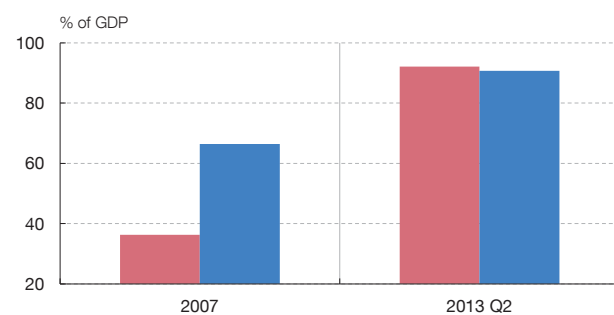
HOUSEHOLD DEBT



UNEMPLOYMENT RATE



PUBLIC DEBT



SPAIN

EURO AREA

SOURCES: Eurostat, INE and Banco de España.

in 2007. Although, due of its nature, that housing wealth had limited liquidity, the high housing overhang further reduced the ability of households to realise the assets locked up in that saving, which is an additional factor restricting the spending power of households. Non-residential construction also declined substantially, since on top of the downturn in business investment there was a sharp fall in government investment, which, as explained below, was one of the main drivers of fiscal consolidation in Spain.

The sharp halt in this sector's activity had a considerable effect on employment because construction is very labour intensive. Construction sector employment came to account for nearly 14% of total employment in 2007, twice as high as in the euro area, with nearly 2.5 million people employed. In 2013 Q2 the persons employed in this sector fell short of one million, with a ratio of 6% of total employment, similar to that of other European countries (see Chart 8 again). As will be seen below, the skills of those workers make them difficult to place in other activities.

Analysis of the behaviour of GDP from the supply side shows that the crisis had an uneven impact across economic sectors. The most notable changes in the composition of GDP were the share accounted for by the value added of construction decreased and that of services increased, with more expansionary performances by information and communication services, business services, consulting and transport. The weight of the value added of industry in GDP remained steady at around 16%, although that ratio conceals a very substantial change in the type of manufacturing firms comprising that sector, since those which survived the crisis are more productive and open to trade. In this respect, it may be surprising that, despite the increase in the weight of exports in GDP, the share of industry – which is the main producer of exportable goods – has not risen in Spain during these years.<sup>15</sup> Two possible reasons for this paradox are the sluggishness of domestic demand – most notably the collapse of residential investment, which acts as a source of demand for industrial products – and the growing outsourcing of some activities to the services sector [see Tiana (2012)].

### ***3.2 Correction of the external imbalance and adjustment through the competitiveness channel***

The ongoing substantial recourse to external saving which accompanied the upturn of the Spanish economy was one of its main sources of vulnerability and marked the unsustainability of a pattern of growth based on the persistent expansion of external debt. The economic crisis halted that trend of rapid deterioration of the external financial position, although scarcely any headway has been made in reversing that trend.

Indeed, these years have seen a significant reduction of the external imbalance, which swung from a deficit of nearly 10% of GDP in 2007 to a surplus in 2013 (see Table 2). This is a considerable correction, but the crisis has been extremely severe and has strongly affected domestic demand. It is therefore difficult to distinguish to what extent this improvement in the

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<sup>15</sup> In any event, it should be noted that the weight of industry in Spain is not lower than in other European countries, except Germany. Thus the ratio in France and Italy is similar to that in Spain.

**REST-OF-THE-WORLD ACCOUNT**  
**% of GDP (in four-quarter cumulated terms)**

**TABLE 2**

	2008 Q1	2013 Q2	2009 Q4/ 2008 Q1	2011 Q1/ 2009 Q4	2013 Q2/ 2011 Q1	2013 Q2/ 2008 Q1
1. Goods trade balance (fob)	-8.8	-1.3	4.9	-0.7	3.4	7.6
Goods exports	18.1	23.5	-2.5	3.9	4.0	5.4
Goods imports	27.0	24.8	-7.4	4.6	0.6	-2.2
2. Services trade balance (fob)	1.9	3.5	0.2	0.5	0.9	1.5
Services exports	8.7	10.5	-0.3	0.7	1.5	1.8
Services imports	6.8	7.1	-0.5	0.2	0.5	0.3
3. Goods and services foreign trade balance (3 = 1 + 2)	-6.9	2.2	5.0	-0.2	4.3	9.1
4. Primary income balance	-2.7	-1.1	0.5	0.4	0.7	1.6
5. Net current transfers	-0.8	-0.4	0.1	0.1	0.2	0.4
6. Current external balance (6 = 3 + 4 + 5)	-10.4	0.7	5.7	0.2	5.2	11.1
7. Net capital transfers	0.5	0.7	0.0	0.2	0.1	0.3
8. Net lending (+) / net borrowing (-) of the nation (8 = 6 + 7)	-10.0	1.4	5.6	0.4	5.3	11.4

SOURCES: INE and Banco de España.

external balance is attributable solely to cyclical or structural factors. Evidently this correction is partly explained by a surge in exports, a development indicative of the improved competitiveness and greater presence abroad of Spanish firms related to the sluggishness of the domestic market. Exports increased by 14% in real terms in that period and, at current prices, rose from a share of somewhat more than one-quarter of GDP at the start of the crisis to one-third of GDP at mid-2013, representing an increase of 8 pp. Also notable was the smaller relative weight of exports to the euro area, a sign of the growing geographical diversification of sales abroad, which underpinned the buoyancy of exports at a time when world growth was tilting progressively towards the emerging economies.<sup>16</sup>

In this five-year period, real imports decreased by 18%, although at current prices their weight in GDP scarcely dropped by 1 pp. It can be assumed that this weakness of imports has a large cyclical component, although possibly the purchases abroad in some segments are being partially replaced by domestic production. Overall, the behaviour of exports and imports reflects the fact that the adjustment channel of competitiveness has begun to function, albeit late, as evidenced both by the improved competitiveness of national production (which foments exports and the substitution of imports) and by the cut-back in purchases abroad derived from the contraction in demand and activity. All told, the size of the effort yet to be made is considerable. Indeed the Spain's long period of accumulating external deficits led to a rather high and persistent negative international investment position (above 90% of GDP, far removed from the threshold of 35% of GDP set in the excessive macroeconomic imbalance procedure),

<sup>16</sup> See Peñalosa (2012).

so it is necessary to combine an external deficit and activity growth to reduce that dependence on external saving.<sup>17</sup> This underscores the importance of competitiveness as a variable which may make the achievement of these two objectives compatible.

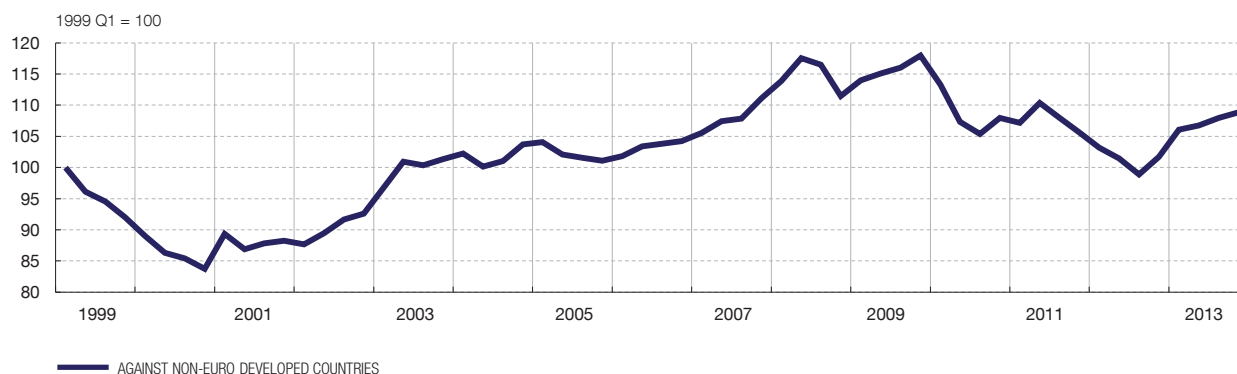
The competitive position of a country depends on numerous factors, many of them qualitative (quality, innovation, trade policies, etc.). A solid competitive position requires progress in those factors, which ultimately means that productivity policies have to be prioritised. At the same time, the adjustment of relative costs and prices is a basic determinant of competitiveness in a monetary union because it is what, in the absence of nominal devaluation mechanisms, enables the real exchange rate to be varied and allows factors of production to be reallocated from non-tradable to tradable goods sectors.

