

Economic recovery and the persistence of fragilities: Spain's domestic debt and foreign sector 2013-2016

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Half-way through 2016, and after two years of healthy activity, forecasts for the Spanish economy continue to be favourable, although Brexit and Italy's banking problems loom dark on the horizon. The OECD (2016), the European Commission (2016b), the IMF (2016) and private consensus (FUNCAS, 2016), all point to an average growth of 2.5% for 2016 and 2017. Given the current trends, with the exception of soaring unemployment, it could be concluded that the imbalances that accumulated before the recession, and those that were generated during the crisis itself, have been absorbed. But this is far from the case. The effects of the crisis are still more than evident, both in terms of potential growth and internal and external deleveraging. The situation is by no means exceptional: similar episodes show that, after credit booms and busts and episodes of debt reduction in conjunction with crises in the real estate and banking sectors, the recessions that follow tend to be deeper and longer lasting (Jordà *et al.*, 2012 & 2014; Abiad *et al.* 2013; Claessens *et al.*, 2013 and Kannan *et al.*, 2013).

Earlier issues of *Policy Brief* have highlighted the role of the accumulation of private sector imbalances in the dynamics of the post-Lehman Brothers crisis (EuropeG, 2012). Subsequently, an initial assessment was undertaken of the difficult task of debt reduction and the critical role played by foreign debt in the 2011-2012 crisis (EuropeG, 2014). Today, in the late summer of 2016, it is no longer a question of trying to understand the reasons for the recession or the difficulties we face in absorbing accumulated debt. What matters now is evaluating the factors underlying the recovery and determining the strength of the foundations on which it is being built.

Before continuing, we should clarify what this *Policy Brief* is not about. Among some of the issues we do not address, despite their obvious importance, several

directly affect the foundations of growth. They include, for example, the dynamics of ULC and the role of wage moderation and productivity in their fall; the restructuring of supply towards sectors that find themselves vulnerable to competition; changes in factor endowments and the contribution of TFP to GDP growth; unemployment and its role in maintaining fragile finances; and, finally, the situation in the real estate market and banking sector. All are elements of great weight and, in part, common to the adjustments being made in the periphery of the euro area (European Commission, 2016A). And although they are all issues that have a critical bearing on an accurate diagnosis of the challenges we face, they fall outside the scope of this *Policy Brief*.

Here we focus on two other partial, yet highly relevant, issues: First, the role of international confidence in Spain's ongoing recovery and, thus, indirectly, the role of internal reforms, specifically those affecting the governance of the euro and the activity of the ECB. In fact, this radical shift can be identified as the hinge that separates the second recession (2011-2013) from the growth stage (2014-2016), a diagnosis for which there is already broad consensus (European Commission, 2016c). Second, we examine the role being played by domestic and foreign debt in the recovery, given their importance in the origin of the problems underlying the euro crisis (European Commission, 2016A).

These two elements are two sides of the same coin: the loss of international confidence in Spain in 2011-2012 led to a marked flight of capital, and was the basis of the ensuing collapse of activity. And this loss of confidence was a reflection of levels of domestic and foreign debt that were perceived as unsustainable.

Therefore, understanding the reasons for the changing perception of Spain's creditworthiness is essential to

any assessment of the strength and prospects of its recovery. This means examining the role played by the fiscal consolidation and the reform policy, and, hence, determining the extent to which the policies promoted by the EU have delayed or promoted growth. In short, what is required is an inevitable rereading of the austerity-expansion debate in Spain.

The rest of the brief is structured as follows. Following on from an introduction outlining the state of the present recovery, the second section summarizes the role played by the internal reforms and the readjustments of certain imbalances in modifying Spanish expectations about the euro. To these we have to add the changes instigated abroad: new mechanisms of EU aid, the actions taken by the ECB and other factors (including, for example, the price of oil). This evaluation of the reasons, both at home and abroad, of the recovery defines the imbalances that remain in the balance sheets of both the private and the public sectors and in that of the foreign sector, which is the focus of section three. And linked to this, in section four, we seek to determine the extent to which the dynamics of this foreign balance is helping to reduce excessive leverage with the rest of the world. This *Policy Brief* finishes by offering some final conclusions concerning the need to reorient the country's economic policy.

1. From the second recession (2011-2013) to a period of expansion (2014-2016): the shift from external to internal demand

Since mid-2013, there has been a substantial change in the main variables of the Spanish economy. The recovery has been consolidated and, after the fall in GDP in the period 2011-2013 (averaging -1.8%), a turnaround was first noted in 2014 (1.4%), rising again in 2015 (3.2%) to reach its highest rate since 2007. This healthy outlook has continued through the first quarter of 2016 (3.4%).

A change in external financing conditions was the prerequisite for this change. Addressing the balance of payments crisis (from summer 2011 to that of 2012) helped normalise the situation and, from the second half of 2013 onwards, its positive effects began to be felt: the risk premium on 10-year government bonds fell substantially between 2012 and 2015 (from 547 basis points in July 2012 to around 100 in January

2015). With the recovery of refinancing conditions as well as of domestic and foreign confidence, all the elements of internal demand were deployed and have contributed to the upward phase in the current cycle.

First, gross fixed capital formation. Between 2013/Q2 and 2015/Q4, GFCF grew at an annual rate of 3.9%, reflecting the sharp rise in spending in capital goods and, to a lesser extent, in construction, thanks to the rise in NFC (6.4%) and general government (6.7%) expenditure, which offset the drop in household spending (-8.3%). In the case of the NFCs, the investment boost, including, among other things, the increase in the use of their production capacity (from an average of 72.7% in the period 2012-2013 to 76.8% in that of 2014-2015), a GOS that reached record levels for the last 15 years (42.9% of its GVA in 2015), improved expectations in both the construction and industrial sectors, the reduction in the interest burden (representing 7.5% of the GOS in 2014-2015, falling from 10.1% in 2013-2014), the recovery of new credit flows (up 10.0% in 2015) and, finally, a reduction in indebtedness.

Second, private consumption. Its increase (2.5% a year between 2013/Q2 and 2016/Q1) reflects the bullish impulses of disposable income, the improvement in future expectations, increasing wealth and the recovery of household credit. In terms of consumer revenue, the combination of increases in income and spending restraints resulted in advances in GDHI in 2014 (0.9%) and, more intensely still, in 2015 (2.3%), contrasting with earlier (averaging -2.0% in the years 2011-2013). To this we should add the fall in prices (-0.3% in 2014-2015), so that disposable family income in real terms increased both in 2014 (1.04%) and in 2015 (2.9%), for the first time since 2009.

The rise in current household income in 2014 (0.2%) and 2015 (1.2%), the first since 2011, reflects an improvement in virtually all its components: an increase in wage income in 2014 (0.9%) and, especially, in 2015 (3.9%); a rise in the GOS of individual entrepreneurs (2.4% in the year ending 2016/Q1); and, in 2015, a rise in current transfers. Only property income fell in 2015 (-15.4%). Meanwhile, current expenditure has also contributed to the rise in GDHI, with falls in 2014 (-1.6%), becoming stable in 2015 (0.0%), driven by the contraction in financial costs (-34.9% in 2015) and a lower direct tax burden (-0.6% in 2015).

In addition, the filtration on the home front of improved foreign confidence and the increase in

employment (1.1 million new jobs being created between 2014/Q1 and 2016/Q1) have resulted in a substantial change in household expectations. Measured in terms of the EC consumer confidence indicator, average results for 2014-2015 stood at -4.3%, much higher than those for 2012-2013 (-28.5%) and better even than the historical average for the period 1986-2015 (-13.4%).

The dynamics of household debt and wealth have also contributed to the expansion of consumption. Net financial wealth (assets minus liabilities) increased strongly: measured with respect to GDHI it rose from 123.5% in 2011 to 164.7% in 2013, was up to 174.6% in 2014 and stood at 178.8% in 2015, figures not seen since 1999. In addition, real estate has also been boosted by the first signs of increases in housing prices (0.3% in 2014, 3.6% in 2015 and 6.3% in the first quarter of 2016). Finally, household credit, although its total stock has continued to decline, has begun to recover: in 2015/Q4, the flow of new credit reached 75.7 billion euros, 31.4% above that granted in summer 2013.

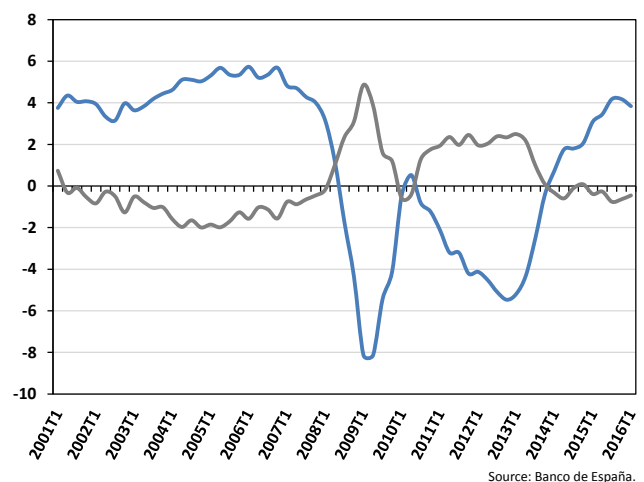
Given the growth in income, wealth and credit and the improved expectations, in 2014 the high income elasticity of consumption (Arce *et al.*, 2013) began to shift towards a demand for durable goods, initially increasing previously frozen levels of consumption, and continuing into 2015 (González and Urtasun, 2015). To this has been added the consumption of non-durable goods, so that private consumption in real terms increased in 2014 (1.2%) and accelerated in growth in 2015 (3.1%), accentuating its increase even more in the first quarter of 2016 (3.7%).

As for the public sector, following a less demanding agreement than expected with the EU regarding the nature of the country's fiscal consolidation (2013), disposable income levels improved thanks to the recovery in tax revenue (a cumulative rise of 7.6% between 2013 and 2015) and social contributions (3.2%) and greater control over financial costs. Thus, income rose both in 2014 (3.0%) and 2015 (8.4%), although the increase was not enough to finance the growth in transfers (-0.1% and 1.0% in 2014 and 2015, respectively) or final general government consumption (0.0% in 2014 and 3.1% in 2015), driven, in part, by the electoral process, which resulted in a continued public dissaving (averaging -3.1% of GDP in the period 2014-2015). However, the most worrying aspect of this behaviour is that it has taken place in an extraordinarily

favourable financial context: the average interest rate of general government debt (ratio between interests – jobs – and general government current liabilities; Financial Accounts of the Bank of Spain) has shrunk from 2.9 (2012) to 2.4% (2015), so that interest payments stood, despite the volume of debt, at a moderate 3.1% of GDP in 2015. Meanwhile, the general government GFCF increased in 2015 by a substantial 21.3%, which also reflects the impact of electoral processes.

