

The Spanish economy: The need for restoring growth potential and modernisation

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The Spanish economy's recovery is currently outperforming that of the eurozone average. To achieve sustainable growth over time, it will be essential to modernise the Spanish economic model with a focus on increasing competitiveness through a variety of channels in addition to lower input costs.

Spain's economic recovery has been the most vigorous in the euro area. As was the case in the preceding recession, the strength of the recovery was influenced by temporary external factors, such as cheaper energy commodities and the ECB's monetary policy. This year's projected growth of around 2.7% will depend on the continuation of this recovery, in addition to financial stability and global economic growth. While achieving adequate growth figures is important, modernisation of the economy through strengthening Spain's competitive advantage in areas apart from direct costs is no less so. Restoring growth potential and modernisation will require the resolution of political uncertainty, arising from government formation gridlock at the national level since the end of last year as well as Catalonia's independence movement.

At the end of 2015, Spain recorded GDP growth of 3.2% – twice the eurozone average. Growth was accompanied by job creation and correction of external imbalances. However, the government struggled to reduce the fiscal deficit in line with the agreed EU target. In fact, as the European Commission (2016) has warned, the structural deficit deteriorated significantly in 2015, while public debt reached almost 100% of GDP.

These macroeconomic developments – signs of a clear recovery following a deep recession – are not, however, supported by sufficient normalisation of economic agents' behaviour. Households have not seen a significant increase in income. Firms

are not scaling up their investment decisions at a rate parallel to the expansion of their business, and perhaps most importantly, in line with the need to strengthen competitive advantages other than lower input costs. The general government, for its part, remains constrained by the application of austerity programmes, forcing a contraction of its spending and investment plans.

At present, indicators also fail to confirm that the Spanish economy will be able to ensure sustainable growth over the medium-term. This is primarily because capital, in all its forms, has yet to recover from the erosion suffered during the crisis, but also because there are insufficient signs

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of a transformation in the growth model towards one in which the quality of factors and institutions takes precedence over keeping costs relatively low. The need for this change is particularly pressing in the political context resulting from the recent general elections. On top of the risks deriving from a deterioration in the international economic environment, less favourable than it was during the recovery, there are the contingencies associated with more complex and less stable political governance. And all of this is taking place in a complex international context, in which the year has started off dominated by severe financial instability, which has hit European bank shares particularly hard.

In what follows, this article aims to identify the existing damage to Spain from the crisis and options for remedying it. It then goes on to describe certain measures to reduce the vulnerability of the Spanish economy to shocks, such as those caused by the 2007 crisis, highlighting the priority decisions needed to encourage a more knowledge-based growth model. The article concludes with consideration given to the constraints deriving from the international environment and the political situation following the general elections in December 2015.

Remedying the damage

Unevenly distributed impacts

Spain was more severely affected by the 2007 crisis than the Eurozone average. Despite the recent recovery, at the end of 2015, GDP was still below 2007 levels. The unemployment rate remains over 20% (compared with 8% in 2007), with a relatively large long-term component, and many households with all members unemployed.

The imbalance that played the largest part in exacerbating the consequences of the crisis was household and non-financial corporate debt with the domestic banking system. The public finances

were comparatively healthy: at the end of 2007, the government's fiscal surplus was 2% of GDP, and public debt stood at 35.5% – among the lowest in the OECD.

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The slump in activity, and – of course – in residential construction, led to a sharp drop in government revenues, driving up the deficit and public debt. This coexisted with increased vulnerability of the banking system, which was the first to be affected by the collapse of global credit markets. The economy's heavy reliance on bank finance meant that financial system disruption was passed on more quickly and more powerfully to the real economy. This in turn intensified the vicious cycle between the tensions in public debt markets, the deepening recession, and worsening bank balance sheets, which included a substantial portion of public debt, and, of course, mortgages.

Applying pro-cyclical fiscal austerity, which Paul de Grauwe (2015) termed “panic-induced austerity”, was somewhat counterproductive to facilitating a recovery in economic growth. As de Grauwe points out, against the backdrop of a recession, these policies reduced the effectiveness of automatic stabilisers, making the drop in activity more intense. There was a manifest erosion of all forms of capital – physical, human, technological – and, consequently, of the economy's potential growth rate.

Basis for the recovery

Spain suffered a significantly worse slowdown in growth than the eurozone average, and external drivers have subsequently played a bigger role in the recovery than in most euro-area economies.

