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Opinion and Discussion Group on Political Economy

Key aspects in the adjustment of the Spanish economy 2012-14: reduction in indebtedness and improvement in foreign trade

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As the winter of 2014 drew to a close, the improvement of the Spanish economy was now evident. With regard to financial issues, the fall in the risk premium, the reduction in interest rates, the rally in the stock market and the return of capital mark the end of the fears caused by Spain possible exit from the euro. With regard to economic activity, the indicators point in the same direction. The fall in employment is clearly slowing, investment in capital equipment is growing, private consumption is recovering and everything points to Spanish GDP growth of around 1% in 2014. The second recession, which began in the summer 2011, can be considered as over.

In this more favourable context, this *Policy Brief* seeks to answer two fundamental questions, which qualify the strength of the current recovery: what is the situation with regard to the deleveraging of the different sectors of the economy, and of the country with respect to the rest of the world, and what is the nature of the improvement in foreign trade. The two are intertwined, since the reduction of the capital imbalances of the non-financial private sector, the public sector and the banking system are preconditions for the freeing-up of the credit flows required for growth to be consolidated and for the adjustment of the foreign trade balance to levels which are sustainable over the medium term, protecting the Spanish economy from new crises of confidence. Hence, the progress of deleveraging, both external and domestic, is analysed in the first part (*1. The slow process of debt reduction*), while the second (*2. Financial crisis and external current account balance: the medium term problems*) presents some reflections about the nature, cyclical or structural, of the improvement in the external current account balance. The paper ends with a final section on desirable policy measures (*3. Adjustment and growth policies in the post-crisis horizon)*.

1. The slow process of debt reduction

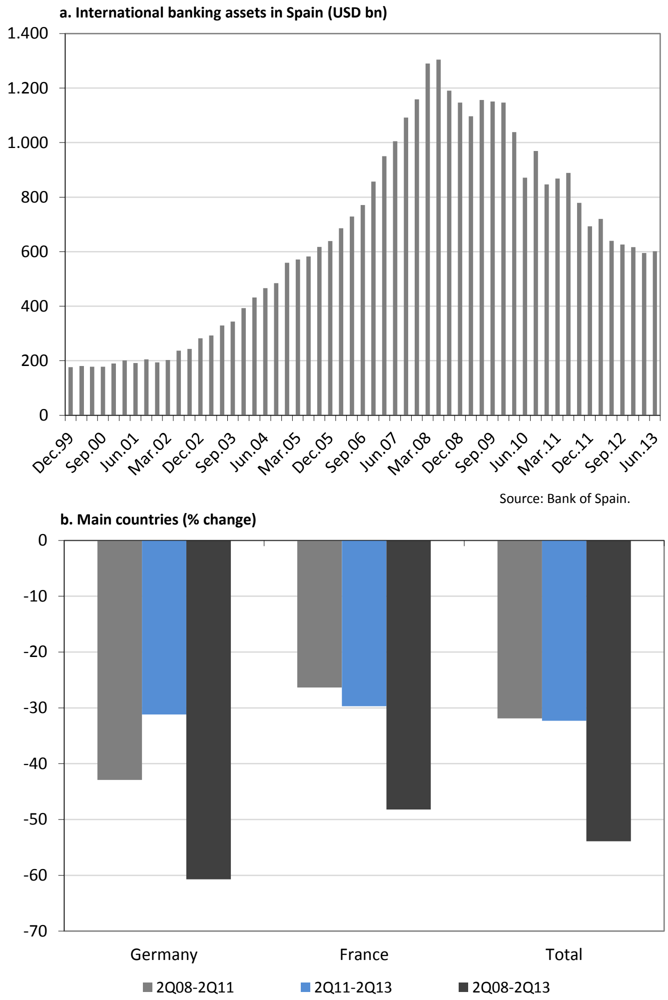
Although it is well known that Spain entered the crisis with a highly leveraged private sector (IMF, 2013a), in the analysis of its problems less emphasis is placed on the role of the foreign debt and, within that, the role of the financial sector. This was decisive in the growth of domestic credit given that, without the abundant external liquidity, it would not have been possible to finance the notable increase in the latter (Trichet, 2004; ECB, 2012), and in the rise of real estate prices (Aizenman and Jinjarak, 2009; Obstfeld and Rogoff, 2010; Obstfeld, 2012), key factors in the Spanish crisis. Indeed, the factors which led to growing external deficits and, therefore, to the accumulation of a very high net external debt, reflect Spain's incorporation into the single European currency, due to the disappearance of the traditional restriction on external financing and other factors that pushed up the debt. Among these, along with the elimination of the exchange rate (Veld et al., 2012a), we would highlight the financial liberalization that permitted the decline of the savings rate (Jaumotte and Sodsriwiboon, 2010) and the fall in real interest rates (Andrés et al., 2010; Burriel et al., 2010; Veld et al., 2012a; EC, 2012). However, it is not only the net external debt which is relevant. With regard to the external financing and refinancing capacity, the key magnitude is gross indebtedness and especially its shorter term component, as it is this that must be refinanced, regardless of the size of the trade deficit. Moreover, the effects of sudden reductions in debtor positions with the rest of the world are different from those caused by the adjustment of excessive current account deficits. While the correction of the latter implies increases in savings and falls in internal demand, the reduction of gross liabilities affects asset prices, causing increases in interest rates and risk premiums, and it can only be corrected by recovering the confidence of international investors.

In short, although both types of debt (internal and external) are two sides of the same coin, with regard to Spain's financial stability, it is external debt (net and gross) that is relevant. That is why these notes begin by analysing its dynamics and current situation.