Thus, domestic demand stopped undermining GDP growth (about 2.8 points on average in the period 2008-2013) to contribute to its growth in 2014 (1.6 points) and, especially, in 2015 (3.6 points), an effect that has increased in the first quarter of 2016 (3.8 points). In contrast, the balance of the recovery is less positive for net foreign demand (Figure 1). The improvement in export figures in the period 2014-2015 – real growth measured as the mean of the export of goods (4.7%) and services (6.5%) – was offset by a marked recovery in imports, both in 2014 (real increase of 6.7 and 4.5% for goods and services, respectively) and, especially, in 2015 (7.4 and 8.1% real growth for goods and services, respectively). Thus, as the cycle has acquired impetus, the contribution of net external demand has changed sign, from adding 2.3 points to the change in GDP in the year ending 2013/Q2, to subtracting -0.4 points in the year ending in the first quarter of 2016.

Figure 1. Net domestic and foreign demand, 2001-2015 (contribution to real GDP growth in percentage points)



2. Internal and external foundations of the recovery: adjustments, reforms and the action of the ECB

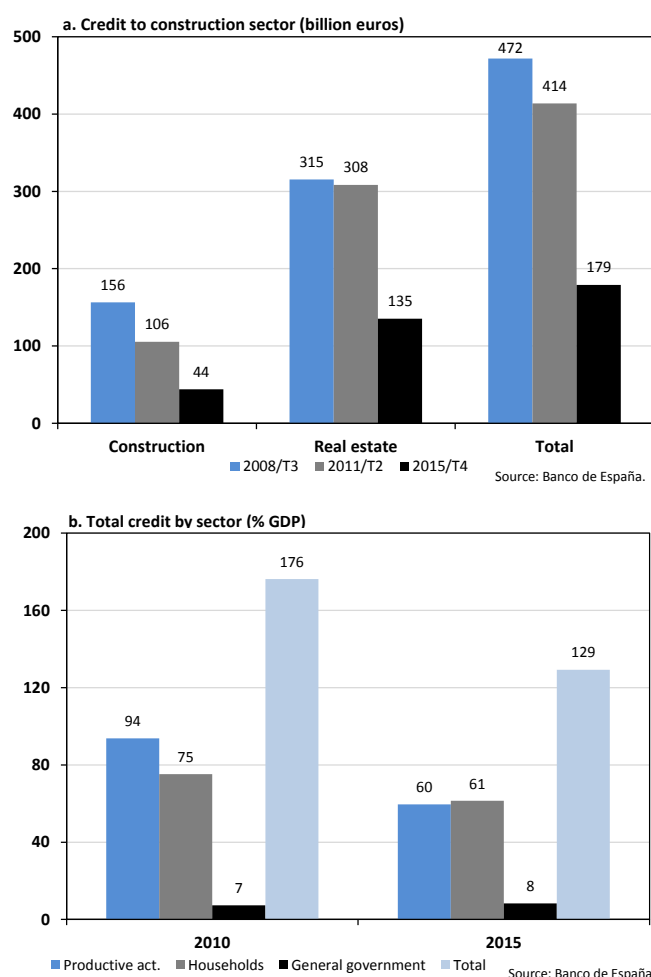
Taking stock of the strengths and weaknesses of the recovery requires a precise evaluation of the reasons that led to the second crisis of 2011-2013. There is no consensus on the factors that resulted in the second recession, although the prevailing opinion highlights above all the contractionary effects of the reforms and fiscal adjustments. However, this view is not shared by this Policy Brief. First, because the fiscal consolidation in Spain has been only a moderate one: with public debt increasing from 35 to 100% of GDP between 2007 and 2015. Second, because whatever the undoubted contractionary effect of these policies, they need to be evaluated in relation to the inevitable collapse of spending generated by the deleveraging of the private sector (Cuerpo *et al.*, 2013; IMF, 2015a; Banco de España, 2015a): an extraordinary burst in domestic demand caused by the more than 22-point reduction in private spending (from a need to finance -10% of GDP in 2007 to a surplus in financial resources of almost 12% in 2012). Third, because their negative effects on activity have to be assessed in terms of their contribution to the recovery in international confidence in Spain; and, finally, also their effects on the changes introduced by the ECB policy and EU reforms.

2.1. A tale of crisis and recovery: the cardinal role of foreign confidence

It is unquestionable that adjustment policies have had recessionary consequences. The IMF has highlighted this fact both in the area of structural reforms (IMF, 2015c; European Commission, 2016a) and in that of fiscal consolidation (IMF, 2015b). But this overall assessment loses relevance in the specific case of Spain, especially if we ignore the causes of the crisis in the country after summer 2011 (Milesi-Ferretti & Tille, 2011; Merler & Pisani-Ferry, 2012; Sinn, 2012 & 2014; Eichengreen, 2015). We should not forget, in this regard, that in the final months of 2010 and in early 2011, the Spanish economy, under the protection of fiscal and monetary expansion, had absorbed part of the post-Lehman Brothers shock, with a GDP that was already growing by late 2010 (0.5% annually), while the contraction in employment had been largely contained by summer 2011 (-0.7% annually), and, in particular, temporary salaried employment was already rising (2.2%).

The collapse in activity from mid-2011 onwards reflected the impact of the crisis in confidence with regard to Spain's future in the euro. This was triggered by the failure to curb the imbalance in public finances, and, as a result, the impossibility of recovering room for manoeuvre to make adjustments in the financial sector, which by that time was heavily exposed to the rampant deterioration in credit conditions linked to the real estate boom (Figure 2). In summer 2011, 57.2% of the 1.8 trillion euros of outstanding credit corresponded to productive activities linked to the real estate/construction sector or to home mortgages, a figure that had barely shifted since the beginning of the crisis (at the end of 2008 total credit to the construction sector represented 60.2% of private credit stock).

Figure 2. Private credit in Spain 2008-2015 by subsector



In this tale, it is the uncertainty generated by the possibility of Spain's abandoning the euro, and the effects of this on foreign and domestic financing and agents' spending expectations, that originated the collapse of activity and employment that characterised

the second recession (King, 2016). Its immediate origins lay in the new Greek crisis and, in particular, in the German decision to impose a severe *haircut* on holders of Greek debt (June 2011), which resulted in a significant and sharp net outflow of funds from Spain (about 380 billion euros until the end of 2012), with its corollary of a rise in risk premiums and refinancing difficulties, especially for the finance sector. The process generated a severe shock in a country with a very high net international debt and foreign liabilities that required about 300 billion euros/year to refinance (Baldwin *et al.*, 2015).

What adjustments were necessary to restore confidence and re-establish capital inflows? First, there were those of a financial nature – this required cleaning up the banks' balance sheets and the restructuring and downsizing of the sector, essential conditions for controlling high interest rates, addressing the sharp increase in bad debts and reducing the difficulties of external financing in the sector. The latter were so acute that they led the ECB to implement its long-term refinancing operations (LTROs) in December 2011 and February 2012, with nearly a trillion euros of new credit, of which the Spanish financial sector was the main beneficiary (with 77% of the outstanding credit of the ECB going to the euro area banking sector in February 2012).

Second, it was necessary to reduce public finance imbalances. Tackling the deficit required a reduction in corporation tax subsidies, an increase in VAT and income tax, a freeze and reduction in staffing and cuts in certain areas of expenditure; and, in the medium- and long-term, a second pension reform. Third, it was necessary to introduce wage restraints and increased labour market flexibility, the result of labour reform measures and the collapse of employment and rising unemployment. Finally, other minor reforms were needed (the de-indexation of public contracts and new default regime, for example).

In the short term, financial reform, stabilizing the deficit and the labour reforms had contractionary effects, be it directly or indirectly, by increasing uncertainty among Spain's households and businesses alike. However, their implementation was necessary to regain confidence abroad and to encourage the refinancing of the debt and, thereby, recover the confidence of resident agents, essential for promoting domestic demand.

But against the backdrop of the collapse of international confidence in Spain and the consequent flight of capital, it was critical to restore external financing. To achieve this, it was necessary to lay the foundations of the promotion of credit and this required accelerating the adjustment of the balance sheets of the finance sector and controlling the explosion in public debt. And both required a cut in financing costs and the inflow of capital into the country. Finally, improving confidence was also a precondition for GDP growth, not only for its external effects but because the high level of indebtedness of the domestic sectors presented high risk levels, which led to spending decisions being postponed, thereby deepening the recession.

In short, had it not been for the recovery of confidence in the second half of 2012, which resulted in the reduction of tensions in the financing of the banks, the outlook for the future would have been extremely bleak. The domestic conditions for recovery, therefore, required precisely the adjustment programme that was implemented in 2012-2013, and which linked up with the measures adopted in 2010-2011. From this point of view, the austerity-expansion debate was, in the Spanish case immersed as it was in the second recession, an intellectually theoretical dilemma but one that was non-existent in practice.

2.2. The external link to the internal reforms, the ESM and the new role of the ECB

A non-quantifiable feature of the structural reforms and fiscal adjustment, but certainly one that is no less important, was their impact on the decisions taken by the European institutions. The hard stance adopted by Germany on the European Stability Mechanism (ESM), and its opposition to extending the ECB's credit facilities, suggest that in the absence of reforms implemented in Spain, what proved to be decisive financial support from the ESM and the ECB to Spain's banking sector would have been, at best, much more complex and exacting. While it is true that these measures have had an impact on other countries, the size of the imbalances in Spain cannot be ignored when evaluating the reasons for their enforcement.

In any case, once decisions had been taken regarding the measures to support and stimulate activity in the euro area, Spain benefited greatly thanks to the fact that the intervention of the ECB underpinned the fall in risk premiums while the depreciation of the euro boosted

its exports. Therefore, if these reforms and a certain degree of fiscal consolidation were the necessary conditions for recovery, these sufficient conditions were introduced from outside Spain.

The origin of this powerful tailwind was the growing activism of the ECB in the face of the increasingly evident financial fragmentation of the euro area. After Spain's banking bailout Spain (July 2012), in September the ECB adopted the Outright Monetary Transactions (OMT), which signalled the end of Spain's problems and the more general crisis afflicting the euro. With this safety net in place, the markedly expansionary measures taken between 2013 and 2016 have helped reduce the costs of external and internal refinancing and to strengthen and extend the protective umbrella of the ECB over Spain.

