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Financial imbalances in the Spanish economy 2013-2019, the effects of COVID-19 and the impact of the intervention of the ECB

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Spain's economic situation in late 2021 consolidated the recovery that began in spring, although the impact of the sixth wave and the new omicron variant on economic activity will not be positive. The effects of COVID-19 occurred on a scale not experienced since national accounts started being compiled, with GDP falling by a record 10.8% in 2020. And, according to most key performance indicators, the Spanish economy has not yet bounced back to pre-pandemic levels.

This remarkable downturn presented an unusual time profile. The first quarter of 2020 saw a sharp decline (-4.3% year-on-year) as a reflection of the effects of the lockdown imposed in the second half of March, which was followed by the collapse of the second quarter (-21.5% year-on-year), the most severe experienced in the euro area. Thus began the ebb and flow of economic recovery, but the effects of the severe downturn that occurred at the height of the pandemic have not yet been reabsorbed. Therefore, despite the fact that the employment crisis has been virtually overcome, GDP in the fourth quarter of 2021 was still 4% lower than the same period in 2019, while private consumption presented a greater downturn (-7.9%) and the international sale of goods barely exceeded pre-pandemic values (-0.4%).

In addition to this incomplete recovery process, the pandemic has left longer-term scars due to a build-up of vulnerabilities in financial markets and high public debt (European Central Bank, 2021b), while expectations for economic growth are lower (European Commission, 2021a). Both these aspects translate into an uncertain future, a scenario that provides the backdrop for this new assessment of Spain's internal and external financial imbalances. Although some of these had been substantially reduced, they were still lingering just prior to the COVID-19 shock, whose impact led to further deterioration. This is cause for concern, since the aggregate debt of the resident sectors in mid-2021 had reverted to shares of GDP similar to those seen in the middle of the last decade. In fact, in 2020, the European Commission (2020b) anticipated that COVID-19 would widen imbalances for countries that already presented them in 2019, such as Spain. Indeed, despite the reduction in both domestic and external indebtedness achieved between 2013 and 2021, the legacy of the imbalances created by the financial crisis is still being felt and, therefore, this Policy Brief must be viewed within the context of the drawn-out deleveraging of the resident sectors, and of these sectors with the rest of the world.

It is important to note that the build-up of imbalances in the 1995-2007 expansion underpinned the severity of the 2008-2012 crisis and forced Spain to choose between making major internal adjustments and abandoning the single currency. The factors that gave rise to this situation were analysed in Policy Brief No. 2 (EuropeG, 2012), which highlighted the nature of the balance sheet recession that led to the Lehman Brothers crash in Spain. Following the euro crisis (2011-2012) and the intervention of the ESM and ECB in Spain's financial stabilization (2012-2013), Policy Brief No. 5 (EuropeG, 2014) analysed the incipient and limited reabsorption of those imbalances and the internal and external mechanisms underlying it. Subsequently, and once the recovery had taken hold, a fresh analysis of the reduction in domestic and foreign debt and the key role of the ECB in this process was carried out. This was the central theme of Policy Brief No. 9 (Oliver Alonso, 2016), which also focused on some of the reasons behind the strong recovery that had started 2013 and analysed whether or not the foundations were solid enough for it to continue. The factors that contributed to the expansion included, once again, the intervention of the ECB, in addition to changes in the governance of the euro. These were

decisive in re-establishing the precarious process to restore international confidence in Spain (European Commission, 2016a), which provided the basis for the lengthy expansion in 2013-2019. Today, in these times of recovery and in the context of the abovementioned uncertainties, this new Policy Brief examines the extent to which the reduction in indebtedness has been altered by the pandemic, the role of the ECB and the European Commission in containing the crisis, and some of the medium- and long-term scars it is expected to leave.

It is important to clarify what topics will not be addressed in a paper of this type. Aspects that play a major role in the indebtedness of the different sectors but are not covered here include the dynamics of ULCs and the role of wage moderation and productivity growth; the partial restructuring of supply towards sectors that are less protected from competition; changes in factor endowment and the contribution of TFP to growth (Diaz del Hoyo et al., 2017; International Monetary Fund, 2017a; Bank of Spain, 2018a); unemployment and its role in sustaining financial weaknesses (European Commission, 2020a, 2021c); the state of the real estate market (Bank of Spain, 2021) and the banking sector (European Banking Authority, 2021); and the impacts of demography and the new influx of immigrants. Moreover, the paper does not intend to provide an overview of the economic policy measures adopted in recent years, despite the fact that these have obviously affected the aspects addressed here, nor will it explore the rise in global indebtedness, driven by interest rates at historic lows. Finally, the paper does not analyse the potential effects of the European Commission's Next Generation EU programme that are expected from 2022; although hugely important, its effects thus far lie more in the field of Keynesian animal spirits than in actual investment. Although all these issues are key to diagnosing the challenges faced by Spain, they fall outside the scope of this paper, whose analysis will focus on changes in finance flows (in volume, agents and instruments) and on stocks of internal and external liabilities (partially modified by benchmark reviews of Spain's external balance [Bank of Spain, 2019] and of the macroeconomic magnitudes of national accounting [National Statistics Institute, 2019]).

The text is structured as follows. The first section (1. Financial flows in 2013-2019 and pandemic-related changes) explores changes in the consumption, investment and capital account balance of households, non-financial corporations (NFCs), public administrations (PAs) and financial institutions (FIs) in the recovery and how these changes have been reflected in the country's external position. Following this analysis, the second section explores the deleveraging of the private resident sectors with the financial system and the dynamics of public indebtedness. The paper then goes on to analyse the dynamics of external debt (whether total liabilities, gross debt or net debt). The presentation ends with a section on conclusions.

It should be noted that, in accordance with the methodology of the Bank of Spain and Eurostat and unless otherwise noted, when the stock values of assets or liabilities for a given financial year are presented, they always refer to the fourth quarter value.

1. Financial flows in 2013-2019 and pandemic-related changes

The Spanish economy underwent sustained recovery from the second half of 2013 up to 2019. Its GDP growth rate in terms of volume in 2013-2019 reached a remarkable 2.6% per year, so that in 2019 it was 7% higher than 2007 levels; in nominal terms, the key variable for assessing debt dynamics, it increased by 3.4% per year (22% cumulative), a rate that accounts for part of the debt reduction. This dynamic reflected the impact of multiple factors, including internal reforms, despite their initial contractionary nature (Andrés et al., 2014), positive factors from abroad (oil, tourism and recovery of the European and global economy) and, above all, the decisive role of European institutions and the ECB. The positive trend was interrupted by the arrival of COVID-19. The sharp contraction in GDP that occurred in 2020, close to -11%, meant that GDP in terms of volume was similar to 2015 level; a truly historic five-year setback.

This section offers a twofold summary of the changes in the capital account balances of the resident sectors: firstly, it presents some of the key reasons underlying the 2013-2019 improvement, the severity of the 2020-2021 crisis and the relatively high GDP growth from the summer of 2021; and, secondly, it explores the different behaviour of the resident sectors (private and public) and the rest of the world and how these were reflected in finance flows. To this end, the first part starts by focusing on two critical aspects of the dynamics in both the expansion (2013-2019) and the pandemic crisis (2020-2021): on the one hand, the shift in employment and production towards service sectors with greater

personal interaction, which were the very sectors most affected by the pandemic; and, on the other, the decisive role played by the ECB from 2012 to 2021 and, in the context of the COVID-19 crisis, by the European Commission and its support programmes. With these aspects identified, the second part analyses changes in the financial balances of the resident sectors during the 2013-2019 growth phase and the severe disruption that occurred in 2020 and 2021. Finally, the third part shows how these changes in the behaviour of the resident sectors were reflected in the external balance, and presents, from the point of view of the balance of payments, some of the features underlying the long period of surpluses with the rest of the world that began in 2012, which, despite the reduction due to the effects of COVID-19, remain in positive territory.

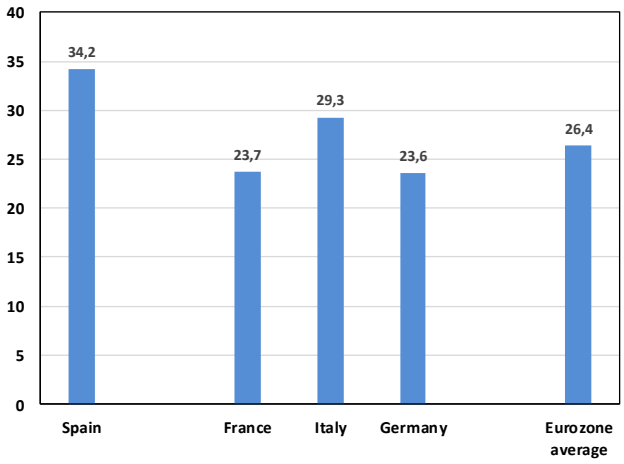
1.1. The framework of the COVID-19 response: production weaknesses and external support

The factors underpinning both the 2013-2019 recovery and the severity of the 2020-2021 shock are admittedly very diverse. This section does not intend to explore all of these, but instead highlights two factors to help shed light on the healthy employment and production situation during the recovery from the financial crisis, and on why, despite the sharp downturn that occurred in 2020-2021, the exit from the pandemic collapse was so swift, at least up until the end of 2021. This was the result, firstly, of the tertiarization of Spain's production system after the financial crisis and, in particular, the boost to personal services, which were the sectors worst affected by COVID-19; and, secondly, of the role of EU institutions (ECB and EC) in both the impetus that led to an improvement after the financial crisis and, more particularly, as a safety net in 2020-2021, when they kept the Spanish economy afloat despite the severe shock it had suffered.

The 2013-2019 recovery and the growing trend towards personal services

On the supply side, the main feature of the transformations that occurred in 2013-2019 was undoubtedly the rising tertiarization of production and, above all, the sharp increase in the contribution of sectors linked to services involving personal interaction (hospitality and catering, part of transport, trade, real estate and artistic and recreational activities). This change not only helps explain the strong boost to employment and economic activity during that period, but also accounts for the differences in Spain's COVID-19 recession with respect to other major EMU countries. Thus, between 2007 and 2019, the contribution of services to GVA increased by seven percentage points (from 68% to 75%) and to employment, measured by the EPA, by around 10 percentage points (from 66% to around 76%). This largely reflects the significant losses experienced in construction and industry during the crisis, together with the very positive momentum in personal services and also in services linked to the production system. The case of construction is paradigmatic; while it contributed around 12-13% to GVA and employment in 2007, its contributions had virtually halved by 2019 (6.5% in both GVA and employment), in line with average figures for Europe. By contrast, industry underwent dramatic growth between 2013 and 2019, with an annual increase of 2.7% in employment and 2.3% in real GVA, although its contribution to the economy as a whole in 2019 was 16% of GVA and 14% of employment, historic lows.

Figure 1. Employment in personal services, 2019 (% of total employment)



Source: Eurostat.