1.1. The 2011-12 balance of payments crisis and the correction of the external imbalances

Assessing the solidity of the Spanish economic recovery requires a careful evaluation of the current account imbalances. These experienced extraordinary growth between 1997, when the conviction that Spain would join the euro caused a notable reduction in borrowing costs**,** and 2008, in the context of a growing openness of financial markets. The crisis initiated in 2007 began to change perceptions of risk, and from 2008 the impossibility to continue enlarging the current account imbalances became evident, because a significant part of the capital inflow had been invested in activities that were not going to generate income in the future. This caused a growing lack of confidence in Spain's solvency, which translated into a continuous outflow of private capital from the country. Thus, between 2008 and 2011, Spain suffered a latent crisis in its external financing, with the result that, between June 2008 and June 2011, the creditor positions of international banking in the Spanish economy fell by 34%, from USD1.1 trillion to USD740 billion (a fall that contrasted with the strong growth experienced since the late nineties, of 630%, from USD148 billion to USD1.1 trillion dollars between December 1999 and December 2007). This growing distrust translated into an increase of the risk premium on government bonds, which compared to 10 year German *bund* yields, rose from 4.8bp to 320.1bp between June 2007 and July 2011, although there is no consensus as to the extent to which the increase in the risk premium was attributable to the deterioration in fundamentals (the level of indebtedness) or rather to panic-driven movements in the markets due to uncertainty over the future of the euro (De Grauwe-Ji, 2013). However, what is beyond doubt is that it was not until May 2010, with the extension of the Greek crisis, when Spanish risk premiums began to rise substantially. Thus, in the first phase of the international financial crisis (between the spring 2007 and late 2009), the Spanish risk premium stayed at around 50bp and around 80bp between January and April 2010. On the other hand, in the May 2010 crisis it rose 133bp, stabilizing at close to 190bp in June and July. Moreover, the Bundesbank considered that the increase in the gap between the periphery's country risk and Germany's reflected the return to a situation more consistent with the real investment risks. Thus, in 2011 Alex Weber, chairman of the Bundesbank, considered that the worrying thing about the behaviour of risk premiums had been their low levels in the phase prior to the crisis, rather than their subsequent increase (Marsch, 2011, p. 280).

Graph 1. International banking assets in Spain



Source: Bank of Spain.

Indeed, by the end of 2009, the recessionary effects of the Lehman Brothers crisis on activity and employment reached its climax, and from then on and until the summer 2011, the Spanish economy entered a phase of continuous improvement. Thus, GDP growth improved from an annual fall of 4.5% in the second quarter from 2009 to a rise of 0.3% between March and June 2011. Employment showed a similar trend, with corresponding falls of 7.3% and 0.9% between the second quarter 2009 and the second quarter 2011, while temporary salaried employment even showed increases (from a fall of 19.8% to a rise 2.1% over the same period). Meanwhile, risk premiums, after their increase in response to the deepening of the Irish crisis (to 246bp in December), began a smooth descent, falling to 201bp in May 2011.

In short, by the summer of 2011, and it appeared that the effects of the international financial crisis were beginning to be reabsorbed, and confidence in Spain remained relatively stable. Unfortunately, the renewed Greek crisis, with fears that the Greek haircut could be extended to other countries and the difficulties experienced in calming the markets, both in Italy and in Spain, translated into a sharp rise in country risk, with notable increases in risk premiums until, in December, the ECB came to the rescue, with its auction of three year loans at an interest rate of 1%: the increase reached almost 310bp in July and August, around 330bp in September and October and 421bp in November.

The fear that Spain would abandon the single currency caused a typical 'emergency stop' in the flows that were financing the economy, and at the same time a sudden and notable withdrawal of creditor positions from the rest of the world (Calvo and Reinhart, 2000; Mendoza, 2010). Thus, between July 2011 and September 2012, the net external balance of the financial account showed a net capital outflow of €318 billion. This was in a context in which the €1.7 trillion of external gross indebtedness in the summer of 2011 (total financial liabilities, excluding FDI) required a substantial annual refinancing. Considering an average maturity of non-FDI financial liabilities of around six to seven years, this could be calculated at approximately €250-300 billion.

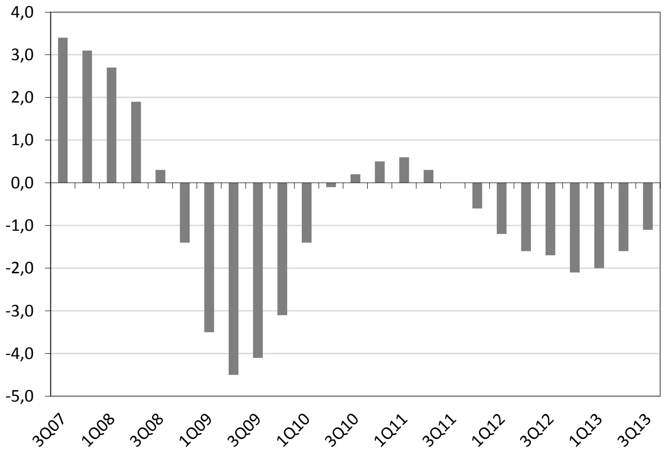
Given the central role of the banking sector in obtaining and channelling this external credit, and the heavy fall in its financing in international markets, this sudden change only could be resolved by amplifying the ECB's role as lender of last resort. The ECB rode to the rescue with an extraordinary injection of funds that, between June 2011 and 2012, increased its lending to the Spanish banking from €47.7 billion (11.1% of the Eurosystem total) to €337.2 billion (77.0% of the total). As a result, despite the important outflow of capital in the 2011-2012 crisis, the country's external position barely changed, reflecting the substitution of private capital by the increase in the Bank of Spain's liability positions in the TARGET2 system, which reached a peak in September 2012 (Merler and Pisani-Ferreti, 2012).

What were consequences of this external financing crisis? In the financial aspect, the contraction of credit steepened, from a quarterly fall of 0.2% in 3Q08-2Q11, to 1.3% in 2Q11-3Q12. In the real economy, the fall in real estate prices also accelerated, with the quarterly decline in new housing prices increasing from 1.0% to 3.3% in the same periods. It also had devastating effects on employment, the fall in which had been decelerating at the end of the first half of 2011 (to a half-yearly 0.5% in January-June 2011, from 4.6% of the first half of 2009 and 0.9% in the same period of 2010). In the second half of 2012, the decline again increased, to 2.7%. Lastly, the half-yearly increase in GDP of 0.1% in January-June 2011 was followed by recession, with a 0.7% decline in the second half of the year, a fall that steepened in the subsequent two halves (0.9% in 1H12 and 1.2% in 2H12).

The second sovereign debt crisis began to draw to a close in the late summer of 2012, although was not until the second quarter 2013 when the situation began to normalize. Important decisions were necessary for that to happen. In June 2012, the EU initiated the Banking Union, among other significant measures to support the countries in difficulties; in July, the Spanish government implemented fiscal changes and sought resources from the EU to rescue the financial sector; and in September, the ECB approved the OMT (Outright Monetary Transactions) and Mario Draghi stated that the ECB would do whatever was necessary to reduce denomination risk, i.e. to guarantee the euro. Thus, from October 2012, the indicators of disparate financial conditions between countries in the eurozone began to decline and, in particular, they began to improve in Spain. The outflow of capital began to reverse, at first slowly and, in 2013, more strongly: as opposed to the outflow of €318 billion between June 2011 and September 2012, from then until December 2013 the net inflows totalled €169 billion. Moreover, these have been accompanied by the stabilization the placement of issues abroad, which had fallen sharply. Likewise, risk premiums have also undergone a clear normalization, with a sharp fall, from the 520.2bp of June 2012 to 198.4bp in the first half of February 2014. In short, by the end of the winter of 2014, the tensions arising from the second sovereign debt crisis seemed to have been largely absorbed.

