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KEY FACTORS AND GROWTH
CHALLENGES IN THE EURO AREA**

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Eloísa Ortega and Juan Peñalosa

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Eloísa Ortega and Juan Peñalosa (*)

BANCO DE ESPAÑA

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Abstract

The economic crisis affecting the industrialised countries in recent years has been singular given its intensity, complexity and the difficulties in overcoming it. The aim of this paper is to analyse the determinants behind the crisis that have made it deeper and longer in Spain than in previous instances, and which have meant that there are significant obstacles to emerging from recession. Spanish EMU membership is a crucial aspect for consideration, as it contributes both to explaining the build-up of imbalances in the expansion and to conditioning the nature of the adjustment in the crisis, given that the range of economic policy instruments is significantly narrower in EMU. The macroeconomic and financial imbalances accumulated in the high-growth phase (the real estate boom, excess debt and the loss in competitiveness), which are all closely interlinked, were factors of vulnerability. But even apparently sounder fundamentals on other fronts, such as the budgetary and labour market situation, saw their weaknesses exposed in the crisis. The experience over the past four years allows some lessons to be drawn on the external sector, the real estate market, fiscal policy and the labour market. These lessons point in particular to the need to avoid complacency in economic policy management in boom periods and to the urgency of adapting the structure of goods and factor markets and the behaviour of economic agents in Spain to the requirements imposed by membership of a monetary union.

Keywords: Spanish economy, EMU, economic crisis, competitiveness, real estate market, debt.

JEL classification: E60, E65, F32, G01, H12.

Resumen

La crisis económica que ha afectado a los países industrializados en los últimos años ha sido singular por su intensidad, complejidad y por las dificultades para su superación. El objetivo de este trabajo es analizar los factores que han determinado que la crisis haya adquirido en España una profundidad y duración superiores a las de episodios anteriores y que la salida de la recesión esté encontrando obstáculos significativos. La pertenencia de España a la UEM es un aspecto crucial a considerar, pues contribuye tanto a explicar la acumulación de desequilibrios en la expansión como a condicionar la naturaleza del ajuste en la crisis, dado que la batería de instrumentos de política económica se ha reducido significativamente. Los desequilibrios macroeconómicos y financieros acumulados en la etapa de alto crecimiento (boom inmobiliario, exceso de endeudamiento y pérdida de competitividad), todos ellos estrechamente interrelacionados, representaban factores de vulnerabilidad, pero, incluso los fundamentos aparentemente más sólidos en otros ámbitos, como en el caso de la situación presupuestaria y del mercado laboral, han mostrado sus debilidades en la crisis. La experiencia a lo largo de los últimos cuatro años permite extraer algunas lecciones en relación con el sector exterior, el mercado inmobiliario, la política fiscal y el mercado de trabajo, que alertan, en particular, sobre la necesidad de evitar la complacencia en la gestión de la política económica en las etapas de auge y sobre la urgencia de adaptar en España la estructura de los mercados de bienes y factores y el comportamiento de los agentes a los requisitos que impone la pertenencia a una unión monetaria.

Palabras claves: Economía española, UEM, crisis económica, competitividad, mercado inmobiliario, endeudamiento.

Códigos JEL: E60, E65, F32, G01, H12.

1 Introduction

Since 2007 the world economy has undergone a phase of marked instability. This has been characterised by successive shocks, feedback effects between the financial and productive sectors, a rapid deterioration in many countries' fiscal position, the difficulties of many of them in creating jobs once more and, lastly, the worsening euro area sovereign debt crisis. Such factors are all undoubtedly making the pace of exit from the recession slower than initially expected and are heightening uncertainty considerably, especially in Europe.