A significant and growing part of Spain's foreign trade is with non-euro area countries. This makes it necessary to consider the nominal effective exchange rate of the euro against

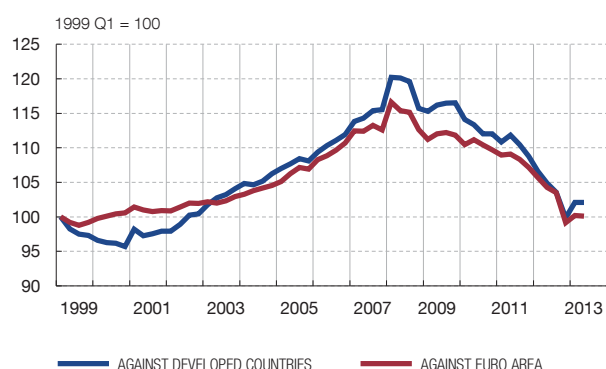
## COMPETITIVENESS

CHART 9

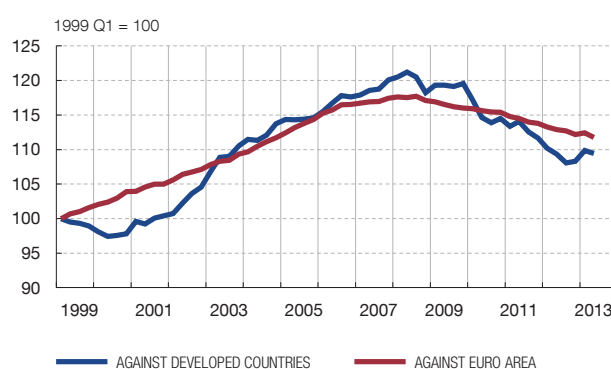
### NOMINAL EFFECTIVE EXCHANGE RATE



### REAL EFFECTIVE EXCHANGE RATE CALCULATED USING UNIT LABOUR COSTS



### REAL EFFECTIVE EXCHANGE RATE CALCULATED USING GDP DEFLATOR



SOURCES: INE and Banco de España.

<sup>17</sup> It should be taken into account that even when the external accounts are balanced or in surplus, a high level of foreign liabilities requires frequent roll-over of financing, which is sensitive to market sentiment and to the prospects of economic recovery or of success in the economic policy measures taken.

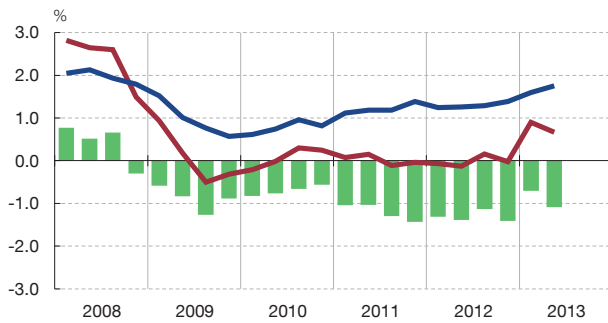
the currencies of our main trading partners. In this respect, the euro has depreciated slightly against those currencies in the last five years, although that trend has reversed in recent months (see Chart 9).

However, to bolster exports and limit the penetration of imports, Spanish prices and costs need to fall relative to those of our competitors, which would restore the competitiveness lost since inception of the euro area. In this process of improvement of competitiveness, the advances made in the crisis years were uneven. It is true that inflation has become more sensitive to the cyclical downturn since the outset of the crisis [see Álvarez and Urtasun (2013)]. However,

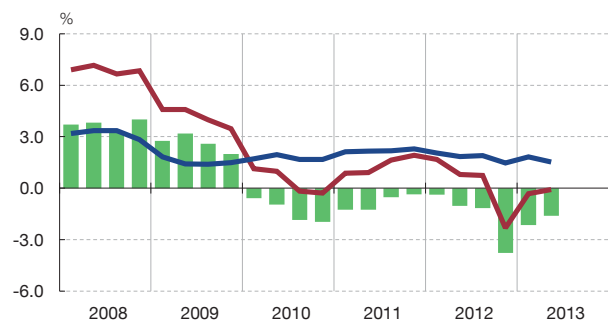
PRICE AND COST DIFFERENCES BETWEEN SPAIN AND THE EURO AREA

CHART 10

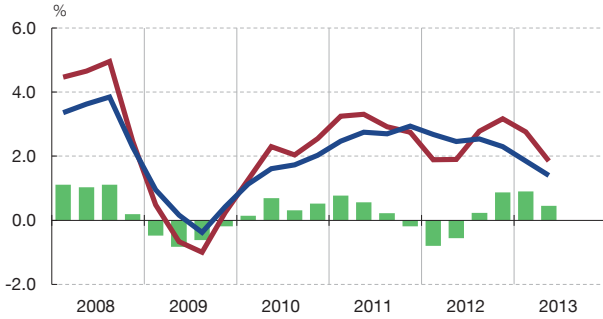
GDP DEFLATOR



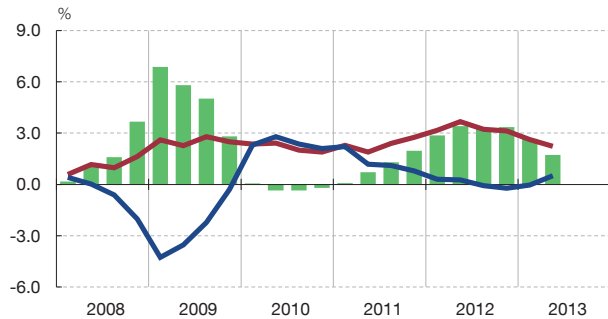
COMPENSATION PER EMPLOYEE



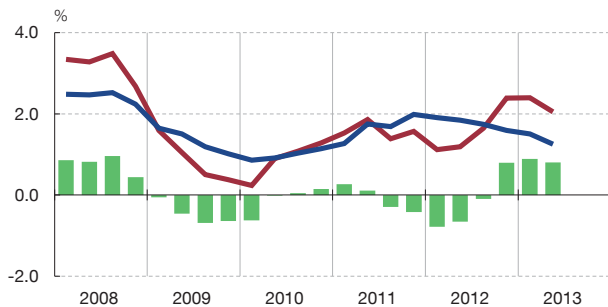
HICP



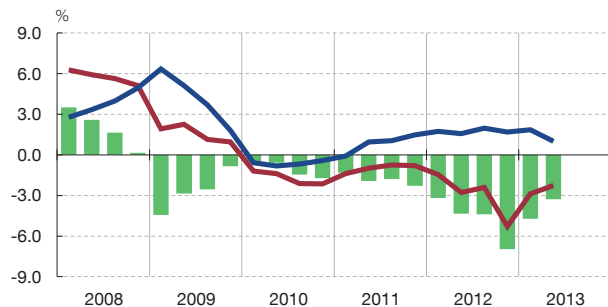
PRODUCTIVITY



CPI EXCLUDING UNPROCESSED FOOD AND ENERGY



UNIT LABOUR COSTS



DIFFERENCE

SPAIN

EURO AREA

SOURCES: Eurostat, INE and Banco de España.



looking at the HICP, the large difference built up in the period 1999-2007 has decreased only partially. To some extent this is due to the rises in energy prices, indirect taxes and administered prices which have been a component of fiscal consolidation strategy in Spain. In the case of the GDP deflator, the difference relative to the euro area has been systematically negative from 2008, although that has not offset the deterioration in prices with respect to the boom years (see Chart 10).

In the case of compensation per employee, the largest adjustment in the period as a whole was in the non-market sector through the public-sector wage cuts in certain years and the decision not to increase wages in others, as a result of which the level in 2012 was similar to that in 2007. By contrast, compensation per employee in the private sector increased by around 10% in the five years as a whole. In relative terms, wages only began to grow more slowly than in the euro area from 2010. Partly owing to this wage rigidity and to the severity of the recession, firms reduced their unit labour costs (ULCs) by shedding labour, i.e. by sharply raising productivity. In this respect, the most significant reversal of losses in competitiveness vis-à-vis the euro area has been precisely in terms of this latter variable. In any event, notably in recent quarters the higher wage flexibility stemming from successive labour reforms has allowed ULCs to be contained, with a higher contribution from wage moderation and a lower contribution from the productivity gains emerging as a result of job destruction (see Table 3 of the Annex for a brief description of the labour market reform measures adopted in recent years).

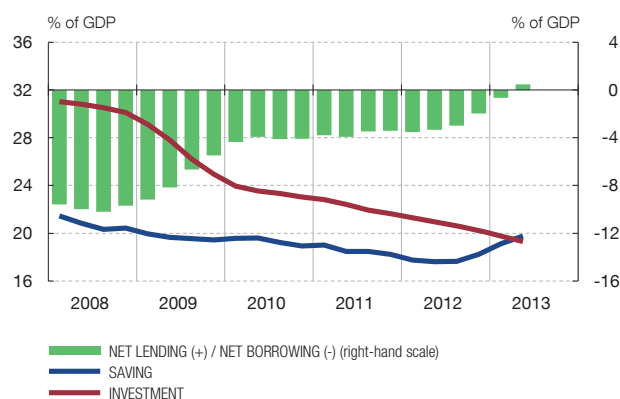
In short, the buoyancy of exports (and perhaps some of the sluggishness of imports) is being favoured by the gains made in competitiveness, although the process of domestic devaluation has been slow and depended excessively on job destruction, as analysed below.