In the tertiary sector, the period 2013-2019 was characterized by the diversion of resources towards sectors more exposed to competition and the expansion of some tertiary branches with direct or indirect links to the external sector (trade, transport, hospitality and artistic and recreational activities), while traditional sectors, such as trade and financial services, began to experience the first hardships of technical change. Overall, personal services in 2019 contributed around 29% to GVA generated in Spain and almost 34% to employment. Just as significantly, if not more so, they contributed a third of GVA growth and 36% of the more than 2.6 million new jobs created. This contribution far outstripped that of other major EU countries; by about 10 percentage points compared to Germany and France,

five percentage points compared to Italy and eight points compared to the eurozone average.

This growing role of personal services in production and employment gained relevance in light of COVID-19 and, above all, of the gap compared to other major eurozone countries, although it is important to highlight the public sector's reduced capacity to meet the needs created by COVID-19 (which was lower than that of other Central European countries due to the high volume of its debt in 2019, which stood at 95% of GDP). In fact, empirical evidence reveals that the impact of the pandemic was greater in economies with a higher share of services (André Sapir, 2020; Meyermans et al., 2021; Gómez y del Río, 2021; Battistini and Stoevsky, 2021). Thus, compared to the average drop in Spanish GDP of 10.8%, GVA in trade, transport and hospitality in 2020 shrank by 26% and in artistic and recreational activities by 25%, while the reduction was less severe in employment (EPA) as a result of the furlough scheme (-2.7% in trade, -3.8% in transport, -16.6% in hospitality and -4.5% in artistic and recreational activities).

Europe and the Spanish economy: ECB support in 2011-2019 and the 2020-2021 changes

At the start of the recovery in 2013-2014, the extremely high levels of internal and external indebtedness represented the main burden for future GDP growth. In particular, the deleveraging involved led to major difficulties in domestic demand as a driver of growth; these were compounded by the fall in productive investment (-29.8% between 2007 and 2013), the severe employment contraction (close to four million full-time equivalent jobs lost, around -19%) and the necessary sectoral repositioning. In addition, there was a loss of momentum in R&D investment, which conditioned future growth. Given these circumstances, it is no surprise that the IMF stated that the potential growth rate of the Spanish economy had fallen to 1.5% per year when the country emerged from the financial crisis in 2014. However, the 2013-2019 recovery saw particularly significant growth in output and employment; in terms of GDP, the levels generated in 2007 had already been recovered in 2016 (annual growth in real terms of 2.6%), although the 2.6 million new jobs (EPA) were still a far cry from pre-crisis levels.

The reasons underlying this positive performance are diverse: within the country, they include the shift of activity towards sectors more closely linked to foreign demand; and from abroad, the decisive contribution of the ESM to the restructuring of the financial system and the critical role of the ECB (Oliver Alonso, 2017), a reflection of the notable rise in its balance sheet (from 20.5% of GDP in the euro area at the end of 2009 to around 40% at the end of 2019) and the subsequent fall in interest rates.

In fact, since 2014, the role of the ECB has substantially shifted from its traditional function as lender of last resort and guarantor of the stability of the financial system to one of sustaining and boosting market prices and, indirectly, alleviating the financial burden on the private sector and, in particular, on the public sector. With respect to its traditional role, the special system designed to deal with the euro crisis, the 2011 and 2012 LTROs, has become a regular mechanism; TLTRO I was launched in June 2014, followed by TLTRO II in March 2016 and TLTRO III in March 2019. After successive extensions, these were extended until the summer of 2022, together with a new long-term financing instrument (at interest rates of -0.25%), the PELTROs. Overall, long-term credit reached €642 billion in December 2019 (from €430 billion in December 2014); meanwhile, the asset purchase programme (APP), which started cautiously in 2009-2012, broadened its scale from 2014 onwards, such that, just before COVID-19 hit in January 2020, its balance sheet had expanded to €2.6 trillion. The COVID-19 crisis has accentuated this process: first, with the maintenance of asset purchases under the ordinary programme at €20 billion a month and its expansion in March 2020 by a further €120 billion in new purchases until December; and, second, and even more importantly, through the pandemic emergency purchase programme (PEPP), a programme designed specifically to combat the effects of COVID-19. This was initially endowed with €750 billion and, after successive increases, was set at €1,850 billion, €1,547 billion of which had already been used by November 2021 (about 13% of eurozone GDP).

Until 2019, the Eurosystem's involvement in Spain had been especially relevant. The purchase of mainly public Spanish securities accrued in the balance sheet of the Bank of Spain in February 2020, just before the pandemic, totalled €336 billion, around 27% of Spanish GDP. In addition, it should be noted that the reinvestment of the amortized amounts effectively diverted these securities from the markets, which helped create a perception of these as a kind of perpetual debt. This obviously helped keep prices high and, therefore, reduced the profits they generated. When the credit resources received directly by the Spanish financial sector (26% of GDP on average in 2012-

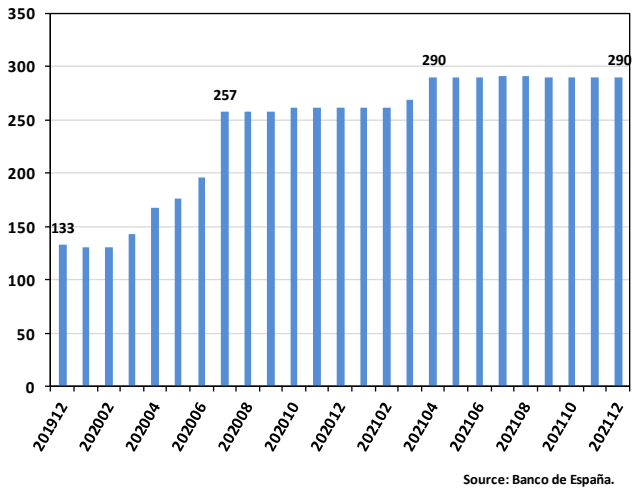
2019, around €130 billion in long-term financing operations in February 2020) are added to the asset purchases, the total funds allocated by the ECB to the Spanish economy just before the pandemic hit were exceptional; the Bank of Spain's balance sheet in monetary policy operations (asset purchase programme and long-term credit) increased substantially from 14% to 41% of GDP between 2012 and 2019 (from €150 to €463 billion).

Including pandemic-related measures, the resources injected by the Bank of Spain into its asset purchases (especially public debt) up to October 2021 increased by about €234 billion (from €336 billion in February 2020 to €571 billion in October 2021), while long-term loans to banking increased by a further €159 billion to reach €289 billion by October 2021. Thus, the monetary policy operations on the Bank of Spain's balance sheet (asset purchases and long-term credit) accounted for an extraordinary 71.5% of Spanish GDP in the second quarter of 2021. In short, this increase has virtually doubled its share of GDP and reflects the key role played by the ECB in the financial stability of the Spanish public sector and Spain's other resident sectors.

The effects of this massive intervention were threefold. First, it precluded the possibility of a new phase of imbalances in the eurozone, as initially occurred in March 2020 with the channelling of funds abroad in the form of deposits (Álvarez et al., 2021) and the problems presented by Italy in March 2021.

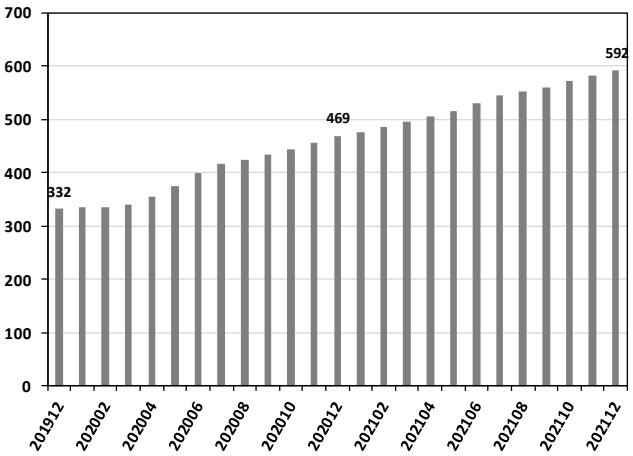
Figure 2. Increasing ECB intervention

a. Long-term credit (LTRO and TLTRO) to Spanish banks, 2019-2021 (billions of euros)



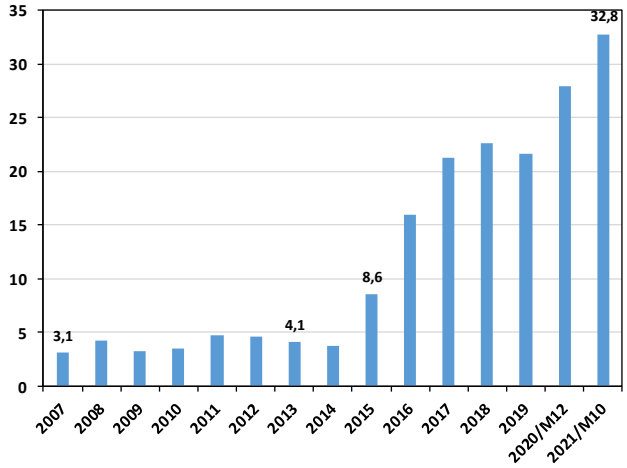
Source: Banco de España.

b. Asset purchases from the Bank of Spain (billions of euros)



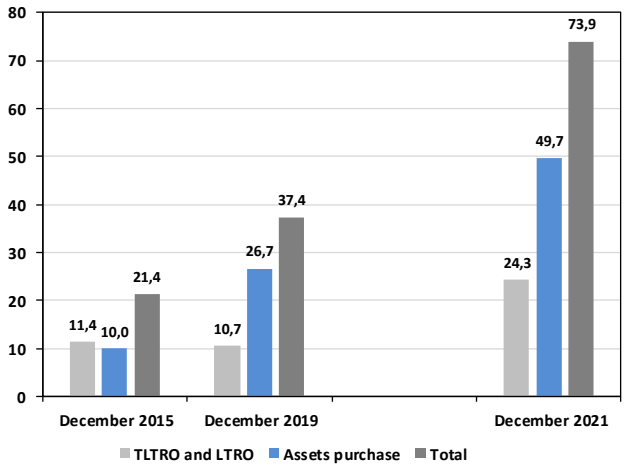
Source: Banco de España.

c. Government bonds and notes in the Bank of Spain's assets, 2007-2021 (% of total)



Source: Banco de España.

d. COVID-19 and the increase in the Bank of Spain's balance sheet due to monetary policy operations, 2015-2021 (% of GDP)



Source: Banco de España.

Second, confidence in the financial stability of the Spanish economy resulted in a significant reduction in interest rates; in September 2021, 10-year interest rates on long-term Spanish public debt were 0.33%. Meanwhile, five-year bond yields were negative; at the three-year and five-year bond auctions, they stood at -0.51% and -0.37%, respectively. This was reflected in a risk premium of 10-year Spanish government bonds of 60 basis points compared to the German equivalent, values not seen since before the financial crisis. Finally, by reducing potential upturns in interest rates and keeping these at levels unheard of in the last decade (and some public debt rates at historic lows), the financial needs of the public sector in 2020 (in excess of €300 billion) were met without difficulty, while the public debt burden was reduced significantly; the same happened in 2021 with the financing of the budget deficit and the refinancing of the proportionate share of the debt. Likewise, the interest rate compression had a positive impact on the income of households and NFCs, although its impact on FIs was negative.

