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# The recovery of the Spanish economy and the challenges ahead

Rafael Doménech  
March 2019

Creating Opportunities

## Main messages



- After an unprecedented crisis, Spain has overtaken pre-crisis levels of income per capita due to a favorable combination of external and domestic factors
- Although it is difficult to estimate their exact contribution, behind the current economic recovery are the effects of structural reforms, in labor and product markets, the financial system and the public sector
- Thanks to these reforms, employment growth has been consistent with a balanced recovery, in contrast with the growth pattern prior to the crisis
- Given these positive effects, to ensure a sustainable and inclusive growth, it is key to continue the process of structural reforms to reduce structural unemployment and inequality, and increase the competitiveness of Spanish firms, productivity and quality of employment, human capital and the quality of institutions, to take advantage of the digital revolution

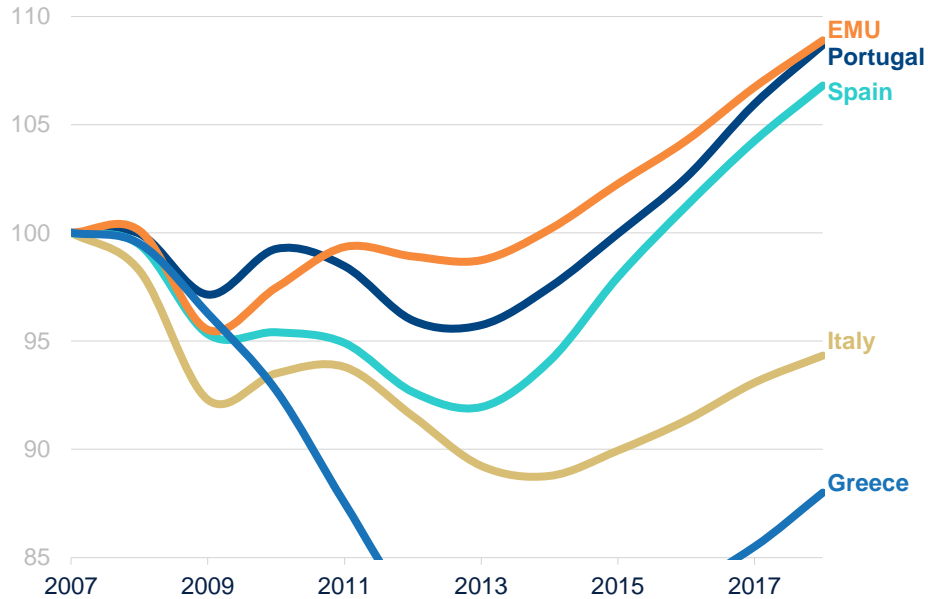


# 01

## **Structural reforms as a driver of the economic recovery**

# Spain has recovered pre-crisis income levels due to a favorable combination of external and domestic factors

**GDP per working-age population, 2007-2018**  
(2007=100)



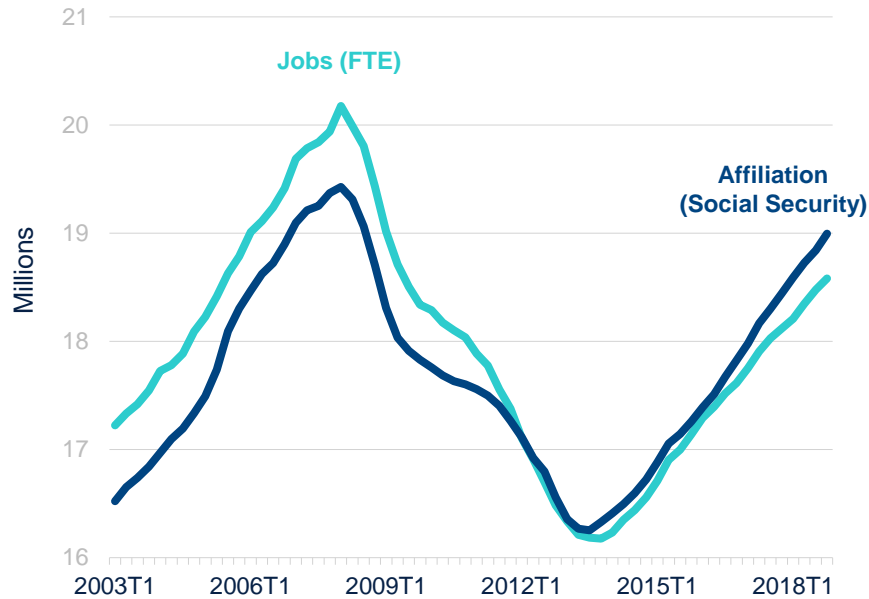
Source: BBVA Research and European Commission

- The recovery has been much more than the natural rebound from a very deep recession and common external conditions
- A simple rebound after the crisis could explain differences with EMU but not with other countries, such as Italy and, more significantly, Greece (-19%)
- Spain and other countries such as Portugal and Ireland have also benefited from important structural reforms implemented

# Spain has recovered pre-crisis income levels due to a favorable combination of external and domestic factors

## Spain: Employment

National accounts and Social Security, millions



- Between 2008 and 2013 19.8% of full-time equivalent jobs were destroyed (15.9% Social Security affiliation), the deepest labor market crisis in our recent history
- By the end of 2018 full-time employment jobs were 7.9% below their peak and affiliation just 2.2%
- In 4Q2018 the unemployment rate was at 14.5%, below the average rate since 1980 (16.7%)

# Spain has recovered pre-crisis income levels due to a favorable combination of external and domestic factors



## External factors

- ECB monetary policy
- Banking union
- Euro depreciation
- International recovery
- Tourism
- Lower oil prices