Thus, in 2013 the ECB cut the ordinary interest rate to 0.5% (May); adopted its forward guidance policy (July) and launched new unlimited, fixed-rate auctions (until July 2014); it tried to reactivate the asset-backed security (ABS) market (July/September); agreed emergency lending operations (swap lines) with the Fed (October); and further reduced interest rates to 0.25% (November) and extended forward guidance (until summer 2015). In 2014, the Bank continued its expansive policy. The targeted longer-term refinancing operations (TLTRO) programme was introduced in June, with the aim of increasing the ECB's balance sheet to early-2012 levels, new covered bond purchase programmes were launched and interest rates were further reduced (0.15%), while deposit facility rates fell below zero for the first time in their history (to -0.10% from 0.0% in 2012). In September, further reductions were made in the standard rate of financing (to 0.05%) and in the deposit facility (to -0.20%), and TLTRO auctions were initiated, with little success although the Spanish bank absorbed a significant portion of their funds.

In 2015, with the route for channelling resources to private credit blocked, and against a worrying backdrop with regards to falling prices, the ECB adopted the expansionary monetary policy of quantitative easing (QE), initially with the aim of purchasing 60 billion euros/month of public debt from European governments and institutions. The QE received a further boost in December, with the intervention being extended until March 2017 and the ECB pledging that debt repayments would continue to be made, while further penalizing deposit facilities (down to -0.30%). Finally, in March 2016 the volume of debt to be

purchased was extended to 80 billion euros/month, while the policy was extended to private securities. The Bank also announced the launch that summer of four new TLTRO auctions and it further reduced both the ordinary interest rate (down to 0.0%) and that of the deposit facility (down to -0.4%).

The consequences of this policy, although modest with regard to credit expansion, were great for both interest and exchange rates. Thus, in early 2016, the Spanish Treasury had already issued securities (up to 9 months) at negative rates, and had added to the growing supply of very long-term debt (50 years at 3.5% interest), while the 10-year bonds were issued in April 2016 at a lower rate of 1.5%. Moreover, the actions of ECB led to a marked depreciation of the euro (from about \$1.40/euro in May 2014 to 1.08 in early 2016).

Along with the intervention of the ECB, overcoming the euro crisis required substantial changes in the governance of the Union, including the introduction of the ESM and the Fiscal Compact in spring 2012 and, above all, the promotion of the Banking Union (June). Likewise, Spain's financial stability has benefitted from the finalisation of the bailout program (January 2014) and the implementation of the banking union (November 2014) and its antecedents (the Asset Quality Review and stress test), which confirmed that the Spanish bailout had been successful.

The combination of this new regulatory framework, the first steps taken towards a single resolution mechanism (January 2016) and the growing activism of the ECB have laid the foundations that seem to offer financial tranquillity to the euro area. This was particularly noticeable in the various episodes of financial crisis experienced in 2015 and 2016. Thus, despite the tensions in Greece in the first half of 2015, Spanish debt risk premiums remained relatively stable (at 120 points), until the outbreak of problems instigated by China in August 2015, and, in particular, the fresh turmoil in the financial markets between December 2015 and February 2016, when they reached 150 basis points. Later, in March and April they steadied somewhat at around 120/130 points but returned to values of 160 in the wake of the Brexit crisis in June and the impact of this decision on Spanish and, above all, Italian banks.

In short, changes in ECB policy, modifications to the mechanisms for protecting the EU, the fall in oil prices (Bank of Spain, 2015d), domestic reforms (particularly those affecting the financial sector), the reduction of

debt in the private and financial sectors and, finally, a more favourable external backdrop allow account for the exceptional conditions that allowed for the growth in spending of the various components of domestic demand from mid-2013 onwards.

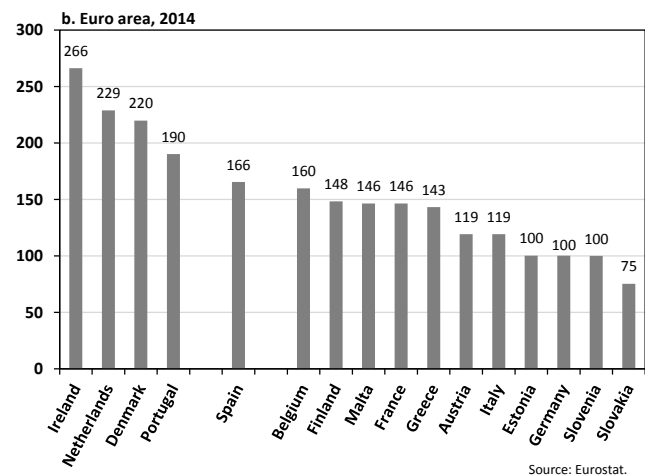
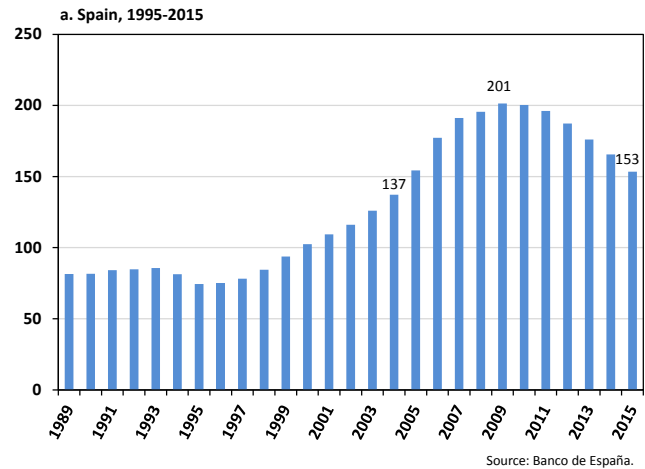
3. Reduction of private indebtedness and its substitution by public debt: higher debt levels in 2016 than in 2007

Since the onset of the recovery in the second half of 2013, the indebtedness of resident sectors has further entrenched the trends present since 2011: namely, the reduction in private (financial and non-financial) sector leverage, both domestic and abroad; the increase in public indebtedness; and, as a result, considerably higher debt levels in 2016 than those experienced in 2007. The following paragraphs summarize these aspects as they affect non-financial resident agents.

For the private sector (households and NFCs, excluding, in the case of the former, equity stakes and investment funds), the more than two years of recovery have meant a substantial reduction in its leverage, whether measured on a consolidated or unconsolidated basis. In the latter case, although the pace of reduction of the absolute values has moderated somewhat (-3.6% per year from 2013/Q2 to 2015/Q4 vs. -4.2% from 2010/Q2 to 2013/Q2), in relation to GDP, debt reduction has become accentuated in the recovery process (European Commission, 2015b): a sharp drop of almost 50 points of GDP from the record high of 2010/Q2 (269.6%) to 215.8% of GDP by the end of 2015. Thus, the annual decrease in this ratio (-8 points/year of GDP between 2010/Q2 and 2013/Q2) accelerated in 2014 (10 points) and even more so in 2015 (15 points).

In consolidated terms, the process in all sectors is similar: falling from 200% to 176% of GDP between 2010 and 2013 (EC, 2014b), and falling again to 153% by 2015, a reduction also of almost 50 points of GDP, presenting an identical acceleration in the reduction in the recovery (Figure 3). Given the different nature of household and NFC liabilities, a more accurate view of the dynamics of private debt requires disaggregating the behaviour of the two sectors.

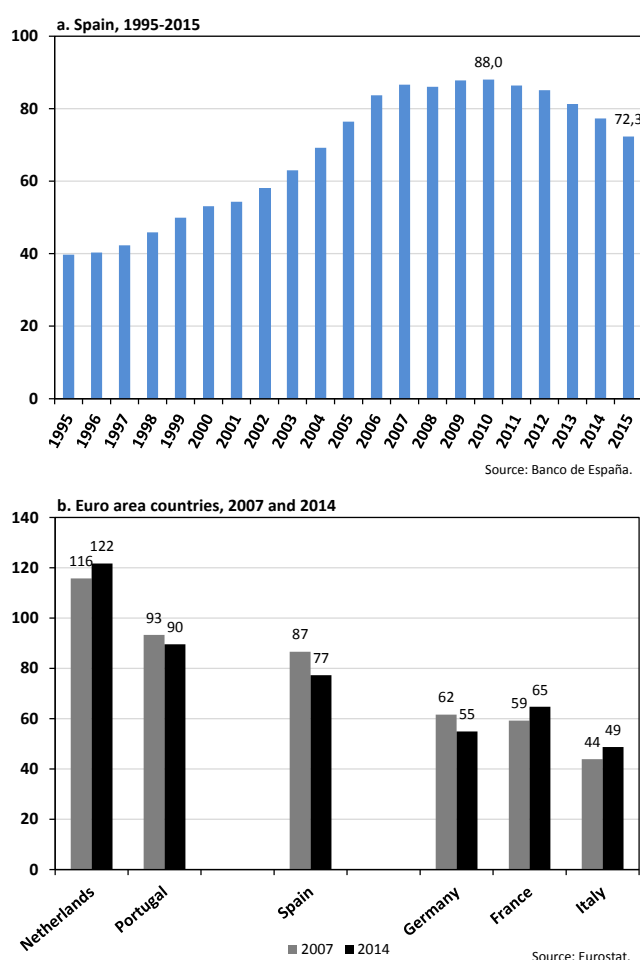
Figure 3. Consolidated private debt in Spain and some euro area countries, 1995-2015 (% GDP)



In the case of household liabilities, while there are significant intra-household differences, the distinctive element of the dynamics of its debt is the major reduction recorded from 960 billion euros in 2008 to 782 billion in 2015. This reflects the effect of a set of factors of opposing dynamics: nominal increases in income (GDP or GDHI), financial sector losses, repayments and a slow recovery of new credit operations between 2013 and 2015 (47.7% from 51.2 billion euros in 2013 to 75.7 billion in 2015). Deleveraging has started to note the effects of nominal GDP growth, with the annual rate of decline accelerating substantially between 2013 and 2015 (annual rate of -5.7%, 9-point cumulative reduction), more than twice the -2.6% rate recorded between 2010 and 2013 (-6.7 points of GDP). The final result has been the sharp fall in debt: from 81.3% of GDP in 2013/Q4 to 72.3% in 2015/Q4. Notwithstanding this, in 2014 (latest data available), the 77.3% of debt/GDP ratio recorded

by Spanish households exceeded the euro area average (64.4%) by 13 percentage points of GDP and was only lower than that of the Netherlands, Portugal and Ireland (Figure 4). In fact, of the 18 members of the monetary union, only Cyprus, the Netherlands, Ireland and Portugal (with 148.4%, 121.7%, 89.2% and 89.0% in 2014, respectively) had levels of family debt higher than those of Spain. And in comparison, with the euro area big three, Spain greatly exceeded the debt of French (64.7%), German (54.9%) and Italian (48.7%) households. It is hardly surprising, therefore, that the EU (2015a) should continue to identify the financial position of Spanish households as being among the most fragile of the euro area, a fragility accentuated by the prevalence of variable interest rates (Ampudia *et al.*, 2014) and high unemployment. The same acceleration in this contraction emerges if the denominator of the debt ratio is changed to family income, although in this case the contraction is even more marked: -5.0% annually between 2013/Q4 - 2015 /Q4 (-12.2 points of GDHI, up to 113.6%) vs. -3.1% between 2010/Q4 - 2013/Q4 (-12.4 points, to 125.8%).