### **3.3 Changes in the balance sheet position of the private sector**

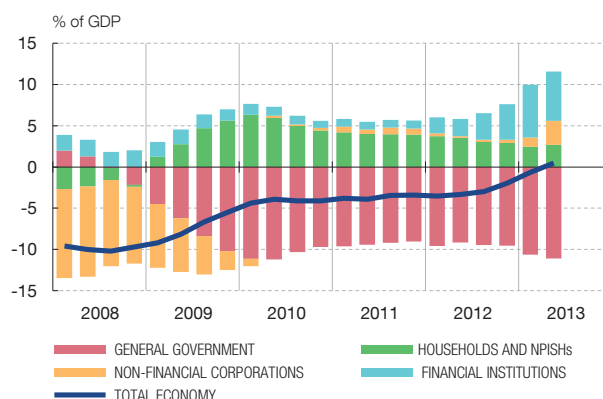
The aforementioned changes in the composition of GDP have their counterpart in the substantial variations in the financial position of the institutional sectors. The reduction in the nation's net borrowing by 11 pp of GDP from the beginning of the crisis was accompanied by a movement of opposite sign in the public and private sectors: in non-financial corporations and households, net lending increased by 18 pp of GDP, mainly as a result of the sharp adjustment in investment and also because of the efforts by both sectors to clean up their balance sheets and reduce their leverage; by contrast, the public sector went from a surplus of nearly 2% of GDP in 2007 to a deficit of 6.8% in 2012 (not counting the impact of financial support) (see Chart 11).

These readjustments by the private sector bring Spanish households and firms closer to the pattern in the euro area (see Chart 12). Thus, the fact that Spanish households were net borrowers in 2007 was exceptional from the European standpoint, where households are usually net lenders. The decrease in residential investment in Spain, the ratio of which to GDP in 2007 was nearly 7 pp higher than in the euro area, allowed the financing capacity of Spanish households to return to a level similar to that in European countries. In the case of non-financial

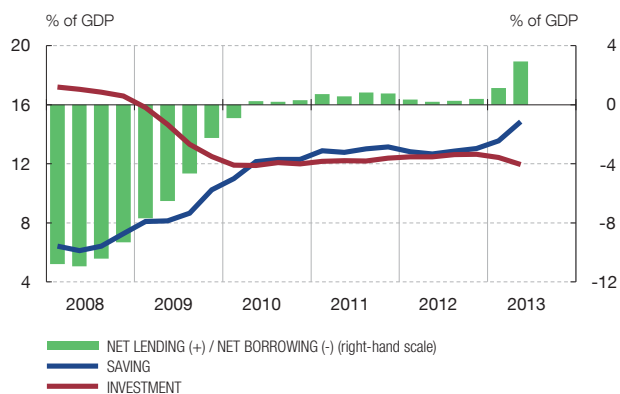
TOTAL ECONOMY



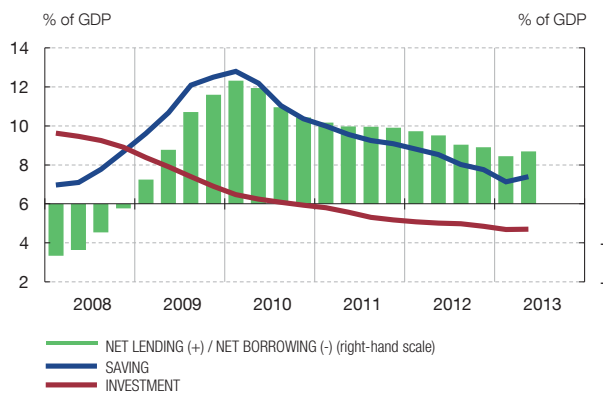
NET LENDING (+) / NET BORROWING (-)



NON-FINANCIAL CORPORATIONS



HOUSEHOLDS AND NPISHs



SOURCES: INE and Banco de España.

corporations, the high net borrowing during the boom, which reached nearly 11% of GDP in 2007, was also much higher than that of European firms due to the combination of a much higher investment ratio and much lower business saving in Spanish firms. During the crisis, business investment expressed as a percentage of GDP decreased in Spain (to a ratio of around 12%), while business saving increased, in this case to ratios exceeding those in the euro area. As a result, the net lending which began to emerge in 2010 contrasts with the persistence of a certain net borrowing by European firms. The financing constraints in Spain and the need to make headway in the process of deleveraging may have made for a sharper adjustment of firms' balance sheet positions in Spain.

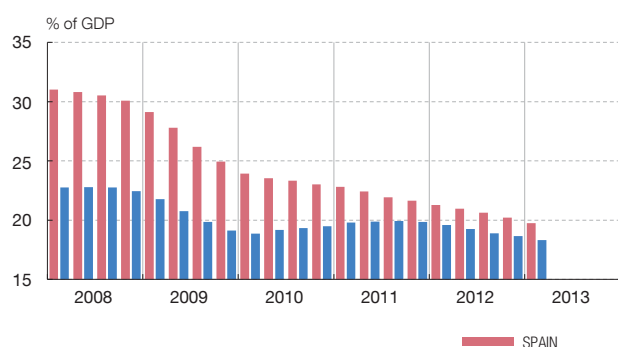
Despite this improvement in the balance sheet position of firms and households, the debt ratios of the private sector remained high, partly because of the weakness of their income. At mid-2013 corporate debt represented 107% of GDP,<sup>18</sup> 10 pp less than at the beginning of 2008, and the debt ratio of households was 80%, 5 pp lower than at the start of the crisis (see Table 3). That is to say, the debt of non-financial corporations and households decreased by

<sup>18</sup> Part of that debt is explained by the process of globalisation of Spanish multinationals, which were particularly active in the years preceding and immediately after the creation of the euro area.

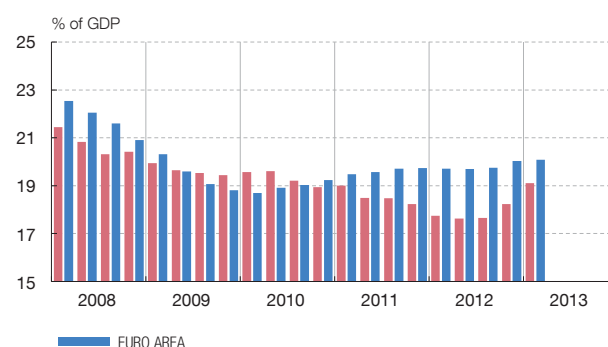
## SAVING AND INVESTMENT IN SPAIN AND THE EURO AREA

CHART 12

## INVESTMENT



## SAVING



SOURCES: Eurostat, INE and Banco de España.

## PUBLIC DEBT AND NON-FINANCIAL PRIVATE-SECTOR DEBT IN SPAIN DURING THE CRISIS

TABLE 3

	Total			
	€bn	Change	% of GDP	Change
2008 Q1	2,500		237.4	
2009 Q4	2,767	267	264.3	26.9
2011 Q1	2,861	94	273.2	8.9
2013 Q2	2,850	-11	278.8	5.6
Change 2013 Q2-2008 Q1		350		41.4

	General government			
	€bn	Change	% of GDP	Change
2008 Q1	378		35.9	
2009 Q4	565	187	54.0	18.1
2011 Q1	686	121	65.5	11.5
2013 Q2	944	258	92.4	26.8
Change 2013 Q2-2008 Q1		566		56.5

	Non-financial private sector			
	€bn	Change	% of GDP	Change
2008 Q1	2,122		201.5	
2009 Q4	2,202	80	210.3	8.8
2011 Q1	2,175	-27	207.7	-2.6
2013 Q2	1,906	-269	186.5	-21.2
Change 2013 Q2-2008 Q1		-216		-15.1

	Firms			
	€bn	Change	% of GDP	Change
2008 Q1	1,235		117.3	
2009 Q4	1,299	64	124.1	6.8
2011 Q1	1,287	-12	122.9	-1.2
2013 Q2	1,092	-195	106.8	-16.1
Change 2013 Q2-2008 Q1		-143		-10.5

	Households			
	€bn	Change	% of GDP	Change
2008 Q1	887		84.2	
2009 Q4	903	16	86.3	2.0
2011 Q1	888	-15	84.8	-1.5
2013 Q2	814	-74	79.6	-5.2
Change 2013 Q2-2008 Q1		-73		-4.6

SOURCE: Banco de España.