## Domestic factors

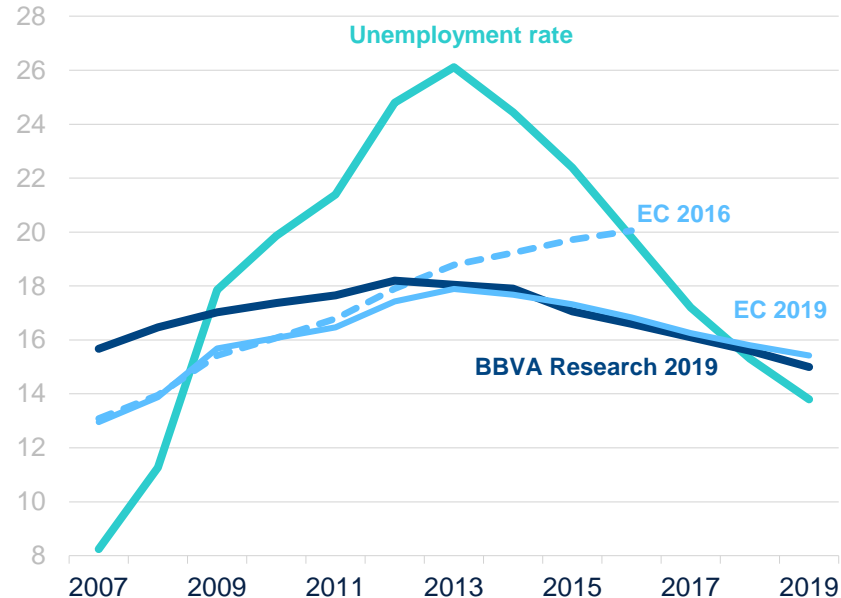
- Internal forces of a free market economy
- Structural reforms

# Estimating the effects of structural reforms

- What has been the **contribution of structural reforms to the economic recovery?**
- This is a difficult question without a straightforward answer:
  - Many reforms interact **simultaneously** making it difficult to disentangle their effects
  - Too short a time span after the reforms for a proper evaluation
  - **Counterfactual exercises**: we have to rely on **models** that, in many cases, have not been designed for the evaluation of the reforms
  - **Academic debate**: the effects of structural reforms at the zero lower boundary; is internal devaluation contractionary (negative demand effects) or expansionary (positive supply effects)?  
See, for example, Eggertsson, Ferrero and Raffo (2014) and Krugman (2014) vs Andrés, Arce and Thomas (2014), Boscá et al (2018) or Cardoso (2019).

# Estimating the effects of structural reforms

## Spain: Unemployment rate and estimates of its structural component



Source: BBVA Research based on INE and Social Security

- The structural unemployment rate is a non-observable variable
- According to the EC's estimates in 2015, structural unemployment would, surprisingly, be growing in 2016 despite structural reforms
- Our estimates suggest a decrease in the structural unemployment rate after the labor market reform in 2012, as the European Commission is currently estimating





# 02

## **Structural reforms implemented**

# Main structural reforms implemented

01

## Labor market reforms

2012 reform, more internal and part-time contracts offer flexibility, Spanish Strategy for Employment Activation, reform in in-job professional training, youth guarantee system, ALMP

02

## Policies to foster competition

Law on Guarantee of Market Unity, Deindexation Law, Entrepreneurship Law, fewer barriers to firms creation and other measures

03

## Fiscal consolidation

A sizeable adjustment of fiscal deficit, constitutional reform, Budget Stability Law, FLA, AIREF and other measures

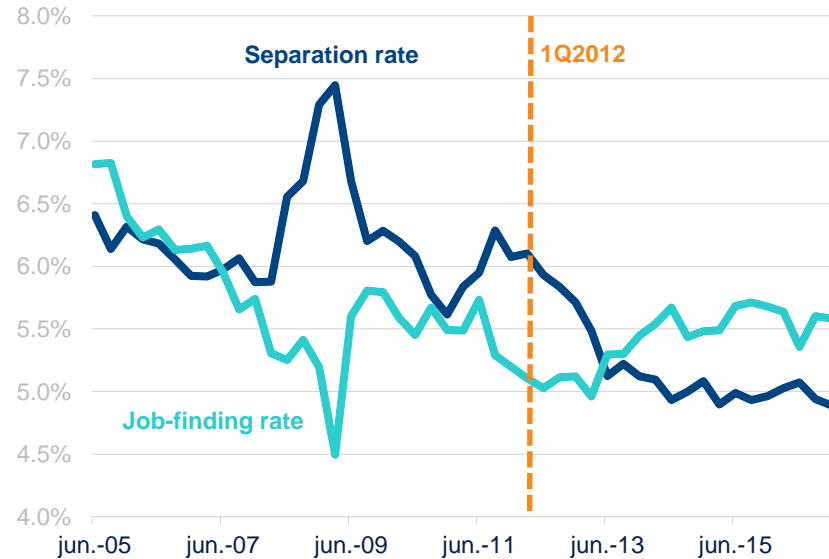
04

## Financial sector restructuring

Financial assistance program, MOU and a significant increase of banks' capital ratios