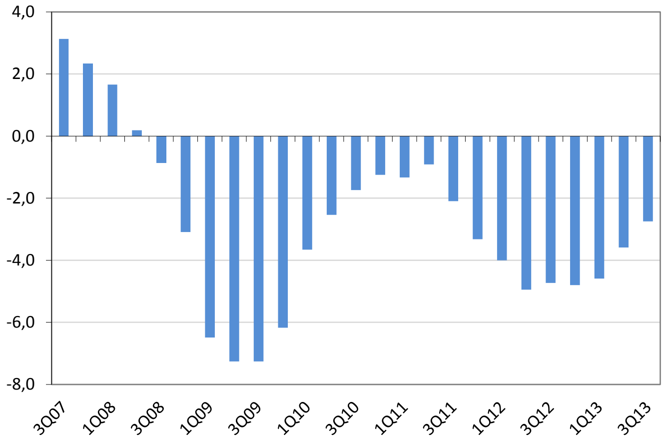
Graph 2. GDP and employment (% annual variation)

a. GDP



Source: INE.

b. Employment

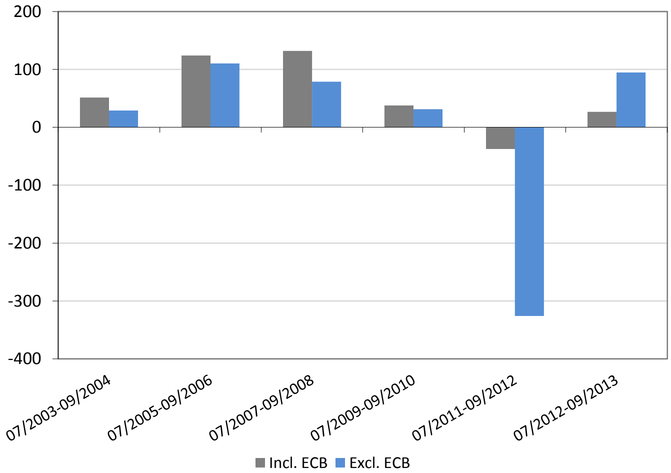


Source: INE.

Nevertheless, the vulnerabilities revealed by the crisis are far from being under control. Any disruption affecting confidence in Spain, or in the euro, could interrupt the calm of the past months in external financing. The problems of balance sheets and external competitiveness have been resolved only to a very limited extent, meaning that any perception of increased risk of loss on the part of Spain's external creditors, whether due to inadequate signals emanating from the country or to real or financial external shocks, could unsettle the current calm. Furthermore, the various episodes in which the ECB has been obliged to relax its monetary policies since October 2012 suggest that the financial fragility of Spain and other eurozone countries is far from overcome.

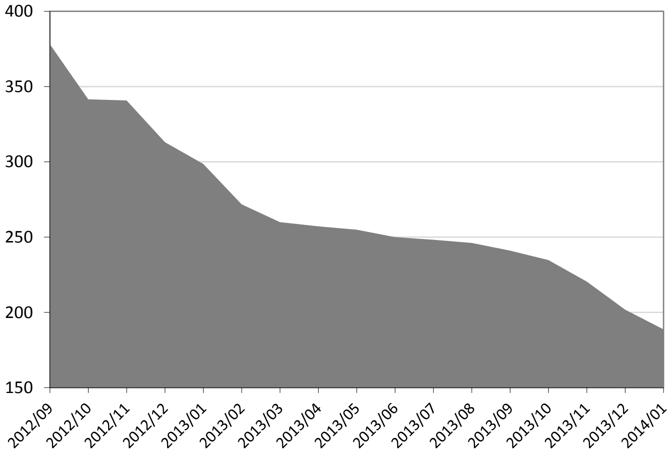
Graph 3. External financing conditions (€ billion)

a. Variation external liabilities - assets



Source: Bank of Spain.

b. Eurosystem loans to Spanish financial institutions



Source: Bank of Spain.

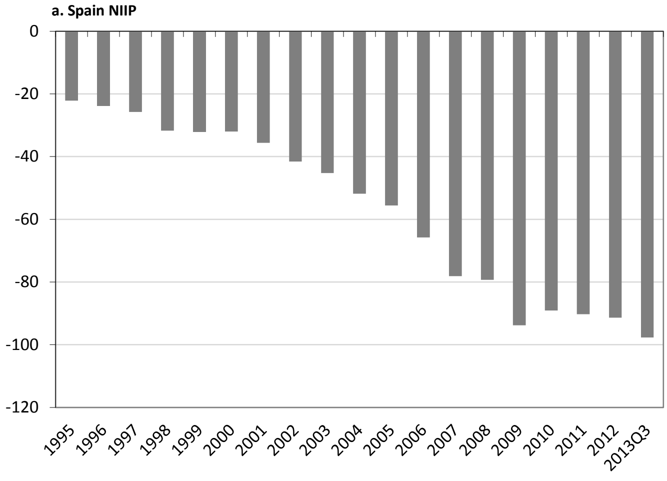
1.2. Net and gross external debt: the importance of the financial sector

The private sector's response to the change in financing conditions in 2007-08 was to be expected: a reduction in consumption and investment and, hence, a reversal of its financial balance, which switched from a funding requirement equivalent to 11.5% of GDP in 2007, to a surplus of 9.0% in 2013. Despite an offsetting change in the public sector, this spectacular adjustment, some 20 percentage points of GDP, translated into a notable fall of the current account balance, from a deficit of 10.0% of GDP in 2007 to 4.5% in 2010 and a surplus of 0.7% in 2013. In this context of decreasing deficits, the net external debt (NIIP, Net International Investment Position) logically continued to grow, although at an increasingly slow pace, rising from 78.1% of GDP in the fourth quarter of 2007 to 97.8% in September 2013, a level that puts the Spanish NIIP among the most negative of the EU (IMF, 2013c), far above the 35% that the EC considers adequate to avoid potential external problems.