15 pp of GDP to 186% at mid-2013.<sup>19</sup> The stabilisation of GDP and its subsequent recovery will, moreover, accelerate that reduction of the ratio.<sup>20</sup>

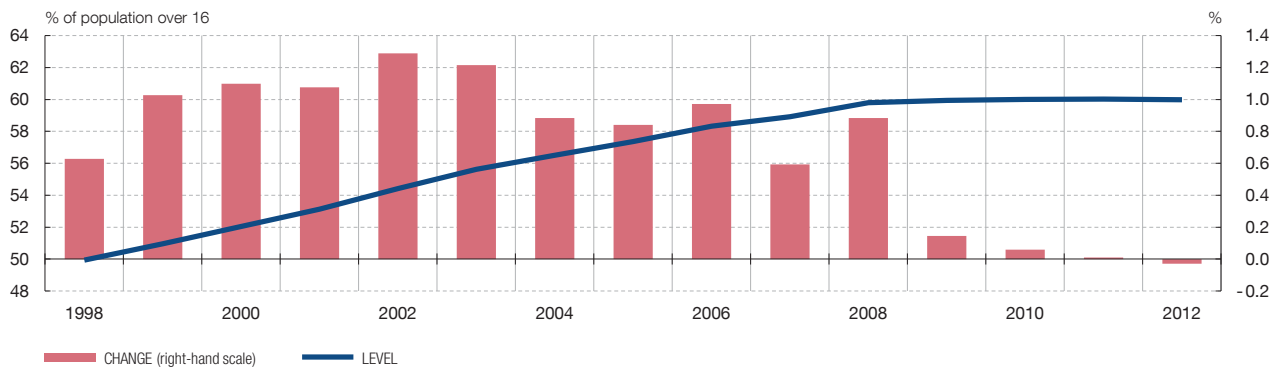
### 3.4 The changes in the labour force, employment and unemployment

After five years of continuous employment destruction the labour market has undergone a far-reaching transformation. The supply of labour has, on aggregate, been notably resilient, although this has changed somewhat in 2013 as the labour force has declined appreciably. That said, in mid-2013, the labour force was 22.7 million, similar to its level in 2008 Q2, against a background of less dynamic demographic developments than in the years leading up to the crisis, as a result of the fall in the foreign population from 2010. This result, which contrasts with the labour force contraction in other downturns, when the discouragement effect or large-scale early-retirement programmes predominated, is mainly attributable to stabilisation of the participation rate at around the high level (60%) reached in 2007 (see Chart 13). The continuous rise in the female participation rate until very recently (in 2013 Q1 it fell for the first time since the start of the crisis) has offset the decline

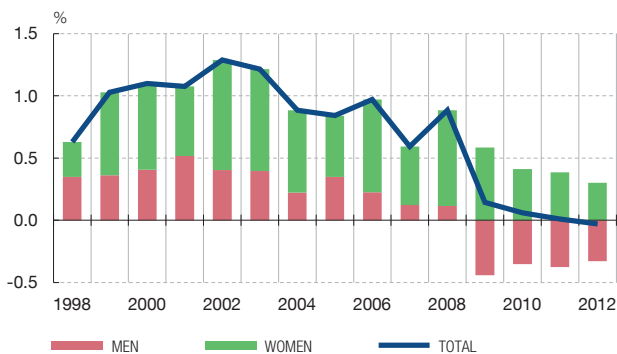
PARTICIPATION RATE

CHART 13

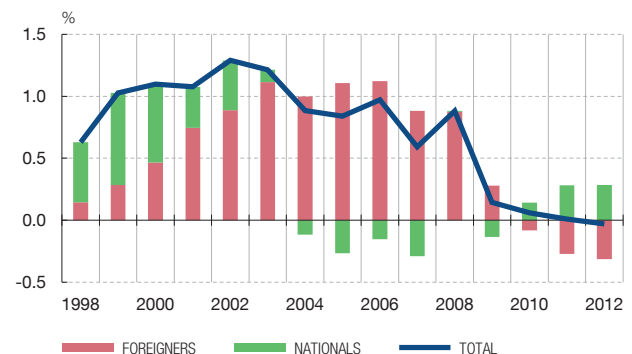
#### LEVELS AND YEAR-ON-YEAR CHANGES



#### CONTRIBUTION BY GENDER TO YEAR-ON-YEAR CHANGE



#### CONTRIBUTION BY NATIONALITY TO YEAR-ON-YEAR CHANGE



SOURCES: INE and Banco de España.

<sup>19</sup> These debt figures include bank loans, fixed-income securities issued and external credit, but not loans granted by general government (which in 2012 represented around 3% of GDP), which however do form part of the debt variable included in the Macroeconomic Imbalance Procedure in the EU. The threshold above which private-sector debt is considered excessive under this procedure is 133% of GDP.

<sup>20</sup> In 2013 Q3 household and firm debt was reduced by an additional €32 billion.

in the male participation rate over these years as well as the decline in the participation of foreign workers. Lying behind this behaviour may be found factors linked to the need to offset the loss of income in the household unit (known as the “second income” effect), but also structural factors, since in recent decades in Spain patterns of female participation have become progressively more similar to those of men, something that previously only occurred at the highest levels of education.

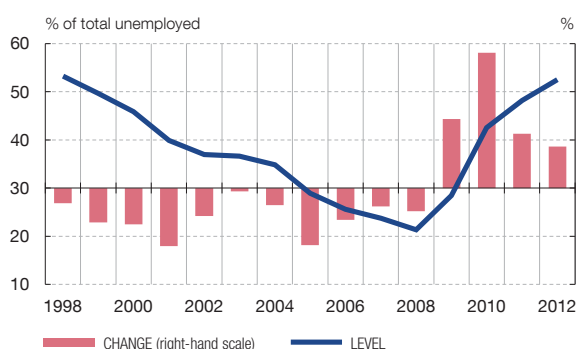
In comparison with the relative resilience of the labour supply, the decline in employment has been sizeable, amounting to almost 20% from its peak, to a level of 16.5 million in 2013 Q2. The adjustment of employment has been more intense among employees with temporary contracts, the number of which fell by 40% from 2007 Q3, accounting for 65% of the total reduction in dependent employment during these years. This feature of the adjustment was especially important in the early stages of the crisis, given the failure of employment conditions to adapt to the cyclical change and the lower costs of dismissal for workers with temporary contracts. Also, the weight of full-time employment has fallen since the crisis, while there has been a considerable increase in part-time employment (the part-time ratio has increased by 5 pp since 2008, to 17%).

Against this background, unemployment has grown very sharply over the last five years (peaking in 2013 Q1 at over six million), the rate rising to 27.2% in 2013 Q1, although it subsequently fell back to 26% in Q3. In this case too there are significant differences between groups: the hardest hit by job losses have been the youngest (the rate of unemployment for 16-24 year-olds stood at 55%) and lowest skilled (with a rate of unemployment of 40%), these groups being especially affected by the destruction of temporary employment. At the same time, the crisis has involved a considerable increase in the average duration of unemployment for all segments of the population. Long-term unemployment (i.e. unemployment lasting for more than one year) stood at 58% of total unemployment in 2013 Q3, compared with 21% at the start of the crisis. The duration of unemployment is particularly high for some groups, such as young people, older workers and the less educated, with the consequent risk of exclusion from the labour market<sup>21</sup> (see Chart 14).

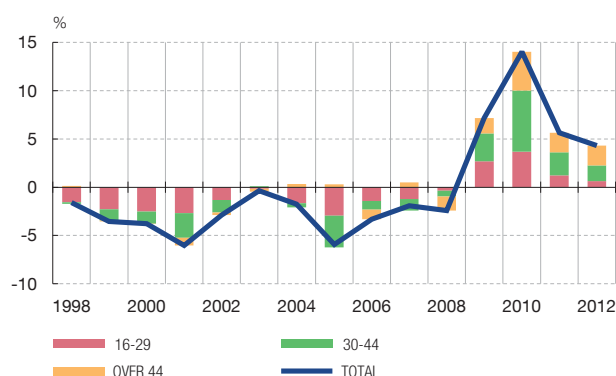
## LONG-TERM UNEMPLOYMENT

CHART 14

LEVELS AND YEAR-ON-YEAR CHANGES



CONTRIBUTION BY AGE TO YEAR-ON-YEAR CHANGES



SOURCE: INE and Banco de España.

21 See Font and Puente (2013).

### 3.5 The structure of public revenue and expenditure

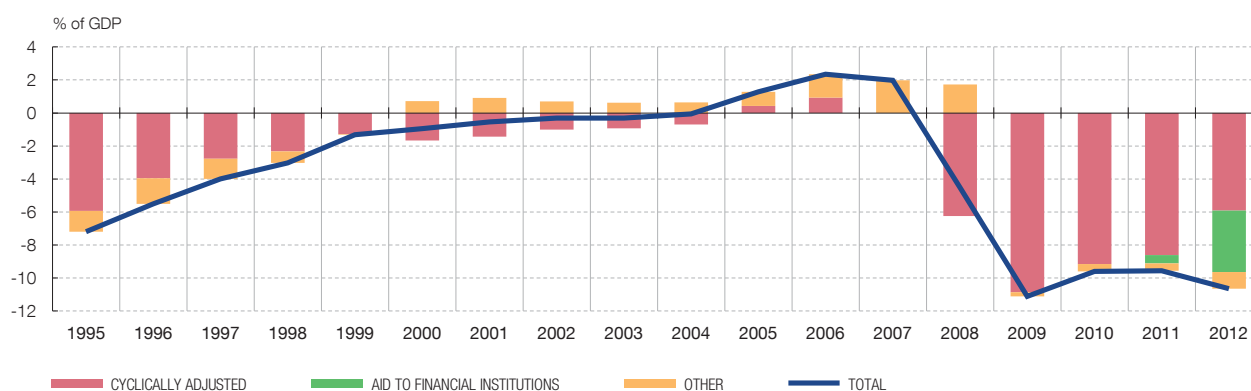
The increase in the budget deficit up to 2009 and the subsequent consolidation process have been accompanied by significant changes in the paths of public expenditure and revenue and their composition. These changes stem from factors of different natures: the impact of the prolonged downturn; the fiscal measures adopted, in some cases temporarily; and the effects of the sovereign debt crisis.

