europeG
Opinion and Discussion Group on Political Economy

"Competitiveness and deleveraging in Spain: the challenges ahead"

Policy Brief **No. 2**
July 2012

ISSN 2014-7457

The Spanish economy is immersed in a crisis which reflects the various effects of a series of shocks which have altered the behaviour of the supply and demand factors which drove Spanish GDP growth in previous years. The common thread linking that succession of shocks is none other than the enormous expansion of debt. Given the volume of debt which Spain had accumulated by 2007, together with the international credit crunch context, the sequence of events was already partly sketched out. Nonetheless, if European economic growth had been stronger, Spain's adjustment process could have been eased.

Thus, it can be argued that the source of our crisis was private sector debt, the volume of which expanded excessively after the introduction of the euro. This allowed a growth in borrowing free from the restrictions previously implied by the need to defend the peseta.

This process can be analysed from different angles. It can be approached from the changes in the growth rate, and the level, of potential output, looking at the changes in the availability of productive factors, or highlighting the reforms (labour, financial, increased competition in certain sectors, etc.) required for a greater growth for total productivity. However, it can also be done by analysing the changes in the factors behind the strong expansion of domestic demand, which is the approach adopted here. Nevertheless, given the crucial role of the external sector, the analysis of other factors on the supply side which have contributed to the imbalances is also unavoidable, especially the link between the growing balance of payments deficit and the behaviour of labour costs and labour productivity.

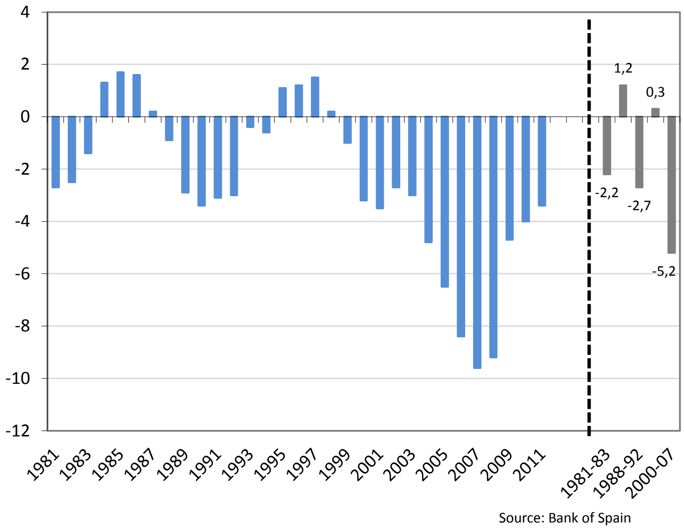
1. The 1995-2008 expansion: some decisive demand-side factors

The decisive factor, which ultimately permitted the strong GDP growth recorded between 1995 and 2008 (3.5% per annum in real terms) was the incorporation of Spain into the EMU. More specifically, it was the effects of the apparent shift in the country's external restriction which, in the form of current account deficits, had aborted previous unsustainable growth phases. The increase in domestic credit was a consequence of this unlimited access to European and international savings. The construction boom, in turn, was the result of this situation, leveraging and stimulating its growth, with the enormous demographic expansion being partly a second order consequence. Both factors in the end combined to allow an intense surge in non-residential GFCF (both public and private) and a strong increase in employment of the different levels of government.

1.1. Spain's incorporation into the EMU and the apparent disappearance of the external constraint

The adoption of the single currency appeared to mark the beginning of a new, structurally different, phase in the Spanish economy, in which the chronic balance of payments problems disappeared. Thus, despite the large and growing current account deficit, between 2000 and 2008 the spread between Spanish and German 10 year bonds stood at around 10-15 basis points. This decline in the perception of risk (from levels of between 400 and 500 basis points in 1995) extended to all agents of the Spanish economy, meaning that non-financial companies, households and the financial system had access to expansionary financing conditions unprecedented in Spain's modern history. The adoption of the euro, in sum, was misinterpreted as a structural change in the conditions of external financing. That vision was no more than a fool's paradise. But, as with any fool's paradise, the growing importance of the current account deficit, and also, especially, of the gross external debt, now appear in stark reality. In addition, the stock market crisis of 2001, and the subsequent recession in Europe and the US, took ECB interest rates to the lowest levels ever known in Spain.