In short, the European intervention in Spain's financial stabilization in 2011-2012 and the highly favourable monetary conditions generated by the ECB in 2014-2015 laid the foundations for the 2013-2019 expansion; against this backdrop, the ECB's continued and expanded involvement during COVID-19, in addition to the suspension of the Stability and Growth Pact and Next Generation EU funds, provided the framework for changes in the behaviour of households, NFCs, FIs and PAs, and its translation to the external sector, which are analysed below.

1.2. Moderate private surpluses in 2013-2019 and high public needs in 2020-2021

One of the defining features of the 2013-2019 recovery was the change in both demand (from domestic to external) and supply (from sectors protected from international competition to sectors more open to competition). How were these reflected in the financial balances of the private and public sectors? Private consumption during those years advanced at an annual rate of 2.2%, although consumption of durable goods did so at a higher pace (6.7%), which reflected the pent-up demand during the worst years of the recession (González and Urtasun, 2015). At the same time, the savings rate decreased; given that investment increased at rates close to 5% per year, the balance of households' capital account showed a clear reduction (average decrease of 1.1% of GDP). In short, the fall in savings, the increase in investment and the reduction in financial surpluses defined the behaviour and financial performance of Spanish households in the post-financial crisis recovery and just before COVID-19 hit.

This dynamic was substantially altered by COVID-19. In 2020, household confidence was dramatically affected by uncertainty about the future evolution of the pandemic and its effects on activity and employment (despite the furlough scheme, employment in 2020 fell by 3%). In addition, although the SURE programme, the self-employed worker protection programme and other measures helped contain the drop in disposable family income, it still ended up falling by 3.3% in real terms. In this context characterized by lower incomes and greater uncertainty, consumption was severely reduced, in part due to the inability to consume certain goods and services and even to postpone expenditure (especially in relation to certain services), such that it fell by an unheard-of 12% in real terms. In the third quarter of 2021, this reduction was still 8% lower than consumption during the same period of 2019 (Christelis et al., 2020).

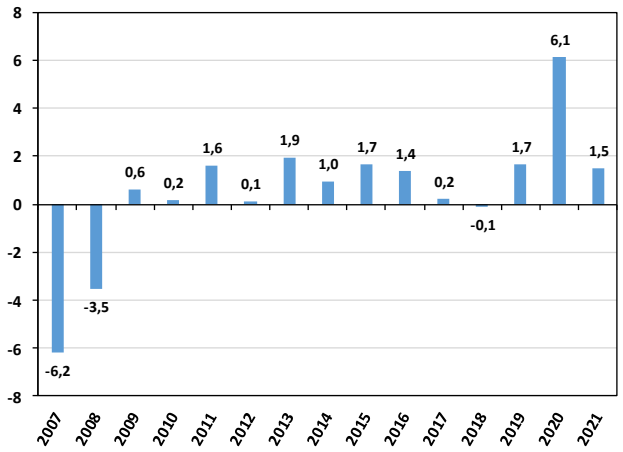
In 2020, this contraction of expenditure, which was much steeper than the decline in income, meant that household savings increased to levels not experienced in recent decades. This was partly due to the lockdown (Rio and Cuenca, 2020; Dossche and Zlatanos, 2020) but reflected, to a greater extent (Christelis et al., 2020; Bank of Spain, 2021), the rise in precautionary saving due to the potential financial implications of the pandemic. This savings rate in 2020 was 9.7% of GDP, which was much higher than figures recorded during the lowest points of the financial crisis (2009-2010), when it stood at around 7%. Given that household investment contracted only moderately, the financing capacity of households also reached a historic high (6.5% of GDP), a surplus of resources that, according to the European Commission, should revert to around 1% of GDP on average in 2021-2022.

With regard to NFCs, sectoral changes (reduced contribution of construction) and investment changes meant that their savings in 2013-2019 were close to 17% of GDP, compared to an investment figure more than three points lower. This generated a financing capacity of around 4% of GDP, a departure from the trajectory experienced during similar growth periods. With COVID-19, the positive impact of cash injections (ICO-guaranteed bank loans), credit arrears and deferrals in some taxes helped absorb part of the drop in income.

Thus, given the reduced savings rate of SNFs (close to 1.4 points of GDP) and the less severe fall in investment (one point less), their financing capacity barely changed, at 2.4% of GDP in 2020. In the sector, the companies facing the greatest difficulties (measured by NPL ratios higher than 3.1% of the corresponding bank assets in March 2021) were those engaged in trade, hospitality and, above all, artistic and recreational activities (European Banking Authority, 2021), with a higher share of vulnerable SMEs (European Central Bank, 2021a).

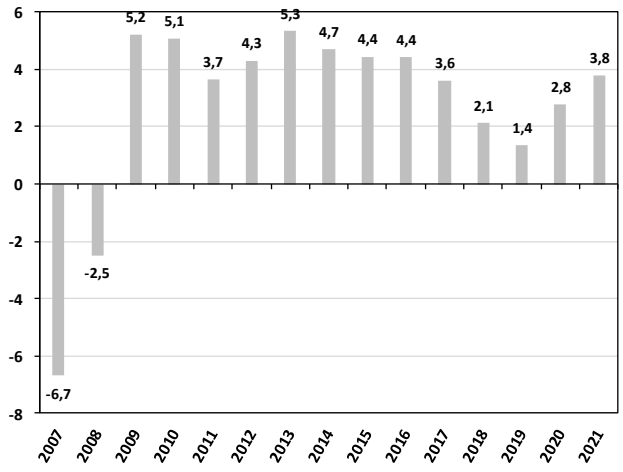
Figure 3. Financing capacity/needs in the Spanish private sector, 1981-2021 (% of GDP)

a. Households



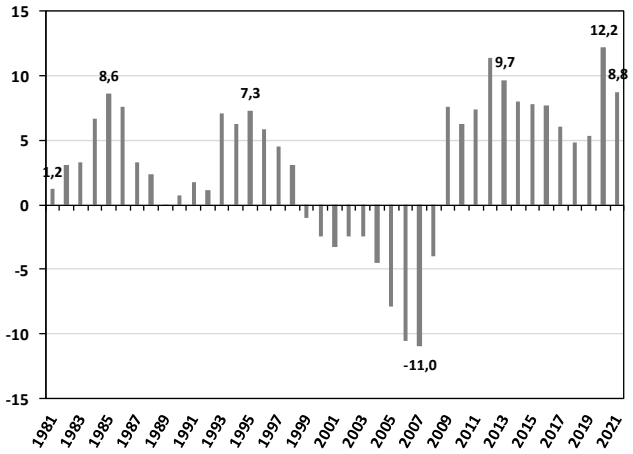
Source: Banco de España.

b. Non-financial corporations



Source: Banco de España.

c. Total private sector (households, NFCs and FIs)



Source: Banco de España.

Overall, the financing capacity of households and SNFs in 2013-2019 stood at around 4.7% of GDP; when the capacity generated by the financial sector (2.3%) is included, the private sector as a whole (financial and non-financial companies and households) presented a financing capacity of 7.1% of GDP in 2013-2019, thus reversing the shortfall in resources it had generated in the 2001-2007 expansion. COVID-19 gave rise to a notable leap in this contribution, so that surplus resources in the private sector in 2019 increased to 12.1%, an unprecedented level that exceeded the historic high of 2012 (11.3%) and was well above figures experienced in previous crises (8.6% of GDP in 1985 and 7.3% in 1995). This trend continued in the year up to the second quarter of 2021, when it stood at around 10% of GDP.

With respect to the public sector, the high deficit volumes in 2013-2019 did not reflect over-investment (an average of 2.2% of GDP, far from the 4.1% of 1999-2007), but negative public saving figures; an average of -2.3% of GDP in 2013-2019 that spiralled to -11% in 2020. This dissaving, in turn, was not a reflection of spending that could ever be described as excessive; in 2015-2019, Spain's expenditure stood at 42.3% of GDP on average, about five points below the 47.4% of the EMU, a long way from that of France (56.3%), Belgium (52.6%), Italy (49%), Germany (44.5%) and the Netherlands (43%), and only above that of Ireland (26.8%), Romania (35.1%), Bulgaria (36.6%) and Latvia (38.5%). In short, Spain's government deficit in 2020 was an elevated -11%, similar to 2009 levels, but decreased moderately to -8.7% in the year up to the second quarter of 2021.

1.3. External financing flows and balance of payments: a decade of surpluses

The most substantial change in Spain's economic performance in recent decades occurred during the 2013-2019 recovery: a lengthy episode of external surpluses that continued in spite of COVID-19, the 10 years between 2012 and 2021 represented the longest sustained period of surpluses with the rest of the world and far exceeded the average of other such periods, although these were always shorter and the surpluses not as high (1971-1973, 1984-1986 and 1995-1997).

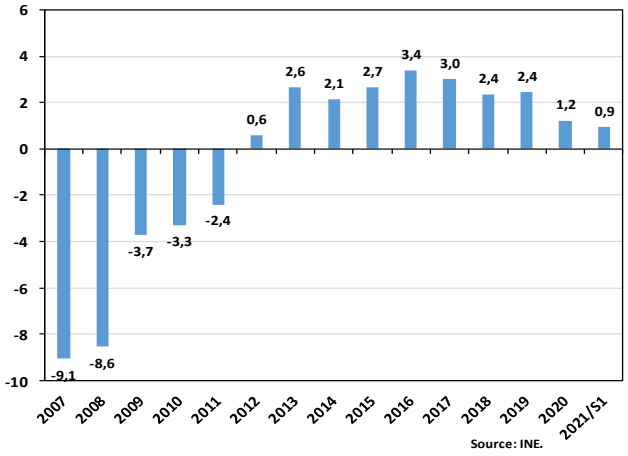
From the demand side, this change reflects the shift from domestic to external demand. The latter's contribution to GDP growth has been consistently positive, a trend that, despite COVID-19 and its effect on the external sector, continued into 2020 and early 2021. The 2013-2019 post-financial crisis recovery phase was not characterized by the typical shift from external to domestic demand, thus breaking with a tradition dating back to the 1960s. This was reflected in an unprecedented structural change in the GDP share of exports of goods and services (Gutiérrez Chacón and Martín Machuca, 2019), from 26% of GDP in 2007 to 33% in 2013 and 35% in 2019, an extraordinary rise of almost 10 points before the pandemic shock. Obviously, the particular circumstances of foreign trade during the COVID-19 crisis, when sales abroad fell by more than 20% (loss of 9.2% in goods and 43.2% in tourism services), caused its contribution to drop to 31% of GDP in 2020, although it had already started to recover in the first half of 2021 (up to 32.7%). This structural change in the GDP share of international sales of goods and services was accompanied by a reduction in the elasticity of imports with respect to GDP (Myro, 2018).

