Letter from the Editors

The January *SEFO* starts off the year on a positive note. Spain consolidated its economic recovery in 2014 and optimism over the outlook for 2015 has increased. GDP growth in 2014 was supported by improved financial conditions and a surprising outperformance of domestic demand. The recovery will gain strength in 2015: firstly, as a result of the progress on the various adjustment processes underway in the Spanish economy, which have situated domestic demand in a position from which it can return to growth; and, secondly, due to the favourable impact of various internal and external shocks, such as falling oil prices and the recently announced ECB debt purchase program.

Nevertheless, the largely transitory nature of these shocks and the persistence of significant constraints make it unlikely for growth to continue accelerating. In addition, the downside to the recovery has been the deterioration of the current account balance, which if it continues, may ultimately mean an increase in debt vis-à-vis the rest of the world, heightening Spain´s vulnerability to market tensions. This is of particular importance in the current context of likely upcoming political changes following the recent elections in Greece, which will put politics in the spotlight once again in the Eurozone.

The fall in oil prices is expected to maintain the current account surplus, at least in the short-term, but given the magnitude of the debt overhang problem, this *SEFO* takes a look at the adjustment process that has taken place in the Spanish debt stock and the resulting dynamics, essentially – who´s who in the Spanish debt market.

Our analysis examines the trends in Spain´s debt composition, reflecting the strong deleveraging effort made by the private sector – a debt reduction of 42% of GDP –greater than in any other country, in contrast to the increased leverage in the public sector with the result being an increase in Spain´s overall debt stock. This trend has been mirrored by the financial sector, which has embarked on an undesirable shift away from loans to productive assets towards public sector financing. Illustrating this point is the fact that Spanish banks today are the main investors in the Spanish Treasury´s securities.

Notwithstanding this shift, banks remain the key intermediaries in the Spanish financial system and, as this *SEFO* points out, they have increased their transparency and solvency post restructuring and the EU surveillance program. The main challenges that remain for the Spanish banks ahead are: privatization of nationalized banks, progress on the sale of impaired assets at the SAREB, increasing credit to the private sector, and finding new sources of profitability.

Finally, we explore recent developments in two areas affecting Spain´s external sector: Foreign Direct Investment (FDI) and Unit Labor Costs (ULCs).

The January *SEFO* examines the role played by Spain in the past few decades, both as a destination and source of FDI. We find that, while Spain has traditionally been an important destination for foreign investment, since the mid-2000s, it has also become a significant source of outward FDI, making Spain today Europe´s 3rd economy for outward FDI as a share of GDP and second for inward FDI. Going forward, it will be crucial for investment promotion policy to take into consideration the creation of the right incentives to foster both inward and outward FDI, and its geographic diversification, given the demonstrated benefits for GDP growth, employment, exports, and efficiency for Spanish firms in the case of the former, and the greater investment in human capital and R&D in the case of the latter.

We end with some considerations about the competitiveness of the overall economy by analyzing the determination of aggregate unit labor costs. We conclude that ULCs do not always accurately explain country competitiveness, as they do not take into account the importance of firm heterogeneity. This is evident in the case of Spain, where ULCs have risen relative to its peers, yet the country´s share of word exports has not fallen proportionately. As we show in this *SEFO,* to understand the real driver of a country´s competitiveness, we need to assess the efficiency of resource allocation among its firms.