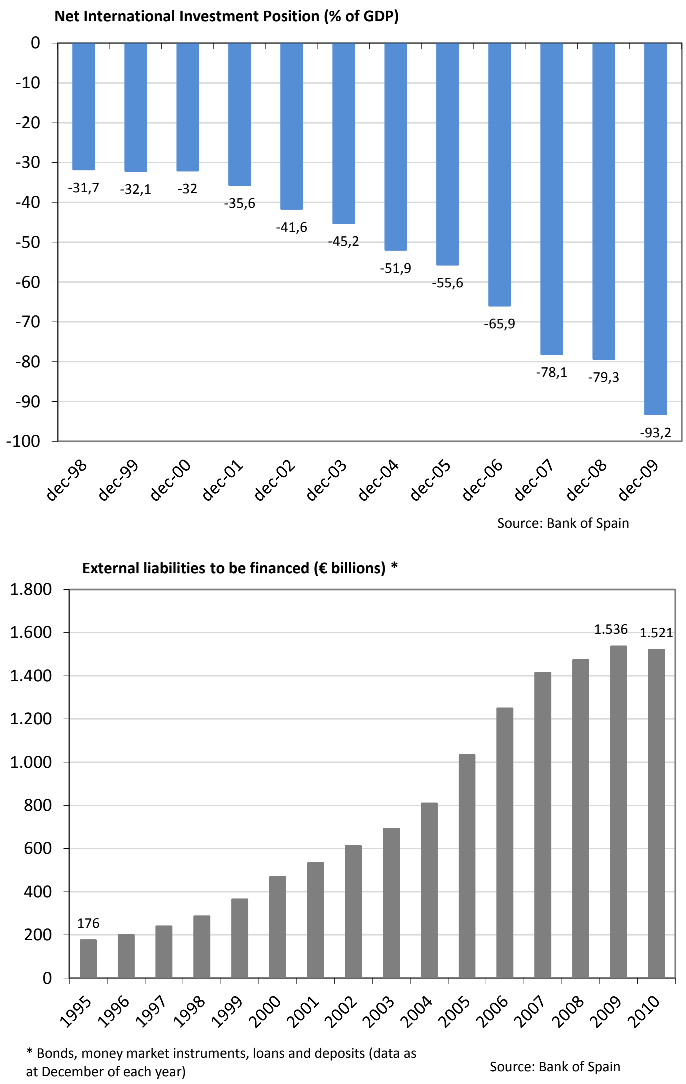
Figure 1.- Capacity/need for funding (% of GDP)



Reduced borrowing costs and the apparent disappearance of the external constraint resulted in a growing recourse to the savings of the rest of Europe, allowing an unprecedented expansion of credit to the private sector (16.5% per annum between 1998 and 2008).

In this context, Spain's external financial position, both net and gross (IIP and total financial liabilities), experienced a severe deterioration, to which markets and rating agencies were apparently indifferent. In net terms, the IIP rose from less than €171 billion in the last quarter of 1998 (31.7% of GDP) to more than €860 billion in the fourth quarter of 2008 (79.3% of GDP), an increase that reflects the accumulation of the growing current account deficits generated in the expansion phase. Thus, after an initial period (1995-97) with a limited external financing capacity, the need for external financial resources rose to 9.6% of GDP in 2007 and 9.2% in 2008, bringing the total of new liabilities acquired by Spain to finance its excess current expenditure to around €500 billion between 2000 and 2008, an anual average of 6.1% of GDP.

Figure 2.- Spain's Net International Investment Position and external liabilities to be financed

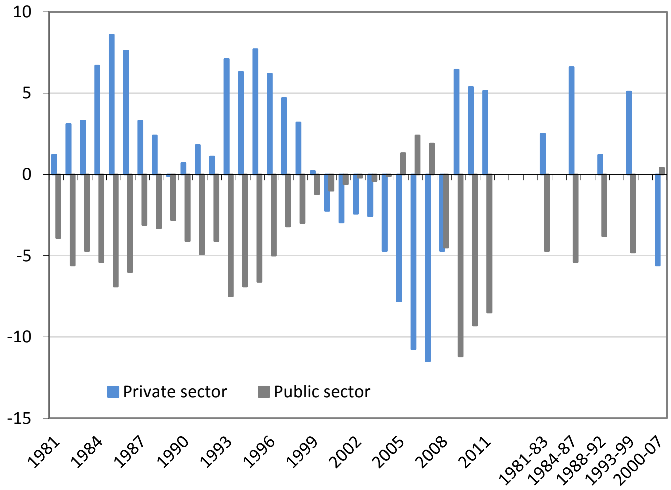


Even before the 2008 financial crisis, Spain's net external financing needs reflected, particularly though not exclusively, an unsustainable deterioration in the balance of trade in goods and services - a symptom of the increasing differentials in the growth of labour productivity and wages with respect to our major trading partners - as well as the need to finance the real estate bubble. Thus, the accumulated 39.7% increase in the CPI in Spain between 1997 and 2008 amply exceeded that of France (21.7%), the Netherlands (28.8%), Germany (18.9%) and Italy (29.7%). The growth in prices fed through into wages so that, in nominal terms, their accumulated increase in Spain reached 45.6% between 1997 and 2008, compared with 32.9% in France or 12.8% in Germany. In addition, the strong growth in employment resulted in small increases in worker productivity, with accumulated growth of only 3.3% between 1998 and 2008, far removed from the increases experienced by France (11.8%) and Germany (11.6%). Hence, unit labour costs (ULC), measured in nominal terms, accumulated growth of around 40% between 1997 and 2008, considerably higher than the bare 1% observed in Germany (or 20.7% in France).