# Effects of labor market reforms

## Spain: flows in the labor market Separation and job-finding rates (In % over total employment)

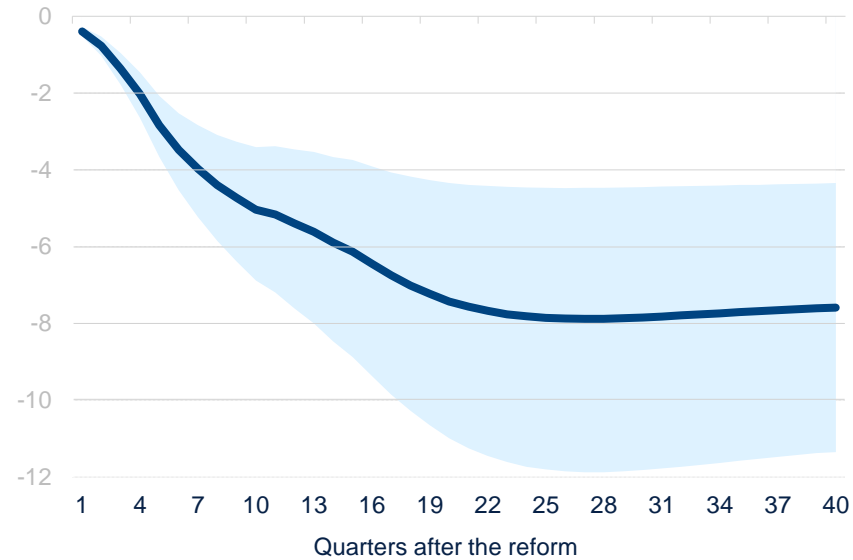


- The 2012 Labor market reform and the 2nd Agreement on Employment and Collective Bargaining prevented greater job destruction in the sovereign debt crisis
- The separation rate (to unemployment and inactivity) felt in the sovereign debt crisis in contrast to the experience of the first part of the crisis
- The current separation rate is below the pre-crisis level

# Effects of labor market reforms

## Counterfactual scenario: effects of labor reforms and wage flexibility if implemented in 2008

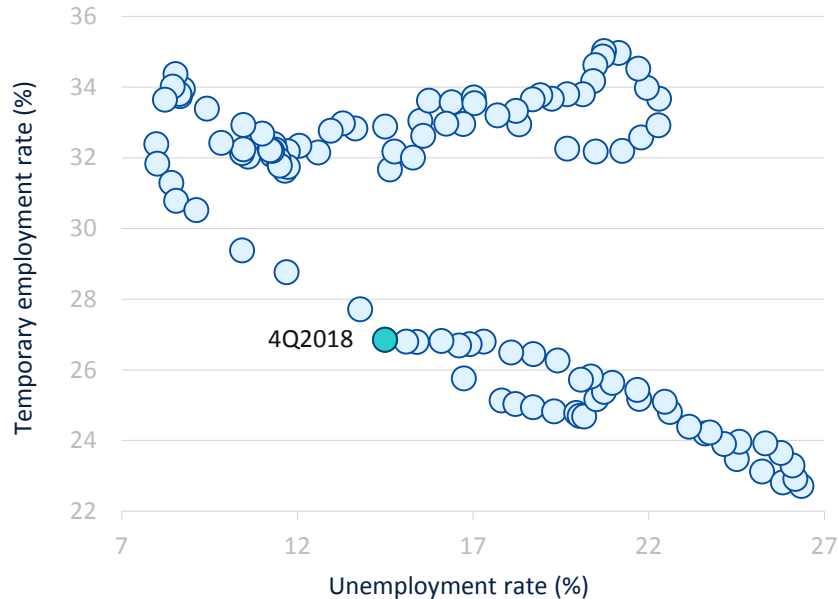
Deviation from the observed unemployment rate



- The 2012 Labor market reform and the 2nd Agreement on Employment and Collective Bargaining prevented greater job destruction in the sovereign debt crisis
- Without the greater flexibility of the reform, additional jobs would have been lost in 2012 and 2013
- The implementation of the reform in 2008 might have prevented the increase by 7.6 pp of the unemployment rate during the crisis

# Effects of labor market reforms

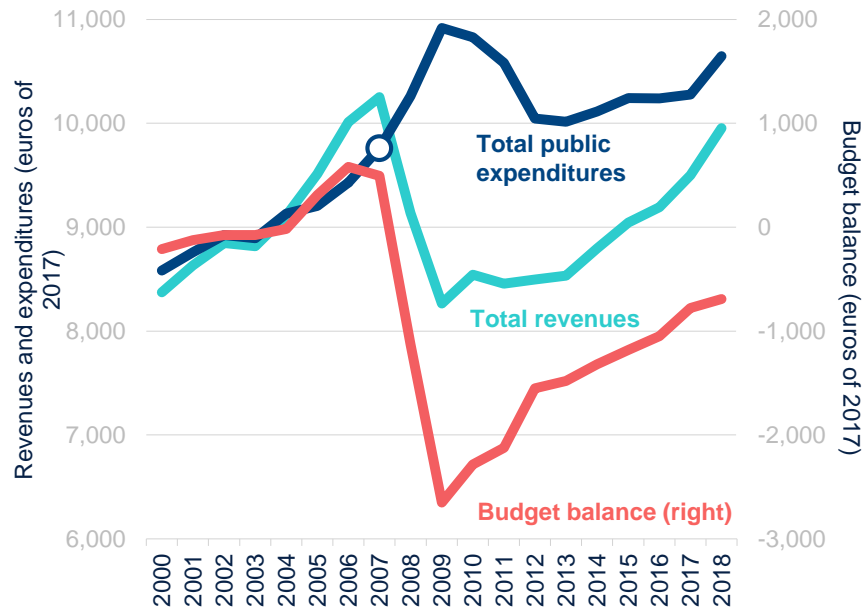
## Spain: temporary employment and unemployment rate



- With the crisis, the temporary employment rate fell ten points to 22.7 per cent, something that did not happen in the crisis of the 1990s
- With the recovery, the temporary rate has risen again and by the end of 2018 was 26.8 per cent
- This rate is lower than in the previous cyclical recovery when, with a similar unemployment rate, seasonality was 33 per cent, but it is still very high in relation to other countries