Until the 2008-2012 financial crisis, the external deficits reflected the traditional shortfall in domestic savings to finance the investment carried out the country, made possible by Spain's membership of the euro, which helped surmount the customary external restriction of resources to finance part of the investment; this was the Spanish version, in the context of the EMU, of the Feldstein-Horioka puzzle (Feldstein and Horioka, 1980). In this new context, families modified their traditional behaviour as fund generators and began a previously unheard-of process characterized by a growing need for resources, which was accompanied by the traditional needs of NFCs in expansions. Thus, at the end of the boom in 2007, the capital account balance of the non-financial private sector (households and NFCs) fell to unprecedented levels, which was reflected in a growing external deficit (EuropeG, 2012; Oliver Alonso, 2017).

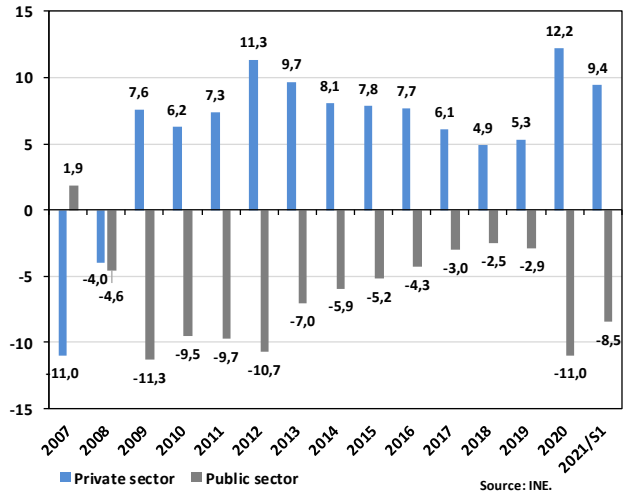
The financial crisis led to a sudden and profound shift in the behaviour of the private sector (households, NFCs and FIs), which gave rise to a remarkable change in the sign and level of its capital account balance in 2007-2012 (Arce et al., 2017), from -11% of GDP to +11%; this was an improvement of 22 percentage points, which revealed the strength of the private sector adjustment during those years. After that high point, and once the crisis of confidence in the financial sector and the country's external stability had been overcome, the surpluses of the non-financial private sector underwent a continuous reduction until they reached 5.3% of GDP in 2019. This decrease was virtually offset by a similar change in the negative balance of PAs (from -7.0% in 2013 to -2.9% in 2019), while the surplus resources of FIs remained at around 2% of GDP.

Figure 4. Spain's external financing capacity/needs, 2007-Q2 2021 (% of GDP)

a. Total



b. Breakdown by sector



This three-way combination of lower surpluses in the non-financial private sector, surplus stability in FIs and a fall in the financing needs of the public sector sustained the surplus with the rest of the world, whose balance shifted from an extraordinary -9.1% in 2007 to 2.6% in 2013 and 2.4% in 2019. Although the pandemic caused a sharp deterioration in the public deficit (again in the order of -11.0%), this was offset by the dramatic increase in the private sector's financing capacity, which allowed the external balance to remain at 1.2% of GDP.

This long decade of external surpluses reflected a structural shift, with notable changes in the sign and value of the main current account balances: from deficit to surplus in non-energy goods and non-tourism services; a substantial reduction in the energy deficit; an increase in the surplus in tourism services; and, finally, loss of the deficit in primary incomes and maintenance of the deficit in secondary incomes. This series of changes were diverse in nature: in the balance of goods and of non-tourism services, they included improved competitiveness, expansion of the export base and a fall in the elasticity of imports with respect to domestic demand (International Monetary Fund, 2017b; Bank of Spain, 2018b); in tourism, competitiveness improved, flows were diverted from North Africa and Turkey, and income in the eurozone recovered; in energy, oil prices fell; and, finally, in primary income, interest rates decreased, and in secondary income, migrant remittances were maintained. In short, these were aspects with disparate characteristics; some of them were permanent but others were temporary or cyclical in nature, although there is only partial consensus in this respect. Thus, while some authors (Myro, 2018) argue that a structural change took place in both export capacity and the reduced imports, other studies (Bank of Spain, 2017; 2018b) estimate that more than half the improvements to the 2007-2018 current account balance were transitional in nature, while 40% of the correction would be permanent. In addition, half of the latter would derive from the reduced structural component of the public deficit from 2010, while a further 20% would be the result of the effects of ageing, lower growth and competitiveness gains (Moral-Benito and Viani, 2017).

In light of the radical change in the external balance, it makes sense to question the extent to which this process was specific to Spain, i.e. a reflection of the measures taken in the country, or whether it was the result of EU intervention. The answer is that it appeared to be a widespread process in the majority of peripheral eurozone countries. Thus, the increased contribution of exports of goods and services to GDP in Spain was part of a more general pattern across the whole of the EMU (from 40% in 2007 to more than 48% in the second quarter of 2021) and, in particular, in the peripheral countries (Ireland, Portugal, Italy and Greece). With respect to the aggregate external balance, Spain's 2.4% external surplus in 2019 was comparable to that of Italy (3.1%), although it exceeded that of Portugal (1.3%) and Greece (-1.1%). Even the reduction in surpluses in Spain's private sector during the 2013-2019 recovery period was, at least to some extent, a common trend, although the Spanish process was more intense.

These similarities are relevant, given that they point to the role of common external factors in the internal reforms forced by austerity programmes and market pressure (reversals and sudden stops of capital flows) and by the prevailing tailwinds in the 2013-2019 recovery (low interest rates, a relatively weak euro, oil and geopolitical factors). Thus, for Spain and the rest of the periphery, being part of the euro has meant adopting policies similar to those relating to the gold standard for the weakest countries in the 1920s (Eichengreen, 1995), which has forced them to reform their economies to prevent capital outflows to the most creditworthy countries, as occurred with gold exports back then. In any case, and in light of the COVID-19 shock and the continued surplus with the rest of the world, it could be claimed that German discipline has been successful, given that it has corrected the external financing problems of countries with external account stability issues, with the notable, though partial, exception of Italy. This discipline corresponds to the German vision of the nature of the crisis that, based on its narrative, reflected the build-up of competitiveness losses and that, therefore, could only be overcome by correcting them (Sinn, 2014).

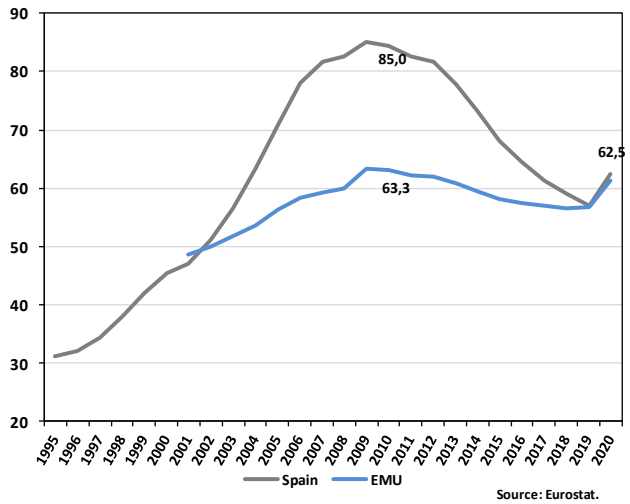
2. From flows to stocks, 2013-2021: private vulnerabilities and reversal of deleveraging

Despite changes in the behaviour of Spain's resident sectors, the debt accumulated by the private sector during the expansion (1997-2007), by the public sector during the Great Recession (2008-2012) and in relation to the external sector (1997-2012) continued to loom large after the financial crisis. Although the emergence of surpluses in the capital account of the resident sectors

was a prerequisite for reducing the high debt volumes (International Monetary Fund, 2017d), redirecting them towards sustainable values required that changes in the performance of the resident sectors and nominal increases in GDP continue for long periods of time (Pierlugi and Sondermann, 2018). To that end, this paper will now review the debt dynamics in the various resident sectors.

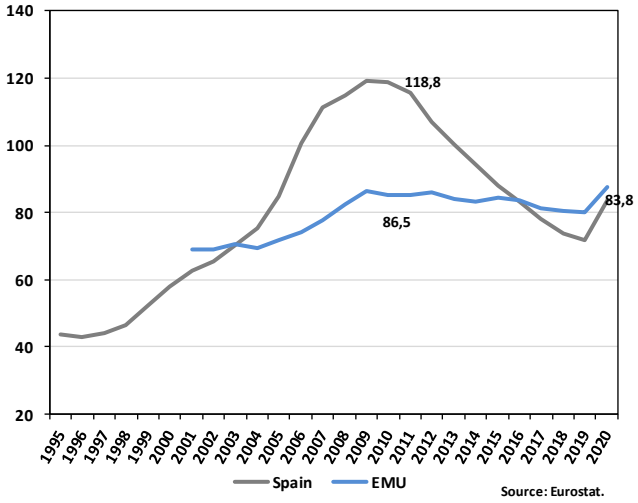
With regard to households, the intense deleveraging process that began in the years prior to the recovery continued in 2013-2019, with a reduction in debt close to 20% of GDP (from 78% to 57%); as a result of the fall in GDP and the reduction in household credit, this ratio rose to 63% of GDP in 2020, a value in line with the average of the EMU, although still a far cry from Spanish values in 1997-2001 (41%) and those of Germany (54.4%) and Italy (41%) in 2019. Moreover, the European Commission assessed the Spanish situation just before COVID-19 (European Commission, 2020a) and stressed that, although Spain's figures for 2019 were lower than the benchmark defined by the MIP, household indebtedness remained excessively high according to the metrics defined specifically for these imbalances in Spain.

Figure 5. Debt ratios (total consolidated liabilities) of Spanish households and the EMU, 1995-2020 (% GDP)



In addition to these household deleveraging dynamics, the NFC deleveraging process (Maudos and Fernández, 2016) also presented a substantial drop in 2013-2019 (from 100% to 73% of GDP in consolidated terms), such that the production sector went into the COVID-19 crisis with significantly healthier balance sheets (International Monetary Fund, 2020), although still in need of debt reduction (European Commission, 2021c). Furthermore, the type of liabilities held by NFCs changed during that time, with bank credit being replaced by indebtedness for larger firms (Bank of Spain, 2018a). This freed up credit resources for large companies and SMEs whose debt was not eligible to be used as collateral in ECB loans (Bank of Spain; 2017; Arce et al., 2017 and 2019). Finally, the effect of COVID-19 on the debt ratio of NFCs was equally intense, due to both the GDP contraction and the rise in indebtedness, partially financed through a bank loan guaranteed by the ICO up to 120 billion. Consequently, the debt of non-financial entities rose to 85% in 2020, a figure lower than the EMU average in 2019. As occurred with households, however, the benchmarks defined specifically for corporate debt in Spain indicated that its value was above reasonable levels.