On the other hand, from the perspective of gross borrowing, which is the key variable in terms of external refinancing, as well as the resources needed to finance excess domestic spending, we need to add Spanish investment abroad. Thus, from an aggregate value of €195 billion in 1995 (49.3% of GDP), gross external borrowing rose to €580 billion in 2000 (92.5% of GDP) and, finally, to almost €1.4 trillion in 2008 (127% of GDP). As Spain's need for external financing began to appear in the late 1990s, the more than €800 billion invested abroad by Spanish residents between 2000 and 2008 had to be financed in its entirety with resources from the rest of the world. This means that the gross liabilities accumulated by the Spanish economy in 2008 stood at €2.2 trillion, compared to €780,000 in 2000 and to €300 billion in 1995. As a part of these liabilities represent foreign direct or portfolio investment in Spain, which would not be expected to generate immediate refinancing requirements, the gross external debt to be serviced by Spain stood at around €1.8 trillion at the onset of the crisis.

It was the private sector which originated this growing external deficit, given that the public sector deficit of 6.5% of GDP in 1995 gave way to a surplus of 1.6% for the years 2005-07. Thus, while in 1995 private sector savings represented 23.7% of GDP, compared to investment of 18.2%, in 2007 the situation had altered radically, with a financing requirement of 12.5% of GDP (due to a decline in savings to 14.2% of GDP and an increase of GFCF to 26.7%). Thus, at the peak of the cycle in 2007, gross investment in Spain stood at 31% of GDP, a figure not seen since 1973 and well above the savings generated by the Spanish economy, of around 20% of GDP.

Figure 3.- Capacity/need for financing in the private and public sectors (% of GDP)



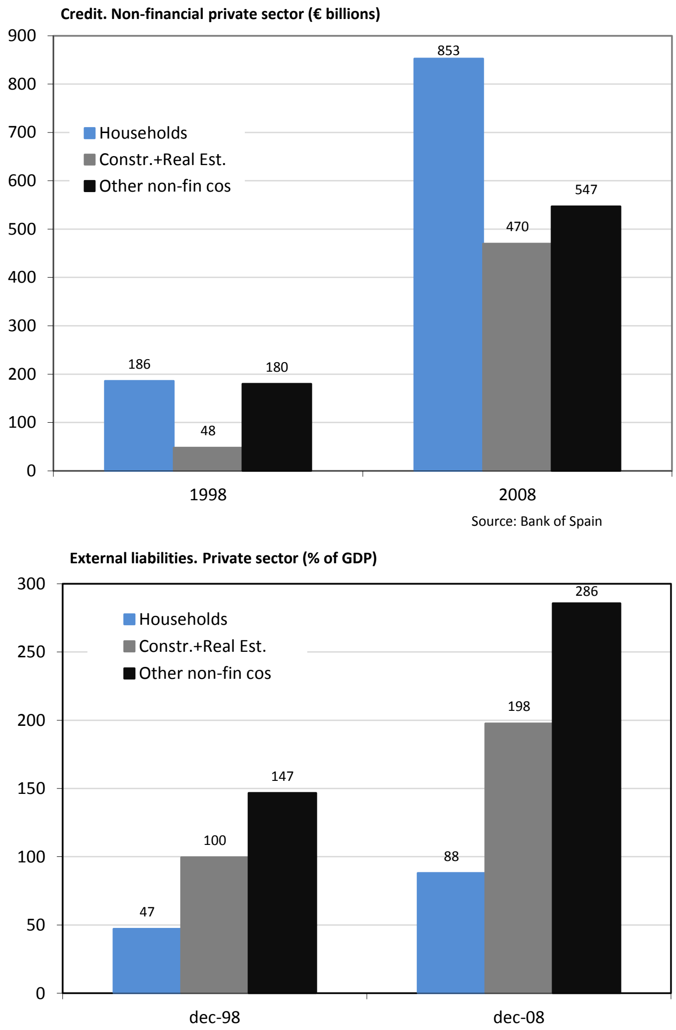
Source: Bank of Spain

1.2. Credit expansion, construction boom, demography and public sector

The ready availability of external funding allowed strong growth in domestic borrowing and, in particular, in credit to the non-financial private sector. Between 1998 and 2008, this increased by 16.5% per annum, from €414 billion to €1.87 trillion (an increase of 352%). This reflected the growth in lending to both households (from €186 billion to €853 billion, or 355%), and to construction and real estate companies (from less than €48 billion to €470 billion, an increase of 879%) and other non-financial companies (from €180 billion in 1998 to €547 billion in 2008, up 204%). Given that during those years GDP rose by 101.7% in nominal terms, bank credit to the private sector increased from 76.7% of GDP in 1998 to 171.8% in 2008.

Moreover, as this process occurred much faster than in the rest of the eurozone, domestic credit to the private sector in Spain sharply increased its share of the total granted in the eurozone, from 8.2% (with a GDP equivalent to 9.0% of the eurozone) to 17.4% in 2007 (compared with a contribution to GDP of 11.7%). In sum, the outstanding debt of the private sector rose from 144% of GDP in 1998 (about €776 billion) to 285% in 2008 (more than €3.1 trillion).