# Better public finances (1): fiscal consolidation

## General government: main aggregates in per capita terms



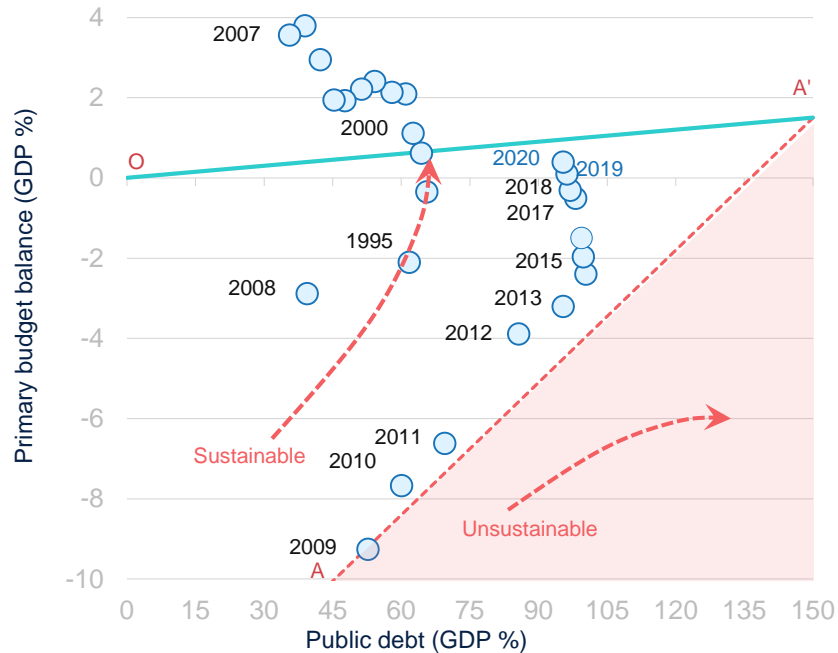
■ A sizeable adjustment: fiscal deficit from 11.2% of GDP in 2009 to 2.7 in 2018 ...

... that has been the result of a reduction in public expenditures of 2.5% in real per capita terms

... and an increase of 20.5% in public revenues, tax rates and tax bases

# Better public finances (1): fiscal consolidation

## Spain: primary budget balance and public debt



- Fiscal consolidation has helped to improve the sustainability of public debt
- This improvement of public finances has contributed to the reduction of the Spanish risk premium

## Better public finances (2): improvements in institutions and rules

01

Constitutional Reform, Budget Stability Law and Reform of local governments reinforce the long-run commitment to a zero structural deficit and public debt below 60% of GDP

02

Commission for the Reform of the Public Administration to increase efficiency

03

Law for Transparency in public administrations: better transparency and efficiency

04

Independent Fiscal Authority (AIReF)



## Better public finances (3): reforms of the pension system

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2011 Pension Reform  
(Law 27/2011, from 2013 onwards)

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Retirement age from 65 to 67y  
More contributed years (15-> 25)  
to compute initial pension & more  
years (37) to full pension

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2013 Pension Reform  
Sustainability factor for new pensions  
(Law 23/1013, on hold since 2018)

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New pensions take into account  
the increase in life expectancy

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2013 Pension Reform  
Index for annual nominal growth  
of the public pensions  
(Law 23/2013, on hold since 2018)

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+ Structural revenues  
- Structural expenditures  
- Deficit correction component

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# Policies to foster competition

## 01

Implementation of Law on Guarantee of Market Unity: freedom of movement and establishment of businesses among Spanish regions. *Doing Business* at the regional level to promote internal competition

## 02

Measures to reduce the time, cost and number of procedures in public administrations for setting up an operating business. Address restrictions to the establishment of large-scale retail

## 03

The Deindexation Law has introduced the Competitiveness Guarantee Index to be used for price updating in the public sector. The index automatically corrects cumulative price differentials with the rest of EMU

## 04

Entrepreneurship Law, measures to facilitate debt recovery and restructuring (2014 and 2015) for firms and entrepreneurs and reform of the insolvency regime

