

Improvements in competitiveness and reduction of imbalances in Spain

Miguel Cardoso Lecourtois¹

Spain's competitiveness gains can partly explain why exports have improved, imports have fallen, the current account has gone from a large deficit to a small surplus and GDP has dropped far less than domestic demand. While recent reforms have helped improve competitiveness, adoption of additional measures would clearly help deepen the structural changes observed in Spain over the last few years, supporting the transition towards an export oriented economy.

Spanish exports have outperformed their European competitors in the last few years. While cost competitiveness has been an important factor in this process, other elements, such as diversification of export markets away from the euro area, the high degree of competitiveness of large Spanish firms, and finally, the strong reform efforts directed at improving the performance of Spain's service sector have also underpinned the robust export growth. Despite the positive impact of this trend on the country's external accounts, a return to persistent deficits cannot be ruled out due to the remaining structural imbalances. At the same time, despite historical inefficiencies, Spain's labor market is proving to be more flexible. Recent wage moderation is helping to reduce job destruction, and may even help in job creation in 2014. The upcoming challenge for Spain will be to keep gaining competitiveness under a lower inflationary environment, which is why it is important that the ECB deliver on its inflation targeting mandate. Finally, while the recently implemented measures are a sign of progress, additional structural reforms will be needed to ensure Spain's transition to a more sustainable, export-led growth.

Introduction

The Spanish economy faced tremendous challenges at the beginning of 2008, as some macroeconomic imbalances were exceedingly high (current account deficit, external private debt, housing oversupply), and some others were just about to become very problematic (unemployment, public deficit/debt). With private domestic demand suffering from adjustments related to a) the deleveraging process; b) the

restructuring of the financial sector; and c) the reallocation of resources away from the real estate sector, the Spanish Government embarked on an ambitious countercyclical fiscal policy. Nonetheless, limits to this strategy began to appear as the perception that the public deficit was out of control started to spread, in part due to the uncertainty regarding capital needs of financial institutions (the *cajas*), but also to the inability of the Central Government to control the Autonomous Regions' finances. Moreover, these problems

¹ Chief Economist, Spain, BBVA Research.

(and those of a similar nature in other countries) exacerbated deep structural holes in European Governance that ended up causing a full blown sovereign debt crisis in the Eurozone. As capital fled the country, uncertainty settled in again, intensifying the already ongoing adjustment. All in all, from peak to bottom, domestic demand fell by 17%. Yet, although GDP also showed a significant drop of 7.4%, this number compares favorably to the ones observed in other countries that faced similar adjustments.

What factors underpin the relatively better performance of the Spanish economy? This article argues that, in part, improvements in cost competitiveness are the reason behind the strong performance of exports and the development of an import substitution process. These two factors have softened the fall in GDP, and have helped reduce important imbalances. At first, the adjustment was based on large increases in labor productivity as a consequence of high job dismissals. Recently, unit labor costs have gone down as a result of more efficient mechanisms, particularly linked to reforms introduced over the last few years. Going forward, some risks

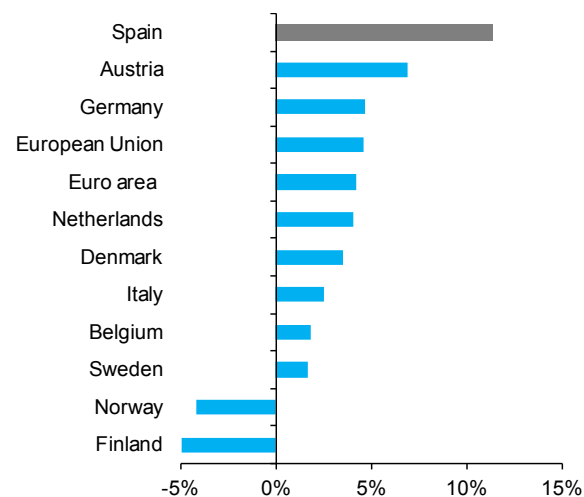
remain. On the one hand, inflation is running dangerously low, making it more difficult to gain competitiveness. On the other, the remaining large imbalances point to the need to further push for reforms to increase competition in key sectors, to help firms gain size and to improve efficiency.