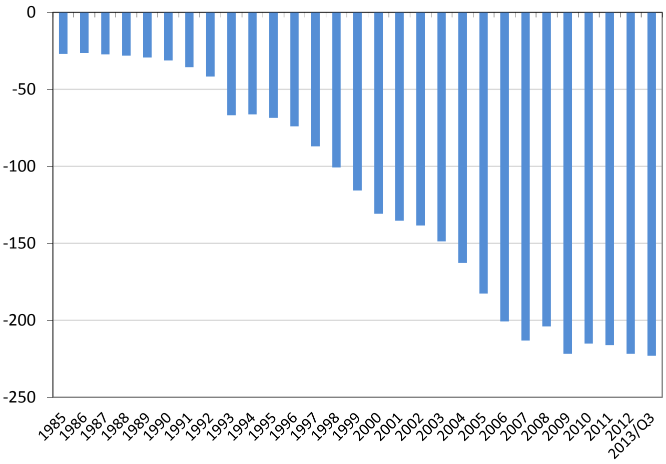
However, it is not only the volume and the dynamics of the NIIP which are significant. It also matters which sectors are the debtors, and in what financial instruments this indebtedness is embodied. Among the leading debtor sectors, the role of the financial sector stands out. Its net external debt (including the Bank of Spain) accounted for 50.5% of the total (some €468 billion) in the fourth quarter of 2012. The external refinancing difficulties discussed above account for the intense deleveraging, which the financial sector reduced its share of the total debt to 43.2% in the third quarter of 2013 (down €418 billion). Moreover, given the nature of the sector's activity, the instruments used in its NIIP present evident potential vulnerabilities, due to their greater liquidity and enforceability, as opposed to the net debt of the non-financial companies sector, which is mainly FDI. Thus, in September 2013, the bulk of the financial sector's net external debt was in the form of cash, deposits and non-equity securities.

Notwithstanding the importance of the net external debt, indicative of the the country's long-term solvency, with regard to the short-term risk arising from liquidity problems, the key variable is the stock of gross debt (excluding FDI). Its volume is significant because it is the country's gross external exposure, not the net debt, which gives rise to the risk of financial instability (Reinhart and Rogoff, 2010; Obstfeld, 2012; Shin, 2012; Catão and Milesi-Ferreti, 2013). From this perspective, between 1998 and 2007 the external gross debt experienced extraordinary growth, from €540 billion to €2.2 trillion and, in terms of GDP, from 100.7% to 213.2%, an increment of 113 percentage points, that cannot be attributed to the internal investment financing needs. Indeed, between 1998 and 2007, only a quarter of the €1.6 trillion of capital inflow to Spain financed current account deficits , while the remainder was utilized for the acquisition of assets abroad. Thus, between 1998 and 2007, of the increase of 112 percentage points of GDP in the external gross debt, three quarters of the total (64 percentage points of GDP, from 63% in 1998 to 127% in 2008) financed the acquisition of assets abroad, a figure that contrasts with the increase of the NIIP by 46 percentage points of GDP (from 32% of GDP in 1998 to78% In 2007), attributable to domestic investment financing requirements.

Graph 4. External debt (% of GDP)



Source: Bank of Spain.



Source: Bank of Spain.

Moreover, although from 2008 a gradual process of external disinvestment began (Spain's international assets have fallen from 134.5% of GDP in 2007 to 128.4% in September 2013), the accumulation of financing requirements translated into an increment of Spain's gross external debt (between 4Q07 and 3Q13) from the 213% to 223%. In addition, this increase has been accompanied by a decline in the proportion represented by FDI, and increases in the shares of different debt instruments, which are those that increase the country's vulnerability . Thus, in September

2013, 165 percentage points of external gross debt (out of 223% of GDP) was made up of deposits, non-equity securities, loans and other outstanding accounts, liabilities which will have to be refinanced in the coming years.

Lastly, the different agents do not reflect the average structure of the country financial assets and liabilities. The concentration of external liabilities in the financial sector deserves special consideration. Thus, of the €1.7 trillion of enforceable gross debt as at September 2013, €922 billion corresponded to the financial sector, mainly liabilities in different debt instruments. Meanwhile, non-financial companies were responsible for €880 billion, but more than half of this was in the form of FDI, a less problematic liability. As noted above, the financial sector, due probably to its greater vulnerability, has deleveraged more quickly than non-financial companies (IMF, 2013c). Indeed, the non-financial business sector has continued to increase its indebtedness, from 78.6% of GDP at end-2010 to 86.1% in 3Q13. Thus, between the fourth quarter of 2007 and the third quarter of 2013, financial institutions (including the Bank of Spain) reduced their external gross debt by more than 18 percentage points of GDP, to 100.9% (and from €1.25 trillion to €1.03 trillion).

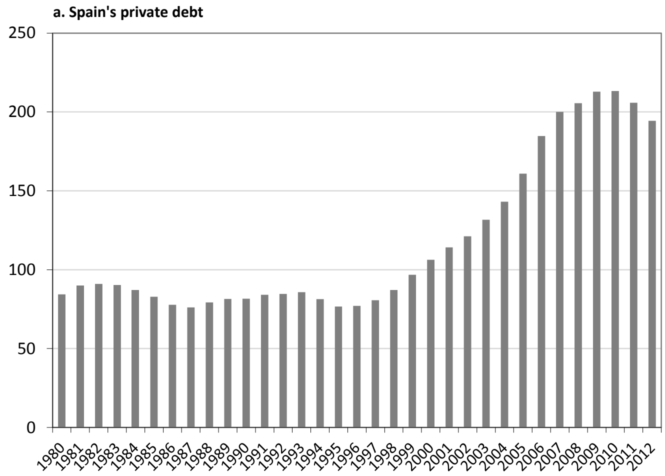
Indeed, since the crisis of June 2011-July 2012, the decrease of the banking sector's external indebtedness (highlighted by the IMF, 2013a), and the improvement in funding sources, has been substantial (IMF, 2013b and 2013c; EC, 2013a and 2013b). In this process, the European intervention of July 2012 played a decisive role, due both to the recapitalizations and to the reduction in impaired assets on the balance sheets of the most troubled banks. This has allowed the dependence on the Eurosystem to be reined in, at the same time as the external stabilization made it possible to issue international debt again. Thus, the proportion of external liabilities of the banking sector narrowly defined (i.e. excluding the Bank of Spain) fell by 33.4% between June 2008 and June 2013 (from €919 billion to €612 billion), a decline that has reduced its share of the country's liabilities from 40.3% to 26.9% of the total. Moreover, with regard to Eurosystem credit, this has fallen substantially, from €389 billion in August 2012 to €189 billion of January 2014, a reduction of 51.4%. Lastly, the international stock of debt issued by the financial sector (which fell from €335 billion to €193 billion between 2007 and 2012), has stabilized at €170 billion in September 2013.