Figure 4. Non-consolidated household liabilities in Spain and some countries of the euro area, 1995-2015 (% GDP)



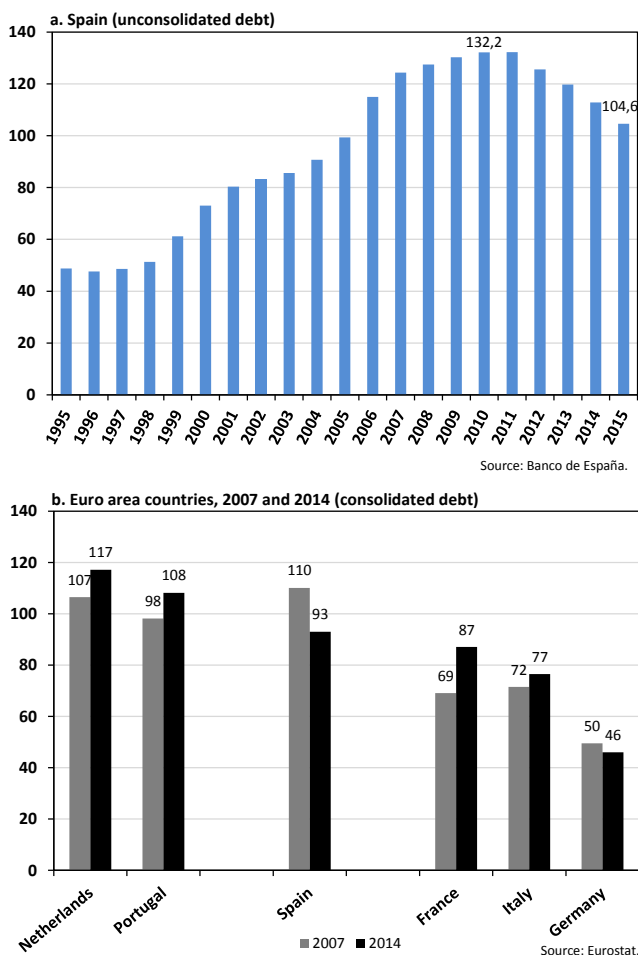
If we shift our focus from the ability of households to service their debt payments to measures of solvency in the sector, the results are more positive. Together with the nominal growth in GDP and GDHI, this reflects an opposite movement to that taken by indebtedness and financial asset prices. Thus, the debt/financial asset ratio has not stopped falling: from 49.6% in 2007 to 43.3% in 2013, reaching 38.8% by the end of 2015, a similar figure to that recorded in 2002. Meanwhile, the net (financial or total) wealth/GDHI ratios present similar results: the net financial wealth/GDHI ratio rose to 178.8% in 2015/Q4, a very similar level to that of the 1999 value (182%). When we include real estate wealth, given that the increase here has been higher than in that of financial wealth, the net total wealth/GDHI ratio value of 791.1% recorded at the end of 2013 has increased to 820.1%, recovering values similar to those in 2011.

Given this dynamic, just how far does household debt need to be cut back? Any assessment of this requires the definition of the equilibrium values, which are affected by potential GDP growth projections. However, various estimates point to values around 1-1.5% (for 2013 to 2030, the EU places it at an average of 1.2% (European Commission, 2015d), the Bank of Spain (2015d) at 1.5%, Cuadrado & Moral-Benito (2016) at around 1% up to 2020 and the IMF (2015d) at an average of 1.1% from 2015 to 2020). To this we need to add expectations regarding inflation which, for the coming years, are largely contained. Based on these considerations, and if the debt level is returned to pre-boom levels (52.4% of GDP on average between 1999 and 2001), the 72.3% recorded at the end of 2015 would still have to be reduced by an additional 20 points. However, the 2015 value of the net financial wealth/GDHI ratio (178.8% of GDHI) was higher than that recorded in the period 1999-2001 (164.1%); and the same is true if the reference rate used is that of total net wealth/GDHI, since its value in 2015 (820.3% of income) was already higher than the average figures for the period 1999-2001 (645%).

As with Spanish households, and although here only an aggregate balance is calculated, the differences between NFCs are marked, with a wide range of different outcomes being recorded depending on firm type (Maudos *et al.*, 2016). But for the sector as whole, there has been a notable reduction in its enforceable debt (i.e., debt securities, loans, insurance and pension systems and trade credits and advances), from 2.0 trillion euros at the end of 2008 to 1.55 trillion in the

last quarter of 2015 (Figure 5), with high absolute reductions until 2013 owing to the high levels of debt clearance in the construction and real estate sectors (Menéndez and Méndez, 2013), a process in which the restructuring of the financial sector and the creation of SAREB (Spain's bad bank) played a key role. Thus, while in 2009/Q1, when the maximum credit levels ever were recorded in the productive sector, the part absorbed by the construction and real estate sectors reached 42.2% of GDP, but by 2013 this had been cut to 23.0%, and by the end of 2015, it had shrunk to a modest 16.6% of GDP, a similar figure to that recorded in 2002-2003.

Figure 5. Unconsolidated debt of the NFCs in Spain and other countries of the euro area, 1995-2015 (% GDP)



As for NFC income (GDP, GVA and GOS), the rate of deleveraging has accelerated over the last two years. In the case of GDP, the reduction of the ratio in the recovery from 2013/Q4 to 2015/Q4 (from -5.0% annually, -15.6 percentage points of GDP in total) was higher than that recorded in the previous crisis, so that, in the last quarter of 2015, debt stood at 140% of GDP. This reduction in indebtedness has occurred despite the

increase in new credit flows. This reflects the differences between the deleveraging mechanisms during the crisis (until 2013) and during the recovery (up to 2016). While in the recession the basic factor was that of repayments or the recognition of losses, in the recovery it has been the increase in income (GOS grew by 4.3% between 2013 and 2015, compared to a decline in the debt stock of -5.4%), which allowed for the aforementioned credit growth while the debt/GOS ratio has shrunk. If our point of reference is NFC debt in the euro area in 2014, the Spanish showed less leverage than Luxembourg, Cyprus, Ireland (179.6%), the Netherlands (117.3%), Portugal (108.3%) and Belgium (101.7%), although their position was worse than that of the big three, exceeding French (87.1%), Italian (76.5%) and, especially, German (46%) corporations. Thus, if we take as our point of reference the average of these three countries, in 2014 Spain's NFCs still required a debt reduction of around 23 points of GDP (despite the corrections made, the EC (2014c) considered that, at the end of 2013, the indebtedness of the NFCs was still excessive in relation with their assets and their capacity of repayment). In the case of solvency measures, the result here is also more positive: the repayable liabilities/financial assets ratio has not stopped falling since the beginning of the crisis (from 88.1% to 81.1% between 2007 and 2013) and at the end of 2015 it stood at 73.6%, a figure not seen since homogeneous data came into existence (end of 1994).

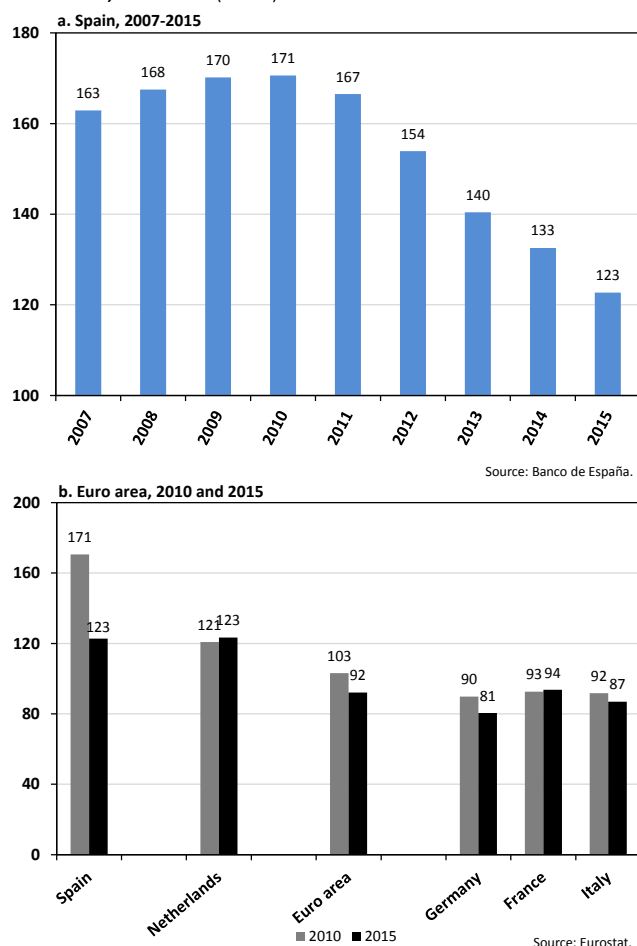
In the light of this improvement, and of its accentuation over the last two years, how far back does NFC debt have to be cut back? If we take as our reference the pre-boom level (121.8% of GDP on average for the period 1999-2001), the value at the end of 2015 (143.5%) was still some 22 percentage points of GDP higher. In contrast, the enforceable debt/GOS ratio in 2015 (628.2%) was already lower than that for the period 1999-2001 (680.5%). And the same is true if the benchmark index used is the enforceable debt/financial asset ratio: the 73.6% recorded in 2015 was lower than the average between 1999 and 2001 (79.3%) (Cuerpo *et al.*, 2013 report, for the end of 2013, a required reduction of about 20 percentage points of GDP using the metric proposed by Arrow *et al.*, 2004).