The first driver was the change in the European Central Bank's stance as of summer 2012, when it showed it was willing to act against the collapse in government bond prices which reflected expectations of a break-up of the euro. Spain was particularly affected by falling bond prices and worsening bank balance sheets. This led to the need for European financial assistance to recapitalise the banks in June 2012, which was the first form of support for the economic recovery, alleviating the harm caused by austerity. From then on, the ECB's adoption of monetary policies modelled after those of the Federal Reserve and the Bank of England enabled further progress on restoring households' and firms' balance sheets to health, and reducing interest on public debt.

Exceptionally expansionary monetary policy adopted by the ECB, the consequent depreciation of the euro and the cheapening of raw materials and consumables, in particular hydrocarbons, represented a bigger stimulus for the Spanish economy than for the eurozone average. This was due to the higher level of debt and the vulnerability of the banking system, along with the higher level of dependence on oil and gas imports. The strength of exports also played a major role in the recovery. Export growth was largely driven by Spanish firms' increased propensity to export in order to compensate for lacklustre domestic demand, and it was also boosted by cheaper input costs, including labour.

Expansionary monetary policy adopted by the ECB, the consequent depreciation of the euro and the cheapening of raw materials and consumables, in particular hydrocarbons, represented a bigger stimulus for the Spanish economy than for the eurozone average. The big question is whether these drivers will endure over time.

The big question raised by this pattern of recovery is whether these four drivers will endure over the

longer term. In the absence of a strengthening of other, more lasting, competitive advantages, it is highly likely that growth will be insufficient to continue reducing unemployment and shrinking the considerable debt burden. This was pointed out by the IMF's latest Article IV report (2015), which warned of Spain's low medium-term growth potential. The IMF forecast growth of 1.8% for the Spanish economy in 2020. Unless there is further deterioration in the international environment, beyond that already witnessed, the Spanish economy could maintain solid growth over the next two years, of 2.7% and 2.3%, in 2016 and 2017, respectively (Table 1). Although not as strong as in 2015, growth drivers include favourable monetary conditions, a gradual recovery in credit and relatively low commodity prices, which are helping keep Spain's growth above its potential rate. However, unless investment picks up and productivity rises, it will be difficult to reduce structural unemployment and thus raise potential growth.

Despite strong job creation in 2015, there are clear risks of further deterioration in most people's living standards, given the trends in average wages, job quality, the number of unemployed receiving no benefits whatsoever, and the widening income and wealth gaps.

These limitations, and the uneven distribution of income generated during the recovery, help explain why last year's macroeconomic figures have not translated into more optimistic perceptions among economic agents. Despite strong job creation in 2015, there are clear risks of further deterioration in most people's living standards, given the trends in average wages, job quality, the number of unemployed receiving no benefits whatsoever, and the widening income and wealth gaps. Reducing inequality is a necessary condition for stability, particularly political stability. However, it is also a prerequisite for economic growth.

Table 1

Economic forecasts

Macroeconomic data on the Spanish economy				
	AFI			
Annual rate (%)	2014	2015	2016	2017
Real GDP	1.4	3.2	2.7	2.3
Consumer spending	0.9	2.9	2.6	1.9
Households	1.2	3.1	2.9	2.1
General govt.	-0.0	2.5	1.6	1.3
GFCF	3.5	6.2	5.0	4.9
Capital goods	10.7	9.7	7.0	6.1
Construction	-0.1	5.6	4.6	4.9
Housing	-1.3	3.0	4.6	5.5
Domestic demand (*)	1.5	3.4	2.9	2.5
Exports	5.1	6.0	5.5	4.7
Imports	6.4	7.8	6.8	6.1
External demand (*)	-0.2	-0.3	-0.2	-0.2
CPI (annual average)	-0.2	-0.5	0.2	1.1
GDP deflator	-0.4	0.6	1.0	1.3
Nominal GDP	1.0	3.8	3.7	3.6
Employment (LFS)	1.2	3.0	2.5	2.0
Unemployment rate (LFS)	24.4	22.1	20.1	18.9
Public sector balance (% GDP)	-5.8	-4.7	-3.7	-2.7
Private sector balance (% GDP)	99.3	100.7	101.3	100.5

Note: (*) Contribution to GDP growth.

Source: AFI, the author.