Export performance in Spain

Spanish exporters have outperformed their European competitors over the last few years. For example, since the first quarter of 2012, Spanish exports have increased by 11%, the best performance among big European economies, and far above the EMU average (Exhibit 1). In part, this relative success can be accounted for by looking at the improvement in cost competitiveness (Exhibit 2). As BBVA Research (2014a) shows, inflation rates have remained, on average, below European levels over the last 5 years, contrary to what happened in the period before the crisis. As Table 1 illustrates, among large European economies, Spain is the one with the second largest negative inflation differential with respect to the EMU average (below Ireland) over the period 2009-2013. This is the result of

Exhibit 1

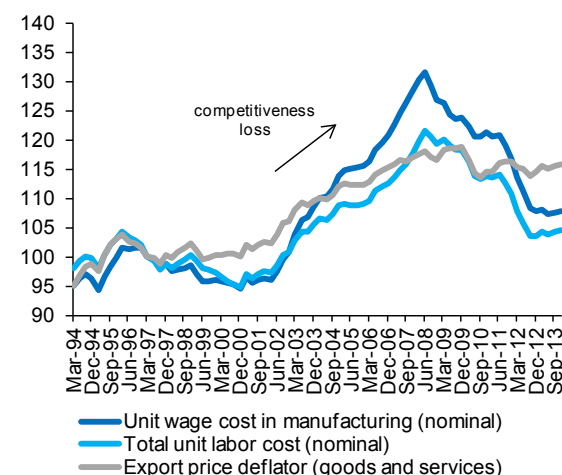
Exports annual growth rate %1Q12-3Q13, volumes swda



Source: BBVA Research using data from Eurostat.

Exhibit 2

Unit Labor Costs



Source: BBVA Research using data from Eurostat.

an uneven adjustment, where labor productivity explains most of the difference in inflation rates, while nominal wages have changed in a relatively similar fashion as in other recession-driven economies. Lower prices, therefore, have been the result of lower labor costs, in part as a consequence of the relatively weaker growth

in nominal wages, but mainly due to the strong adjustment in employment and the increase observed in labor productivity.

Nonetheless, as Cardoso, Correa and Doménech (2012) show, a so-called “Spanish paradox” emerged as sales to the rest of the world grew

Table 1

Inflation accounting in EMU-12**GDP Deflator (contributions to percentage change) (average yearly growth rates in percentage)**

1999-2008					
	Total	Wages	Productivity	Margins	Taxes
EZ-12	1.93	1.22	0.34	0.84	0.21
In deviation with respect to the average of EMU-12					
Germany	-1.17	-0.60	0.23	-0.35	0.00
Ireland	1.21	1.06	0.29	0.28	0.16
Greece	1.38	0.44	0.05	0.79	0.20
Spain	1.77	0.56	-0.33	0.79	0.08
France	-0.05	0.23	0.02	-0.19	-0.06
Italy	0.45	-0.05	-0.34	0.18	-0.02
Netherlands	0.66	0.71	0.38	0.18	0.15
Portugal	0.98	0.65	-0.03	0.02	0.27
Finland	-0.44	0.38	0.40	-0.29	-0.14
2009-2013					
	Total	Wages	Productivity	Margins	Taxes
EZ-12	1.93	1.22	0.34	0.84	0.21
In deviation with respect to the average of EMU-12					
Germany	0.26	0.09	-0.31	-0.10	-0.04
Ireland	-1.82	-1.31	0.41	0.42	-0.52
Greece	-0.76	-1.84	-0.48	0.78	-0.18
Spain	-1.05	-0.23	1.17	0.24	0.11
France	0.03	0.19	0.08	-0.15	0.06
Italy	0.21	-0.24	-0.28	0.01	0.16
Netherlands	-0.17	-0.18	-0.17	0.04	-0.21
Portugal	-0.48	-0.47	0.43	0.79	-0.37
Finland	0.79	0.43	-0.39	-0.42	0.40

Note: The contribution of the margins is calculated as a residual. The total is the sum of the contributions of wages, margins and taxes minus the contribution of labor productivity. Productivity is measured as output per worker. 2013 is AMECO's forecast.