Figure 6. Consolidated debt ratios of NFCs in Spain and the EMU, 1995-2020 (MIP definition: debt securities and loans) (% GDP)

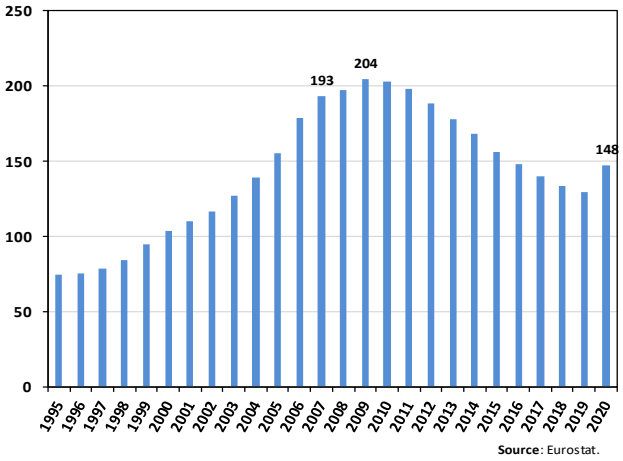


The fact that the private debt of households and NFCs remains about 53 GDP points above 1997-2001 figures bolsters the evidence that reducing indebtedness in recessions following loan-financed residential construction booms is a long, drawn-out process and returning to previous values tends to happen slowly (Claessens and Kose, 2013; Kannan et al., 2013), a process similar to that of the credit-to-GDP ratio that took place during the expansion (Tang and Upper, 2010). However, although the deleveraging process could not be considered complete in 2019, the balance sheet during the financial crisis and the subsequent recovery were certainly rather positive (García-Vaquero and Casado, 2019); between 2010 and 2019, the Spanish private non-financial sector had reduced its (consolidated) indebtedness by about 70 GDP points, from 203% to 130%, although the COVID-19 crisis in 2020 increased it to 148%, a figure in line with the EMU average. Thus, this debt in 2020 was below that of the

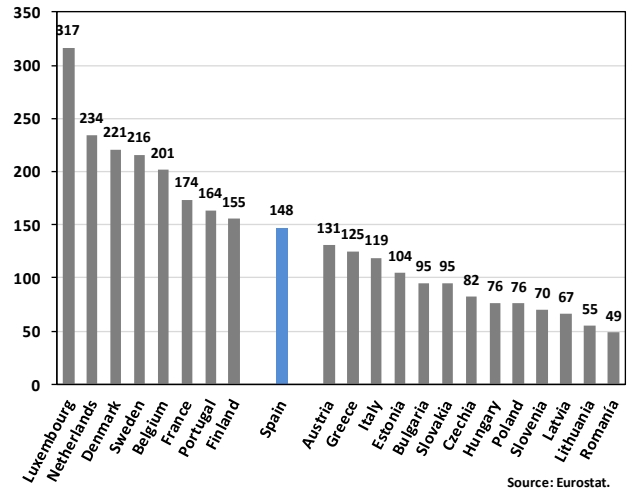
Netherlands (234%), Denmark (221%), Sweden (216%), Belgium (201%), France (174%), Portugal (164%) and Finland (155%), although still far from the Spanish average of 1997-2001 (94%) and 2019 figures for Italy (119%) and Germany (105%). As with the debt of households and NFCs, the Commission estimated in 2019 (European Commission, 2020a) that the reference value for total private sector indebtedness, based on the main economic indicators, was still 25% higher, while the maximum prudential level (the level of indebtedness from which the probability of a banking crisis increases) was 30% higher.

Figure 7. Consolidated private debt in Spain and some euro area countries, 1995-2020 (% of GDP)

a. Spain, 1995-2018



b. Euro area, 2020

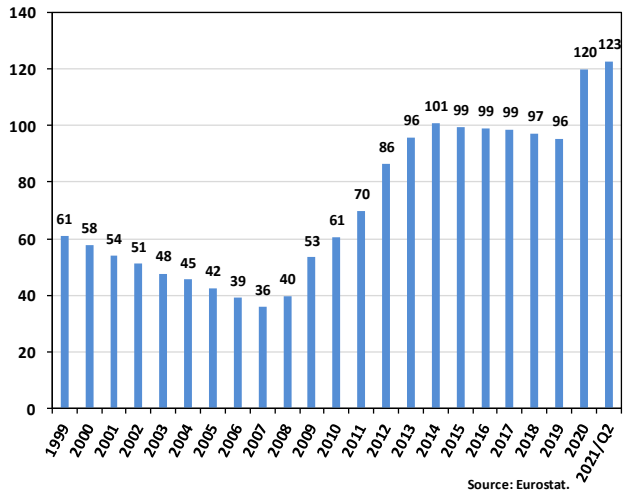


The contraction in the bank credit balance was decisive in the process to reduce private debt; between 2009 and 2019, this decrease was virtually identical to that of private debt, close to 75 GDP points (from 172% in 2009 to 96% in 2019), although it stood at 106% in June 2021. Its sharp decline just before COVID-19 reflects, together with the increase in nominal GDP, write-offs and take-over of losses by the banking sector, especially that aimed at construction and the real estate sector, which in 2019 contributed just 21% of the amount extended to the production sector. This figure was similar to the average for 1997-2001 and has fallen even further in the context of COVID-19 (to 19.1% in June 2021). Despite this adjustment in bank credit, the reduction is far from complete. This need is reflected in its theoretical excess (the difference between the share of GDP and of credit to the Spanish private sector in relation to the EMU total); according to this indicator for the end of 2020 (9.7% of GDP and 10.3% of credit), this excess would still be around €73 billion, a figure well below the more than €730 billion achieved in 2008 at the height of the credit expansion.

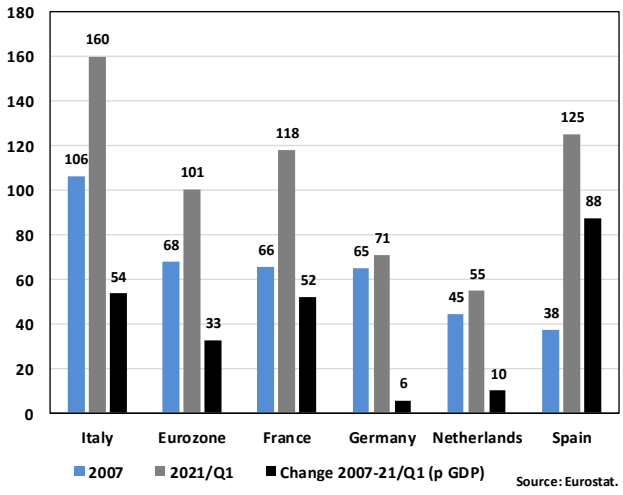
Finally, between 2013 and 2019, as a reflection of the credit stock contraction, non-monetary and monetary financial institutions (except the Bank of Spain) also presented a substantial reduction in their enforceable liabilities, which, at the lowest points of the crisis (2011-2012), led to the intervention of the ECB (with its LTROs of December 2011 and February 2012), the subsequent intervention of the ESM to finance the bank restructuring process (July 2012) and, finally, the ECB's announcement concerning the potential launch of the OMTs, should they be necessary to stabilize the situation (September 2021). Thus, while liabilities other than deposits and shares of non-monetary and monetary financial institutions (except the Bank of Spain) amounted to 127% of GDP in 2013, these had decreased by more than 32 GDP points by the end of 2019, to 95%. Specifically, this fall was greater in absolute terms for non-monetary financial institutions (insurance companies and similar), with about 20 GDP points (from 80% to 60%), while monetary institutions (except the Bank of Spain) reduced them by about 12 GDP points (from 47% to 35%), which reflected the credit crunch that followed the previous boom. This adjustment is highly relevant. The fact that the non-monetary and monetary financial sector (except the Bank of Spain) managed to reduce its enforceable debt by around 30 GDP points is noteworthy, given its role in the severity of the 2011-2012 financial crisis and the fact that a significant number of these liabilities with the rest of the world were enforceable.

Figure 8. Public debt in Spain and some euro area countries, 1995-Q2 2021 (% of GDP)

a. Spain, 1999-Q2 2021

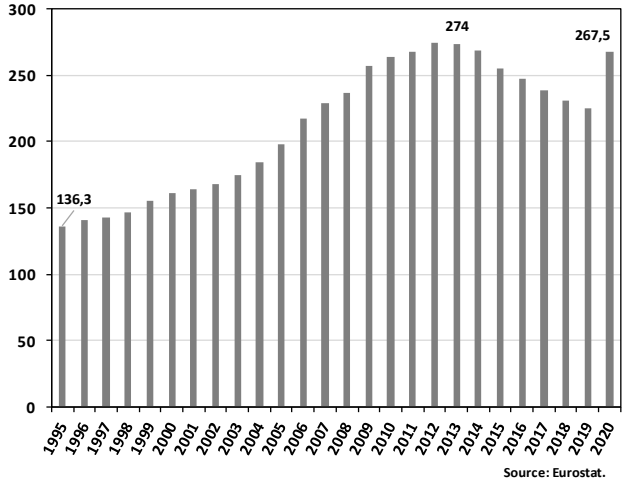


b. Eurozone countries, 2007 and Q1 2021



Finally, with respect to the indebtedness of PAs, substantial changes have also occurred that must be evaluated with caution in relation to the vulnerabilities of the Spanish economy. Taking into account the effects of COVID-19, and up to the second quarter of 2021, four of these are worth highlighting: the strong increase in public liabilities, up to about 176% (unconsolidated financial accounts) and 122.9% of GDP, according to the EDP; the strong concentration in FIs (whose contribution to GDP increased from 42% to 69% between 2013 and Q2 2021 (although a significant portion is held by the Bank of Spain) and the rest of the world (above 54% of public debt in Q2 2021, from 37% in 2013); the increase in average maturity to more than seven years; and, finally, the significant contraction of the financial burden, from values close to 3.5% of GDP in 2013 to 2.2% of GDP in the second quarter of 2021. Alongside these characteristics, COVID-19 gave rise to new developments that will leave longer-term scars: firstly, a sharp increase in gross financing needs that reached about 25% of Spanish GDP in 2020 and 2021, significantly higher than before the crisis (European Commission, 2021c), which represents a troubling weakness (Bank of Spain, 2021); and, secondly, a structural increase in public debt beyond the first post-COVID financial years. With regard to this aspect, the Commission estimated just before the pandemic (European Commission, 2020a) that, in its baseline scenario, the gross debt of PAs would remain virtually unchanged until 2030, at around 95-96% of GDP, a forecast that was strongly revised upwards in early 2021 (European Commission, 2021a) to 137% of GDP by the end of the decade; however, subsequent estimates have reduced it to 117% of GDP in 2031 (European Commission, 2021b), a figure in line with those of the International Monetary Fund for 2025 (International Monetary Fund, 2021). Despite this stabilization, the Debt Sustainability Analysis conducted in 2021 showed that Spain was among the seven countries (together with Belgium, Greece, France, Italy, Portugal and Romania) with high sustainability risks in their medium-term public finances.

Figure 9. Debt[1] of the non-financial sectors (private and PAs) in Spain, 1999-2020 (% of GDP)



1. Consolidated private debt according to the MPI criterion (debt securities and loans) as the sum of the consolidated liabilities of households and private non-profit institutions (PNPIs) and NFCs. Debt of PAs defined according to the excessive deficit procedure.