In 2012, the ratio of public expenditure to GDP, excluding the impact of state aid to credit institutions, was 4.8 pp higher than in 2007 (3.4 pp in terms of primary expenditure), standing at 44% (see Chart 15). Current expenditure increased by more than 7 pp of GDP over this period. One third of this increase was attributable to the weight of contributory pensions, one quarter to the increase in unemployment benefits and a somewhat smaller percentage to the increase in interest payments. The compensation of employees increased to a lesser extent (by 1 pp of GDP), having increased until 2009 and fallen thereafter. This expansionary path of current expenditure was

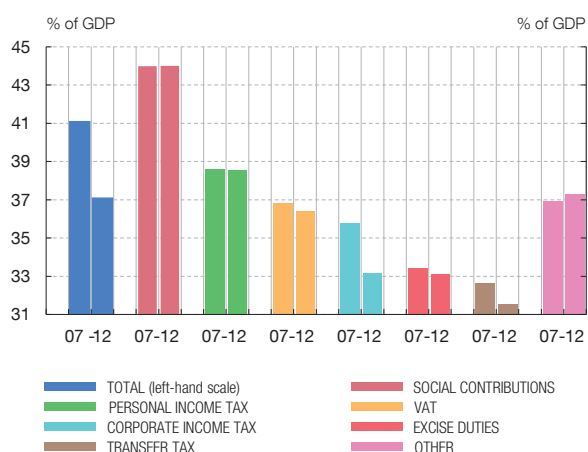
#### GOVERNMENT DEFICIT: REVENUE AND EXPENDITURE

CHART 15

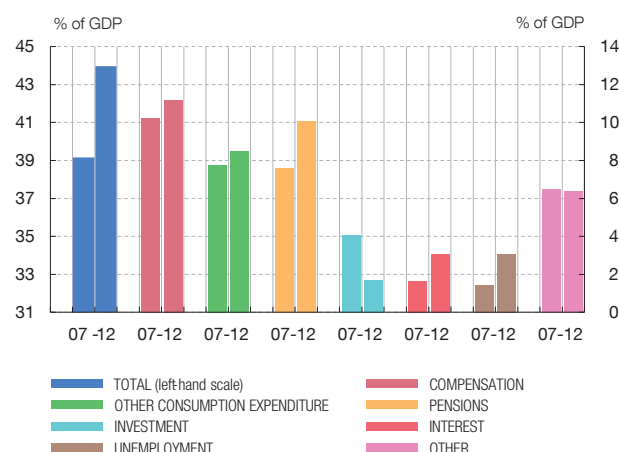
##### GENERAL GOVERNMENT ACCOUNT BALANCE



##### GOVERNMENT REVENUE



##### GOVERNMENT EXPENDITURE (a)



SOURCES: INE and Banco de España.

a Excluding aid to financial institutions.

partly offset by lower public investment, the only component of public expenditure to have fallen in weight since the start of the crisis (it has been halved to 1.7% of GDP), although in this case too the reduction was concentrated in the period 2010-2012. If the analysis of general government expenditure is limited to the budgetary consolidation phase that began in 2010, a somewhat different view is obtained, since the public expenditure ratio in this three-year period, excluding the impact of the financial aid, fell by 2.3 pp of GDP (3.4 pp in the case of primary expenditure).

The ratio of public revenue to GDP fell, in turn, by 4 pp between 2007 and 2012, to 37.1%, despite the fact that from 2010 onwards there were increases in the rates of most taxes (personal income tax, VAT and excise duties). More than half of this decrease is explained by the loss of corporate income tax receipts, which barely responded to the changes in the tax until 2012, and a further 25% to the lower receipts from transfer and stamp tax, which is linked to second-hand housing transactions. Other indirect taxes (VAT and excise duties) explain the remaining 25%. Finally, both personal income tax receipts and social contributions had a similar weight in 2012 to that in 2007, although they fluctuated around this level during the period. The deterioration in domestic demand, with very severe falls in household consumption and residential investment (the basis of indirect tax revenues), and the negative employment trend (which underpins personal income tax and social contributions) lie behind this reduction in the tax burden in Spain, a development that is proving difficult to reverse. In this case too, if the analysis is restricted to the fiscal consolidation phase, the ratio of revenues increased moderately until 2012, and somewhat more strongly in 2013.

These changes have led to modifications in the structure of public expenditure and revenue over these years, some of which, as seen above, merely reflect the impact of cyclical factors. This may be the case of a significant part of the loss of revenue recorded over the last five years. However, the changes in the structure of production and spending accompanying the readjustment of the Spanish economy will entail lower revenue levels in future than in the period before 2007. Given the inertia displayed by certain components of public expenditure, this means that the fiscal consolidation drive needs to be sustained.<sup>22</sup> In the medium term, the restructuring of public finances will be facilitated by the increase in revenue that may arise from reform of the tax system and from the containment of public expenditure that should stem from general government and pension system reform.

In this respect, the measures implemented since 2010 have enabled the budget deficit to be cut by 4 pp from its peak in 2009, to 6.8% of GDP in 2012, although this still represented a deterioration of 9 pp from 2007. The primary structural balance has, in turn, been reduced by 7 pp since 2009, to a level that is still well above the thresholds established by EU obligations. The deficit path during these years was influenced by the impact of aid for the banking system, causing a faster rise in public debt, which reached 92% of GDP in 2013 Q2, and thus in interest payments, which in 2013 are expected to absorb almost 2 pp of GDP more than in 2007 [see Gordo et al. (2013)].

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<sup>22</sup> See Hernández de Cos et al. (2011).

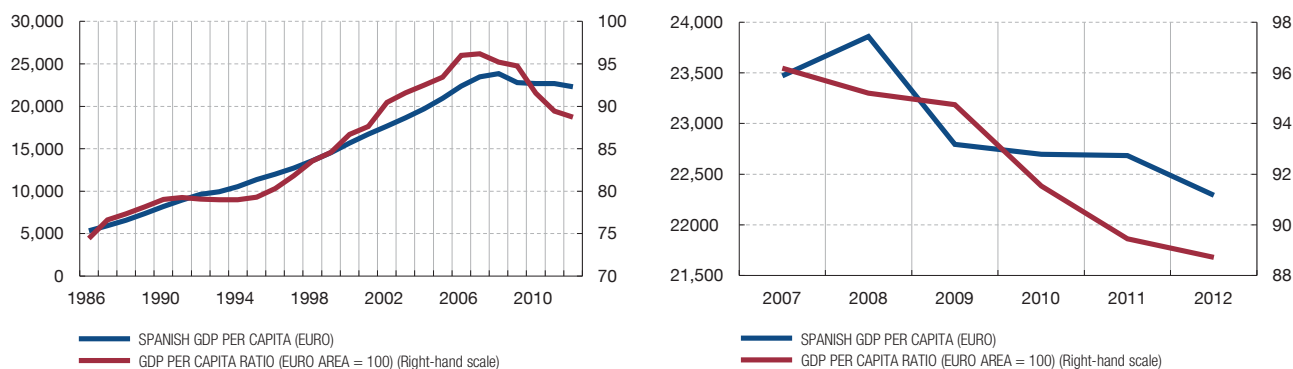
### 3.6 The changes in the relative level of economic welfare

Since the beginning of the crisis, Spain's per-capita income has fallen by almost 5%, causing its position relative to the euro area to worsen by nearly 8 pp, to stand at 88.7% of the average income of this group of countries in 2012, down from a peak of 96.2% in 2007, according to the latest Eurostat estimate (see Chart 16). Despite this significant setback, the figures show that most of the progress in economic welfare in Spain since European integration has been maintained (in 1985, per-capita income relative to the countries that would subsequently make up the euro area was 74%). In terms of its determinants,<sup>23</sup> the decline in the level of real per-capita GDP in recent years has been exclusively due to the poorer behaviour of the rate of employment in Spain, which stood 14 pp below the average euro area rate in 2012 (see Chart 17). This was partly offset by the more favourable performance of productivity, discussed above, which closed the negative gap that had opened up during the years before the crisis, and has reached a level slightly above that of the euro area.

However, from the viewpoint of the determinants of productivity, it should be emphasised that the strong growth in this variable was due to the notable increase in the capital/employment ratio which, in conjunction with the sectoral changes indicated, seems to be giving rise to a pattern of specialisation that makes less intensive use of labour. This type of specialisation is more consistent with the adjustments required by an increasingly competitive world, but poses significant challenges for Spain because of its high employment rate. Accordingly, an extraordinary effort needs to be made to increase the training (and thus the productivity) of the unemployed and to press ahead with sectoral reallocation, so that a pattern of income growth can be achieved which mobilises all the labour available.<sup>24</sup>

SPANISH GDP PER CAPITA AND COMPARISON WITH THE EURO AREA (a)

CHART 16



SOURCES: Eurostat, INE and Banco de España.

a The euro area does not include the latest countries to join.

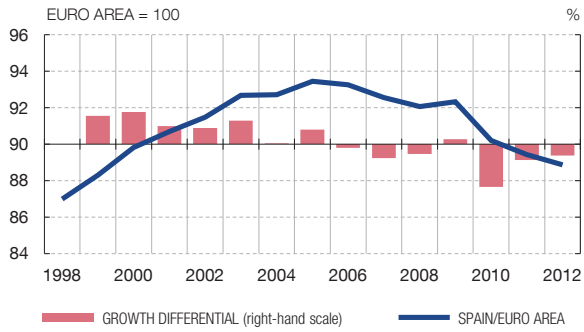
<sup>23</sup> GDP per capita is obtained by multiplying the proportion of the population of working age by the rate of employment and by average labour productivity (i.e.  $GDP/P = WAP/P * N/WAP * GDP/N$ ).