Source: BBVA Research using AMECO.

at the same rate as world exports in the period previous to the crisis, keeping Spanish export share quotas relatively stable. This happened as price competitiveness deteriorated constantly, contrary to what one would have expected. Also, as the IMF (2013a) shows, during the crisis, export performance has been surprisingly positive, given the behavior of fundamentals, including price competitiveness.

Compared to a scenario of no reforms, almost 50% of the increase in exports of large firms from 1990-2008 can be ascribed to the increased competition and lower monopoly power that were the result of reforms in the services sector.

What could be behind this “Spanish paradox”? One clue lies in the ability of Spanish exporters to diversify destinations away from the euro area where demand has stayed weak. BBVA Research (2014b) finds that 40% of export growth during the crisis can be explained by the effort to geographically diversify exports. Another comes from research that points out that large Spanish firms are as productive as their foreign counterparts and that productivity differentials have appeared as a result of the predominance of small firms in the Spanish economy. Firm size is a strong determinant of export performance as Cardoso, Correa-López and Doménech (2012) show. Therefore, competitiveness among these large exporting firms could be strong. Finally, a stronger reform effort than in other economies pertaining to key sectors of the economy could also be behind the paradox. BBVA Research (2014c) looks at the performance of large manufacturing firms from 1990 until 2008 in Spain and particularly at the impact of improvements in regulation in the services sector. Compared to a scenario of no reforms, the study finds that almost 50% of the increase in exports of large firms during that time period can be ascribed to the increased competition and lower monopoly power

that were the result of reforms in the services sector. Moreover, this effort was markedly above what the median economy in the OECD achieved during that time frame.

Import substitution

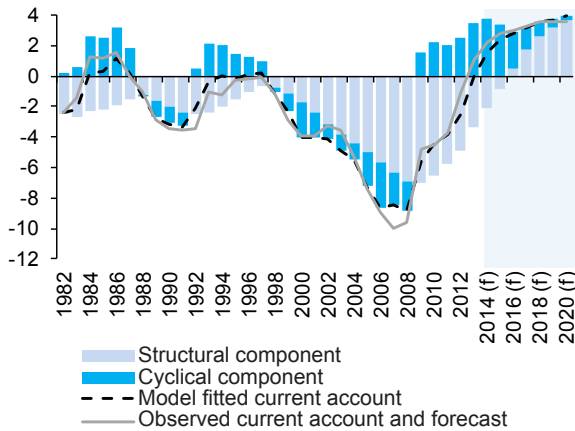
The gains observed in cost competitiveness are not only important to explain export growth, but also have been key in explaining import performance. As BBVA Research (2013b) shows, the adjustment observed in Spanish demand over the last few years is, for the most part, the result of the drop in revenues recorded in the private and public sectors. A restructuring away from the real estate sector, the need to reduce indebtedness by the private sector and the reduction of the public deficit explain the decrease in domestic demand and in imports. However, the performance of domestic prices against that of foreign prices has also had an impact on expenditure decisions, favoring the acquisition of Spanish produced goods. In particular, not only have import prices gone up for the first time in two decades relative to the domestic ones, but also the responsiveness of demand to changes in those relative prices has changed. As a result, BBVA Research (2013b) finds that 40% of the decrease in non-energy imports over the crisis can be explained by an import substitution mechanism related to the change in relative prices.