The Spanish economy has been much affected by these developments, as the imbalances accumulated in the boom period made it particularly vulnerable to changes in macroeconomic and financial conditions, and in expectations about the continuity of the upturn. The international financial crisis precipitated the correction of the real estate and private-sector debt excesses marking the high-growth phase which preceded the recession. The deterioration of the macroeconomic scenario and, most particularly, in employment bore most adversely on public finances and on the position of financial institutions whose balance sheets showed greater exposure to real estate risk.¹ Spain went into recession in 2008 Q2 and remained there until 2010 Q1, when a modest recovery ensued that came unstuck in the second half of 2011, as the sovereign debt crisis heightened and spread to an increasingly large number of countries.

Evidently, the high degree of synchrony of the crisis at the international level and the additional complications that the euro area crisis entails, affecting the Spanish economy in particular, are hampering the recovery. Admittedly, too, the absorption of the macroeconomic imbalances generated in Spain during the expansionary phase is influencing the path of emergence from the crisis.² But it is worth asking whether other factors linked to the insufficient degree of adaptation to the macroeconomic stability that EMU membership requires — and which were, in part, responsible for these imbalances — hinder or delay the resumption of a sounder growth path.

The aim of this paper is to review the factors which have made the crisis deeper and longer in Spain than in previous instances, and which have meant there are significant obstacles to emerging from recession. The article takes a selective approach to this matter, focusing on macroeconomic developments and on non-financial economic policies. Within this group of issues, particular attention is paid to developments that have acted as catalysts of the recession or of the subsequent adjustment, or that shed light on the effective possibilities of stabilisation by means of the economic policies implemented. In this respect, Spanish EMU membership is a crucial aspect for consideration, since it contributes both to explaining the build-up of imbalances during the expansion and to conditioning the nature of the adjustment during the crisis. Finally, mention should be made of the enormous uncertainty still clouding the outlook for the Spanish and European economies more than four years after the international financial crisis broke, in light of the forceful strains prevailing on financial markets and the doubts surrounding the outcome of the sovereign debt crisis. Such uncertainty naturally restricts the prospective nature of the analysis that follows, one which mostly turns on the lessons that may be drawn from the experience of recent years.

¹ An exhaustive analysis of the channels through which the international financial crisis spread can be found in Banco de España (2009). A detailed analysis of the imbalances that built up during the upturn is given in Estrada et al (2009).

² On this matter, see Banco de España (2010), Malo de Molina (2010) and Suárez (2011).

To this end, the first section reviews the stylised facts of the latest contractionary cycle in Spain, comparing it with the crises of recent decades. The determinants of the deep-seated recession and of the subsequent economic adjustment are then examined, while the fourth section seeks to draw some lessons from the crisis regarding the external sector, the real estate market, fiscal policy and the labour market. Finally, some conclusions are drawn.

2 Stylised facts of the periods of contraction (2008-2009) and stagnation (2010-2011)

The economic crisis affecting many of the industrialised countries in recent years has been singular given its intensity, widespread scope, complexity and the difficulties in overcoming it. In this respect, Spain, which is one of the countries that experienced a most marked expansion in the previous period, now stands out for its heavy fall in employment, for the difficulties the recovery faces and for the greater risks posed by a double-dip recession. Some of these matters merit greater attention.