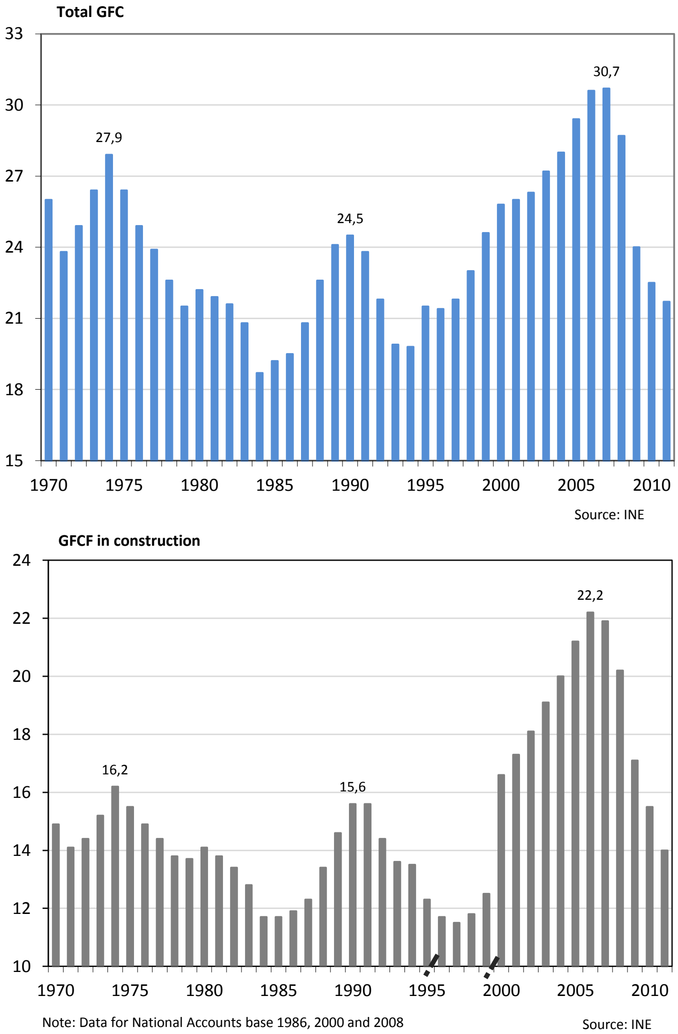
Figure 4.- Credit and liabilities. Non-financial private sector



These increases reflected the growing recourse of Spanish financial and non-financial entities to international markets and, in particular, to those of the eurozone. Thus, in June 1999, claims on the Spanish economy in the hands of French, German, Italian and Belgian banks totalled about €91 billion, or 16.9% of the Spanish GDP, a proportion which rose to more than €392 billion in December 2008, 36.1% of GDP.

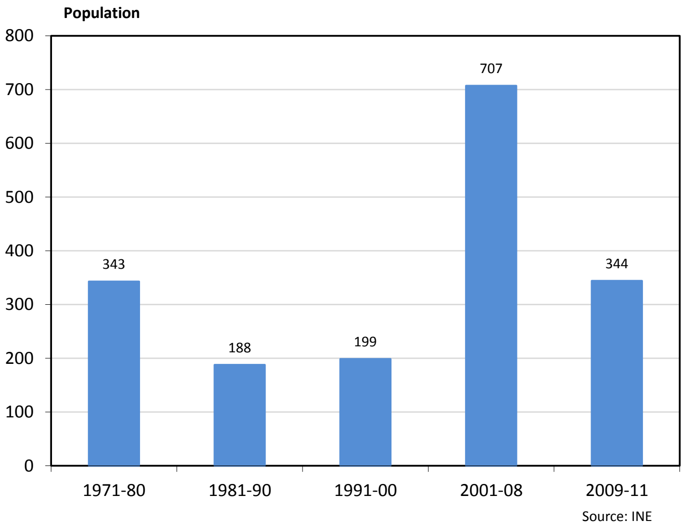
The availability of credit, its low cost and the low indebtedness of households and real estate companies meant that the residential sector became a natural channel of expansion. Real estate demand experienced a quantum leap, with average housing starts rising from around 250,000 (between 1980 and 1998) to more than 580,000 between 1999 and 2008 (with a peak of about 800,000 in 2006). Even so, this expansion in the supply of housing was not sufficient to prevent significant increases in prices (new housing prices increased at an average annual rate of 9.5% between 1997 and 2008, among the highest in the OECD).

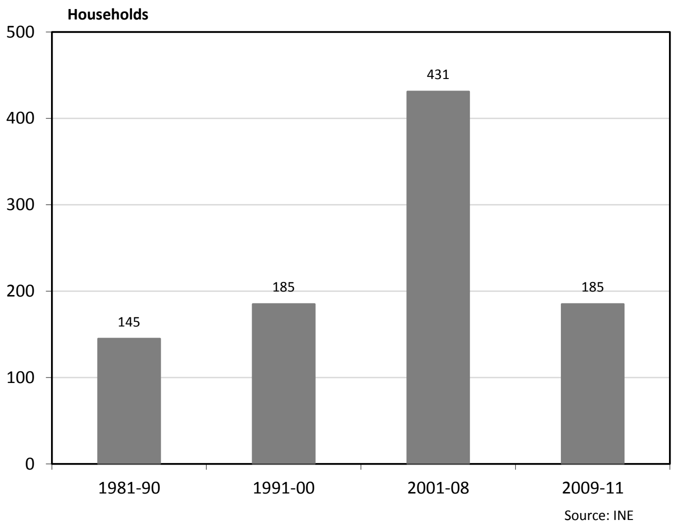
Figure 5.- Total GCF and GFCF in construction (% of GDP)