Current account balance

The result of the improvement in export growth and the decrease in imports has been a strong turnaround in the trade and current account deficits. The latter has gone from a deficit above 11% of GDP to a surplus close to 1% of GDP. Going forward, maintaining such a surplus will be key for the Spanish economy as the level of net foreign debt is still very large, and the reliance on capital markets makes the economy especially vulnerable to sudden stops of capital flows. Correa-López and Ugarte (2013) show that an important part of the adjustment seems

Exhibit 3

Spain: Cyclical and structural components of the current account
(% of GDP)



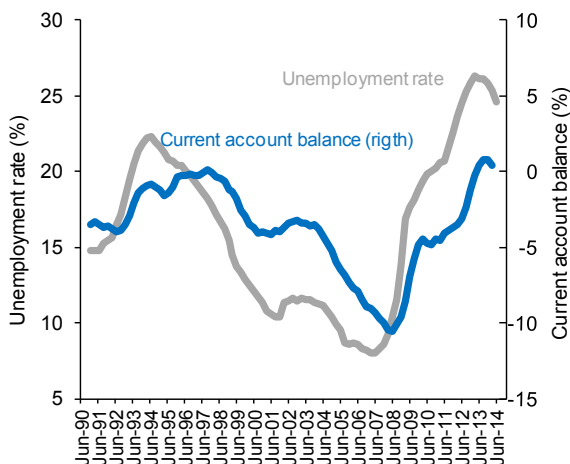
Note: (f) denotes forecast. Forecast values for the explanatory variables are from IMF-WEO. Read text for further detail.

Source: BBVA Research.

to be permanent (see Exhibit 3), and find that the improvement observed shares several similarities

Exhibit 5

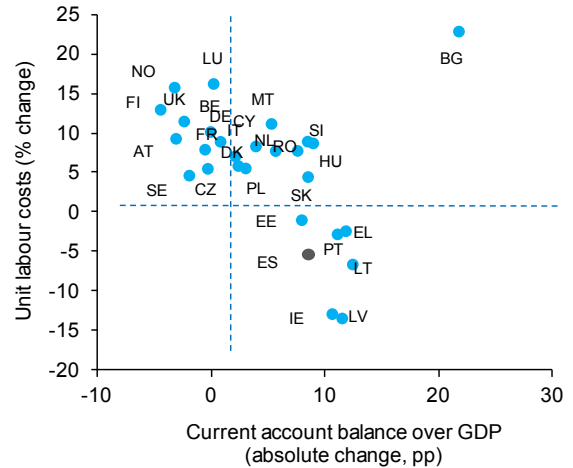
Spain: Current account balance and unemployment rate
(%, SWDA data)



Source: INE.

Exhibit 4

Nominal unit labour cost and current account balance
variation 2008-2012



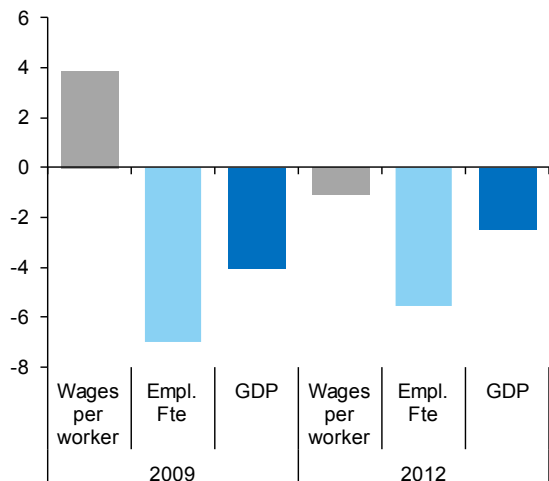
Note: Positive values on the horizontal axis correspond to an improvement in the current account balance, and vice versa.

Source: BBVA Research based on Eurostat.

with historical current account reversals. Among those are the improvements in unit labor costs

Exhibit 6

Spain: Real wages and employment in the private sector and GDP
(cumulative % change, SWDA data, %)



Source: INE.