Aggregating households and NFCs (and in consolidated terms for each sector), what is the correct path to take? In 2014, the average stock of debt of the NFCs and households in the euro area was 142.8% of GDP, about 27 points lower than the corresponding figure for Spain,

although Spain's position is worse in comparison with Germany (100.9 % of GDP) and Italy (125.2%), while France presents higher values (151.8%). Based on this measure, at the end of 2014, the private sector still needed to reduce the weight of its debt by about 30 percentage points of GDP (European Commission, 2014a). In 2015, deleveraging needs, given the dynamics of debt reduction and GDP growth, have fallen. They are however higher if we take as our objective debt levels at the beginning of the period of expansion: the 170.3% of private debt (the unconsolidated sum of the (consolidated) values of households and NFCs) in 2014 exceeded by 60 percentage points of GDP the 110.6% recorded in 2000.

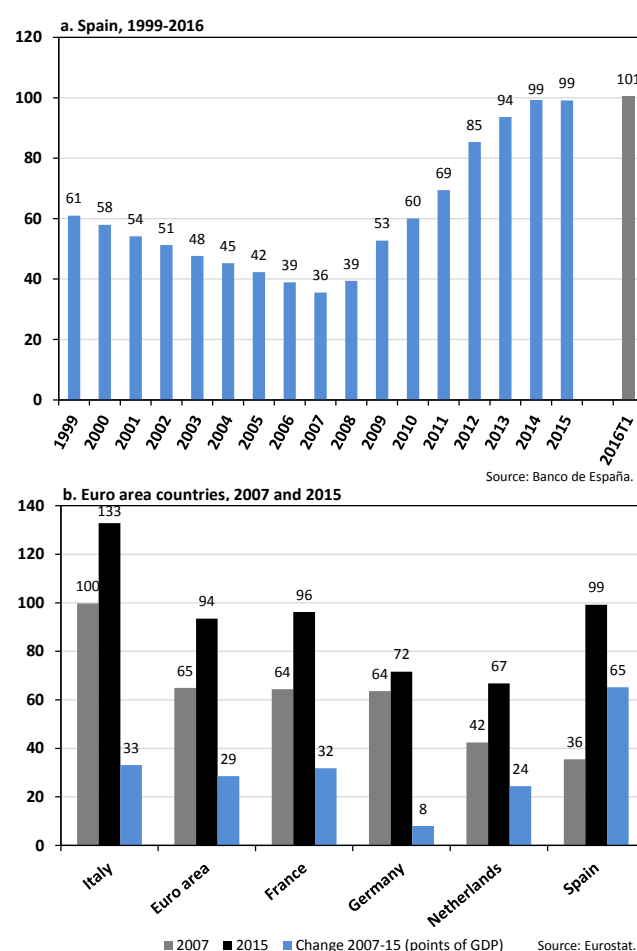
Another way to assess the debt reduction needs of the non-financial private sector is according to their active credit: at the end of 2015, this already represented 13% of the total granted in the euro area, higher than the 10.4% provided by Spanish GDP, suggesting a theoretical surplus credit of 253 billion euros, about 23 percent of GDP which, as other forms of NFC debt are not considered, this theoretical volume of deleveraging should be considered the lower limit (Figure 6).

Figure 6. Private sector credit in Spain and in some countries of the euro area, 2007-2015 (% GDP)



Finally, and as regards the public sector, despite the improvement in 2014 and 2015, Spain has not been able to comply with the revision of the deficit targets agreed in 2013. Thus, since the beginning of the recovery in 2013, public debt has increased 7.1 points of GDP, reaching 100.5% in the first quarter of 2016 (Figure 7). What can we expect from this pattern? The provisions of the EC (European Commission, 2015d) fix its maximum at around 105% of GDP in 2017-2018 and, then, it should be gradually reduced, although its fall to acceptable values is predicted as being long and drawn out: in 2025, it would still represent between 90 and 100% of GDP, depending on the different growth and interest rate scenarios.

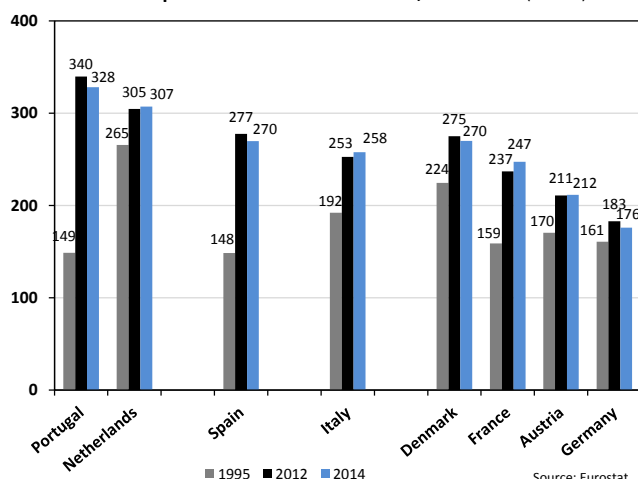
Figure 7. Public debt in Spain and other countries of the euro area, 1995-2015 (% GDP and change in points of GDP)



In short, the debt of the non-financial sectors (households, NFCs and general government) was, at the end of 2015, higher than the figure recorded at the end of the expansion: a total of 232% of GDP (definition of MIP debt) in 2007 vs. 265.2% in 2015. While it is true that the non-financial private sector has reduced its debt (-32.3 percentage points of GDP since 2007), it is

equally true that the public sector has increased its debt levels (by 65.2 points), drastically modifying its composition (European Commission, 2016c). However, given that private debt reached its maximum level in 2010, if the comparison is made from that date, the total leverage (non-financial private sector and public sector) has not changed: 264% of GDP in 2010 compared to 265% in 2015 (Figure 8).

Figure 8. Total non-financial (private and general government) sector debt in Spain and euro area countries, 1995-2014 (% GDP)



4. Foreign debt and balance of payments with the rest of the world: shifting events in the recovery

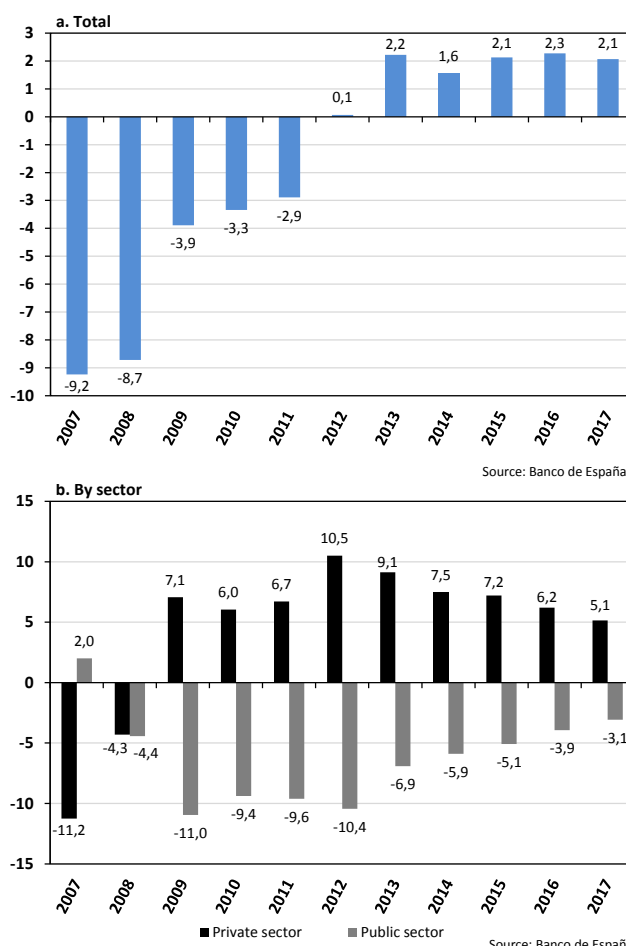
The dynamics of foreign debt is a function of both the change in GDP and modifications in the debt stock, which in turn depend on changes in the balance of payments with the rest of the world. In the recovery process, shifts have been recorded in both elements. In the case of GDP, substantial advances have been made; while, in that of net debt, Spain has presented a current account surplus since 2013. Despite these positive trends, the fact is that net debt has only experienced a moderate reduction. At the same time, between the crisis of 2008-2013 and the recovery of 2013-2016, domestic demand has regained its traditional importance, impeding GDP growth for the first time since the onset of the crisis. This change has not occurred as a result of a reduction in exports or because of a lower penetration of world markets. Basically, it reflects the increasing rate of imports. Moderation in the current account balance, and the fact that some of its balances (energy, primary income) depend on exceptional items, beyond our control, leads

us to question the future of the external balance. Thus, in what follows, this *Policy Brief* turns its attention to the dynamics of debt and the reasons underpinning it and then it seeks to explain the change in the country's foreign indebtedness.

4.1. Improvement in the external balance: transitory or structural?

Between 2007 and 2013, the highly negative balance presented by the current account (-9.6% of GDP in 2007) was radically corrected, albeit that once positive values had been reached, and against the backdrop of a recovery of domestic demand, its progress was suddenly cut short: 1.5% of GDP in 2013, 1.0% in 2014 and 1.4% in 2015. In terms of Spain's financing capacity/need, the dynamic has been somewhat more positive (Figure 9). The significant financing need recorded in 2007 (-9.2%) has given way to external financing capacity in 2013 (2.2%), 2014 (1.6%) and 2015 (2.1%), since the financial balance (basically, capital transfers originating from the EU) has been maintained, since the beginning of the crisis, at around 0.5% of GDP.

Figure 9. Spain's external financing capacity/need 2007-2017* (% GDP)



Thus, since 2013 Spain has experienced an atypical period of current account surpluses. Over the last forty years (AMECO data), only in the periods 1984-1986 and 1996-1997 did the current account present a positive balance, or indeed one that was close to zero (an average of 1.2% and -0.7% of GDP in these periods, respectively). However, in terms of the country's financing capacity/need (INE, 1986), it recorded modest external surpluses in 1971-1973, 1978-1979, 1984-1986 and 1995-1997. If EC forecasts for Spain (which extend until 2017) are added to the surplus of 2013-2015, we will be facing the longest period of external resource generation since the 1960s. In short, the situation as regards current account surpluses and financing capacity in 2013-2015 was, in historical terms, quite exceptional.