Modernising the economy

Restoring lost capital, increasing investment, and raising productivity are necessary conditions for the Spanish economy to maintain sustainable medium-term growth. However, they are not sufficient conditions. The pace of modernisation of the economy, which experienced a slowdown as a result of the crisis, must also increase. Long before the crisis, there was already a need to shift the competitive advantage of sectors of the Spanish economy towards increased reliance on knowledge-based factors and to reduce vulnerabilities typical of less advanced economies.

There are a number of priority areas on which it should be possible to reach agreement, regardless of the ultimate distribution of political power. These may be summarised as follows:

Strengthening technological capital and education

The Spanish innovation system was one of the biggest victims of the crisis. Spain was already near the bottom among advanced economies in terms of R&D investment before the crisis, and now its position has further worsened. In 2008,

Spain devoted 1.35% of GDP to R&D, 0.45 points less than the EU average, and by 2013 this had dropped to 1.23% of GDP. Elsewhere in the EU, investment in R&D has risen steadily during the crisis, such that Spain's investment effort has dropped by 60% in relative terms since 2004. The distance by which Spain lags behind the leaders in innovation has widened even further (Mulet, 2016).

Although the economy grew in 2014, public and private R&D investment dropped significantly compared to the previous year, and consequently, with respect to the start of the crisis. Another feature that differentiates Spain from the rest of the EU is the source of this investment. In Spain, almost half comes from public sources, whereas the EU average is just 32%. This means that this form of technological capital is highly dependent on the willingness of governments to invest, and on the priority given to R&D in any budgetary adjustment decisions taken. Whereas in other economies, the allocation of public funds tends to be fairly stable, in Spain it is highly volatile, suggesting a lack of a consistent strategy in this area.

This is an area in which there needs to be a long-term strategy, with sufficient political backing to ensure it is not at the mercy of future budget cuts.

Closely linked to better budgetary support for technological capital is education funding. As pointed out by Serrano and Soler (2015), young people's basic skill level prior to joining the labour market is insufficient. From compulsory to higher educational levels, Spain's position relative to other countries is not in line with the size of its economy.

Spain has not been able to devise a policy guaranteeing sufficient stability of adequate standards to enable school-leavers' skills to match the needs of today's society and economy. At the same time, continual changes to education policy have done little to achieve the other basic goal of reducing persistent and marked social stratification.

Businesses and entrepreneurship

The quality of management is crucial to ensuring good economic performance. Society needs to generate the necessary incentives to ensure top talent devotes its abilities to entrepreneurship. It is also necessary in order to ensure efforts are productive, and to clearly distinguish entrepreneurs from profiteers, as John Maynard Keynes put it.

However, while creating the right conditions and removing barriers for new start-ups is important, taking the comprehensive parameters of the World Bank's Doing Business Report as a reference, it is no less important to encourage business growth, so as to ensure that businesses are better able to adopt innovation. Micro-enterprises (those with fewer than nine employees), of which there are 3.1 million in Spain, continue to account for a disproportionate share of firms (96%).

In short, there are undoubtedly gains to be made by encouraging the emergence of business structures that operate more efficiently. And this inevitably entails increasing the average size of firms, so they are able to assimilate trends in innovation and introduce appropriate improvements to the management of business subsystems. Both boosting the economy's potential growth rate and achieving productivity gains depend on these general improvements in business functioning.

Institutional quality and social inclusion

The loss of trust in Spain's institutions is one of the reasons for the major shift that has taken place in the country's political landscape. There is a pressing need for renewal, to bring institutions closer in line with economies undertaking best practice, and to break the ties of political influence that pervade the economy.

As stated by the European Union, it is also worth progressing towards diversification of the financial

system, reducing the reliance on banks and laying the foundations for assimilating the proposed changes to support Capital Markets Union.

No less important when defining growth strategies and growth sustainability is social inclusion. Michael Spence (2016) recently underlined the risks of those patterns of growth that systematically exclude population subgroups, leading to weak political and social cohesion, and ultimately, undermining growth prospects. Again, the provision of good quality education and health services is crucial to the necessary equality of opportunities and intergenerational mobility.