# Restructuring the financial system (1)

## Phase 1 of the restructuring



2008

Creation of FAAF and increased coverage of DGF



2009

Creation of FROB. Injection of 10bn € into savings banks



2010

Reform of legal framework of savings banks



2011

Minimum capital requirement of 8% (general) or 10%

## Phase 2 of the restructuring: focus on asset valuation



Feb-May 2012

New regulation: 80bn € in provisions and capital buffers



June-Sep 2012

Financial assistance program, MOU and capital needs by bank



Post-MOU

Creation of Sareb and asset valuation in the European banking union

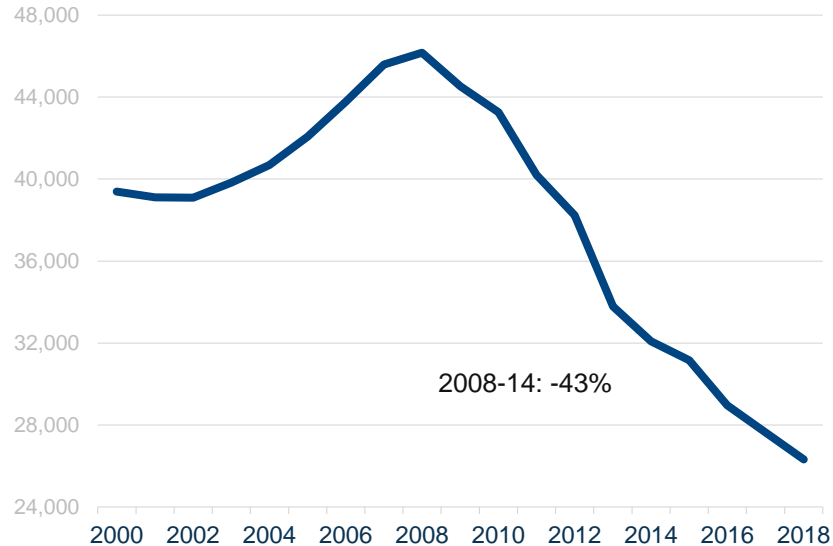


From 2014

Disintermediation and promotion of capital markets for SMEs and venture capital

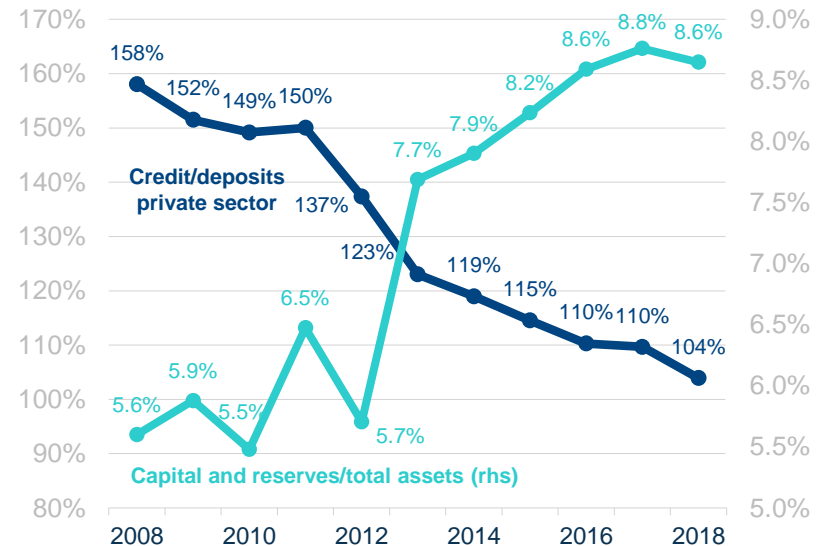
## Restructuring the financial system (2)

### Number of branches of Spanish banks



Source: BBVA Research based on Bank of Spain

### Solvency and liquidity of Spanish banks



Source: BBVA Research based on Bank of Spain

**The Spanish banking system now has higher capital and liquidity ratios and experienced an intense growth in credit flows. The current NPL ratio is 4.1%, close to the EU average (3.4%)**

# Effects of structural reforms and adjustments

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ULC growth 2003-2007  
3.5% Spain vs 1.5% EMU

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ULC growth 2014-2018  
-0.3% Spain vs 1.0% EMU

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GDP deflator growth 2003-7  
3.9% Spain vs 2.1% EMU

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GDP deflator growth 2014-8  
0.6% Spain vs 1.1% EMU

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Exports/GDP  
25.5% in 1Q2008

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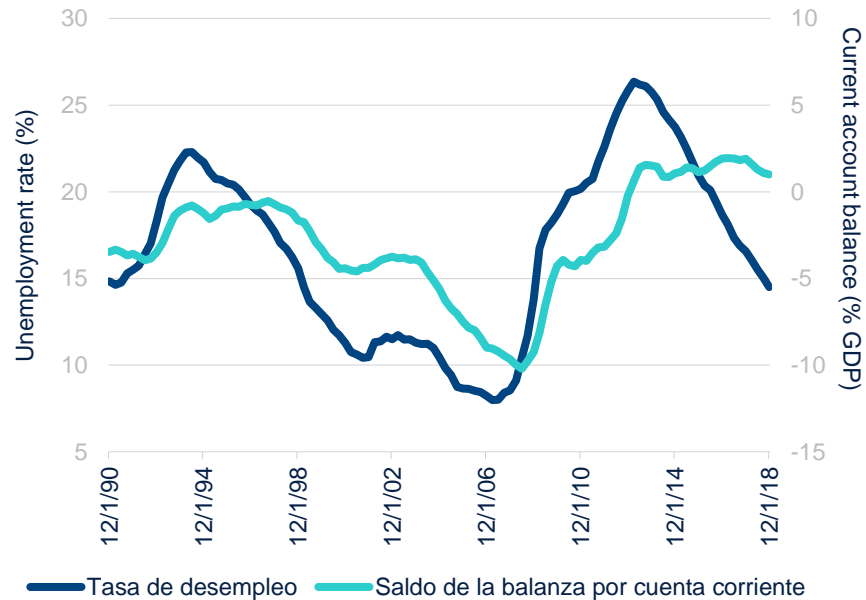
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Exports/GDP  
34.4% in 4Q2018

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# Effects of structural reforms on competitiveness

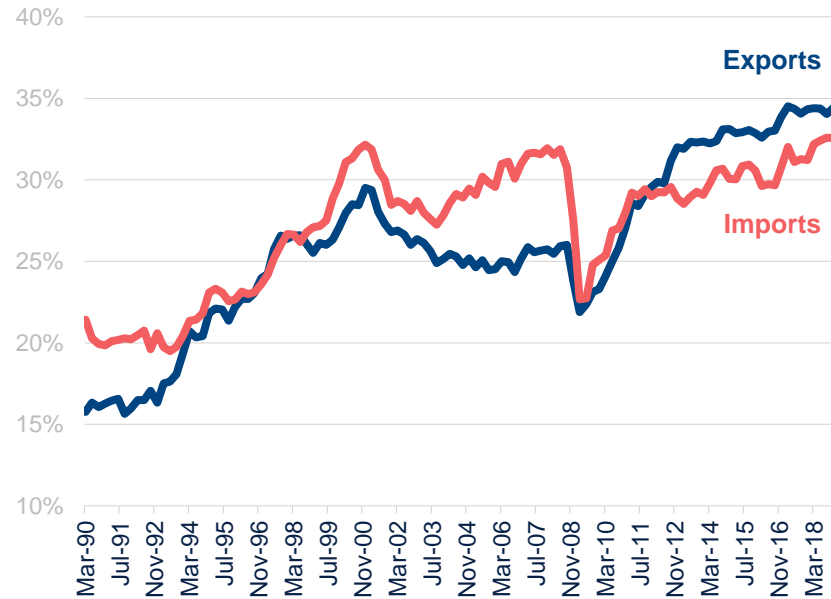
Spain: current account balance and unemployment rate  
(In %)