In addition, the increase of GFCF in residential construction was part of a broader process of growth of GCF as a percentage of GDP. This, which had stood at around 22.5% (1995-99 average), rose strongly to an average of 29.5% in the 2004-08 period, reaching 30.7% of GDP in 2007, a historical high only reached previously in 1973, as noted above. These increases reflected both the expansion in strictly productive capital equipment (due to the growth of the domestic market and to the industrial rationalization processes arising from globalization and offshoring) and the impact of investment in construction. Between 2000 and 2007, this sector experienced a gain of 5.3 percentage points in its share of GDP, from 16.6% in 2000 to 21.9% in 2007, reflecting, basically, the increase in the residential sector (new housing and renovation), which rose from 4.7% of GDP in 1997 to 9.0% in 2000 and to 12.2% in 2007.

Figure 6.- Demographic trends. Population and households (average annual change in thousands)





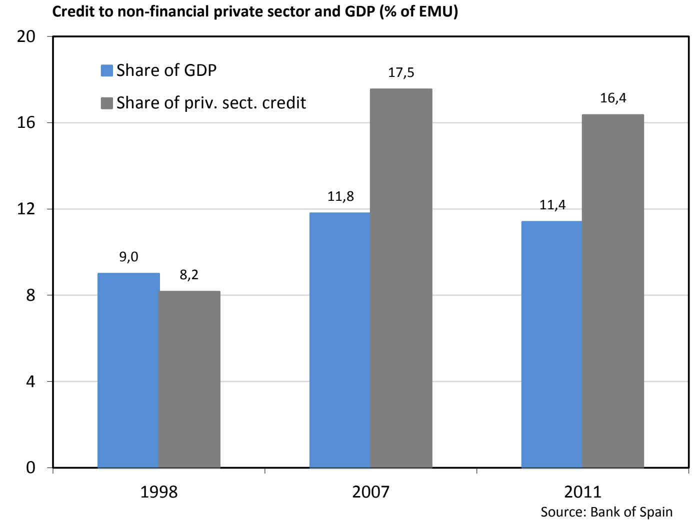
Lastly, to the above list of factors should be added an important change in population trends. Driven by immigration, the population increased by 16.4% between 1995 and 2008, an annual rate of 1.1%. This strong growth is key to the growth of the domestic market, which accounts for an equivalent part of the increase in investment, both residential and non-residential, and both private and public productive investment. In fact, the contribution to GDP growth of generated by the immigration shock has been estimated at close to 35-40% between 2000 and 2008. At the same time, the immigration shock and the changes in the structure of the native population, its behaviour and living conditions together brought about a substantial change in the dynamics of the creation of new households: compared to an increase of around 160 thousand new homes per year between 1975 and 1997, the average rose to almost 400 thousand per year between 1998 and 2008.

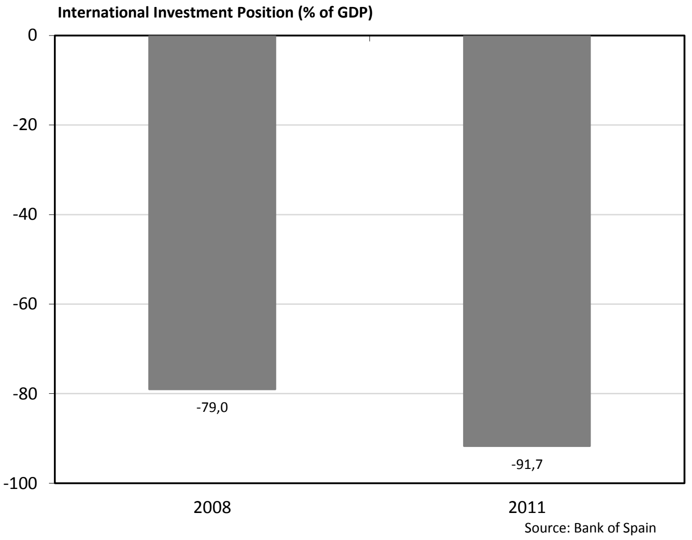
Finally, in the context of the gains in income and the cyclical upturn in public revenues, the public sector also contributed mightily to the previous expansion. Its contribution, as measured by jobs created in collective services (offered by both the private and public sectors), can be estimated at an annual average of 21.3% of new employment in the 1995-2008 period, from a sector that represented 18.1% of the country's employment in 1995.