From an aggregated point of view, the pandemic caused a sudden halt in the deleveraging process in the resident sectors, which aggravated the imbalances that already existed before the COVID-19 impact highlighted by the European Commission in 2020 and, in particular, in 2021 (European Commission, 2021c). Given the upward dynamics of the indebtedness of the non-financial private sectors and public sector during COVID-19, it is not surprising that the aggregate debt of the non-financial sectors of the Spanish economy (households,

NFCs and PAs) returned to virtually the same levels as after the financial crisis and absorbed practically the entire 2013-2019 deleveraging effort: in 2020, it stood at 268% of GDP, not far from the high of 275% in 2012. However, despite similarities in the 2021 and 2020 figures, its sectoral structure differed substantially with respect to the structure during the financial crisis; notable reductions in the debt of the non-financial private sectors, despite the increase due to COVID-19, were offset by the sharp increase in public debt.

3. Reduction in net foreign debt in 2013-2019 and the upward impact of COVID-19

It is widely accepted that the problem facing Spain during the lowest points of the 2011-2012 crisis was the refinancing of the foreign debt accumulated during the expansion (Reinhart and Rogoff, 2010; Obstfeld, 2012b; Shin, 2012; Catão and Milesi-Ferretti, 2013) because, in times of mistrust, the critical aspect in the financial stability of countries with excessive foreign debt is refinancing. This brings to mind a well-known weakness for emerging and developing countries: sudden stops or reversals of capital flows (Mendoza, 2002 and 2010; Waysand et al., 2012; Obstfeld, 2012a and 2012b), although the financial crisis in Europe extended this to the most fragile countries in the eurozone, as occurred in 2011-2012. At that time, it was essential that Spain obtain sufficient capital inflows to amortize or refinance the maturing liabilities (in the order of approximately €300 billion a year); capital outflows of close to €350 billion in 2012 met this need. The result? Inevitable losses in the value of financial and real assets, a significant rise in interest rates, a reduction in deadlines and an increase in country risk (the yield spread between 10-year Spanish public debt and the German equivalent reached a maximum of 548 basis points in July 2012). The capital flight could only be contained by the ESM, which intervened by financing the restructuring of the country's banks and, eventually, by the ECB's launch of the OMTs.

At that moment, in line with the fall in indebtedness in the resident sectors, a slow process to reduce external debt began, although this varies depending on the definition of external debt. The amount of external liabilities is not as relevant as the amount of external debt or the net international investment position (NIIP); the former constitutes the total owed by a country (regardless of whether or not it is enforceable), while debt encompasses only liabilities that generate interest or amortization payments, definitions that point to potential financing (or refinancing) problems; finally, the NIIP (difference between external assets and liabilities) is an indicator of a country's external solvency. These therefore represent two different approaches: financing (or refinancing) and solvency, although it is clear that the problems posed by the former, if not adequately addressed, may call the latter into question. Thus, the following is a brief overview of these three quantities in the 2013-2019 recovery, Spain's situation just before the pandemic and the effects this had on foreign debt, with a view to subsequently assessing the impact of COVID-19.

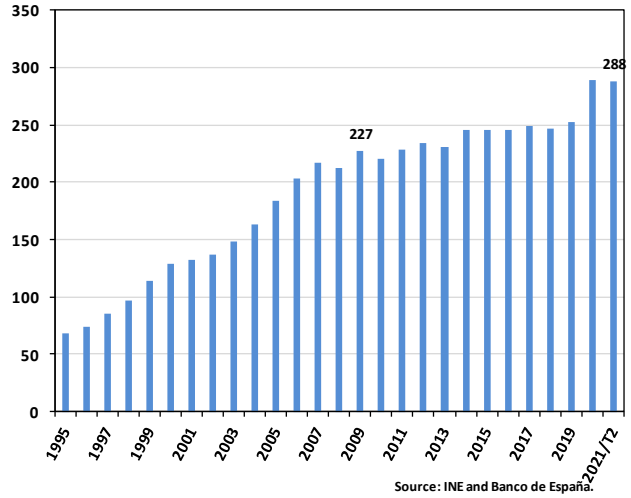
Nevertheless, the country's solvency (as measured by the NIIP) will also be addressed. Given the drastic changes in the debtor and creditor positions of the Bank of Spain and PAs, the subsequent section analyses how these changed during the recovery, while the last section extends the analysis to the NIIP.

3.1. Foreign deleveraging in 2014-2021: improvements up to 2019 and pandemic-related changes

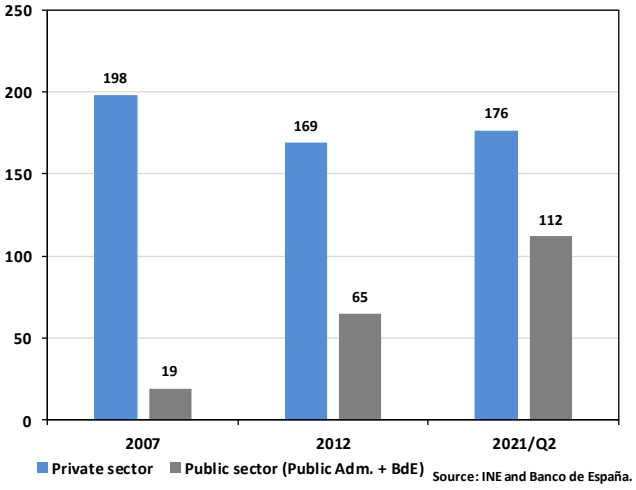
Thanks to its membership of the euro and despite strong progress made in the deficit with the rest of the world, Spain's financial assets abroad increased spectacularly, thus reflecting how Spain began to eliminate the country risk associated with the devaluations with which it had traditionally addressed its balance of payment crises. This increase was due to two different sources: growing external deficits in 1995-2007 and a marked expansion in asset purchases in the rest of the world (in those years, their contribution to GDP doubled, from 60% in 1997 to 132% in 2007). The financing of both processes (balance of payments deficits and asset purchases in the rest of the world) obviously occurred through a very sharp increase in liabilities with the rest of the world (from 85% of GDP in 1997 to 217% in 2007). However, this sharp rise only partially reflected the need to finance the growing external deficit during those years (the balance of the country's capital account changed from 0% of GDP in 1997 to -9.1% in 2007), but was associated primarily with the expansion of asset acquisitions by Spanish companies in the rest of the world.

Figure 10. Spain's external liabilities, 1995-Q2 2021 (% of GDP)

a. Total



b. Breakdown by sector



In short, Spain's model of financial integration with the exterior in the first decade of the 2000s was based on a sharp increase in its liabilities, especially those that were enforceable, to finance the negative external balance and the increase in creditor positions with the rest of the world. From the start of the 2013-2014 recovery, this pattern did not change; the bulk of Spain's asset acquisition in the rest of the world was financed with international debt (Alves et al., 2019), such that Spain's liabilities continued to grow even during the lowest points of the crisis (up to 230% of GDP in 2013) and extended into the recovery process. Thus, between 2013 and 2019, while the country's total external financing capacity reached just over €200 billion, the net change in assets approached €990 billion; with this, the total increased by about 39 GDP points in 2013-2019 (from 139% of GDP in 2013 to 178% in 2019, from €1.4 trillion to €2.2 trillion in nominal terms). COVID-19 boosted these acquisitions; between the end of 2019 and the first half of 2021, while the financing capacity totalled €26.2 billion, Spain's assets abroad increased by €222 billion (to 211% of GDP in the second quarter of 2021). With this, the 253% GDP share of foreign liabilities in 2019 increased abruptly in 2020-2021, to 288% in the second quarter of 2021. In this context, it should be noted that the rise in external indebtedness after the financial crisis took place despite the withdrawal of a significant part of international banking positions from the country (the "Grand Retrenchment" referred to by Milesi-Ferretti and Tille, 2011), which resulted in a substantial reduction in its positions: from a high of 1.1 trillion dollars in the first quarter of 2008, to 370 billion in the fourth quarter of 2016; since then, some degree of recovery has taken place, with values reaching around 490 billion in the first quarter of 2021.

Although the liability dynamics are reasonably close to the financial demands faced by the country, it is necessary to disregard the part that does not generate amortization or interest payments (Jiménez and Martín, 2017) that define external debt, a direct reflection of potential external vulnerability. With regard to this variable, changes also occurred during the recovery in terms of both the amount (at the end of 2019 external debt stood at around 164% of GDP, about 19 points above the figure for 2008) and composition (only partially FDI inflows, while other, less long-term, liabilities increased). With COVID-19, the external debt situation continued to rise and reached historic levels (198% of GDP in the second quarter of 2021), thus reflecting the fall in GDP and the increase in debt of the Bank of Spain, together with the rise in the value of liabilities caused by the reduction in interest rates.

3.2. Sectoral structure of external indebtedness in 2013-2021: the growing role of the Bank of Spain and PAs

The 2008-2012 financial collapse was directly related to both the volume to be refinanced abroad and the debtor sectors abroad; a substantial portion of the liabilities owed by the country were accrued in banking, which exacerbated the problems generated by capital outflows, restricted credit and made it difficult for PAs to issue public debt. This was the Spanish version of the banking crisis - public sector financing crisis - banking crisis loop, a situation that echoes other periods in modern European economic history; the failure to carry out publicly funded banks bailouts was a key feature of the Austrian and German banking crises of May-July 1931 (Straumann, 2019).

What were the dynamics of this indebtedness in the post-financial crisis recovery process and, in particular, how had its sectoral composition changed? This aspect is relevant, since the most significant changes that occurred between 2013 and 2019 related not to the total amount or the amount of the increase, but rather to the sectoral structure and, in particular, to the changes made to the external indebtedness by FIs, PAs and NFCs.

Thus, the payment problems of the worst years of the financial crisis (2011-2012) essentially reflected the very high external financing burden of the financial sector, which, as a whole, was responsible for a remarkable 106% of GDP, even in 2013. In addition to this debt position, that of non-financial corporations accounted for 83% of GDP, while PAs accounted for 33% of GDP. In total, external liabilities accounted for 231% of GDP. In the 2013-2019 recovery, two major changes occurred: the total amount increased to 253% of GDP in 2019; with respect to the debtor sectors, the aggregate debt of financial institutions (monetary financial institutions, the Bank of Spain and non-monetary financial institutions) barely changed (from 106% in 2013 to 110% at the end of 2019), while the external liabilities of PAs increased (from 41% to 53% of GDP), as did those of NFCs (83% to 90%). But the virtual stability of the debt position of FIs is equivocal; behind it lies a substantial change in composition, with a reduction in non-monetary and monetary financial institutions (excluding the Bank of Spain) and, at the same time, a sharp increase in the Bank of Spain's debts, a process that extended into the COVID-19 crisis. Thus, with respect to the first quarters of 2009 and 2021, there was a dramatic reduction in external liabilities in the former (from 87% to 55% of GDP), a reflection of the external deleveraging process in banking, after the long 1997-2007 boom in which the use of external wholesale financing was a key factor in supplying credit to the resident sectors. In addition, non-monetary financial institutions (investment funds, insurance companies, etc.) fell from 30% to 20%. However, while the high level of indebtedness in the financial sector reduced substantially, the existing risks cannot be underestimated.