- In the past, job creation implied a large deficit in the current account
- So far, employment growth is consistent with a current account in surplus
- The challenge now is to reduce unemployment without increasing the current account deficit

# Effects of structural reforms on competitiveness

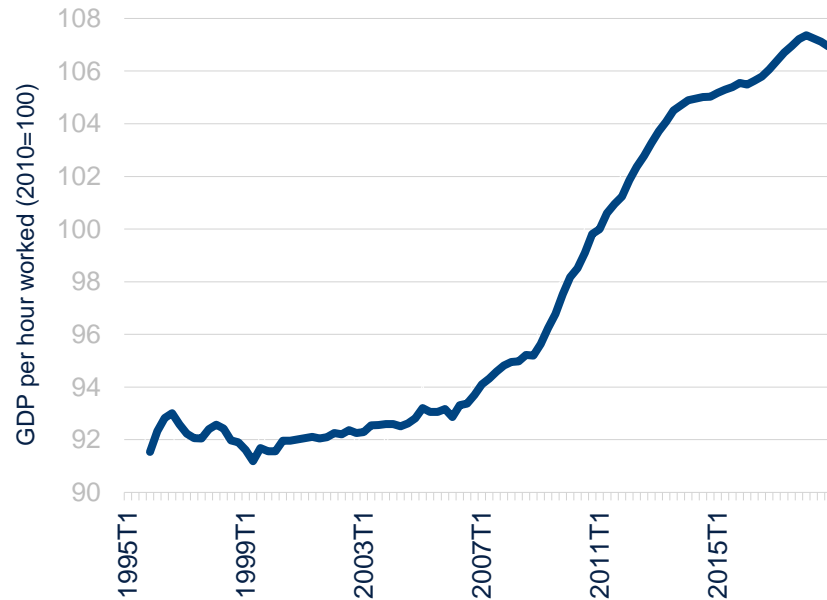
Spain: share of exports and imports over GDP (%)



- The share of exports over GDP has been growing during the recovery (almost 10 pp) and the Spanish economy shows a positive current account balance, something completely unusual in previous expansions
- In contrast, the share of imports is almost the same as two decades ago

# Effects of structural reforms on productivity

**Spain: GDP per hour worked**  
(2010=100)

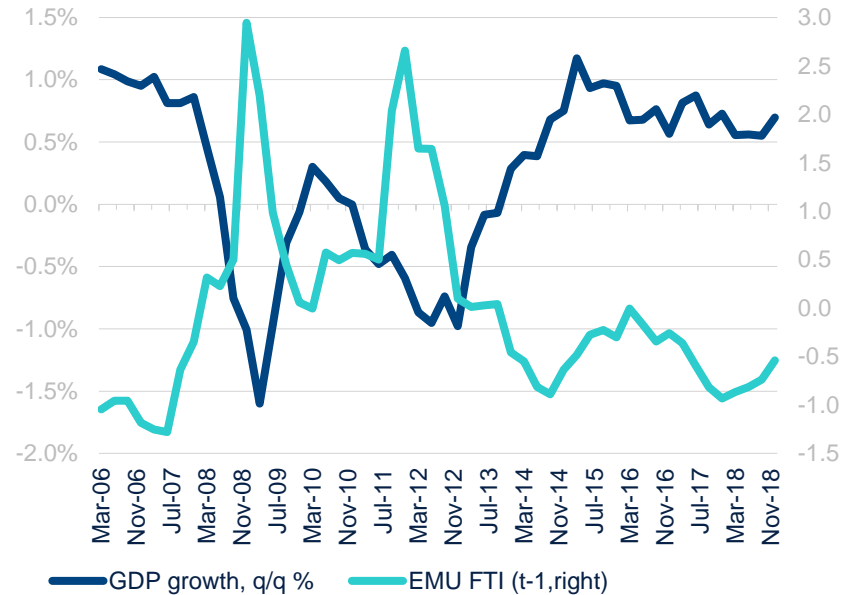


- Productivity has been growing during the recovery, in contrast to its stagnation from 1995 to 2007
- This evidence is consistent with the dominance of supply factors during the current recovery



# Effects of structural reforms on financial tensions

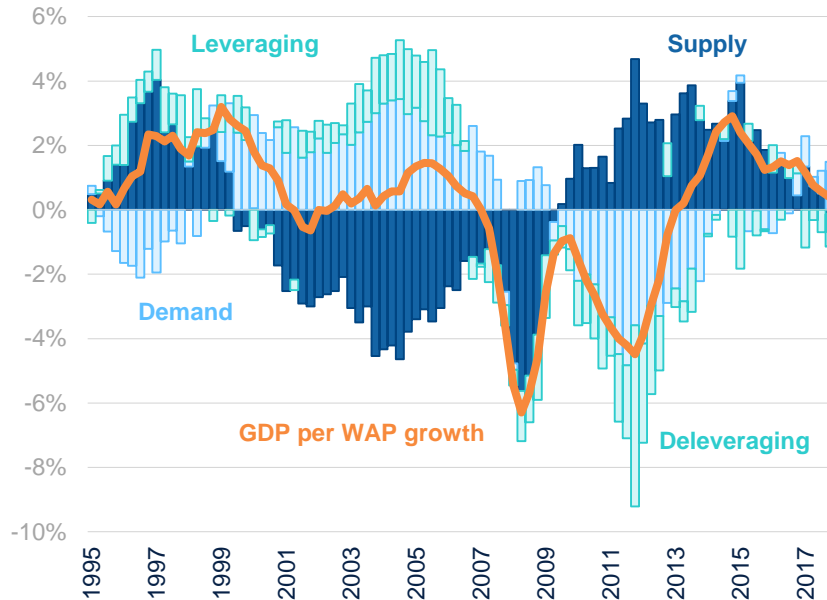
Spain: GDP growth and financial tensions  
2006-2018