(see Exhibit 4). Nonetheless, key to their analysis is the fact that a still large part of the adjustment can be explained by cyclical factors, due to disappear over the coming years. In fact, recent evidence points toward a deterioration of the current account as the economic outlook has improved (see Exhibit 5). As BBVA Research (2014d) shows, some of the recent worsening of the current account can be traced back to temporary factors, like the introduction of fiscal incentives to the purchases of automobiles, or the one time decrease in precautionary savings due to lower uncertainty. Although some structural reforms (see below) make it more likely that the surplus in the current account will be maintained, a return to persistent deficits cannot be discarded given the structural imbalance that remains.

The response of employment to wage moderation

The adjustment in labor costs in Spain has historically been very inefficient. For example, the OECD (2014) shows the lack of responsiveness that real wages have had to job destruction. Exhibit 6 shows that in 2009, as employment was falling significantly, real wages increased. This intensified job destruction and put the weight of the adjustment of labor costs on employment, and particularly on temporary contracts. These have relatively low dismissal costs, and given the rigidities associated with collective bargaining procedures, firms usually chose to rely on firing this type of worker in order to adjust. Nonetheless, over the last couple of years a change has occurred, and wages fell at the same time that job destruction intensified (due to the European sovereign debt crisis in 2012 and 2013). It is unclear whether the higher responsiveness is the result of the employment and collective bargaining agreement sealed in January 2012 by unions and entrepreneurs, or the consequence of the labor-market reform approved in February of the same year. Nonetheless, both OECD (2013) and BBVA Research (2013b) find that over the last two years, the Spanish labor market seems

to have gained flexibility. In particular, the results presented in BBVA Research (2013b) indicate that if salary demands had not moderated in 2012, an additional 60,000 jobs would have been lost in the short-term. In the medium and longer-term, wage moderation in 2012 will save around 300,000 jobs. Furthermore, if the institutions in Spain's labor market had been more appropriate at the start of the crisis, this would have saved 1,000,000 jobs over the longer term. Based on this type of evidence, the IMF (2013b) called for a pact between unions and employers in order to speed up the ongoing adjustment, reducing average wages in exchange for job creation. Overall, it seems that the recent wage moderation has been useful in reducing job destruction, and may also be responsible for higher than expected job creation during the 2014 recovery.

If salary demands had not moderated in 2012, an additional 60,000 jobs would have been lost in the short-term. In the medium and longer-term, wage moderation in 2012 will save around 300,000 jobs. Furthermore, if the institutions in Spain's labor market had been more appropriate at the start of the crisis, this would have saved 1,000,000 jobs over the longer term.

The problem with deflation

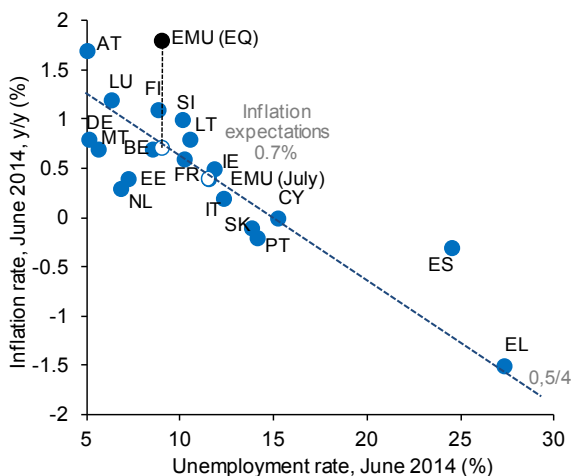
Competitiveness gains can partly explain why exports have improved, imports have fallen, the current account has gone from a large deficit to a small surplus and GDP has dropped far less than domestic demand. Moreover, recent reforms may have improved the functioning of the labor market, making wages more responsive to unemployment. Therefore, as the recovery consolidates, real wages should follow more closely changes in labor productivity, keeping

competitiveness gains and allowing for further export growth. This is part of the adjustment that both the Spanish economy and other peripheral economies have to go through. Indeed, as Exhibit 7 shows, competitiveness gains seem to be larger in those economies where unemployment is higher. However, as inflation has gone down in the EMU, the curve in Exhibit 7 has shifted downwards, so much that over the medium-term high unemployment rates would be consistent with very low inflation rates. Considering a structural unemployment rate of 10% for the EMU, if inflation was to remain around current levels, expectations would be around a 0.8% inflation rate, too low according to the ECB mandate.