Support from the international environment

The extent to which the international environment will be conducive to achieving these two essential goals – restoring and modernising the economy – in the short and medium term is currently unknown. As was discussed in the first section, temporary external factors have made the biggest contribution to the Spanish economy's recovery and continued growth depends on the

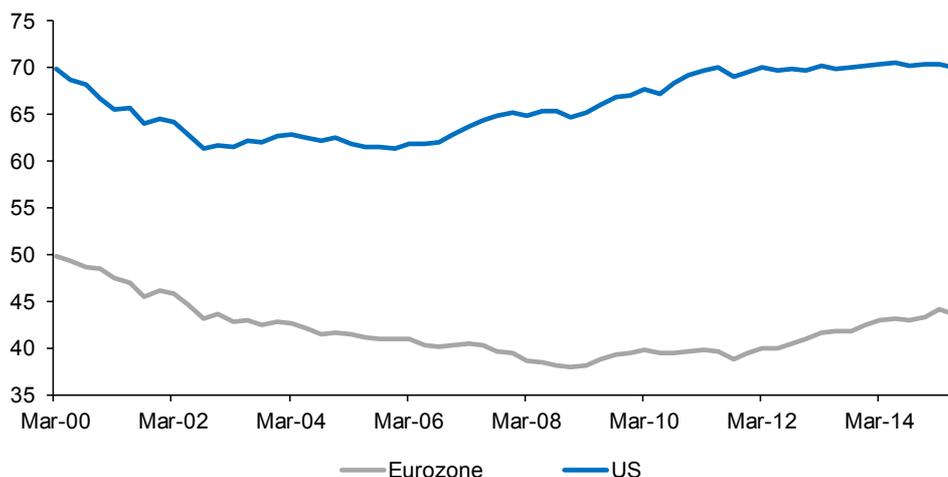
persistence of these factors. Various factors may alter the expansionary momentum with which the Spanish economy entered 2016 and slow the rate of investment.

The expansion of the global economy and international trade will be less favourable to Spain's growth than in 2015. Apart from the deceleration observed in emerging economies, there are renewed risks of financial instability deriving partly from the explicit divergence in monetary policies between the main economic blocs, with a differential impact on highly indebted energy companies. Another potential source of risk is the uneven capacity of financial systems in less advanced economies to facilitate deleveraging decisions by private-sector actors that often have high levels of dollar-denominated debt.

Irrespective of the underlying causes and the analysis of the factors triggering the slump in stock markets in the opening weeks of 2016, the resulting loss of financial wealth could have an adverse impact on growth in advanced economies. This will, of course, rein in expectations and limit the propensity to consume and invest. With the caveats that apply to specific estimates of the wealth

Exhibit 1

Households' financial wealth (% of total wealth)



Source: AFI, the author.

effect depending on the economy (assumed to be greater in the United States than in Europe, given the greater share of financial wealth in the U.S., as shown in Exhibit 1), it is highly likely that drops of more than 15% in share prices, over such a short period, will cause aggregate demand in the U.S. and Europe to contract. Moreover, given that banks' shares have been the hardest hit, it may also slow the normalisation of intermediation activity, and thus, in particular, hold back lending in the euro area.

Developments affecting China's economy and financial system have been a powerful driver of financial instability registered in the early part of the year. The perception that the world's second largest economy has entered a phase of slower growth and is struggling to stabilise and normalise its financial system and currency regime remain disruptive factors for global financial stability. Even though the direct commercial and financial links between Chinese and Spanish economies are relatively insignificant, there is clearly capacity for contagion, whether through links with major euro-area economies or through emerging economies with which Spanish firms have more direct ties.

Concerns over China's growth and financial stability remain disruptive factors. Even though direct commercial and financial links between China and Spain are relatively insignificant, there is capacity for contagion through links with major euro-area economies or through emerging economies with which Spanish firms have more direct ties.

The impact of the slowdown in Chinese import demand, particularly in the case of commodities, is one of the factors contributing to the more acute difficulties being faced by economies of relevance to Spain, such as Brazil. Spain's direct investment in Brazil is fairly significant, and it generates substantial income and profits for some of Spain's

largest firms, which have a key place in Spanish stock market indices.

Additionally, the complexity of the geopolitical context, with falling energy and commodity prices, also does little to favour economic and financial stability. The tension between Saudi Arabia and Iran is just one illustration of this.