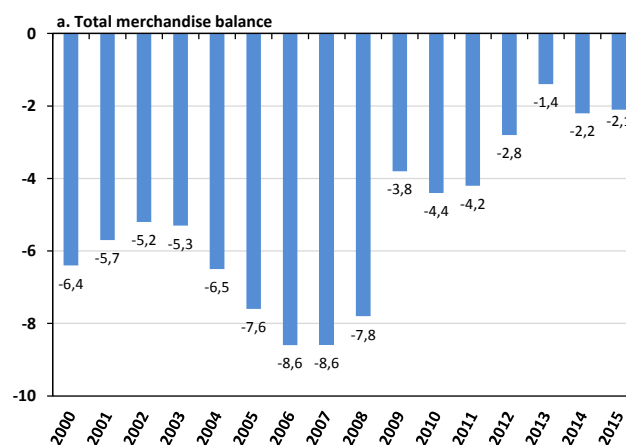
The extent to which this new dynamic reflects, on the one hand, a structural change or, on the other, modifications in demand generated by the crisis is a critical matter for debate. Of particular relevance here is how to curb the improvement in the current account surplus when domestic demand takes over as the engine of GDP growth. In this process of containment, what stands out is the worsening of the non-energy trade balance, at the expense of the increase in the surplus of non-tourism services and the reduction in the deficits on the energy and income balances.

As far as the current account balance is concerned, the motors of improvement up to 2013 were, basically, the non-energy trade balance and the balance of both tourism and non-tourism services (Figures 10 and 11). The pattern of export growth and the moderation/reduction in purchases, which allowed the strict adjustment of the negative foreign trade balance, is what has changed during the recovery.

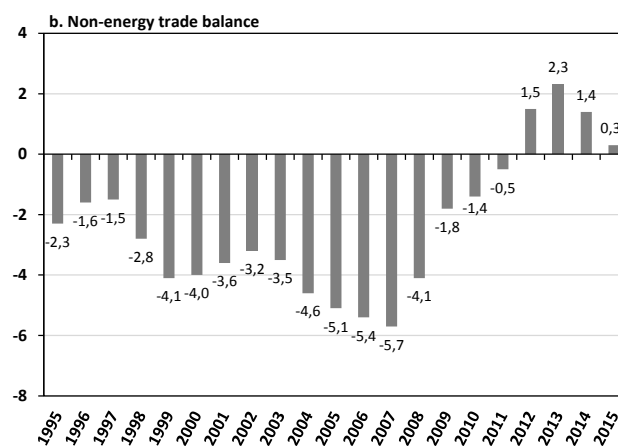
Thus, in the case of the non-energy trade balance, the recovery in domestic demand has meant a steady deterioration, so that between 2013 and 2015, the balance has steadily fallen: from 2.3% of GDP in 2013 to 0.3% in 2015. This is not evidence of a fall in exports, but rather a sharp and intense increase in foreign purchases: while the latter are up by more than 3 percentage points of GDP (from 16.9% to 19.9% of GDP), the former have risen more moderately (from 19.2% to 20.1% of GDP). In any case, the weight of exports to GDP has reached record highs – an average of 23.1% in the period 2014- 2015. This has resulted in an improved global market share, reaching 17.1 per thousand in both 2014 and 2015, increasing from a 2012 low of 16.0 per thousand. This positive export

dynamic reflects a growing geographical spread into emerging areas with a higher import propensity (Myro, 2013); an increase in the number of exporting companies (Gomez and Martin, 2014) and greater diversification in the type of products exported (Oliver, 2016); as well as a fall in the ULCs due to the containment of these costs and increased productivity and, linked to this last aspect, a recovery in the attraction of FDI in Spain, which also drives sales abroad. In fact, when improvements in Spain's price competitiveness, measured in terms of ULCs, are compared with prices in developed countries, the cumulative loss since joining the euro has been partially (an adjustment of about 15 points, according to Prades & García, 2015) or almost totally corrected (about 20 points, according to Gómez & Martín, 2014). Although it is also argued that large, exporting companies with links to foreign capital presented a much more favourable ULC dynamic before the crisis than the economy did as a whole, which would explain the "Spanish Paradox" (Antràs *et al.*, 2010).

Figure 10. Goods trade balances, 1995-2015 (% GDP)



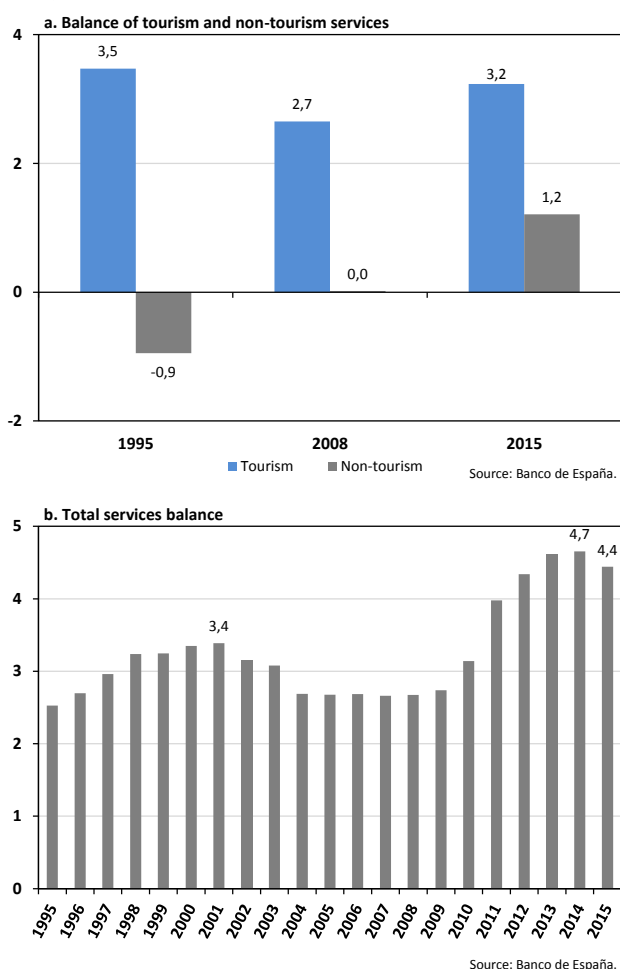
Source: Banco de España.



Source: Banco de España.

The sharp increase in imports of non-energy goods in 2014 and 2015 are indicative of the recovery in the consumption of durable goods and in investment, the two components of domestic demand with the greatest import content, while foreign purchases of intermediate goods confirm the growing integration of Spain in global production through FDI (Bank of Spain, 2015c). In any case, imports of goods increased to 25.4% of GDP in 2015 (24.3% in 2013), which can be explained by the rise in the imports of non-energy goods (from 18.7% of GDP in 2013 to 21.8% in 2015). Additionally, non-tourism services (Macías & Martín, 2010) remained at maximum values during this period, with a surplus of 1.2% of GDP in 2013, 1.3% in 2014 and 1.2% in 2015, reflecting similar movements in exports (4.7%, 4.9% and 5.1% of GDP in 2013, 2014 and 2015, respectively) and in imports (3.4%, 3.6% and 3.9% of GDP 2013, 2014 and 2015, respectively).

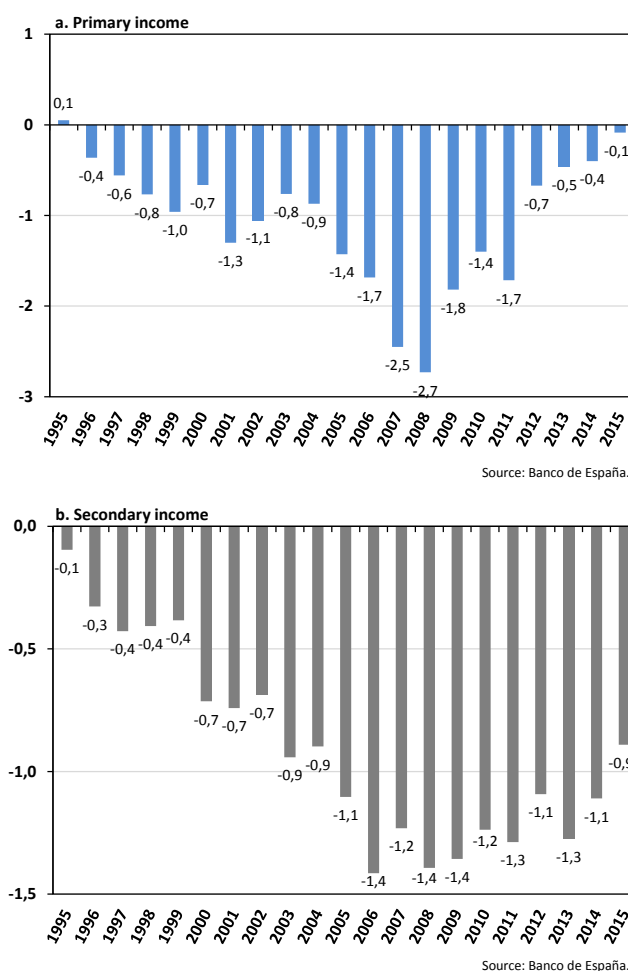
Figure 11. Service trade balances, 1995-2015 (% GDP)



Finally, over the last two years, the energy, tourism services and primary income balances have partially

mitigated the deterioration of the above balances. In the case of energy, the change has been brought about by the collapse in oil prices, so that the 2013 deficit (-3.7% of GDP) had been cut by 2015 (-2.3% of GDP). In the case of the primary income balance (Figure 12), the cutting of the deficit has also contributed to maintaining the current surplus: from -0.5% in 2013 to -0.1% of GDP in 2015. We should highlight, in relation to Spain's foreign debt stock, the fall in interest payments (from 46.0 billion euros in 2011 to 31.1 billion in 2015), reflected in the reduction in the negative balance of this income (from -2.2% of GDP in 2012 to -1.7% in 2015). Finally, deficit in the secondary income balance has been moderate (from -1.3% to -0.9% of GDP between 2013 and 2015).

Figure 12. Service trade balances, 1995-2015 (% del PIB)



In the light of these trends, what is the short-term future of the external balance? As far as the balance of goods is concerned, its evolution during the recovery has been the subject of two hypotheses. The optimistic view is that the improvement in exports is structural in

nature, while the increase in imports is more transitory. A less positive reading suggests the improvement in exports is limited, while imports are responding, as in the past, to the growth in domestic demand.

The hypothesis that postulates a transitory increase in imports suggests that, structurally, the import content per unit of final demand should have been reduced. This would reflect adjustments in both demand and supply. In the case of demand, falling prices and internal costs would have shifted purchases abroad, especially as regards non-durable consumer goods (Bank of Spain, 2014); in the case of supply, sectoral restructuring (losses in construction and the increasing weight of services) would reduce the import content per unit of GVA. Thus, the increase in imports in the last two years would be a transitory reflection of the freeze in domestic demand resulting from the crisis (González & Urtasun, 2015).