In the case of Spain, Exhibit 8 from BBVA Research (2014a) shows that trend inflation (as measured by the trimmed mean that better forecasts inflation on a 2 year horizon) has remained around a percentage point per year below that of the EMU over the last few years, more or less the reversal of the situation seen in the period before the crisis. This is in line with the need to recover competitiveness and for exports to become the main engine for growth. However,

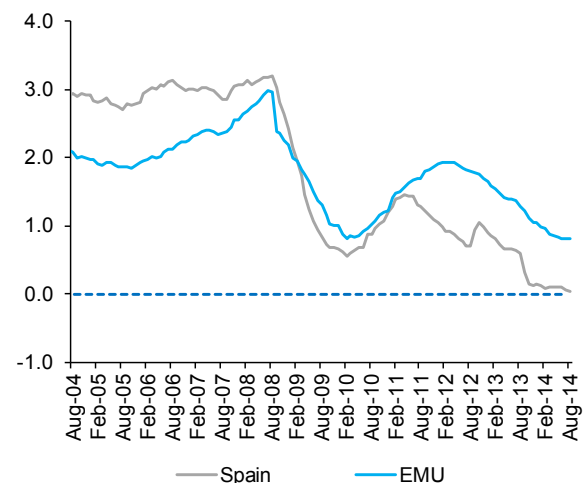
Exhibit 8 also shows that over the last year or so, there has been a constant downward pressure on Spanish inflation as a result of the downward trend of EMU inflation. Up until now, the difference between EMU and Spanish inflation has remained constant, but note that the Spanish trend is currently at zero. At this point, firms could be finding it difficult to keep gaining competitiveness when facing “the zero bound”. As Arellano, Jansen and Jiménez (2013) have demonstrated, as the distribution of nominal wage changes in Spain has shifted to the left, an ever-increasing share of workers are receiving a stagnant wage. Although further adjustments might be needed in order to keep competitiveness gains under a deflationary environment, nominal wages have been shown to be downwardly rigid when facing the zero bound (see for example, Daly and Hobijn (2014)). This lack of flexibility is a threat to the firm’s survival as inflation transforms into deflation: real labor costs go up, which given nominal wage rigidity, increases the pressure to adjust employment. The combination of no wage growth and job destruction increases the value of debt in terms of households’ disposable income. This is particularly important in an economy

Exhibit 7
Unemployment and inflation
(percentage)



Source: BBVA Research.

Exhibit 8
Trimmed means of CPI



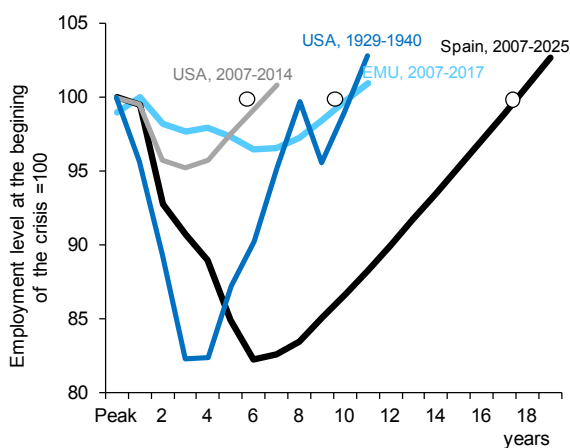
Source: BBVA Research.

where a significant percentage of families remain overindebted, and where leverage is still a drag on domestic demand.