Within the euro area, growth has been weak since the start of the public debt crisis in 2010. GDP at the end of 2015 had still not returned to its end-2007 level, and economic players' confidence levels also remain low. Inflation has as yet failed to respond to monetary stimuli, suggesting, as some authors argue (Roubini, 2016) that the traditional causal link between money supply and price changes may have been broken. Despite low capital costs, investment is scant, as is productivity growth, while the export sector is unable to make a significant contribution to growth owing to the weakness of the emerging economies. It will not be easy either for the euro area to free itself from the obstacles to increasing its potential growth, as highlighted by the various academics working together under the title of Rebooting Consensus Authors (2015). Some of the imbalances making the crisis more acute in the euro area have yet to be corrected. These include the quality of bank assets or banks' exposures to home-country public debt, and the general vulnerability in those economies with high levels of private debt to the normalisation of ECB monetary policy. Shrinking financial margins and increased regulatory pressure are a bad combination for some European banking systems, as stock markets have recently noticed.

Banks' shares were hit hardest as prices slid in the first few weeks of 2016, particularly in the euro area. Concerns over the banking sector seem to be predicated on the assumption that near-zero interest rates, lacklustre economic growth, high default rates and greater regulatory pressure will be irreconcilable with adequate margins and returns on equity. This is particularly relevant in the case of retail banking. Fears became more acute when it became apparent that the ECB had

limited room to manoeuvre through reliance on extra stimulus without generating more financial instability.

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This has all contributed to a renewed focus on the concept of “secular stagnation.” On November 8th, 2013, at the IMF’s Economic forum, Larry Summers “resuscitated”, as he himself put it, Alvin Hansen’s idea of the possibility of a secular stagnation in advanced economies. This is an idea that is particularly applicable to the euro area. Since then, events have done nothing to refute this hypothesis. Investment decisions are far from expansionary, despite real interest rates being at record lows. At the end of another IMF conference, Olivier Blanchard (2015) took up Summers’ position, arguing that in a context in which there was a chronic excess of saving relative to investment, keeping the economy at its potential rate would require extremely low, or even negative, interest rates. This is a situation, however, that as well as involving low medium-term growth, also implies frequent episodes of financial instability.

Against this backdrop, the effectiveness of monetary policy is constrained not just by the level of interest rates or decisions to implement quantitative easing, but also by the difficulties that are becoming apparent in the monetary policy transmission mechanism. In this context, a more active fiscal policy is therefore needed. As evidenced by the Juncker Plan – to be implemented by mobilising pan-European investments to counteract the risks of stagnation and encourage improvements in business productivity. European

institutions need to be aware of the damage caused by the approach to the crisis adopted from mid-2010 onwards, which, while falling short of stabilising public finances, seriously eroded the euro area’s potential growth. The resulting loss of welfare fuelled public discontent with the process of EU integration and heightened nationalist tensions in certain countries. Bringing plans for common investments in technology and energy networks to fruition should not only make it feasible to achieve growth just below that of 2016 levels, which most analysts estimate at 2.7%, but also facilitate a necessary improvement in the pattern of growth as well as bolstering productivity.

Concluding remarks: The role of political uncertainty

In the current international context, which in no way guarantees adequate growth rates, the Spanish economy is in the midst of its own internal transition owing to the break with the prevailing pattern of government.

The results of the recent general elections have not eliminated the traditional parties, but have enabled new parties to emerge that will need to

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be taken into account in the future. New scenarios now exist that make equally novel outcomes possible in the Spanish political scene. However, Spanish and foreign economic agents are justifiably sceptical over the stability of such scenarios, and this is having a negative impact on the investment climate.

So far, financial variables, particularly government bond prices, have not reflected the country’s

current political uncertainty, but this situation could change. The ECB's public debt purchases are undoubtedly significantly moderating the potential negative impact of the difficulties of building a sufficiently stable coalition government. The same obstacles make it difficult to find solutions to the complex dynamics of the situation in Catalonia or adopt decisions to agree new deficit and public debt targets with the authorities in Brussels. The prolongation of these situations may end up producing significant economic and financial impacts, in the event they result in the freezing of investment decisions by Spanish and foreign firms.

It would therefore be desirable for an outcome to emerge in which there was a sufficient majority, notwithstanding its duration, to be able to manage three crucial issues: the situation in Catalonia,

The difficulties in building a sufficiently stable coalition government are also obstacles to finding solutions to complex situations, such as that of Catalonia or the adoption of decisions as regards new deficit and debt targets with EU authorities.

negotiation with the European Commission to relax the 2016 public deficit target and lift the sanctions imposed for breach of the 2015 target, and improve the quality of the country's institutions. A willingness to act on these three fronts is essential to address the other medium-term objective mentioned earlier – modernising the Spanish economy's growth model, which is closely linked to the sustainability of its growth rate and the generation of better quality jobs.

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