2. The 2008-2012 crisis and the collapse of the drivers of growth

With the outbreak of the financial crisis in September 2008, the trends of the factors related to domestic demand which had previously driven growth began to reverse. Firstly, the availability of credit has given way to a growing deleveraging, which translates into a contraction. Between late 2008 and 2011, the credit directed to the non-financial private sector accumulated a fall of 3.7% in nominal terms (and 8.1% in real terms). A return to levels of indebtedness more consistent with our ability to generate income will involve a tough credit adjustment, which will curb the growth of domestic demand. Thus, for credit to the non-financial private sector to represent the same proportion of the eurozone as is the case for GDP (11.4% in 2011), a contraction of close to €500 billion would need to take place, a fall of nearly 30% of total domestic credit to the private sector in Spain at the end of 2011 (€1.8 trillion). Indeed, after four years of crisis, the deleveraging of the private sector has barely begun: its liabilities (excluding shares and other equity) continued to grow faster than GDP until 2010 (from 275% of GDP in 2007 to 284% in 2010), and it was only in 2011 when the expected reduction began, to 274% of GDP at the end of that year.

Figure 7.- The deleveraging process during the crisis





In addition, the fool's paradise of financial flows to Spain at low interest rates and with a risk premium similar to that of Germany has given way to a different situation, in which the external constraint has visibly returned. In a sense, it can be said that Spain today behaves as if it had gone back to the peseta, though without the benefits of being able to control the exchange rate. The markets' view of the country risk has returned to levels not substantially different from those existing before Spain adopted the euro, with the risk premium sky-rocketing in June to levels close to six hundred basis points. This new situation, in terms of trends, is going to last for a long time, and its importance is clear: the return of an external constraint which will prevent the accumulation of excessive deficits.

Other factors such as demography and residential construction will also have contractionary effects over the next few years. The accumulation of unsold new housing (more than 800,000 units at the end of 2011), together with the foreseeable trends in credit and demography, suggest that the construction sector's productive capacity will remain far below previous levels for a long time to come. Not only will it remain below the very high levels of 1998-08 (568,000 housing starts per year), but below the long-term average, such as the period between 1980 and 1997 (with starts of around 250,000 per year).

With regard to demography, the combination of losses of young immigrant population and the age structure of the resident population represent a structural change in the rate of growth and composition of the population. Thus, the INE's latest short-term estimates (2011) point to a decline population, estimated at close to 600 thousand people in the period to 2021. Although this is barely 1.2% of the 2011 population, its economic impact will be much more significant, given the important changes that will occur in the age structure, in particular the significant reductions in the 20-39 age group. This cohort is forecast to lose more than 3.5 million members between 2011 and 2021 (a fall of 26.5%, from 13.7 to 10.1 million), with its share of the total population declining from 29.7% in 2011 to 22.1% in 2021. The shrinking of this group points to negative effects on first-time buyer demand for housing, durable goods demand and, in general, on aggregate consumption in the coming years.

Finally, the expansive role of the public sector has ended and its impact on economic growth has reversed, with a contractionary effect on activity since 2010. This has resulted in some reduction in negative saving, which had been particularly strong (from 5.3% to 4.7% of GDP between 2009 and 2011), although its total funding requirements are little changed.

3. Crisis, current account deficit and external refinancing

The changes which have occurred since the beginning of the crisis in the factors which drove GDP growth, and those foreseen over the next few years, should be considered in the light of the difficulties in reducing the current account deficit and Spain's high volume of external financial liabilities. In fact, an insight into the causes of the excesses of the 2000s can be gained by focussing on the contribution of the external sector. Between 1988 and 2008, while domestic demand contributed 4.4 percentage points per year to annual GDP growth of 3.5%, net external demand was subtracting 0.9 points. Although the external deficit has been partly corrected during the crisis (from a funding requirement of 9.6% of GDP in 2007 to 3.4% in 2011), the fact that it has persisted during the recession years puts it in a different context to previous cycles. Thus, in the midst of the crisis, and with significant falls in domestic demand, the net requirement for external financing accumulated between 2008 and 2011 stood close to €225 billion (an annual average of more than 5% of GDP).

Among the factors behind the difficulties in containing the external deficit, perhaps the most disturbing in the medium term is the structural reduction of the surpluses of some items and the increase, also structural, of deficits in others. With regard to the balance on goods trade (and, partly, also to services), the loss of external competitiveness emerges as a key element in the deterioration, given that ULC have consistently increased more than those of our major trading partners, in an external context characterized by the intensification of international competition. The appreciation of the real exchange rate helps to explain why four years, and the biggest ever contraction in domestic demand, have been necessary to bring the goods trade deficit down to levels more in line with the country's history, on the order of 0.75% of GDP, from 8.6% in 2007. Despite this partial reduction, the exceptional circumstances that have made it possible should not be forgotten. Hence, stronger growth of domestic demand, increases in imports and tensions in the markets for commodities, particularly oil, could substantially increase the deficit (Spain's energy trade deficit has risen from 2% of GDP in 2003 to more than 4% in 2011).