This view runs contrary to the maintenance of the import content per unit of GVA in the main productive sectors (automobile, chemical, etc.) (Cabrero & Tiana, 2012). This points to structural deficiencies in available technology, so that the drag effect of increases in industrial production (given their lower weight in the aggregate GVA and the greater import content) is smaller than in other countries: an increase of 1% (input-output tables for 2007) in final demand in the industrial sector would increase aggregate GVA by 0.16%, vs. 0.39% in Germany and 0.36% in France (Cabrero & Tiana, 2012). The latest analyses available, based on input-output tables prior to the crisis (2005 and 2007), reveal continuity in the import content of the main (non-energy) production sectors. The largest differences are in market services and industry, reflecting higher FDI in Spain than in other advanced countries: FDI/GDP ratio in Spain in 2010 was 44%, almost twice that recorded in Germany. In motor vehicle manufacturing, for example, Spain's import content (63.3%) greatly exceeds that of Germany (38%), France (44%) and Italy (37%). The same is true of the chemical industries (an import content of 55% in Spain vs. 34%, 29% and 47% for Germany, France and Italy, respectively). Continuity is also found in the import content of the most important components of domestic and external demand. In fact, it seems that in the case of intermediate goods, it could have increased owing to the growth in FDI and the growing engagement of Spain in the international division of production. From this point of view, simulations conducted in import growth for the crisis years (Cabrero & Tiana, 2012) point to an

aggregate behaviour in accordance with the dynamics of domestic demand and compatible with changes in its distinct components. Thus, the increase in (non-energy) imports until 2014 was in line with expectations based on historical experience, so that the internal devaluation does not seem to have generated the anticipated import substitution (Bank of Spain, 2015b). In fact, the estimates of the Bank of Spain (Gordo *et al.*, 2008) point to the great sensitivity of imports to changes in final demand and a low price elasticity (an expression of the import needs of intermediate and capital goods). Likewise, the quarterly model of the Bank of Spain for 1995-2012 uses high income elasticities of imports, both in the short and medium terms (Gómez & Martín, 2014).

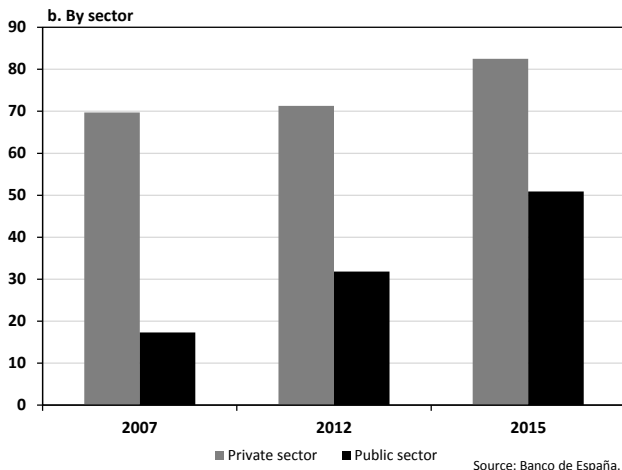
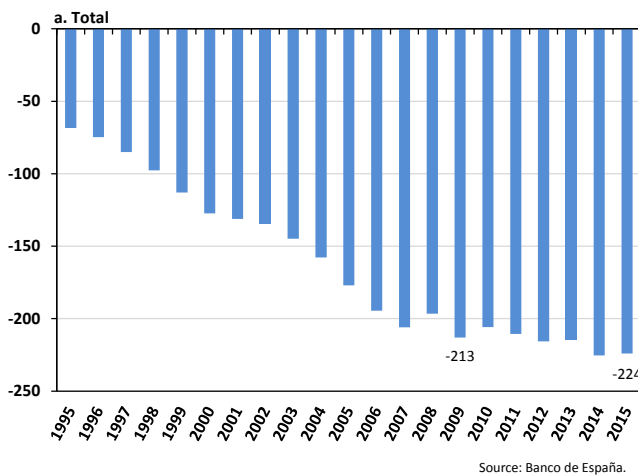
A number of other aspects cast shadows on the future growth capacity of the export of goods, especially the incomplete transfer of falling cost prices, where the differential accumulated between 1999 and 2007 has been maintained (Bank of Spain, 2015b) by increases in energy prices and administered prices, in accordance with the deficit reduction strategy (Gómez & Martín, 2014), and the role of the contraction of domestic demand in the export increase. Export of goods that incorporate this strength, along with the traditional variables of external demand and price competitiveness (Prades & García, 2015), suggest an important role in boosting exports in the crisis, especially in the field of private consumption.

4.2. The external balance and difficulties in reducing indebtedness with the rest of the world

Even today, after nearly three years of recovery in activity, the high net international investment position (NIIP) emerges as Spain's main structural fragility, both because of the inherent solvency problems and the high investment income payments it involves (Catao & Milesi-Ferretti, 2013), as well as because of the negative domestic debt stocks and other imbalances in the MIP flows (Obstfeld, 2012; Kang *et al.*, 2013). The high value reached of around -90% in early 2016 – a long way off the -35% of GDP marked by the MIP (European Commission, 2015b; 2015c) – potentially leaves the Spanish economy in a fragile position, exposed to sudden capital inflow stops or reversals. In Europe, only Cyprus (-129.2%), Greece (-126.4%) and Portugal (-109.4%) recorded worse figures than those of Spain. And the figure of -90% places Spain well above Ireland (-70%), Italy (-26.7%) and France (-17.4%), and a

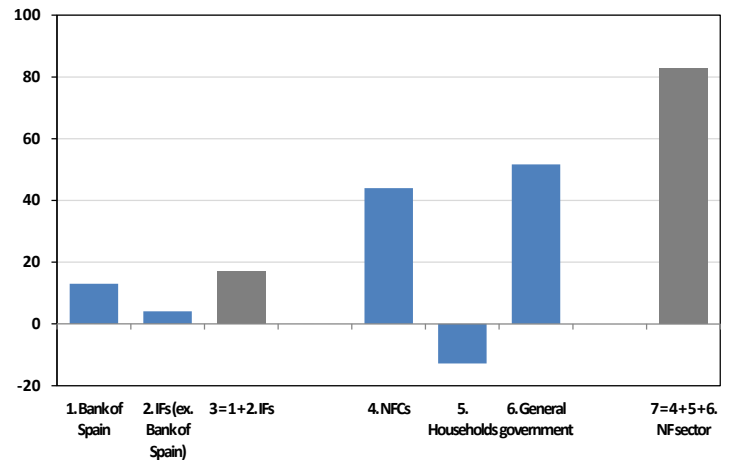
long way from the positive values of Germany (49.2%) and the Netherlands (66.7%).

Figure 13. Spain's external liabilities, 1995-2015 (% GDP)



However, and although in terms of external solvency the relevant variable is the NIIP, in the short term, gross debt and, in particular, the repayable liabilities are more relevant, because it is these flows that can change suddenly in response to a fall in confidence in Spain's ability to meet its external payments, as occurred in the 2011-2012 crisis (Lane and Milesi-Ferretti, 2012; Lane and Pels, 2012). In the case of total liabilities, at the end of 2015 their value stood at 224.1% of GDP (Figure 13), while repayable liabilities (total assets of the rest of the world in relation to Spain's minus equity investments and investment funds) reached 1.7 trillion euros. Therefore, in this last section, this Policy Brief reviews the situation and prospects of both types of foreign indebtedness.

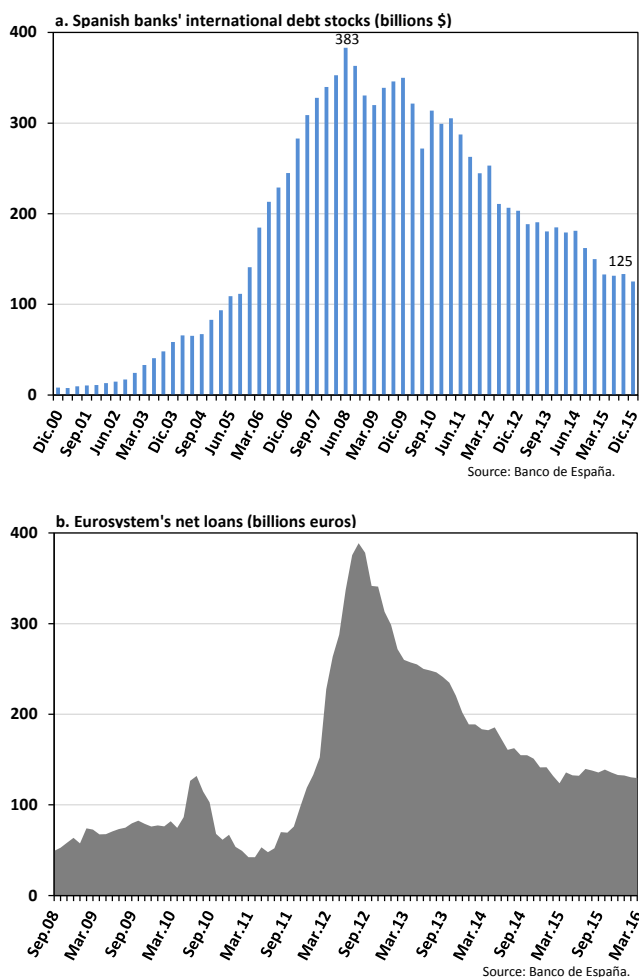
Figure 14. Spain's net external liabilities (NIIP), fourth quarter of 2015. By indebted subsector (% of total)



If we start with the NIIP, the most notable trends between 2013-2015 were the gradual fall in the overall value, the change in its sectoral composition and, finally, the change in the instruments that comprise it. The persistence of the external financing capacity, the changes (base 2010) in the ECB and the balance of payments and the recovery of nominal GDP growth in 2014-2015 contributed to its fall (from -96.2% in 2013 to 90.8% in the first quarter of 2016), while changes in the valuation acted against its further reduction. As for the breakdown by sector, from 2013/Q2 to 2015/Q4, the financial institutions (FIs) reduced their net debt dramatically (from 35.7% to 15.3% of GDP), while increases were recorded in the debt of the non-financial corporations (from 35.7% to 39.3% of GDP) and, especially, in that of the public sector (from 29.1% to 46.1% of GDP) (Figure 14). The reduction in debt of the FIs was reflected in the fall in the stock of international emissions to values not recorded in the last ten years (125 billion dollars), as well as in the credit with the ECB (at a minimum level of 130 billion euros at the end March 2016, a far cry from the nearly 389 billion of August 2012) (Figure 15). And, while it still explains 47.1% of total Eurosystem credit, it is a long way from the almost 80% recorded in the spring of 2012. Finally, composition by instrument has deteriorated, with an increasing bias towards debt securities, linked to the growing weight of the public sector: between 2013/Q2 and 2015/Q4, these have increased from 63.5% to 70% of the total, while cash and deposits have lost weight (from 44.1% to 36.2%). Overall, and according to the European Commission (2016c), about 80% of GDP reflects the net balance of negotiable debt, of which about 60 percentage points

of GDP are private and public sector debt and about 20 percentage points of GDP are the TARGET2 balances, which are refinanced by the financial sector.