- Quarterly GDP growth in Spain was highly correlated with financial tensions in the previous quarter
- European banking union and ECB monetary policy were crucial to reduce financial tensions at the European level
- Structural reforms and the recovery of the economy have been critical to reduce domestic financial tensions and the Spanish risk premium

# Effects of structural reforms on GDP growth

## Spain: growth decomposition of GDP per working age population



- The main factors behind growth of GDP per working-age population have been supply shocks, ...
- ... which have been more relevant than in the recovery of the second half of the 90s
- In contrast, during the expansion before 2008 supply shocks made a negative contribution to growth (inefficient reallocation of resources across sectors and firms)



# 03

**Continuing the process of structural reforms to ensure a sustainable and inclusive growth**

# Continuing the process of structural reforms to ensure a sustainable and inclusive growth

## Labor market



- Internal flexibility
- Quality of contracts
- Long-term unemp.

## Competitiveness



- Size of firms
- Exports
- R&D

## Public sector



- Consolidation
- Tax reform
- Efficiency

## Long-run factors



- Better education
- Training
- Institutions

# Labor market: more and better employment

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6.8%

of workers under collective agreement at the firm level, 2017

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Promote collective bargaining and internal flexibility at the firm level  
Reduce judicial uncertainty

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29.9%

of temporary employment 4Q2018

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More incentives to open-ended contracts (e.g., Austrian model)  
(see BBVA Research, 2014 and Doménech, García and Ulloa, 2018)

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40.3%

of the unemployed has been jobless for more than 1 year

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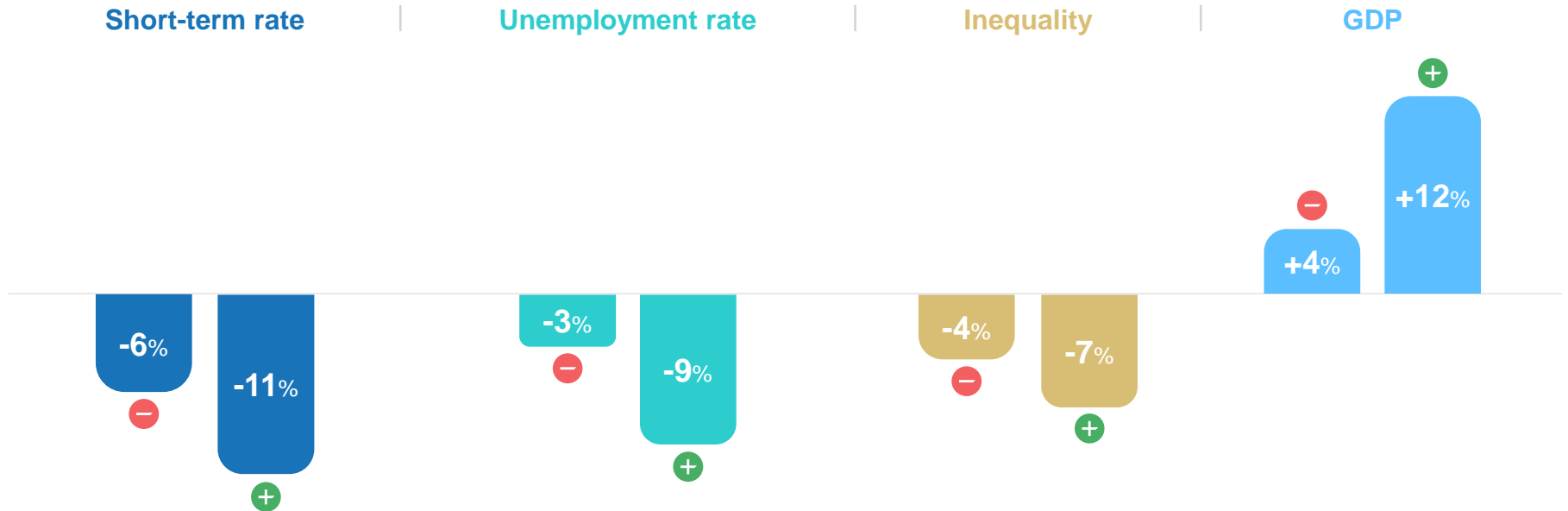
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ALMP and better integration with unemployment benefits to increase job search

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# Labor market: more and better employment

Long-term impact of the permanent employment proposal made by BBVA Research and the Sagardoy Foundation



# Policies to increase competitiveness

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**4.7%**  
Workers per firm

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Better regulation & business climate  
to promote firm growth  
Increase efficiency of judicial system

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**50%+**  
Target share of exports over GDP  
given by the pattern of  
Germany, South Korea, etc.