The surplus on tourism services, in turn, despite the growth seen in 2011, has tended to decline in the past fifteen years (from 4.1% in 2000 to 2.5% in 2009 and to 3.1% in 2011), due both to the increase in residents' payments and to the growing international competition. However, it should be noted that there has been some improvement, as a result of the recession in domestic demand and the correction in real terms in prices and costs, which can also be appreciated in non-tourist services (from a deficit of 0.8% of GDP in 2000 to 0.1% of GDP in 2009 and a surplus of 0.8% in 2011). Similarly, the growing deficit in investment income has been contained somewhat, no doubt assisted by the fall in interest rates (the deficit of 1.2% of GDP in 2000 rose to 2.9% in 2007 before falling back to 2.4% in 2011). However, the country's external indebtedness and the tensions in capital markets point to a renewed worsening of this balance. Lastly, transfers add to the overall deterioration.

Even so, it should be recognized that the favourable trend in exports of goods and services in the past two years has prevented a worse outcome in GDP growth. Similarly, the reversal in the trend of unit labour costs (ULC), which have fallen by 4.4% between 2009 and 2011, is a positive factor that contributes to the improvement of the competitiveness of the Spanish economy.

In the final analysis, the post-crisis dynamism has allowed only a moderation in the pace of deterioration in the net international investment position (NIIP), which rose from €822 billion (78% of GDP) at the end of 2007 to €989 billion (94% of GDP) in the fourth quarter of 2011. In addition, as noted above, at least as important as the economy's net financial balance is the gross volume of external liabilities to be funded. Together with other investments in Spain (with the exception of foreign direct investment), these have grown from €1.7 trillion at the end of 2007 (160.9% of GDP) to the €1.8 trillion in the fourth quarter of 2011 (167.4% of GDP).

4. Summary and lines of action

This *Policy Brief* has analysed the imbalances facing Spain, generated in the expansionary phase which began with the adoption of the euro, and possible ways to correct them. Indebtedness emerges as the common thread of the analysis: its growth fuelled the engines of demand that led to these imbalances, embodied in the excessive growth of the current account deficit and external debt (gross and net). In this context, the Spanish economy faces a situation with three possible outcomes.

The first is the persistence of the imbalances that it faces today. In fact, when monetary union began, it was suggested that the trade deficits with other eurozone countries were no more serious than those between regions within the same country. However, reality has proven that they are indeed different and now it is impossible for a country with the Spanish economy's macroeconomic imbalances to belong to the eurozone.

The second hypothetical scenario, exit from the eurozone and the immediate devaluation of the currency, is a solution that does not solve the underlying problems (lack of competitiveness and the high levels of external and internal debt), but it could allow the most urgent problem to be tackled: the restoration of competitiveness without, theoretically at least, having to depress growth. However, leaving the euro would probably have catastrophic consequences in the form of a revaluation of debt denominated in euros and other currencies, difficulty of access to markets, very serious strains in the financial sector, and inflation. Hence, this alternative certainly does not solve the problems which Spain faces.

The third hypothetical scenario, favoured by EuropeG, is the adoption of the measures and reforms required to restore competitiveness to the Spanish economy and to move forward in the deleveraging process (internal and external), while staying in the euro area. However, this scenario is unlikely to succeed if Spain is unable to escape the vicious circle of austerity, recession and the reduction of the public deficit.

Obviously, the fact that the objective of this *Policy Brief* is to examine the action to be taken by the Spanish economy to restore balance and competitiveness does not imply that EuropeG ignores other problems. In this sense, it must be emphasized that Spain shares the two big problems that plague Europe (euro crisis, sovereign debt crisis and difficulties in generating growth) plus its own specific issues (internal and external indebtedness and competitiveness). Solving Europe's two big problems is a necessary, but not sufficient, condition for dealing successfully with Spain's specific problems. Even if they are solved, Spain must take its own measures.

Main lines of action

1. There is no action plan without a goal, a strategy and a timetable for fulfilling it. The goal can only be the recovery of external competitiveness, in order to increase international demand and hence contribute to GDP growth and the necessary deleveraging of the private sector. In other words, to improve the relationship between increases in productivity and costs or, in accordance with the more usual indicator, the other way around: to reduce the growth in labour costs per unit of product.

A reasonable goal would be to close the gap that has arisen during the boom years in a relatively short period of time, taking the eurozone average as a benchmark. This process should be carried out taking into account that the more it occurs through increases in productivity, the less emphasis needs to be placed on cost reduction, and that wages are not the only costs that need to be reduced.

2. For the next few years, our economy may be unable to rely on its main drivers during the boom years. The key driver will have to be the external sector. This requires not simply a statement of intent, but a program of action aimed at achieving this end. Such a program must be developed on both the supply side, where the Spanish administrations have effective levers for action, and the demand side, where in any case action must be taken basically at the European level.

On the supply side, it should include: (a) a systematic and rigorous diagnosis of the situation in order to identify strengths and weaknesses, both by productive sector, and by company size; (b) the establishment of clear and measurable objectives, formulated in terms of target export quotas in the different world markets, also by sector and by economic region; (c) the design of an appropriate strategy for achieving these objectives, through a program of measures to be taken and a time line for their implementation; (d) a mechanism for evaluating, supervising and monitoring by independent experts; and (e) close coordination with business sectors concerned. In short, we need to treat the development of our export industry as a question of state and raise awareness in society as a whole of the fact that, to a large extent, the future of the Spanish economy is staked on the success of this program.