Figure 15. External financing of the Spanish finance sector, 2000-2015



In turn, the dynamics of gross debt (total liabilities) has been less positive: between the dates cited, its value has increased from 213.5% to 224.1% of GDP. An improvement that reflects increases in Spanish assets abroad (from 124.0% to 135.7% of GDP between 2013/Q2 and 2015/Q4), higher than the fall in NIIP, and changes in the valuation of assets and financial liabilities. Meanwhile, and given that among these liabilities FDI is computed, from this set the payable debt is of interest (financial liabilities except FDI), which has shown a slight reduction (from 162.3% in 2013/Q2 to 160.6% of GDP in 2015/Q4).

By sector, the effects of the ECB's lax policy are reflected in an accentuation of the reduction of the external debt of the financial sector and, in particular, of its liabilities. This aspect is especially relevant since in the 2011-2012 euro crisis it was one of the main factors. So, while in summer 2012 the liabilities of the

FIs that had to be refinanced reached 107.5% of GDP, by the end of 2015 they had shrunk to 79.1%, a similar process to that of all the sector's liabilities (from 118.3% to 91.2% of GDP). This fall in the gross debt of the financial sector, close to 30 percentage points of GDP, emerges as one of the most important improvements of the deleveraging process in which the Spanish economy is immersed. For their part, in terms of gross debt (total liabilities, including FDI), the NFCs have undergone the opposite process to that experienced by the FIs, rising from 69.5% to 82.3% of GDP between the same dates. This increase reflects the growing attraction of Spain as a destination for FDI, although, in terms of NIIP, this progress has been offset by an increase of a similar magnitude in Spanish investments abroad (between 2013/Q2 and 2015/Q4, FDI abroad in Spain increased from 53.9% to 57.9% of GDP, while that of Spain abroad also grew, from 48.9% to 53.7% of GDP). The downside of these movements has been the sharp rise in general government liabilities, from 33.6% to 50.9% of GDP between 2013/Q2 and 2014/Q4.

Finally, what path must the NIIP take before it can be returned to sustainable values? Its current high value shows that there is a long way to go. And although nominal GDP growth has permitted a degree of reduction, we should not forget the high import content of final demand, so that improvements in the current account surplus have a limit that seems located, in the best of cases, at around 1.5% of GDP/year. But with surpluses of this size, the EU estimates (2016c) that, by 2024, the NIIP would only have been reduced to 50% of GDP. And in the not unlikely case of the deterioration of this balance, to -1.5% of GDP, then the NIIP would still stand still at 75% of GDP.

4. Conclusions: economic policy, cyclical improvement and structural weakness

As of summer 2016, the economy continues to grow strongly and, although there are some signs of a slowdown, the improvement recorded in GDP and employment are beyond question. However, this apparent recovery hides significant weaknesses, pointing to the need to strengthen the changes initiated during the crisis, both on the supply and demand sides.

The main challenge facing the Spanish economy is correcting its massive net external debt and, also, reducing its stock of external liabilities. The relevance of

both debts was revealed in the sudden capital inflow stop and reversal that took place between summer 2011 and autumn 2012. The country found itself in a situation of high-risk, unable, without foreign backing, to stem the flight of capital. Without the stabilization policy and structural reforms, and their contractionary effects on short-term growth, it would have been impossible to restore confidence and, with it, the capital flows needed for foreign refinancing.

It is true that, in recent years, some of the country's more problematic imbalances have been corrected and others are in the process of being brought into line. Among the former, there was a substantial reduction in private debt between 2010 and 2015 (almost 50 points of GDP) and a reduction in the Fls' foreign debt between 2007 and 2015 (including the Bank of Spain, from 105.6% to 79.1%; excluding the Bank of Spain, from 103.5% to 59.3%). And, in the case of the correction of the external imbalance, there has been a significant improvement in the current account balance and in external financing capacity, to such an extent that in the last three years they have been returned to positive figures. At the same time, exports of goods and services have reached record highs in relation to GDP (as high as 33.1% in 2015) and sales of goods have recovered their share of the world market (17.1 per thousand in 2015).

Yet, despite these undoubted successes, and confining ourselves to the issues discussed in this *Policy Brief*, we should forget neither the primarily external context in which this improvement has taken place, nor the continuity of some of its most important aspects.

In the case of these tailwinds from abroad, it should not be forgotten that the recovery has taken place in the context of a monetary policy that, in addition to facilitating the financing of a massive (internal and external) debt, has isolated the country from external tensions, which have certainly not been absent from the international arena. In the last year, the tremors generated by Greece, the devaluation of the Chinese *renminbi* (August 2015), the turbulence on the global financial markets (December/January 2015-2016), the shock of Brexit and the Italian banking crisis (June 2016) are examples of the extent to which the ECB has succeeded in isolating Spain from external shocks. But even with this capacity, the risk premiums, which had reached a minimum of around 100 basis points (January 2015), have picked up again and, after Brexit, reached,

at least temporarily, 190 points – in short, a clear reminder of the limits of the monetary policy.

Additionally, an expansionary fiscal policy also helps account for the improvement seen since 2014. The increase in the deficit, however, has had hardly any impact on Spain's financing costs, due to the ECB's aggressive policy – since it began its asset purchase programme (March 2015), it has acquired about 80 billion euros worth of government bonds, to which in recent months we have to add the acquisition of private debt. In short, Spain has experienced uncharacteristically favourable domestic and external financing conditions, to which should be added the effects of ECB policy on exchange rates and oil prices not seen for over a decade. These factors help explain some of the improvement experienced in the last three years. But, at the same time, they highlight the limits of current growth.

However, the main weakness remains, namely the high net external debt: at the end of the first quarter of 2016, it reached figures that put it above 90% of GDP, far from the 35% required by the EC. Nor has Spain reduced its stock of foreign liabilities (1.7 trillion euros in 2015), which require continuous refinancing in the range of between 200 and 300 billion euros/year. As such, Spain remains exposed to changes in foreign confidence as regards its ability to pay. And, on the domestic front, the private non-financial sectors' needs for deleveraging can be estimated in the range of 20-30% of GDP, while those of the public slip increasingly away from the target of 60% of GDP laid down by the EU.

It is in this ambivalent context of obvious improvements resulting from internal corrections and external impacts, but at the same time of persistent structural problems, that the measures that need to be taken have to be understood.

How can the reduction in these leverage ratios be accelerated? Correcting foreign debt requires nominal GDP growth, external surpluses or a combination of the two; while internal leverage requires GDP growth, the containment of public imbalances and the continuity of private debt.

GDP growth is, therefore, the hinge that links both debt reduction processes (internal and external). But it cannot be achieved, by way of a priority, as an increase based on internal demand. We need nominal GDP increases and, at the same time, biased increasingly

towards external debt. From this point of view, the balance of the last three years of recovery has moved in the opposite direction, from net external to net domestic demand. And if Spain continues on this path, it will not enable a more than modest reduction in net foreign debt. Changing this trend requires not only maintaining but increasing the export effort, while import intensity is compressed per unit of final demand. This type of GDP growth is the only one that can simultaneously generate current account surpluses higher than the scant 1% of GDP on average achieved over the last four years.

The combined effect of exceptional external circumstances and the maintenance of, or increase in, internal and external debt highlight the need to forge ahead with the reform and adjustment process initiated in the worst years of the crisis. And in particular, the roadmap of economic policy over the next few years should involve increasing the external surplus at the expense of growth in domestic demand. It is true that in the short term, it is easier to mobilize resources to promote domestic demand. But the Spanish experience shows how these policies have always ended in failure. Staying in the monetary union requires (indeed, as it did in 1999) a paradigm shift in the orientation of economic policy, from the promotion of domestic demand to that of external demand and the creation of conditions that enable a transition to an external sector that provides more growth – a growth which would as a result be much more sustainable in the medium and long term.

But this imperative shift in demand requires increasing the country's competitive capacity on the supply side, that is, enhancing the quality of production factors and boosting the contribution of total factor productivity. It is not the aim of this *Policy Brief* to catalogue the public actions and measures that should help increase productivity, improve external competitiveness and bias growth towards external demand. All of them can be summed up as the need for an infrastructure (energy, rail, roads and airports) that is designed first and foremost to shift the productive fabric towards the external sector and to increase productivity (which has been brought to a sudden halt by the recovery). In short, it is a question of reorienting the policy of public works and other infrastructure to the external sector and improving productivity in the private sector, abandoning other targets which, as shown by the development of the country's high speed rail (AVE), fall well short of laying the foundations for a sustainable

growth model. The same conclusions can be drawn if we analyse human capital or the field of total factor productivity – the list of tasks remaining to be undertaken is long and well known.

This shift in orientation is not only necessary, it is absolutely essential if Spain hopes to address the imbalance that represents the greatest threat to its future (foreign debt) and lay the foundations for correcting the growing domestic debt. In short, the crux of its economic policy must be reoriented towards improving productivity and the foreign sector. In 2012 and 2014, and from this very *Policy Brief*, we called for the need for a major political and social pact that might place the external sector at the heart of economic policy. In recent years, unlike in the past, GDP and employment have recovered. But this improvement seems to slow progress in the right direction. Because today, like yesterday, the demands of this new *policy* have not been modified.

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Abbreviations

AMECO: annual macro-economic database, European Commission
EC: European Commission
ECB: European Central Bank
ESM: European stability mechanism
EUROSTAT: Statistics Office of the European Commission
FDI: foreign direct investment
FIs: financial institutions
FUNCAS: Spanish Savings Bank Foundation
GDHI: gross disposable household income
GDP: gross domestic product
GFCF: gross fixed capital formation
GOS: gross operating surplus
GVA: gross value added
IMF: International Monetary Fund
INE: Spanish Statistics Institute
IRPF: Spanish income tax
LTRO: Long-term refinancing operations
MIP: macroeconomic imbalance procedure
NFCs: non-financial corporations
NIIP: net international investment position
OECD: Organization for Economic Cooperation and Development
OMT: outright monetary transactions
QE: quantitative easing
SAREB: Company for the Management of Assets proceeding from Restructuring of the Banking System
TFP: total factor productivity
TLTRO: Targeted longer-term refinancing operations
ULCs: unit labour costs
VAT: value added tax

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