Therefore, although it is expected that the Spanish economy will have to show lower inflation levels than those of its main trade partners, gaining competitiveness would be easier with a higher level of inflation for all members of the Eurozone. This does not require anything more extraordinary from the ECB than to fulfill its mandate of attaining an inflation rate close to, but below 2% on average. Recent measures announced by the ECB (see the introductory statement to the press conference of ECB President, Mario Draghi on September 4th, 2014) are aimed at delivering on this target. They show a commitment to raise inflation expectations, to jumpstart credit in the Eurozone and to trigger a depreciation of the exchange rate. All of this should help. Furthermore, the Governing Council of the ECB has been clear in its intention to act if these actions were not enough.

Exhibit 9

GDP growth and job creation



Note: USA and EMU data for 2014-2017 correspond to BBVA Research forecasts. Regarding Spain, the simulation has been done assuming that output per worker increases by 0.6% per year (as in 1992-2007) and GDP grows at 2.5% per year.

Source: BBVA Research and Lebergott (1964).

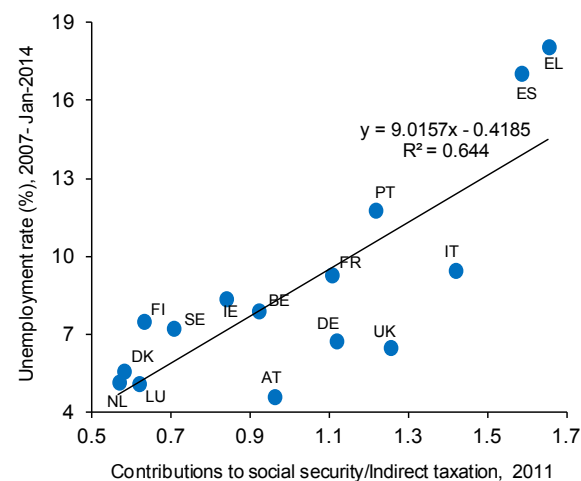
The way forward?

Although the Spanish economy has taken steps to correct its outstanding imbalances at the beginning of the crisis, further measures are needed, as some of those imbalances are still very high. As an example, Exhibit 9 shows that the economy has lost around 18% of the jobs that existed at the beginning of the crisis. Assuming a 2.5% GDP growth rate and a labor productivity growth similar to the historical average, it would take the economy around 10 more years to recover those levels. This shows the urgency to act immediately and decisively to improve potential growth and to bring forward that date as much as possible.

The Spanish economy has lost around 18% of the jobs that existed at the beginning of the crisis. Assuming a 2.5% GDP growth rate and a labor productivity growth similar to the historical average, it would take the economy around 10 more years to recover those levels.

Exhibit 10

EU: Unemployment rate and social security contributions over indirect taxation (percentage)



Source: BBVA Research.

There are several ways to keep improving competitiveness. First, it is important to pursue a more efficient, transparent tax system that promotes growth and does not jeopardize the fiscal consolidation process. The tax reform the Government has announced improves upon the current system, by making it more simple (reducing tax brackets), more efficient (lowering high marginal rates, reducing the number of tax deductions) and more in line with the needs of the Spanish economy (by shifting the tax burden from direct to indirect taxation). Nonetheless, it could still be improved by further advancing on these issues, including a fiscal devaluation (reducing social security contributions and increasing indirect taxes). There is evidence that European countries with higher ratios of social security contributions to indirect taxes are also those with the highest unemployment rates (see Exhibit 10). In particular, a reduction of 3.5 pp in social security contributions, offset by an increase in indirect taxation of 2pp would bring an increase of 0.7% in GDP and 200,000 more jobs in the short-term (see Boscá, Doménech and Ferri (2012)).

Further advances are needed in order to deepen the labor market reform, so that wages move closer to labor productivity and to encourage the use of permanent contracts. In Spain, the temporary rate represents a larger share of the total employment rate if compared to other European countries (24.3% vs. 15.8% in EMU). This affects productivity and competitiveness, as firms are less likely to invest in training workers (given the short duration of their contracts). Correa-López and Doménech (2012) estimate that a 1% fall in the share of temporary contracts for non-exporting firms in the manufacturing sector would increase their probability to export by 1.5%. So, for the median firm, converging to the average temporary rate would increase its probability to export by around 15%.