<sup>24</sup> See Izquierdo, Puente and Font (2013).

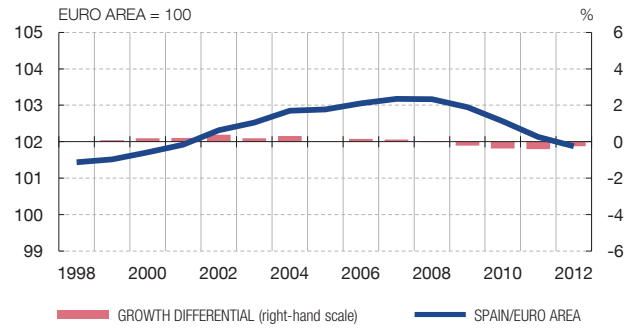


COMPONENTS OF GDP PER CAPITA

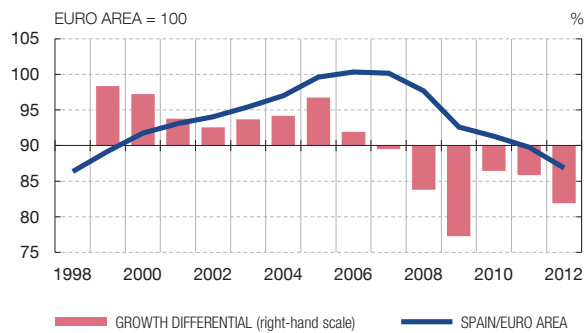
GDP PER CAPITA



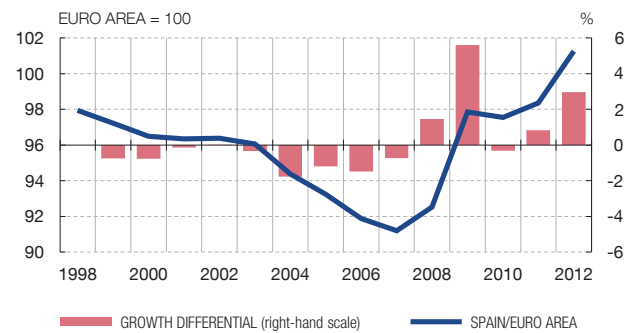
WORKING-AGE POPULATION RATIO



EMPLOYMENT RATE

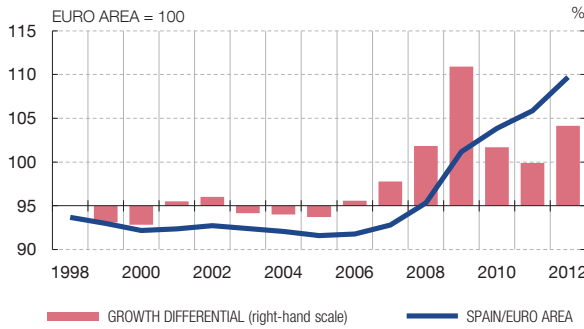


APPARENT LABOUR PRODUCTIVITY

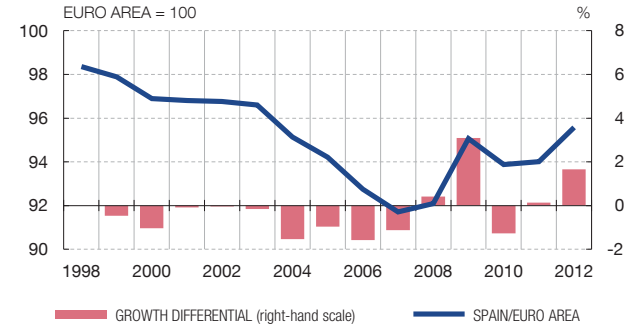


DETERMINANTS OF LABOUR PRODUCTIVITY

TOTAL CAPITAL STOCK PER PERSON EMPLOYED



TOTAL FACTOR PRODUCTIVITY INDEX



SOURCES: Ameco and Banco de España.

#### 4 Economic policy during the crisis

The economic crisis in Spain has been unusually deep. With the perspective of the six years that have passed since the outbreak of the global financial crisis, the severity of the recession in Spain can now be seen to be the consequence of a combination of numerous causes. The starting position of the Spanish economy in 2007 was characterised by certain profound macro-financial imbalances that had built up over the expansionary phase and that heightened vulnerability to financial shocks, particularly if these occurred during cyclical corrections. In addition, the growing complexity of the crisis, as the links between the macroeconomic and financial problems became stronger, was aggravated by the flaws that emerged in the single currency project. All this made it difficult to diagnose the full extent of the problems and to articulate the necessary economic policy responses, which were frequently late and in some cases insufficient.<sup>25</sup> The delay in the policy reaction worsened the problems of confidence and ultimately meant that the response had to be greater when the margin for manoeuvre had become significantly narrower. Albeit with delay, the adoption of adjustment and reform policies, both at the euro area and Spanish economy level, is establishing conditions that will allow the legacy of the crisis to be overcome and a path of recovery initiated.

As seen in the previous section, readjustment of the Spanish economy is proceeding via two basic channels: competitiveness (which for the first time in recent economic history is taking place through a process of internal devaluation) and the balance sheet of the private sector. However, these mechanisms have not been friction free and they have not always been the most rapid or efficient either, for a number of reasons. Focusing on the purely domestic ones, first, the institutional framework of the Spanish economy in 2007 (including the labour market institutions, product market regulation, the structure of the public sector and the financial system) was not conducive to the adjustment of the imbalances or the reallocation of resources towards activities with better prospects, which has meant that the impact of the crisis has been concentrated on employment. Second, it is necessary to consider the gradualism in economic policy management, which affected the speed of adjustment of the economy. Misdiagnosis and the internal resistance of agents and sectors affected by the possible reforms contributed to delays in taking decisions, which had to be made in a very adverse environment. In some cases, expectations that the recession was going to be less prolonged or that recovery was close undermined the urgency of the reforms.

Fiscal policy management suffered from some of these problems. Having been clearly expansionary in the early stages of the recession, it had to become very contractionary in the second phase of the crisis in order to counteract the major budgetary deterioration that had built up over previous years and to combat the effects of the sovereign crisis, which was especially virulent in countries considered to be vulnerable. In any case, as seen above, the stabilisation capacity of fiscal policy in the early stages of the crisis was very limited. A

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<sup>25</sup> Influenced in some cases by the changing recommendations of international institutions during these years.

substantial part of the expansionary stimulus leaked into saving and increases in wages and public-sector employment would soon be seen as unsustainable. In addition, the stimulus may have contributed to ambiguous signals regarding the size of the crisis and the most appropriate adjustment channels.

The fragility of public finances in the middle of the sovereign debt crisis forced a sudden change in the fiscal policy stance in 2010, at a difficult time from the viewpoint of the economy's cyclical situation, which was exacerbated by other contractionary forces stemming from tightening financial conditions and deleveraging by firms and households. In addition, as the recession continued and the effectiveness of the measures adopted was reduced the restrictive fiscal drive had to be stepped up. Finally, the public policy reversal may have generated uncertainty in economic agents' decision-taking, exerting an additional contractionary impact on spending.<sup>26</sup>

At the same time, the sequence of the adoption of structural reforms and, in particular, the gradualism in the application of the labour market reform measures set the pattern followed by the internal devaluation process, both as regards its intensity and the factors driving it. The initial failure of labour costs to react meant that in the first phase of the crisis firms responded to the abrupt contraction of demand by resorting heavily to labour shedding. The implications of an adjustment of this type have been widely documented: it amplified the effects of the crisis, adversely affected disposable income and slowed down the necessary process of internal devaluation. In fact, until very recently the latter process hinged almost exclusively on the productivity increases generated by the contraction in employment. Following the labour market reform of 2012, which was more ambitious than previous reforms, the importance of wage adjustment as a factor driving internal devaluation increased, although employment continued to be affected by the severity of the cyclical conditions and by the lags with which the structural changes are passed through to the economy.<sup>27</sup>

The scope of the product market reforms and their sequence during these years were not always adequate to address the critical situation. This delayed the pass-through of cost moderation and productivity increases to prices. The cyclical sensitivity of inflation has increased during the crisis, but price rises have reduced the purchasing power of households, so that their real disposable income fell by 11% between 2008 and 2013 (while in nominal terms it stagnated). Over the period as a whole, the CPI increased by 11%, although energy prices and rises in taxes and regulated prices explained most of this increase.

The Spanish economy must simultaneously undergo a process of deleveraging, especially in mature sectors, and reallocate resources towards new sectors with a greater projection. For this to happen, product and factor market reforms, in the broad sense, are essential. In recent years various initiatives have been launched in this respect, but they have

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<sup>26</sup> Hernández de Cos and Jimeno (2013) discuss fiscal policy transmission mechanisms and, in particular, their asymmetric impact, depending on the situation of financial tension or the state of expectations.