However, there will be little point in revving up the engines of the export sector if there is no external demand in the EU, to a large degree, and the rest of the world. Thus, to a considerable extent, the future of the Spanish economy depends on European growth.

Achieving this involves various lines of action. First, the ECB could be expected to take more decisive initiatives, both in the field of monetary policy (a sustained reduction of the interest rate and an increase in liquidity) and, with regard to the stability of the sovereign debt markets of the countries most affected, acting forcefully (directly or through the ESM) in the secondary market. Second, direct actions to stimulate demand, both by EU institutions (the EIB, for example) and on the part of those countries in a position to do so. Finally, in the countries that must consolidate their fiscal positions, as is the case of Spain, with no margin for expansionary policy, there is scope to reduce the deficit more gradually or to promote selective investment projects (those which contribute to increase productivity), funded by EU institutions.

3. In the next few years, the Spanish economy will be subject to a severe reduction of indebtedness, but full awareness of this and of its implications is lacking. This indebtedness affects the private sector especially, though not exclusively, and also in good measure the debt owed to creditors of other countries. To give an idea of the amounts involved, in broad terms this will mean reducing the debt by about a third. The experience of other countries indicates that these processes are tough, complex and difficult. It is best to take on board that it has to be done, set it on the right track and take the necessary mitigating measures, rather than seeking to deny it and dealing with it on an improvised basis. With this in mind, three considerations should be emphasized.

First of all, experience indicates that (a) priority should be given to reducing private debt first, rather than public debt; (b) it is not advisable to try to reduce both at once with similar severity; and, (c) it is better to act quickly rather than dragging out the process for years. Therefore, the public sector deficit reduction should be reconsidered in a reasonable time frame and efforts focussed on the deleveraging of the private sector.

Secondly, the main protagonist in any deleveraging process is the financial sector, especially as we are talking about a heavily banked economy, as is the case in Spain, and even more so because this indebtedness is in good measure to foreign creditors. This means that the deleveraging process cannot be considered to have advanced significantly until the banking system has really cleaned up its balance sheets and regained its solvency.

It is important to emphasize that, by definition, deleveraging means reducing the ratio of private debt to nominal GDP. Hence, it seems inevitable that net credit will grow only very slowly in the next few years, if it does not simply decline. Once cleaned up, the financial system must resume its role of assessing risk and providing the necessary flow of credit to sound businesses. The deleveraging process will have to be asymmetrical, therefore, as is already happening in part, though at the moment perversely, as it is not the most creditworthy companies that are receiving credit, but the large debtors or those companies that due their size or strategic location have a greater capacity for influence.

Thirdly, experience also suggests that, in any process of private deleveraging, in the end there will inevitably be an agreement between private creditors and debtors to restructure the value and repayment terms of the debt. Indeed, this process has already started, hence the problems of the banking sector. Its difficulty and complexity in the Spanish case is due precisely to the confluence of the financial system's leading role and the importance of external borrowing.

4. Finally, the recovery of the Spanish economy's competitiveness and the restoration of its basic equilibrium is a complex and painful process. This is doomed to failure without the acceptance and support of a broad social majority, not just its fatalist resignation, but the active conviction that such a process is desirable.

For this to happen, two conditions must be fulfilled. Firstly, the majority of society must be convinced that the objective to be achieved will help to resolve the problems we face and to obtain a socially satisfactory result. Secondly, the burdens of the sacrifice must be distributed equitably.

Only if these two conditions are satisfied will there be an appropriate social environment to ensure the success of the measures taken. We have already referred in part to this when considering the hypothetical scenarios before us, ruling out an exit from the euro and devaluation, provided that the chosen alternative offers reasonable hopes of success. Otherwise, it would not be surprising if, faced with the announcement of a difficult time ahead, society may prefer to try anything, however crazy as it may seem.

That is why the political factors and those relating to the social model are decisive, and without them it will be difficult to escape from the crisis. In this regard, it is useful to emphasise two specific aspects.

First. An essential element of the objective must include the resulting social model, i.e. a basic agreement on the distribution of income considered socially desirable (as advocated by Rawls, perhaps), which involves a grand compact on the welfare State and taxation. This is not a zero-sum game, as there is a positive net value, because societies with smaller inequalities are more prosperous and competitive. Moreover, inequality increased during the boom years, and only the existence of very high levels of indebtedness, partly supported by a wealth effect that now has collapsed, allowed the more humble sectors of society to maintain artificially high levels of spending.

Second. To achieve the stated goal, it is essential to introduce the intertemporal factor. This is because the distribution of the efforts required to recover competitiveness (which essentially affects unit labour costs) in the initial stages falls on wage earners, the unemployed and, in short, on the weakest sectors of society, and those least responsible for the critical economic situation. Such a result is unacceptable in terms of justice, socially intolerable and economically counter-productive. Thus it is necessary to make a firm commitment regarding the final outcome of the process in terms of income distribution, spreading the costs and benefits over time, so that those who are worst affected today will see this effort more than compensated in the following time periods.

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The *Policy Brief* reflects the group's position, and the contributions of its members, on the basis of a first draft prepared by Josep Oliver.

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With the support of:
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