More investment in human capital is also needed. A third of the labor force does not have a secondary education degree, and two thirds do not have a

college degree. Moreover, half of the unemployed used to work in a sector (construction) whose size has permanently shrunk. Pushing forward reforms on active labor market policies for retraining the long-term unemployed according to exporters needs is essential.

It is also necessary to make it easy and attractive for firms to grow. Size is the most important variable that determines export probability: according to Correa-López and Doménech (2012) every time a firm adds 10 workers, its probability of exporting increases by 2%. Although big firms are equally as productive in Spain as in other European countries, small firms are not and represent a larger percent of the total (on average, 99.2% of firms have less than 50 employees which is higher than the 97.1% recorded in Germany). Special tax regimes aimed at small firms could be counterproductive, reducing the incentives to grow and promoting the black economy. Currently, 90% of firms adhere to the special tax regime.

Finally, competition should be increased in key sectors that could become bottlenecks. As explained above, the improvement of the competitiveness of the non-tradable sector (services) will be key going forward to sustain export growth. In the past, a great deal of the higher than average inflation in Spain has come not only from excessive wage growth, but also from firms margins increasing at a very fast pace (see Table 1). Rent seeking is rampant in some sectors. BBVA Research (2014c) shows that if Spain had adopted the best practices in the regulation of services over the 1990s and 2000s, it would have faced the crisis with a volume of manufacturing exports 20% higher, thus being a stronger actor in international markets.

This is not a complete list of reforms needed in order to improve competitiveness, but their adoption would clearly help deepen the structural changes observed over the last few years in Spain, towards an export oriented economy.

References

ARELLANO, A.; JANSEN, M., and JIMÉNEZ, S. "Más sobre el ajuste de salarios," Nada es Gratis Blog, 23 de octubre de 2013.

BBVA RESEARCH (2013a), "Persistent unemployment and wages in Spain," *Spanish Economic Outlook*, Second Quarter.

— (2013b), "The substitution of imports for domestic output during the crisis: preliminary evidence," *Spanish Economic Outlook*, Fourth Quarter.

— (2014a), "La moderación de la inflación española en el último quinquenio," *Spanish Economic Outlook*, First Quarter.

— (2014b), "Export diversification to explain regional growth," *Spanish Economic Outlook*, First Quarter.

— (2014c), "The effect of anti-competitive regulation on the real exports of firms in Spain," *Spanish Economic Outlook*, Second Quarter.

— (2014d), Consumption Outlook, First half.

BOSCA, J.E.; DOMÉNECH, R., and FERRI, J. (2012), "Fiscal Devaluations in EMU," *Working Paper* 1211, BBVA Bank, Economic Research Department.

CARDOSO, M.; CORREA-LÓPEZ, M., and DOMÉNECH, R. (2012), "Export shares, price competitiveness and the 'Spanish paradox,'" VoxEu.org, 24 November 2012.

CORREA-LÓPEZ, M., and DOMÉNECH, R. (2012), "The internationalisation of Spanish firms," BBVA Research *Working Paper*, forthcoming.

CORREA-LÓPEZ, M., and UGARTE, A. (2013), "An analysis of the performance and the determinants of the current account in Spain," BBVA Research Economic Watch, November 19, 2013.

DALY, M., and HOBIJN, B. (2014), "Downward Nominal Wage Rigidities Bend the Phillips Curve," Federal Reserve Bank of San Francisco, *Working Paper* 2013-08.

IMF (2013a), "Rebalancing the Euro Area: where do we stand and where to go?," Euro Area Policies: Selected Issues Paper, July.

— (2013b), Spain 2013 Article IV Consultation, IMF Country Report 13/244.

OECD (2013), *The 2012 labour market reform in Spain: a preliminary assessment*, Paris.

— (2014), *2014 Economic Survey of Spain, On the Road to Recovery*, Paris.