By contrast, the Bank of Spain's external liabilities increased by about 50 GDP points (from 3% to 52%) in the same period (2009-2021), a dramatic development that was directly related to the Eurosystem's asset purchases, especially after 2015 with the regular acquisition programme and from April 2020 with the pandemic programme. The fact that these acquisitions from the issuing institution resulted in external liabilities indicates that a significant portion of those that corresponded to the Bank of Spain ended up on the balance sheets of institutions located in overseas financial hubs, mainly in the Netherlands and Germany, in the form of TARGET2 debit balances (Cecchetti et al., 2012; European Central Bank, 2013, 2016 and 2017; Praet, 2016; Baldo et al., 2017; Bank of International Settlements, 2017; Eisenschmidt et al., 2017; Couré, 2017; International Monetary Fund, 2017c; Alves et al., 2018; Arce et al., 2019). In addition, the amount generated by acquisitions within the country, insofar as they enabled the acquisition of assets in the rest of the world to be financed, also increased TARGET2 balances. Although this increase was nothing new, the nature of the factors driving it had changed.

Figure 11. Spain's external liabilities by sector, Q4 2009-Q2 2021 (% of GDP)

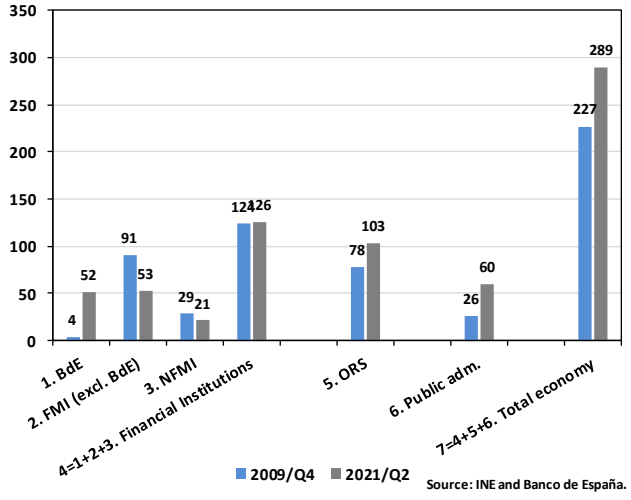
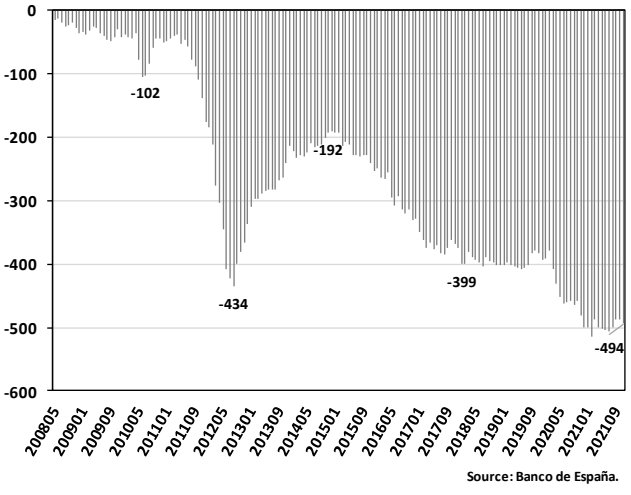
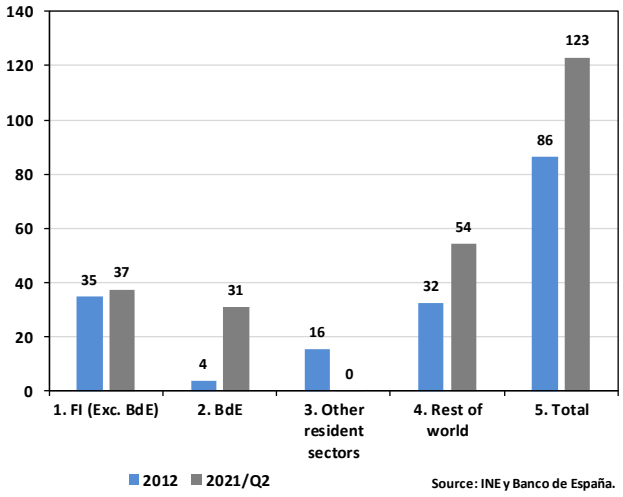


Figure 12. TARGET2 balances of the Bank of Spain (billions of euros)



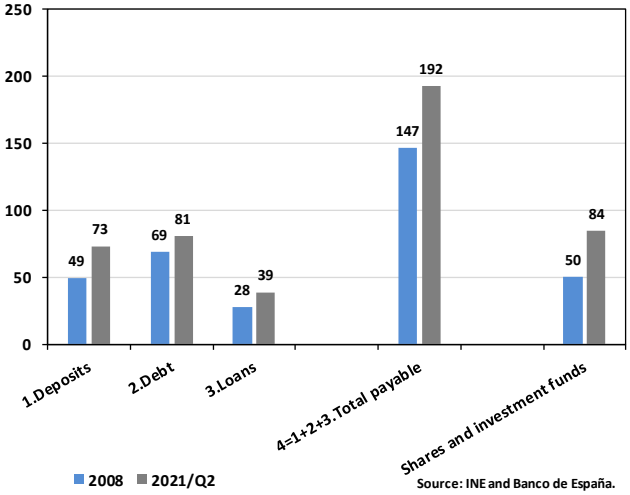
Another substantial increase occurred in 2008-2013, which reflected the mistrust in Spain's external solvency and the consequent outflow of capital (up to €434 billion in August 2012); after the intervention of the ESM and the ECB in the summer of that year, TARGET2 balances decreased substantially to €189 billion in December 2014, when they began to rise again (Martínez Pagés, 2016) to reach €378 billion in February 2020, just before the epidemic hit. With COVID-19 and the ECB's new asset acquisition programme (the pandemic programme), as well as continued purchases under the regular programme, they exceeded more than 500 billion in June 2021.

Figure 13. Debt according to the excessive deficit procedure (EDP) by counterpart sector (% of GDP)



In addition to this major change in the sectoral composition of external liabilities, two others are worth mentioning. First, the public debt held by the rest of the world increased considerably (from 37% of GDP in 2013 to 54% in Q2 2021). It is clear that, in 2010-2012, the trigger for the crisis was the weakness of the public sector and its inability to sustain the financial system, together with other solvency problems in the private sector. Although public debt increased to 120% of GDP in 2020, the current situation is stronger, since a significant proportion of these liabilities is held by the Eurosystem (Bank of Spain), despite the fact that the amount held by the domestic banking system has increased. Second, the increase in NFCs' liabilities vis-à-vis the rest of the world (from 83% of GDP in 2013 to 103% in Q2 2021) largely reflects capital inflows to finance FDI.

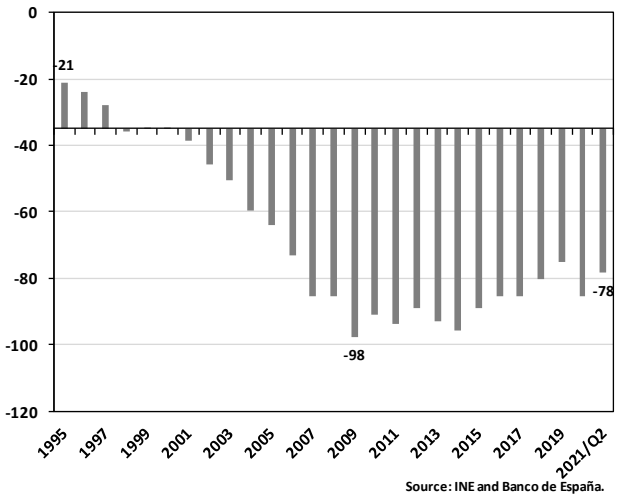
Figure 14. Spain's external liabilities: breakdown by instrument, 2008-Q2 2021 (% of GDP)



3.3. Net international investment position (NIIP) in the 2013-2019 recovery and the 2020-2021 COVID-19 crisis

When one considers external solvency (measured by the NIIP) rather than external financing problems (liabilities or gross debt), there was a significant reduction in 2009-2019 (from -98% of GDP in 2009 to -93% in 2013 and -75% in 2019), although COVID-19 had a marked impact, mainly due to its effect on GDP and the negative valuation effects due to the rise of the euro (Álvarez et al., 2021); it reached -84% in the first quarter of 2021. These figures mean that Spain's NIIP remains well above the MIP threshold of -35% of GDP, which puts the country at clear external risk (International Monetary Fund, 2017b). Although it is true that, in European terms, the NIIP of -84% of GDP in Q2 2021 was significantly lower than that of Greece (-181%), Ireland (-154%) and Portugal (-101%), the figure for Spain is still far below those of other net debtor countries, such as France (-35%), and, of course, even further from countries that hold credit positions, such as Italy (5%), Austria (14%), Belgium (52%), Germany (61%) and the Netherlands (102%). In addition, this figure is also well above the benchmarks that are defined based on estimates with countries' fundamental characteristics (NIIP norms) and those that indicate the level beyond which there is higher risk of a foreign payment crisis (prudential NIIP thresholds); these limits, for 2016, were -37% and -61% of GDP, respectively (Turrini et al., 2019).

Figure 15. Spain's international investment position, 1995-Q2 2021 (% of GDP)

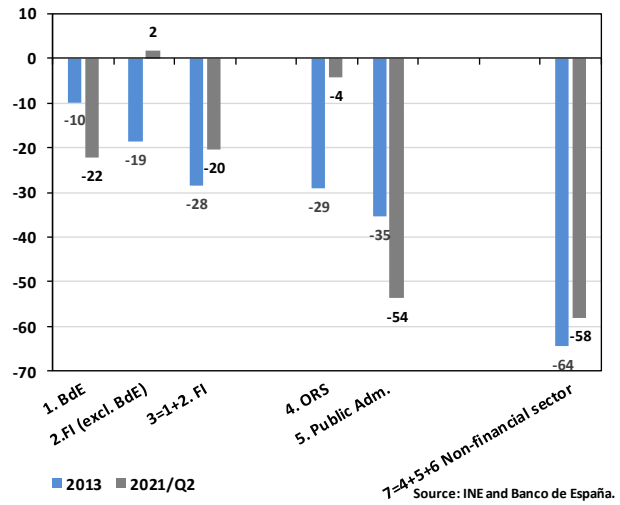


Source: INE and Banco de España.

What are the factors behind the fall in NIIP during the recovery and the subsequent rise during COVID-19? These changes are only a partial reflection of changes in the external balance. The most critical factor in its reduction up to 2019 and the subsequent increase were the dynamics of nominal GDP, while changes in the value of external assets and liabilities and other variations in volume (which reflect other changes in value or statistical discrepancies between the NIIP and the BP) had a lesser impact (Alves et al., 2018). According to Alves et al. (2019), with respect to the period 2016-2018, of the 12 GDP point decrease in the NIIP, about nine points reflected the nominal increase in GDP and a further six indicated the country's improved financing capacity, while the valuation effects and other variations in volume increased the NIIP by about three points. Indeed, the dynamics of GDP, together with changes in valuation, also explain the increase in the NIIP during the COVID-19 crisis (European Commission, 2021d). Moreover, in the reduction of the NIIP, substantial contributions cannot be expected from the net external balance, for which difficulties are expected for values greater than 1% of GDP (Cuadrado and Moral-Benito, 2016).