1.3. Financial sector and domestic private and public debt

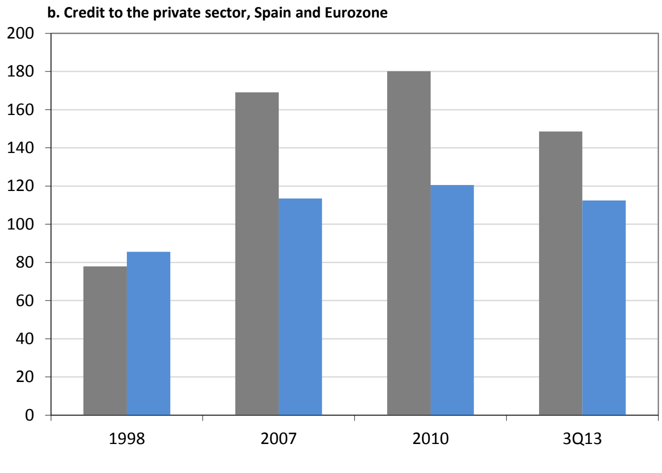
In order to identify precisely the adjustments that the Spanish economy should undertake, we need to consider not only the dynamics of the external debt, but also the changes in the internal financial imbalances. With regard to the private sector, it has already been noted that the 2007-08 crisis translated into an abrupt, and heavy, reduction in its spending, which changed its funding position from deficit to surplus. However, the stock of consolidated private debt (according to the EC's definition in the MIP, Macroeconomic Imbalance Procedure) continued to grow until 2009, when it reached a historic high of 213% of GDP. From then on, it experienced a clear reduction, falling by close to 20 percentage points of GDP, to 194% in 2012, some 34 percentage points higher than the values recommended by the European Commission (160% of GDP). Those 20 percentage points reflect increases in private sector savings of close to 10 percentage points (from 14.2% of GDP in 2007 to 23.9% in 2013), and similar reductions in investment (from 26.9% of GDP in 2007 to 16.6% in 2013). Measured as total private sector liabilities, consolidated private debt has fallen from 231% of GDP in the second quarter of 2010 to 209% in the second quarter of 2013.

In the private sector, non-financial companies continue to figure amongst the most leveraged of the eurozone, with a debt equivalent to 227.5% of GDP in 2012 (compared with the eurozone average of 196% for 2011); in turn, households had borrowings of 87.8% of GDP, a figure similarly much higher than the eurozone average of 69.1%. In short, in 2012 (latest eurozone data), it is evident that the non-financial private sector's borrowing still surpasses the eurozone average by some 50 percentage points of GDP, a figure that must be seen in relation to the excess net external debt of almost 55 percentage points of GDP, according to the European Commission's MIP indicators (2013).

Graph 5. Private debt and credit to the banking sector (% of GDP)



Source: Bank of Spain.



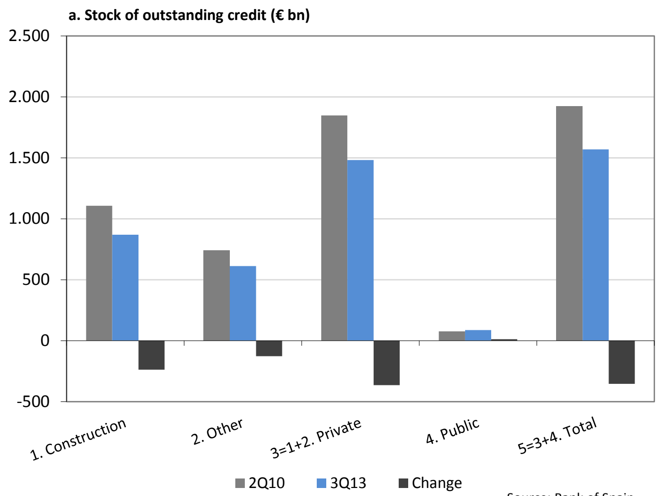
Source: Bank of Spain.

These figures in turn reflect an excess of credit to the private sector which, in December 2013, stood at 142% of GDP (compared to the eurozone average of 116%), so that although the reduction in private indebtedness is perceptible, it is very far from having concluded (EC, 2013b). Moreover, any simulation based on the evolution of nominal GDP and moderate increases in private debt indicates that reducing the latter to sustainable values over the medium term would take a long time period, close to 10 years.

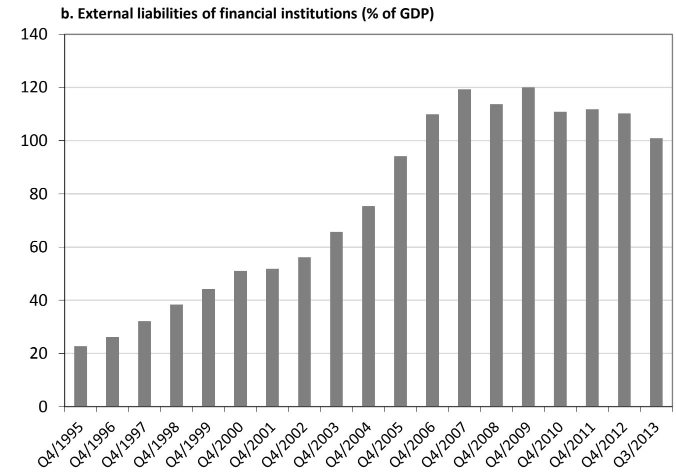
The adjustment in private sector behaviour was indirectly responsible for the emergence of the public sector deficit. That resulted from the sharp fall in public sector income, in turn caused by the collapse of consumption and private investment, and, at the same time, by the action of automatic stabilizers, and/or the discretional increase in public spending. This caused the collapse of public savings (which, added to the financing of investment, was reflected in a continuous demand for resources) from a surplus of 2% of GDP in 2007, to a public deficit that averaged close to 10% of GDP in the 2009-12 period. Lastly, this explosion of the deficit, and the financial recapitalization requirements, caused an abrupt increase in public debt, from 36.3% of GDP in 2007 to 94.3% in 2013.

The economic crisis, the private sector deleveraging and the increase in the public debt have had significant effects on the financial sector's balance sheet which, moreover, has suffered great difficulties in securing funding, due to the dependence on external financing. Because of this, below we review the changes in the financial sector's balance sheet and the problems that it has caused.

Graph 6. Financial sector: outstanding credit and external



Source: Bank of Spain.