<sup>27</sup> See Izquierdo, Lacuesta and Puente (2013).

not always been implemented as rapidly as would have been desirable and their final formulation has, on occasions, been less ambitious than initially intended. A recovery in activity will require obstacles to entrepreneurial initiative to be removed, market unity through the elimination of regional administrative barriers strengthened, sectors liberalised and an increase in the size of Spanish firms promoted, while avoiding the “threshold effects” that arise when fiscal, legal or administrative requirements are imposed beyond a certain size.

The restructuring of the banking system has been a key element of the economic policy response, since the fragilities that emerged in one of its sub-sectors have been at the heart of the economy’s confidence and financing problems. This aspect of economic policy lies beyond the specific focus of this paper, but it should at least be mentioned that the necessary restructuring has also faced difficulties, not unrelated to the specific institutional features of the savings bank sector, where the problems were concentrated. As already indicated, the prolongation and worsening of the crisis finally forced the authorities to use public funds to recapitalise the most vulnerable institutions at a time when public finances were very weak, so that Spain eventually had to appeal to the EU, in 2012, for financial assistance. The programme agreed with the European authorities has dispelled the doubts overhanging the sector, although full normalisation of financing flows will require completion of the European reforms, with a fully credible Banking Union, and progress in the complex process of deleveraging the Spanish economy.

Despite the halting rhythm of economic policy actions, significant progress has been made overall with reforms on various fronts. Had these reforms been adopted earlier or as part of coordinated efforts their impact would have been more effective.

## 5 Conclusions and challenges

Despite the depth of the crisis in Spain, the progress made on reforms on various fronts is, on balance, encouraging, although not free from important risks and challenges. During this period some of the imbalances that built up during the upturn have been corrected and several key variables are currently very close to average European levels. The weight of the construction sector, in terms of both GDP and employment, has been considerably reduced, as have house prices, the external balance is in surplus, and private-sector debt ratios have begun a gradual decline.

All told, the legacy of the crisis, in terms of the magnitude and persistence of unemployment, the massive housing overhang and the still high levels of indebtedness of households, firms (in certain sectors in particular) and, above all, of general government, gives rise to a complex outlook. This suggests that the recovery will be gradual and shrouded in uncertainty.

In the first place, this uncertainty affects the functioning of the economy's adjustment mechanisms. With regard to the stimulus from competitiveness, the drive to adjust the real effective exchange rate needs to be sustained. In terms of the unit labour costs of the economy as a whole, the cumulative depreciation during these five years has been equivalent to that achieved with the peseta devaluations between 1992 and 1995; however, as seen in this article, the increase in the external and internal competitiveness of domestic production has still not been sufficient to bring about a recovery in employment. A closely related question is to what extent the structural reforms implemented will be capable of ensuring more balanced contributions from costs, productivity and prices to the internal devaluation process. For the latter to have lasting effects it must stem from increases in productivity based on efficiency gains in productive processes, but, above all, given the high rate of unemployment, the containment of prices, mark-ups and wages that offsets the productivity slowdown must be sustained as the labour market recovers.

Given the fragility of domestic demand (owing to the delicate net-worth position of the private and public sectors) and the large negative external position, the buoyancy of net external demand is fundamental to economic recovery. This requires that the competitiveness indicators go beyond what might be considered a situation of apparent equilibrium (which some analysts estimate as the beginning of Stage Three of EMU in accordance with certain measures of the real effective exchange rate). The need to attain sufficiently competitive price and cost levels is underlined by the high sensitivity of imports to the buoyancy of final demand. This sensitivity clearly apparent in the second stage of the crisis, when barely any progress was made correcting the external deficit and inflation rebounded.<sup>28</sup>

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<sup>28</sup> See IMF (2013).

Against this background, the stabilisation of consumer prices is essential as a mechanism to safeguard the purchasing power of households without having to resort to pressure on wage costs. The initiative to eliminate references to the CPI in public-sector prices and contracts, along with the lower importance of the inflation rate in wage and pension setting, will help to improve the competitiveness of domestic production and will contribute notably to putting Spain on a path of price stability over the coming years.

At the same time, households and, above all, firms have been making headway improving their balance sheet position, an adjustment that is leading to a reduction in the high levels of debt assumed before the crisis. Both phenomena are having a short-term contractionary impact on private-sector spending which, in the current circumstances, cannot be offset by government action. In this context, the question arises as to when the point will have been reached where balance sheet clean-up and private-sector deleveraging allow a boost to consumption and investment, and these components can begin to have a positive impact on activity, reinforcing the positive contribution from the external sector. For this to happen, it will be increasingly necessary to combine the decline in the debt ratios with the maintenance of a sufficient supply of credit for solvent agents.<sup>29</sup> This process, already under way, is especially important to ensure adequate financing is available for innovative business projects and export industry expansion plans, thereby enabling resources to be reallocated from traditional activities towards those linked to the production of tradable goods and services.

An additional source of uncertainty relates to the difficulty of determining how much of the decline in activity has ultimately affected the foundations of growth and, therefore, the economy's ability to expand in the medium and long term. This is a difficult question to answer, the analytical instruments available having been clearly inadequate for the task.<sup>30</sup> Potential output estimates have been revised significantly downward in recent years, casting doubt on the true impact of the crisis on the productive base. This doubt extends to a variable that plays an essential role in future growth capacity, structural unemployment, the real magnitude of which cannot be easily estimated either.

From the perspective provided by the analysis of the crisis in this paper, supply-side policies ought to play a major role in the current phase of the cycle. Given the impossibility of using demand policies, it is supply-side reforms that, by removing the obstacles hampering business initiative, can boost investment, employment and exports.

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<sup>29</sup> Ayuso (2013) analyses measures to promote the financing of firms, and especially of SMEs.

<sup>30</sup> Borio (2012) discusses some of the analytical challenges the international financial crisis has highlighted, including that relating to the estimation of potential output.

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## ANNEX

GDP GROWTH AND ITS COMPONENTS BY PHASE  
(Rates of change)

TABLE A.1

	2009 Q4/ 2008 Q1	2011 Q1/ 2009 Q4	2013 Q2/ 2011 Q1	2013 Q2/ 2008 Q1
1. National final consumption expenditure	-2.0	0.1	-6.3	-8.1
1.1. Household and NPIISH national final consumption expenditure	-4.8	-0.7	-5.9	-11.1
1.2. General government final consumption expenditure	6.6	2.3	-7.2	1.2
2. Gross capital formation	-22.9	-5.7	-14.9	-38.1
2.1. Fixed capital	-22.9	-6.8	-14.9	-38.9
2.1.1. Capital goods	-26.7	9.2	-4.2	-23.3
2.1.2. Construction	-22.6	-14.5	-21.6	-48.1
Housing	-29.2	-15.9	-19.2	-51.9
Other construction	-14.5	-13.1	-23.6	-43.2
2.1.3. Other products	-6.8	18.7	-1.2	9.4
3. National demand (1 + 2)	-7.9	-1.2	-8.1	-16.4
4. Exports of goods and services	-9.6	15.0	10.0	14.4
4.1. Goods	-8.7	18.1	11.5	20.2
4.2. Services	-11.3	9.2	6.6	3.2
4.2.1 Other services	-9.1	11.0	7.7	8.7
4.2.2 Tourism	-14.0	6.9	5.1	-3.3
5. Final demand (3 + 4)	-8.3	2.0	-4.0	-10.2
6. Imports of goods and services	-18.1	6.9	-6.1	-17.9
6.1. Goods	-19.6	9.1	-7.1	-18.5
6.2. Services	-12.3	-0.3	-2.5	-14.8
6.2.1 Other services	-10.8	0.3	-1.5	-11.9
6.2.2 Tourism	-20.1	-3.4	-8.5	-29.3
Contribution of net external demand (a)	3.3	1.8	5.0	9.6
7. Gross domestic product (5 - 6)	-5.0	0.7	-3.3	-7.5
7.1 Agriculture and fisheries	-5.5	7.9	-13.9	-12.2
7.2 Industry and energy	-10.4	11.2	-4.6	-4.9
7.2.1 Energy	-5.1	20.5	-1.5	12.7
7.2.2 Industry	-11.6	8.8	-5.5	-9.1
7.3 Construction	-13.6	-17.2	-17.0	-40.6
7.4 Services	-1.6	2.0	-0.2	0.2
7.4.1 Market services	-3.5	2.3	-0.9	-2.2
7.4.2 Non-market services	4.6	1.0	1.8	7.4
7.5 Net taxes on products and imports	-6.8	-4.4	-7.3	-17.5
Memorandum item				
Total economy GVA	-4.8	1.2	-3.0	-6.5
Market economy GVA	-6.6	1.2	-4.0	-9.3
Total economy employment	-9.2	-1.9	-9.0	-19.0
Market economy employment	-11.9	-2.7	-10.3	-23.2
Non-market economy employment	2.8	1.2	-4.2	-0.3
Unemployment rate (level)	18.8	21.3	26.3	26.3
Unemployment rate (change)	9.2	2.5	5.0	16.6

SOURCES: Instituto Nacional de Estadística and Banco de España.

a Contributions to GDP growth.