However, as with the stock of liabilities or external debt, a breakdown of the NIIP by sector or instrument is just as relevant as the absolute value. Therefore, unlike in other, more aggregated analyses of NIIP dynamics (Arce, 2017), this report will now present some of the significant changes in sectoral composition that occurred up to 2019, especially those caused by COVID-19. In 2013, the bulk of the NIIP related to particularly problematic sectors: of the 93% of GDP at that time, only 10 points corresponded to the Bank of Spain, while PAs contributed 35 GDP points; thus, the NIIP of the remaining sectors amounted to about 48 GDP points. In 2019, the drop in NIIP to -75% reflected the asymmetric behaviour of PAs and the Bank of Spain, whose net position worsened; of non-monetary financial institutions and monetary financial institutions (except the Bank of Spain), which presented a marked improvement; and of NFCs, which remained stable (at around -32% of GDP between 2013 and Q2 2021). Thus, the NIIP of the Bank of Spain was -15% of GDP in 2019 (from 10% in 2013), while PAs also increased their net external debt (from 35% to 47% of GDP), so that, together, these two sectors accounted for a 17 GDP-point increase in the NIIP. Along with these transformations, those that affected other monetary financial institutions (except the Bank of Spain) improved the net external position by about 17 points (from -19% to -1.6% of GDP), while the other resident sectors improved the net debt by similar values (from -29% to -11% of GDP in 2019). COVID-19 and its negative impact on the NIIP were particularly noticeable in the worsening of the net position of the Bank of Spain (from -15% to -22% between the end of 2019 and the second quarter of 2021) and of PAs (from -47% to -54%), while other monetary financial institutions improved it (from -2% to 2%). This sectoral change in the NIIP is again the result of the ECB's intervention: directly, through the asset purchase programme and the corresponding increase in the Bank of Spain's TARGET2 positions; indirectly, because the increase in prices and the fall in yields associated with such purchases drove the acquisition of liabilities of PAs by the rest of the world.

Figure 16. Net international investment position, Q2 2021. Breakdown by subsector (% of GDP)



Source: INE and Banco de España.

In short, the private sector (financial and non-financial) reduced its net external exposure to a much greater degree than the aggregate figures would suggest: from about -48% in 2013 to barely -2% in Q2 2021, while PAs and the Bank of Spain increased their net debt positions (the former by about 18 points and the latter by 12 points). Finally, the improvement in its composition is also noteworthy, since a substantial part of the 2013-Q2 2021 change occurred in the most enforceable liabilities; excluding non-defaultable instruments, the situation was better, with a 2020 figure close to -53% of GDP (MIP auxiliary indicators; European Commission, 2021d).

4. Conclusions

This report has highlighted the positive reduction in private financial imbalances in 2013-2021, notable improvements in the external balance, and reductions in the ratios of domestic private debt and those of Spain with the rest of the world, despite the damage caused by COVID-19 to public finances. All of this took place in a context characterized by receding financial constraints, renewed market confidence, stability and a sharp reduction in risk premiums. A partial or hasty reading of these results could lead one to conclude that a substantial number of the problems that led the Spanish economy into the most severe financial crisis it had experienced since the 1960s had been solved. Drawing this conclusion would be a mistake. It would also be misguided to assume that, given the stability enjoyed since 2013, the possibility of new external payment crises had vanished. The increase in risk premiums in Italy in recent years (first after the 2018 elections and, subsequently, with the COVID-19 shock) or in Spain at the beginning of the pandemic offer a stark reminder that they were only kept under control by the ECB's intervention.

It is true that, with regard to the external balance, the surpluses with the rest of the world that continued for a decade constitute a historic milestone, as does the increase in exports to unprecedented highs, both in absolute terms and in relation to GDP. However, the role of one-off, non-permanent factors in improving the external balance cannot be overlooked: about two thirds of the improvement can be considered temporary. Today, after COVID-19 and as the recovery process intensifies, we can expect decreases in the private savings rate and progress in private savings investment, such that only a compensating balance of public finances would contain the worsening external position; given the situation of PAs, this does not seem feasible.

In addition to this improvement in the financial surpluses of the private resident sectors, there has also been an improvement in the stock surplus, whose accumulation accounted for the severity of the 2008-2012 crisis. In this context, and until COVID-19 hit, a striking private deleveraging process had taken place (close to 70 GDP points). Despite its increase in 2020, this helped keep the debt of households and companies below 2012-2013 figures. However, achieving values that do not threaten the country's financial stability still requires that it be curtailed by more than 40 GDP points. As if this were not enough, the contraction of private debt cannot be viewed in isolation from the expansion of public debt, which is expected to remain at values around 120% of GDP in the upcoming years, one of the country's most worrying weaknesses.

Despite the 2013-2019 deleveraging process, the rising private debt-to-GDP ratios as a result of the pandemic and the unusual public debt figures following COVID-19 mean that the indebtedness of the non-financial resident sectors in 2021 stood at around 270% of GDP, a level only comparable to 2012 figures, during the lowest points of the financial crisis. In view of this internal debt with respect to external debt, and despite the partial improvement and changes in sectoral composition up to 2019, the situation continues to be very troubling: the increase in the Spanish economy's liabilities vis-à-vis the rest of the world, close to 290% of GDP in June 2021, and the rise in gross debt to 198% and the NIIP to 85% once again reflect fragilities that could translate into sudden stops or reversals of foreign financing flows, as occurred in 2011-2012.

In light of all the above, what needs to be done? What measures can be taken to reduce these vulnerabilities? To answer these questions, it is important to recall the deleveraging successes of 2013-2019, which were rooted largely in the ECB's considerable intervention, monetary support that was enhanced during COVID-19; in 2020-2021, the ECB's role in supporting public and private finances and in maintaining global confidence in Spain's financial capacity was decisive. In fact, when one considers all intervention measures taken by the ECB in the Spanish economy, the figures that emerge are truly remarkable: the Bank of Spain's monetary policy operations have risen substantially, from the equivalent of 21% of GDP in 2015 to an exceptional 72% of GDP in the summer of 2021. These values are indicative of the

extraordinary dependence of Spain's financial stability on the ECB's involvement.

This would not be a problem if EMU functioned as a federal state. But this is not the case. Therefore, we cannot ignore the fact that interest rates and risk premiums are critically dependent on the acquisition of Spanish debt by the ECB. This is no minor issue; given the accumulation of public (and, to a lesser extent, private) debt on its balance sheet, monetary intervention on a scale similar to that which began in 2015 is unlikely to be maintained. At some point in the near future, a process to reverse current interventions must be initiated. This is even more critical in light of the differences between the south and centre of the EMU in the 2021 public debt-to-GDP ratio (a ratio of 2 to 1), which point to a very complex balance for the ECB's intervention; thus, it is hard to imagine significant increases in its intervention should the pandemic crisis enter a new phase or another external shock occur and cause further deterioration in the financial balance sheets of the resident sectors or in Spain's balance sheet with the rest of the world. This does not mean that the ECB could not intervene; the OMTs have not been used, but they are waiting on the sidelines for a crisis that requires stabilization of debt markets.

Despite the extraordinary extent of the ECB's support, Spain still has an extensive window of opportunity to make further changes to the production structure with a view to maintaining and expanding the external surplus and, at the same time, reducing internal and external indebtedness; until at least 2024, the ECB intends to reinvest the amortized public debt from the pandemic programme, while the timeline for that corresponding to the ordinary asset purchase programme will be longer so that there is enough time for the Next Generation EU funds to close the gap generated by COVID-19 with respect to central eurozone countries. This leeway should be fully exploited, because new crises that could limit the scope and effectiveness of the current monetary policy cannot be ruled out; the yields of the ECB's intervention are diminishing and the potential costs increasingly high.

This inevitably brings us back to the role that nominal GDP growth must play in reducing domestic indebtedness, external debt and the NIIP. If the strong increase in the inflation rate ends up being temporary, which definitely remains to be seen, real GDP growth will be the very mechanism to continue the requisite reduction in debt (private and public, internal and external). In that respect, it could be argued that, despite improvements in exports and industry, its increase in the 2013-2019 recovery continued in its more traditional, less robust version: strong employment gains, combined with low labour productivity and low TFP. This reflects the fact that the factorial redistribution process underlying the recovery of exports and investment, and that of GDP itself, is far from desirable (excessive contribution of the tertiary sector and, in particular, of personal services); in addition, there are deficits in aspects that restrict robust progress in business activity, where many of the weaknesses that existed before the financial crisis continue to exist today or have even been heightened, as in the case of R&D expenditure. Thus, the prospects for substantial change in these trends are limited; even with the dramatic effects of Next Generation EU, it is difficult to imagine real GDP growth over the next decade much above 2.0% per year.

Given the importance of nominal GDP growth in the desirable, and essential, reduction in the NIIP and the internal and external debt, efforts should aim to reinforce policies that promote productivity growth, which was extremely unsatisfactory in the 2013-2019 recovery. Therefore, the recommendations made in these reports in recent years have not changed substantially; there is little more to add. In addition, the prominent but temporary role played by the ECB in stimulating growth before the pandemic, containing its decline afterwards and contributing decisively to financial stability requires, if possible, the implementation of further reforms to improve the factor endowment of the Spanish economy; in human capital, in research, innovation and development, and in infrastructure that ultimately aims to increase total productivity growth. All of this is long overdue, but is no less urgent today.

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Abbreviations

AMECO: annual macro-economic database, European Commission
APP: Asset Purchase Programmes
BP: balance of payments
EC: European Commission
ECB: European Central Bank
EDP: excessive deficit procedure
EMS: European Monetary System
EMU: Economic and Monetary Union
ESM: European stability mechanism
EUROSTAT: Statistical Office of the European Union
FDI: foreign direct investment
FI: financial institution
GDHI: gross disposable household income
GDP: gross domestic product
GFCF: gross fixed capital formation
GOS: gross operating surplus
GVA: gross value added
ICO: Official Credit Institute
IMF: International Monetary Fund
INE: National Statistics Institute
LFS: Labour Force Survey
LTRO: long-term refinancing operations
MIP: macroeconomic imbalance procedure
NEXTGEN: Next Generation EU
NFC: non-financial corporation
NIIP: net international investment position
NPL: Nonperforming loan
OMT: outright monetary transactions
PAs: public administrations
PELTRO: pandemic emergency longer-term refinancing operations
PEPP: pandemic emergency purchase programme
PNPI: private non-profit institution
SMEs: small and medium-sized enterprises
SURE: Support to Mitigate Unemployment Risks in an Emergency
TARGET2: Trans-European Automated Real-time Gross Settlement Express Transfer System
TFP: total factor productivity
TLTRO: targeted longer-term refinancing operations
ULCs: unit labour costs

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