Source: Bank of Spain.

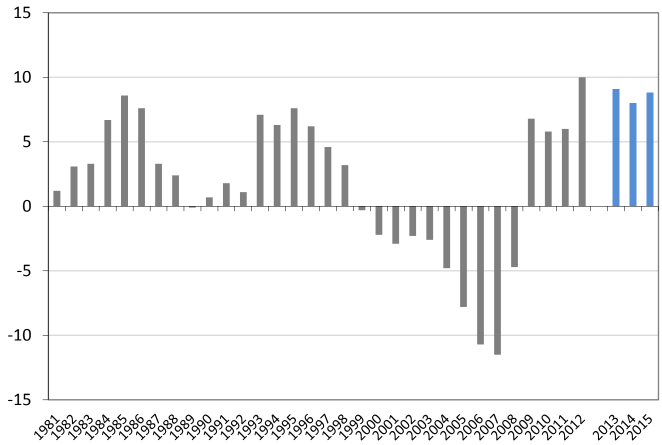
With regard to the sector's assets, in 2007 61% of the outstanding credit (€1.1 trillion) was related to construction. It should be recalled that, between 1996 and 2007, more than 63% of new credit to the private sector (€970 billion) was directed to construction (real estate plus the construction and acquisition of dwellings by households), while all other activities accounted for the remaining €500 billion. Hence, it is no wonder that, between December 2010 and September 2013, credit to the private sector contracted by 21.5% (€396 billion); that fall is reduced to 17.4% if assets absorbed by Sareb are included. Part of that reduction reflects the growing importance of the provisioning of bad debts, while the growth of doubtful debts points to further contractions in outstanding credit. By sector, the reduction has been very strong in construction (down 40%, from €430 billion to €258 billion), while for other non-financial companies the contraction has been smaller, specifically 17.9% (from €555 billion to €456 billion); meanwhile, credit to households has fallen by 10.6% (from a peak of €859 billion in December 2010 to €768 billion in September 2013).

To the weakness arising from private insolvencies, one must add the vulnerability of the assets to changes in the valuation of the public debt. Between December 2007 and December 2012, this saw a dual process of increase and of redistribution of its main creditors, with a clear decrease in the relative position of external creditors and an increase in the banking sector. Thus, while in December 2007 both sectors made a similar contribution (almost 36-37% of the total), in September 2013 the financial sector's share had risen to almost 45% (12.3% of its unweighted risk assets), meaning that the share of government bonds in its assets had risen from €184 billion in the fourth quarter of 2007 to €575 billion in the third quarter of 2013 (and from 17.5% of GDP to 56.3%). Specifically, of the €800 billion increase in public liabilities between December 2007 and September 2013, some €391 billion (48.9%) was absorbed by the financial sector. On the other hand, the rest of the world maintained a share of around 30%.

Nevertheless, the risks to financial stability persist, from potential renewed deterioration of assets, margin compression, and from the precarious situation of financial stability, at the mercy of changes in the perception of the solidity of the financial system and of the thoroughness and effectiveness of the reforms under way. All in all, the financial sector has five main sources of vulnerability. The first is the fragility of the improvement in its external financing. It is true that in January 2014 the Spanish banking found itself less dependent on the Eurosystem, but it is just as true that the process only began to consolidate from the spring of 2013. Secondly, despite the reduction in the banking assets, they continue to be excessive. Spain's share of credit to the private sector in the eurozone (14.9% of September 2013), was well in excess of its proportion of the area's GDP (0.9%). This, if the figures remain unchanged, would indicate that there is still excess domestic credit to the private sector on the order of €391 billion, though this measure does not include the effects of the different share of bank credit in the financing of the activity in each country.

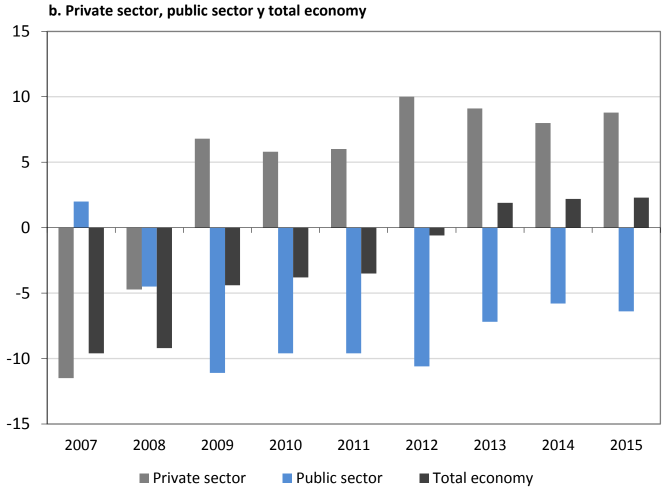
Graph 7. External financing surplus/deficit (% of GDP)

a. Private sector



Source: Bank of Spain.

b. Private sector, public sector y total economy



Source: Bank of Spain.

Related to this last point is a third vulnerability, arising from the outstanding credit to the construction industry, the rise in impaired credits and the fall in real estate prices. Lastly, the final point to highlight is the concentration of public sector debt in its balance sheets. This catalogue of difficulties translates into obstacles to credit growth, where the trend, as indicated by the European Commission (EC, 2013a), should be assessed in the context of the need for certain sectors to deleverage and the liquidation of the legacy of toxic assets.

2. Financial crisis and external current account balance: the medium term problems

2.1. Is the correction of the external current account balance sustainable?

The slow adjustment of the capital imbalances is indicative of the difficulties face in a context of recession or low growth, as is the case of Spain. A more aggressive adjustment policy would require nominal GDP growth rates of more than 5%, and even if this were achieved, a return to levels sustainable over the long term would require close to a decade. Moreover, given the size of the external debt, the potential problems posed by its financing and the high level of internal indebtedness, it remains essential to strengthen the external sector's contribution to growth, to the detriment of domestic demand. This is because, with regard to the latter, the demographic contraction, the correction of the real estate excesses, the need to continue deleveraging the private sector and the shrinking of the public sector all point to a modest rate of growth. Moreover, the obstacles to credit growth, stemming from the balance sheet excesses, also hinder the possible expansion of domestic demand.

In this situation, external demand becomes a lifeline. Indeed, it has already avoided the collapse of GDP in the toughest part of the recession: in the 2008-13 period, the average annual fall of 1% in GDP was the result of the collapse in internal demand (responsible for 3 percentage points of the real decline in GDP), partly offset by external net demand (with a positive contribution of 2 percentage points). Moreover, external demand is the main mechanism for first stabilizing and then reducing the high net external debt.