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Better regulation & business climate  
to increase internationalization  
Competition in intermediate inputs

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**50%**  
Average gap in R&D investment  
with respect to the EU8

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PPPs from institutes  
specialized in providing  
knowledge transfer, technology  
and innovations to SMEs

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# General government: sustainability and efficiency

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**-2.7%**

Budget balance over GDP in 2018

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Complete the consolidation process  
Fight against tax evasion  
New finance system for regions

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**80%**

Social security contributions over indirect taxes are higher in Spain than in EU8 2016

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Fiscal reform: more transparent and efficient system with less distortion  
Fiscal devaluation and notional accounts in the pension system

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**34.2%**

Gap in Government Effectiveness in 2013 with respect the EU8 (WGI)

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Increase efficiency and quality of public spending (new technologies, digital revolution and better management)

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# Better human capital and institutions in the long run

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**18.3% vs 10.7%**

Early leavers from education and training in Spain vs EU, 2017  
(% 18-24 years old)

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Fight against early school leaving

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**27.2%**

Unemployment rate for workers with less than or lower secondary education in 2017

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More efficient vocational education and training programs

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**19%**

Average gap in Indicators of Governance in 2013 with respect to the EU8 (WGI)

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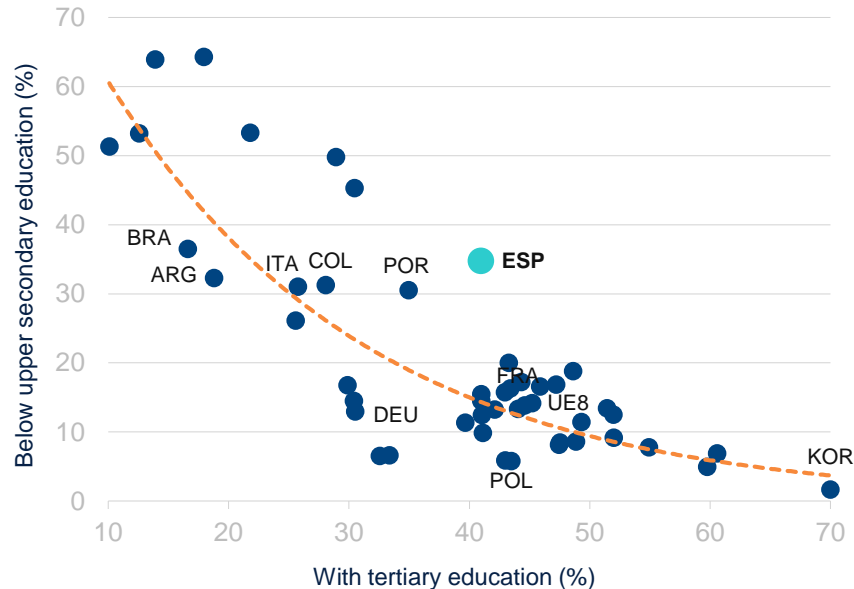
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Increase quality of institutions  
Better regulators  
More efficient judicial system

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# Better human capital and institutions in the long run

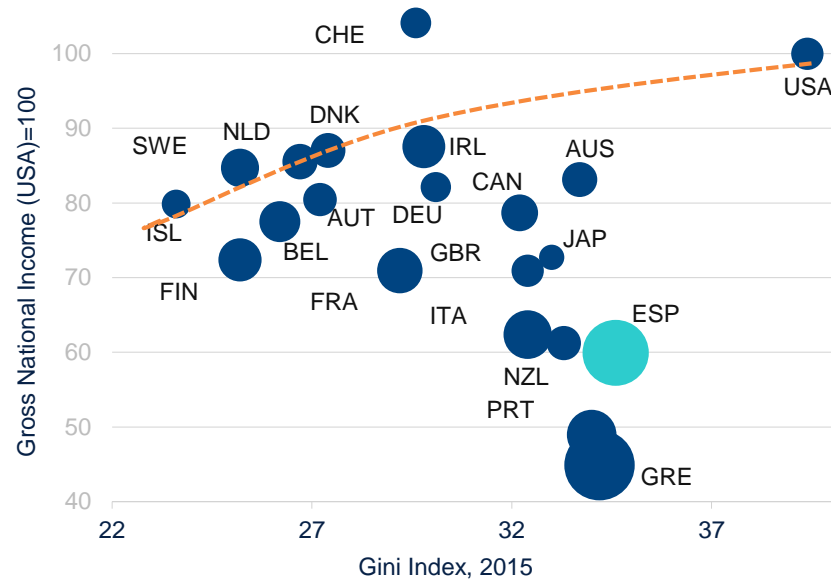
Percentage of the population aged between 25 and 34 years by education level in 2016



- Skill-biased technical progress and new jobs that might be hard to imagine at the present time not only require more but, above all, better and more flexible training
- The dual distribution of educational levels in Spain means that approximately one third of the younger population may lack the skills needed for the digital transformation

# Inclusive growth in the age of digital disruption

## Per capita income, inequality and unemployment OECD, 2016



### An efficient and fair transition

- There are **big disparities among advanced economies** as regards to per capita income, unemployment and inequality
- The challenge is to **manage the technological and digital transformation** by spurring growth while reducing both **inequality and the unemployment rate**.
- Certain countries, such as **Spain**, are far from the frontier, allowing for higher-growth policy strategies that do not raise unemployment and inequality

## Main messages



- After an unprecedented crisis, Spain has overtaken pre-crisis levels of income per capita due to a favorable combination of external and domestic factors
- Although it is difficult to estimate their exact contribution, behind the current economic recovery are the effects of structural reforms, in labor and product markets, the financial system and the public sector
- Thanks to these reforms, employment growth has been consistent with a balanced recovery, in contrast with the growth pattern prior to the crisis
- Given these positive effects, to ensure a sustainable and inclusive growth, it is key to continue the process of structural reforms to reduce structural unemployment and inequality, and increase the competitiveness of Spanish firms, productivity and quality of employment, human capital and the quality of institutions, to take advantage of the digital revolution

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