	2008	2009	2010	2011	2012	2013
<b>Public expenditure</b>						
Employment			Replacement rate limited to 15% (with exceptions)	Replacement rate limited to 10% (with exceptions)	No replacement, with exceptions	No replacement, with exceptions
Compensation per employee	3.5% increase	3.5% increase	No wage increase. 5% wage reduction in July	No wage increase	No wage increase. Increase in hours. December extra payment eliminated	No wage increase. Reduction in holidays
Non-wage final consumption expenditure			Expenditure cut: immediate action plan	Cut in purchases by regional and local government: May 2010 package	Education and health measures	Education and health measures
Pensions, etc.	Initial increase in line with projected inflation. Adjustment for inflation deviation	Initial increase in line with projected inflation. Adjustment for inflation deviation	Initial increase in line with projected inflation. Adjustment for inflation deviation	Pension freeze, except for minimum pensions	Initial increase in line with projected inflation. Adjustment for inflation deviation	Increase in excess of projected inflation
Unemployment		Increase in benefits ("PREPARA" programme)			Review of benefits for over 45s. Reduction in National Public Employment Agency contribution	Percentage reduction from sixth month
Subsidies		Car purchase incentive scheme			Reduction in employment-promotion rebates	Efficient vehicle incentive programme ("Plan PIVE")
Public investment		State fund for local investment	Public investment reduction	Public investment reduction	Public investment reduction	Public investment reduction
Other		State fund for reinvigorating the economy	State fund for local environmental sustainability			
<b>Public revenue</b>						
Personal income tax	Tax relief for births ("Plan CUNA"). €400 deduction		€400 deduction eliminated	Elimination of tax relief for births ("Plan CUNA"). Increase in rates > €120,000	Increase in rates	Elimination of house-purchase deduction for new purchases. Increase in withholdings on professional activities and savings. Elimination of house-purchase deduction compensation
Corporate income tax				Partial payments brought forward	Partial payments brought forward. Limits imposed on deductions for financial costs and goodwill	Limits on amortisation deduction
Wealth tax		Reduction in rates to zero			Reintroduced	
VAT	Consolidation in the returns of corporate groups	Increase in refunds for monthly declaration	Rate increase in July	Extra-low rate applied to housing	Rates increased and products reclassified	Housing taxed at low rate
Excise duties and other taxes	Rate freeze	Rates on hydrocarbons and tobacco raised		Rates on tobacco raised	Rates on hydrocarbons and tobacco raised. University fees increased	Rates on hydrocarbons and tobacco raised. New taxes on electricity production and storage
Property tax					Rates increased	
Social contributions						Maximum contribution base increased. Inclusion in base of payments in kind

SOURCE: Authors.

**LABOUR MARKET MEASURES AND OTHER STRUCTURAL REFORMS 2009-2013**  
**Hiring, collective bargaining and dismissal procedures**

TABLE A.3

	2009	2010	2011	2012	2013
Hiring (a)		Extension of groups eligible for employment-promoting contracts		New contract to support entrepreneurs for firms with fewer than 50 workers, and groups to whom training and apprenticeship contract applicable extended	Elimination of the requirement to have completed studies within the previous 5 years to be eligible for a work-experience contract
		Limitation of term of contract for a specific task or service to three years and of temporary contract renewals	Training and apprenticeship contract extended to under 30s	Re-establishment of the prohibition on the renewal of temporary contracts	New 6-month temporary contract for under 30s with less than 3 months' experience
Collective bargaining		Possibility of agreeing an opt-out from the provisions of the sectoral agreement at the firm level, irrespective of their content		Precedence of firm-level agreements, with any conflicting clause in higher-level agreements null and void	
		Possibility of amending certain working conditions when this contributes to preventing a negative performance by the firm or to improving its situation	Precedence of firm-level agreements over higher-level agreements, unless there is a clause to the contrary in an agreement at state or regional level	Further specification of conditions for opting out of higher-level agreements	Possibility of unilateral amendment by the firm of employment conditions when this improves upon the minimum conditions established in the agreement
				Limitation of automatic extension of the term of the agreement to one year	
Dismissal procedures				Reduction in compensation for unfair dismissal to 33 days' pay per year worked, subject to a maximum of 24 months' pay (previously 45 days and 42 months' pay)	
		Redefining of the reasons for objective dismissal including the existence of actual or projected losses, or persistent decline in the level of revenue		Elimination of payment of wages for the duration of the procedure	
		Gradual increase in the cost of dismissal for temporary contracts between 2012 and 2015		Redefinition of the reasons for objective dismissal, with a year-on-year decline in ordinary revenue or sales for three consecutive quarters being sufficient	Elimination of administrative authorisation for redundancy programmes

SOURCE: Authors.

a During this period the scope of the social security contribution rebates for certain contracts were reduced and modified: focus on training, apprenticeship and entrepreneurship contracts for young persons.

LABOUR MARKET MEASURES AND OTHER STRUCTURAL REFORMS 2009-2013 (cont'd)  
Passive and active employment policies

TABLE A.3

	2009	2010	2011	2012	2013
Unemployment benefits	Replacement of unemployment benefit for persons subject to an application for contract suspension or short-time working	Unemployment benefit for workers subject to an application for short-time working, irrespective of the size of the firm	"PREPARA" programme. Assistance payable for 6 months to unemployed persons who have exhausted their unemployment benefit and who undertake to participate in active employment and job-search policy activities	Reduction of the amount of contributory unemployment benefit from 60% to 50% of the regulatory base from the sixth month of unemployment  Increase in the minimum age for receiving the special allowance until retirement age from 52 to 55, and cancellation of the special 6-month allowance for the over 45s	Extension of the possibilities for capitalising unemployment benefit for under 30s who use the amount to make a contribution to the share capital of a newly established commercial entity
	Extraordinary unemployment benefit for workers not entitled to unemployment allowance who have exhausted their contributory benefit	Unemployment benefit in training contracts		Stricter rules for calculating income to determine eligibility for unemployment allowance  Restriction of the group of beneficiaries of re-insertion scheme income	Self-employed persons aged under 30 who do not employ anyone may continue to receive unemployment benefit (for up to 270 days)
Active policies and labour market intermediation		The National Public Employment Service's branch network is strengthened  Private for-profit entities are authorised to carry out labour-market intermediation activities	Actions to improve the employability of groups affected especially seriously by the crisis  Inclusion of unemployed persons in training activities targeted at persons in employment	Plan for external relocation through authorised relocation firms in applications for contract suspension or short-time working  Private entities permitted to participate in the design and planning of the vocational training sub-system for employment  Temporary Employment Agencies (ETTs) may act as placement agencies for permanent employment	ETTs may execute agreements to make workers available to other firms under the terms of a training and apprenticeship agreement, the ETT being responsible for supervising the training

SOURCE: Authors.

**LABOUR MARKET MEASURES AND OTHER STRUCTURAL REFORMS 2009-2013 (cont'd)**  
**Other structural measures**

**TABLE A.3**

	2009	2010	2011	2012	2013
Other structural measures	<p>Various laws were amended to adapt them to the law on the taking up and pursuit of service activities. Many activities are affected: professional services, industry and construction, transport, information and communications, etc.</p> <p>The Urban Leasehold Law and the Civil Procedure Law were amended to foster house rentals through increased legal certainty.</p>	<p>Actions to expedite the formation of companies and reduce administrative burdens.</p> <p>New Retail Trade Law which reduces the requirements at regional level for the setting up of new establishments (overriding reasons of general interest).</p>	<p>Sustainable economy law: it removes obstacles to improving the quality of the regulation and reform of regulatory bodies so as to strengthen their independence.</p> <p>A government spending rule is introduced whereby the increase in spending may not repeatedly equal each year the medium-term growth rate of nominal GDP.</p> <p>Reform of the pension system: the retirement age is gradually raised, the number of years on which the pension is calculated is increased and a sustainability factor is included.</p> <p>The principle of budgetary stability is recognised at constitutional level: limits on the government deficit and government debt are written into the Constitution.</p>	<p>The constitutional reform is implemented through the Organic Law on Budgetary Stability and Financial Sustainability: it sets quantitative limits on the budget deficit (it prohibits regional governments from running structural deficits), government expenditure (which may not exceed nominal potential growth) and the government debt ratio (60% of GDP).</p> <p>The regulation of the retail sector is eased (liberalisation of the licence system, trading hours and price discounts)</p>	<p>An independent authority on fiscal responsibility is set up to strengthen the fiscal framework and ensure effective compliance with the principle of budgetary stability.</p> <p>A new framework is approved to promote business activity based on tax and SME financial support measures, reducing administrative burdens and fostering internationalisation.</p> <p>In the housing market, property rental conditions are liberalised through additional flexibility in contracts and in setting rents (removal of compulsory indexation to the CPI), and the tax treatment of house purchases is changed to make it equal to that of house rental.</p> <p>The reform of the electricity sector is approved.</p> <p>Creation of the National Markets and Competition Commission, in which the functions of the senior sectoral bodies will be concentrated.</p>

SOURCE: Authors.

NOTE: At the date of this paper going to press, the following legislation was before Parliament: the Law regulating the sustainability factor and revaluation index of retirement benefits, the Law for ensuring a single market, the Law for improving the quality of education and the Law on professional services and associations.

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