The turnaround in the external sector's contribution to the increase in GDP reflects the export effort, while imports languished. Thus, after an external deficit of 9.6% of GDP in 2007, the average financing requirement fell to less than half in 2009-11 (3.8% of GDP); the second phase of the crisis brought a sharpening of this correction (a fall of 0.6% in 2012) and, for the first time since 1997, in 2013 the external current account balance turned positive (1.9% of GDP according to European Commission estimates).

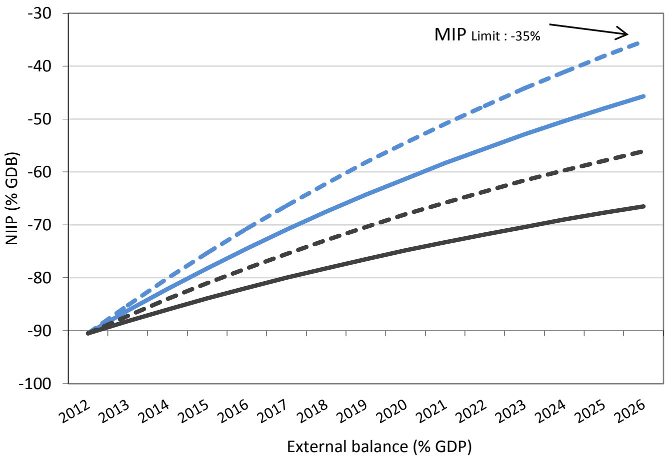
At the same time, this improvement in exports reflects the recovery in competitiveness. In this environment, labour costs have moderated, or fallen, steadily since 2010. This is the so-called internal deflation. Moreover, the fall in employment and the disappearance from the market of the least productive companies have translated into notable increases of GDP per employed worker: a rise of 13.4% between 2008 and 2013 in Spain set against falls in Italy (1.4%), France (1.4%) and Germany (0.5%). This trend, together with that of salaries, accounts for the decline observed in unit labour costs (ULC). This means that the Spanish ULC, which increased by 42.3% in 2009 compared with 1997, set against barely 7% in Germany, fell back 5.3% between 2008 and 2013 (compared with increases of close to 10% in Germany, France and Italy).

The internal devaluation and improvement in productivity have led to falls in the ULC, which have been reflected in the improvement in exports. Nevertheless, given the weakness of imports, it is not clear how the current adjustment in the external current account balance should be characterized. Indeed, in early 2014, there is little that can be affirmed about its more or less structural character. Even the IMF (2013d) considers that it is a passing phenomenon and that, on a cyclically-adjusted basis, the 2013 surplus would be transformed into a deficit (of 2% of GDP). In any case, it is necessary to make a precise diagnosis of the underlying trends in the external current account balance, as well as of the time required to bring the net external debt back to sustainable values.

With regard to this second aspect, to return the NIIP to levels of around 50% of GDP would require surpluses of 1% of GDP and nominal increases in GDP of 5% for at least 10 years. However, trends in the Spanish economy in the past decades seem to indicate that the hypothesis of an external surplus of 1% during a such a long period is not very realistic. Indeed, the structural level of the current account balance seems to closer to a deficit of 2% than a surplus of 1% (over the period between 1981 and 2013, more than three decades, its average was 2.3%). Since the 1980s, the only years when Spain has achieved an external surplus was at the end of the recession, and the years following the crisis, in the eighties (an average of 1.2% between 1984 and

1987) and at the beginning of the expansion of the nineties (1% average from 1995 to 1997). This means that with a trade deficit of 2% of GDP and nominal GDP growth of 4%, the NIIP would fall modestly, to 75% of GDP in 2025; and if the nominal increases in GDP were to reach 6%, the debt would still stand at 61% in 2025. In short, to bring the net external debt back to acceptable levels is going to take a long time.

Graph 8. Theoretical evolution of Spain's NIIP 2012-2026
Annual nominal GDP growth of 5% and various hypotheses of external balances (current and capital accounts)



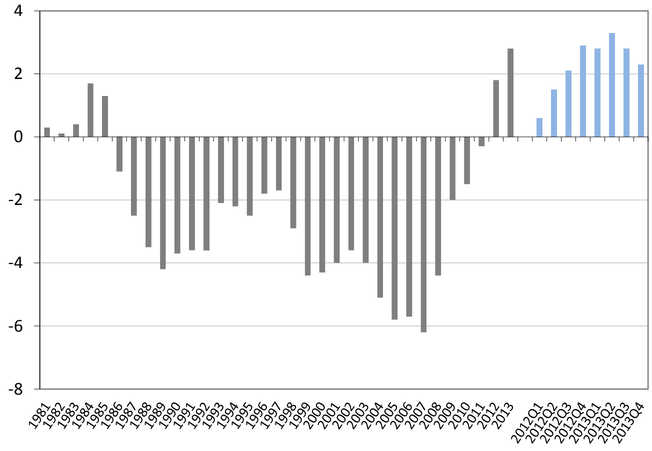
Source: EuropeG.

2.2. Structural changes in the external current account balance

Another issue, directly linked to the previous one, is the potential trend in the elements that make up the current account balance. To be brief, an analysis of its behaviour in the decade prior to the crisis points to the difficulty of maintaining the present surplus. This is for the following reasons. First, the importance of energy imports in the merchandise trade balance. Secondly, the emergence in 2013 of a surplus in non-energy goods and in services reflects, in addition to the increase in exports, a fall in domestic demand, which seems difficult to maintain in the medium term. Indeed, the latest data for 2013 already point to a notable reduction in the contribution of net external demand to GDP growth and an increase in internal demand. Third, the export effort has been exceptional, suggesting difficulties in maintaining it at such high levels. Indeed, its exceptional nature is reflected in the fact that exports of goods and services reached a historic share of GDP in 2013 (34.1%), above previous highs achieved after major devaluations of the peseta exchange rate. Fourthly, the contribution of the investment income balance to the current improvement reflects an anomalous situation in the level of interest rates. And, lastly, because the deficit on current transfers (migrant remittances) seem unlikely to change, while the surplus on the capital account (EU transfers) is set to decline.

