Letter from the Editors

The persistence of the crisis and its impact on Spain´s economic model revealed the need for a variety of structural reforms. In this September issue of the SEFO, we focus on the structural reforms recently undertaken in Spain, their resulting impact (in particular on the country´s competitiveness) and the challenges that lie ahead for the Spanish economy.

We start with an examination of the main structural reforms adopted in Spain since the crisis and the subsequent internal devaluation process. Essentially, the recent reform agenda can be divided into 5 pillars: i) modernization of government; ii) competitiveness reform; iii) financial system reform; iv) fiscal reform; and v) labour reform. Many of the legislative changes represent major structural changes in their respective spheres, with the effects of the measures to be felt over time. Nonetheless, some of the initial impact of the reforms is already palpable.

In this context, this SEFO offers a more detailed assessment of how Spain´s recent reforms have helped boost competitiveness, improving exports, reducing imports, reversing the current account from a large deficit to a small surplus, and allowing for a less pronounced drop in GDP than that of domestic demand. We add a word of caution on the current account. As the recovery gains speed, imports will once again pick-up. Moreover, sustaining the surplus depends to a large extent on the behaviour of EU and other economies. The September SEFO analyses these issues even further by deconstructing the Spanish labour market and the impact of Spain´s labour market reform on the external sector, most notably exports, as well as on the profitability of non-financial corporations.

We begin by taking a look at the effects of the recession on Spain´s labour market – specifically trends in the Labour Force Participation rate. We find that the recent crisis has affected the Spanish Labour Force Participation rate through various channels, namely changes in working-age population, in part fuelled by migration, as well as altering patterns in discouraged workers and students. Trends have recently improved, as a result of more favorable macroeconomic conditions, but it remains difficult to say whether or not these improvements will be permanent or transient.

As regards exports, Spanish exports have outperformed their European competitors over the last few years. For example, since the first quarter of 2012, Spanish exports have increase by 11%, the best performance among big European economies. It is usually assumed that the favorable performance of Spain´s exports during the crisis can be linked to the internal devaluation process – i.e. the drop in unit labour costs. While it is true that unit labour costs have fallen, the internal devaluation has not been passed on to final export prices. Export prices have actually moved upwards throughout practically the duration of the crisis. Nevertheless, the reduction in unit labour costs has increased profits, which to a large part have helped firms to reduce their levels of indebtedness and has made Spain's export industry more attractive in relation to other countries as a destination for domestic and foreign productive investment. As we show in this SEFO, the significant increase in ROA for operating assets of Spanish non-financial corporations is evidence of this increase in profitability. ROA for operating assets in Spain was 8% before taxes in 2013 – a sound basis for a corporate-led recovery of the Spanish economy.

This SEFO also provides our standard analysis of the latest trends for the Spanish economy and financial sector. Consensus forecasts show that the outlook for recovery remains on track and improving. Furthermore, we analyze the health of Spanish financial institutions ahead of important EU-wide events -on the one hand, the upcoming Asset Quality Review (AQR) and stress test and on the other, the launch of the ECB´s TLTRO facility and announcement of the securitized asset purchase program. In line with the ECB´s latest decisions, we highlight the importance of continued EU authority support for reactivation of the securitization market. Once seen as part of the problem as a result of its connection to the latest financial crisis, securitization is quickly being seen as part of the solution to reactivate credit flows to the private sector. A more favorable regulatory climate will be needed for this market to play a bigger role in credit reactivation in European economies, including Spain. The ECB faces a difficult challenge balancing two distinct policy objectives of liquidity provider and supervisor. We believe Spanish banks are well positioned to take advantage of both the upcoming EU liquidity support, as well as meet solvency requirements.

Finally, we explore the impact of central bank extraordinary measures, such as their lowering long-term interest rates to levels way below those justified by economic fundamentals – the Spanish Treasury yield curve a case in point. Such trends should contribute to stabilization of the debt to GDP ratio in peripheral countries, such as Spain.