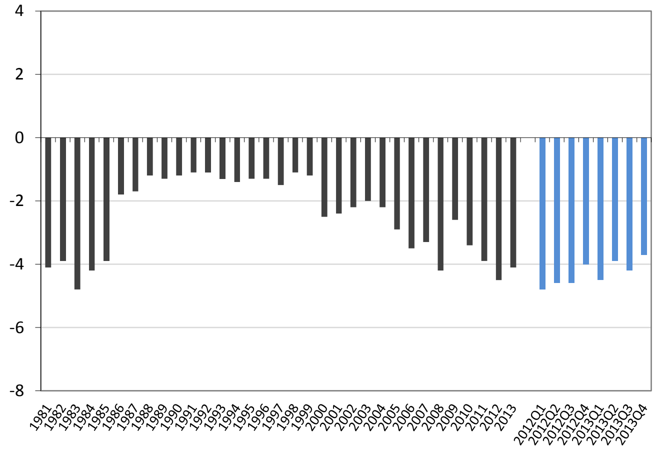
Graph 9. Trade balance of the Spanish economy (% GDP)

a. Non-energy merchandise balance



Source: Bank of Spain.

b. Energy balance



Source: Bank of Spain.

To better understand these factors, below we briefly discuss some extremes of the merchandise, services and investment income balances. With regard to the merchandise balance, this has seen an exceptional adjustment, from an average deficit of 6.5% of GDP over the 1999-07 period to only 1.1% in 2013. Nevertheless, this correction hides disparities between its main components, energy and non-energy. Thus, three quarters of the merchandise deficit between 2009 and 2011 (4.5% of GDP) corresponds to energy

(3.3 percentage points of GDP). The same happened in 2012, when the goods deficit of 2.7% of GDP was composed of a non-energy surplus of 1.8% more than offset by the energy deficit (4.4% of GDP). Moreover, it is to be expected that, if the strong export effort is maintained, and given the significant elasticity of imports to changes in the components of private domestic demand, the share of imports in GDP will tend to rise (goods imports have remained around 25% of GDP, both in the 2002-07 period (24.7% of GDP), and in 2010-13 (24.6%).

With regard to services, there are also signs suggesting that there is a high cyclical component in their modest improvement. In aggregate (tourism and non-tourism services), they recorded an average surplus of 2.8% of GDP in the 1999-07 boom period, though with a clear decreasing tendency (from 3.3% to 2.2%), as payments increased faster (from 4.5% to 6.7% of GDP) than income (from 7.7% to 8.9%). This trend reversed in the crisis, with the surplus increasing between 2007 and 2013, from 2.2% to 3.9% of GDP, due to the recovery in both the tourism surplus (to 3.2%) and non-tourist services (to 0.7%). In short, it seems unlikely that this balance will offset, or in any case only in part, the deficits generated by the other components of the current account balance.

Meanwhile, the investment income balance has reduced its deficit, after the boom years when the increase in the external debt practically duplicated it (from 1.5% of GDP in 1999 to 2.9% in 2007), falling back to 1.9% in 2012. The fall in interest rates was the decisive element in this correction. Lastly, to this constellation of factors one must add the effect of potential external shocks, arising from changes in the terms of foreign trade, as happened with the price of the petroleum and the rise of the euro in the 2000s.

In short, the analysis points to reductions in the medium term in the surpluses of those balances that have offset, even if only in part, the deficits in goods and investment income. At the same time, moreover, the gap of those balances already in deficit will widen once internal demand recovers part of its strength and/or the conditions of international growth and the eurozone lead to rises in interest rates.

3. Adjustment and growth policies in the post-crisis horizon

The Spanish economy is emerging from the tunnel of the second recession. The external financing situation has improved substantially, and the forecasts for activity and employment anticipate a new cycle, although its strength remains to be seen. Nevertheless, the problem of excess debt remains, as do the obstacles to reducing it, especially the external debt. This suggests that it would be an mistake to think that the risk of new financial panics has passed. Hence, this last section poses some thoughts about which policies would be desirable in this post-crisis phase.

These are defined by the restrictions facing Spain and by the capacity to launch expansive policies in Europe. The need to stimulate growth and continue with the adjustments defines the framework of action for economic policy in Spain. Any proposal must ensure the continuity of the process of strengthening external competitiveness, of readjusting factors and sectors and of improving competition. On the other hand, at the European level it is necessary to continue with lax monetary policies, together with the implementation of mechanisms to stimulate demand.

In Spain, there are four factors which mark out the possible framework of action. The first is the continuing high levels of indebtedness, private and public, internal and external, despite the efforts of the last three years. The second is the long time needed to bring the debt down to levels compatible with financial stability, internal and external. The third is the question marks hanging over the sustainability of the improvement in the external current account balance. As with the reduction of the debt, the current account surplus is simultaneously insufficient and too tenuous to solve the external debt problems, the main risk to financial stability. Lastly, the difficulties in promoting strong growth in domestic demand, not only because very substantial aspects thereof are still damaged (demography, public sector, residential construction), but because the flow of credit required faces obstacles to its growth, and will continue to do so. Credit growth is restricted both by the need to reduce doubtful loans to the construction industry, and by the high levels of household and non-financial company debt, together with the financing needs of the public sector. This diagnosis suggests that, despite the improvements, the

Spanish economy still faces potential financial risks, both from internal problems and from those which may appear in the eurozone or elsewhere.

Taken together, these elements leave little margin of manoeuvre for public policy: to extend the structural reforms that increase the economy's potential growth rate, especially with regard to the goods and services most protected from competition; orientation of fiscal policy to discourage borrowing and encourage saving, to contribute to close the external deficit; to accentuate the internal devaluation, supported by fiscal mechanisms (increase in VAT and reduction of social contributions), to maintain the export effort, and a mildly restrictive fiscal policy, to avoid renewed problems with the sovereign debt. However, though Spain's margin for manoeuvre is very restricted, the same is not true of the eurozone as a whole and the ECB. From this point of view, the efforts required from our economy should be accompanied by more expansive European policies, that would allow Spain to consolidate the improvements achieved so far. Otherwise, it will be difficult to avoid further crises of the euro.

In short, domestically, in Spain, continuation of the internal devaluation, structural reforms, fiscal consolidation, increase in competition and promotion of exports are the pillars on which public action should be based. Abroad, in the eurozone, policies to support economic activity on the part of the ECB, and to stimulate demand by the European authorities and/or the central EU countries. Only the appropriate policy mix*,* domestic and external, can guarantee success.

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EuropeG is composed of Antoni Castells (director), Manuel Castells, Josep Oliver, Emilio Ontiveros, Martí Parellada and Gemma García (coordinator).

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EuropeG
Parc Científic de Barcelona
Baldiri i Reixac, 4
08028 Barcelona
Tel. +34 93-4033723
www.europeg.com

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