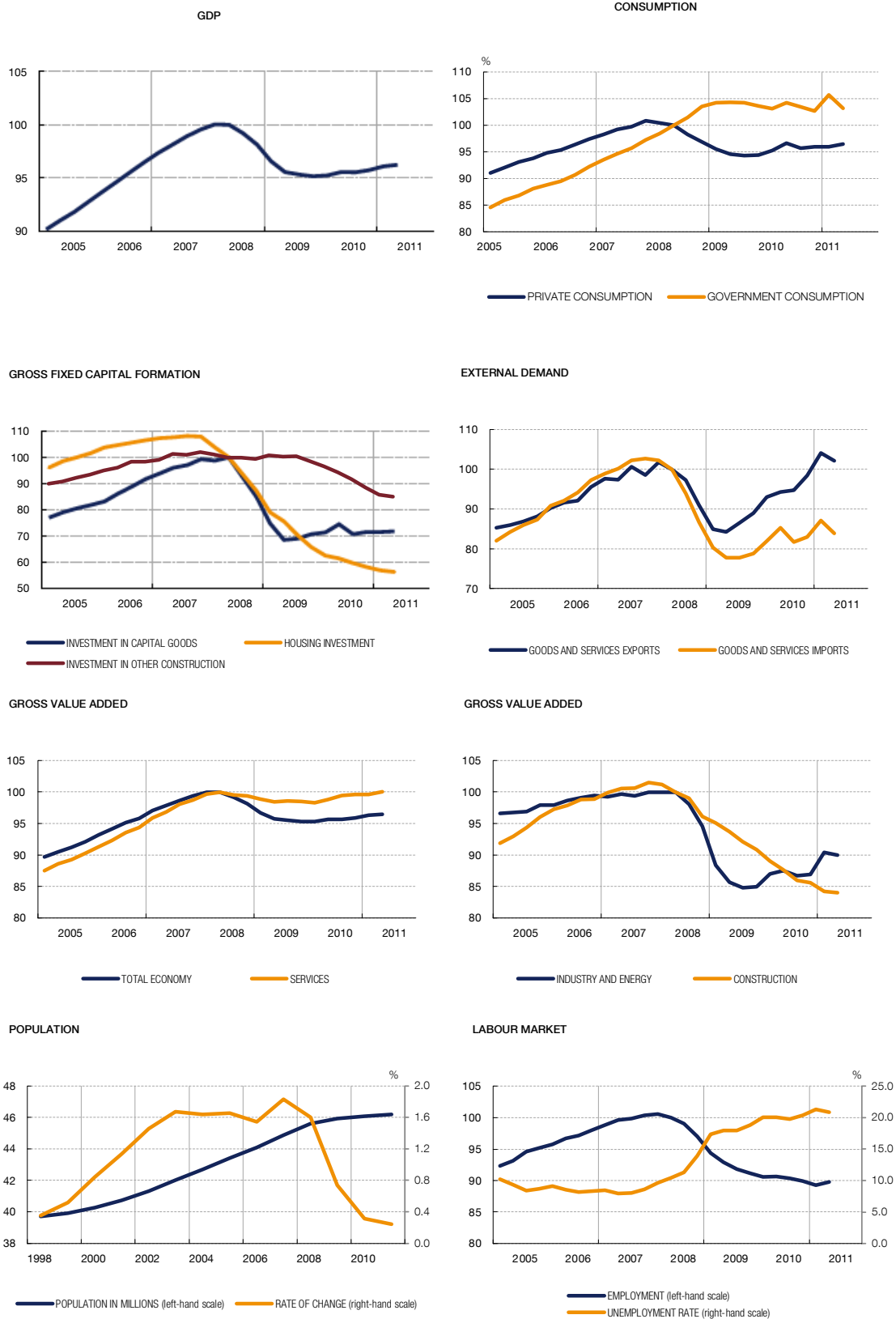
2.1 The contractionary cycle: 2008-2009

GDP began to fall in Spain in 2008 Q3 and continued to diminish over the rest of 2008 and throughout 2009, making for six consecutive quarters of declines. In cumulative terms, that meant a decline in the level of output of around 5 pp³ (see Chart 1). The employment adjustment has been virulent and protracted (the decline in employment began in early 2008 and continued apace in late 2011), while productivity has followed the same countercyclical pattern as in previous recessionary episodes. In terms of components, the adjustment in activity was centred on national demand, which fell by 8 pp to end-2009, with cumulative declines of more than 5 pp in private consumption, 29 pp in investment in equipment and 18 pp in investment in construction. As a result, imports also fell sharply, by more than 20 pp in cumulative terms. Although exports were impacted by global trade grinding to a halt and fell by 11 pp, net external demand cushioned the adverse impact of the decline in national demand on activity due to lower imports. On the supply side, the most significant fall was in value added in industry (15 pp) and construction (9 pp), whereas this variable hardly fell in services, as non-market services offset the 4 pp fall in market services.

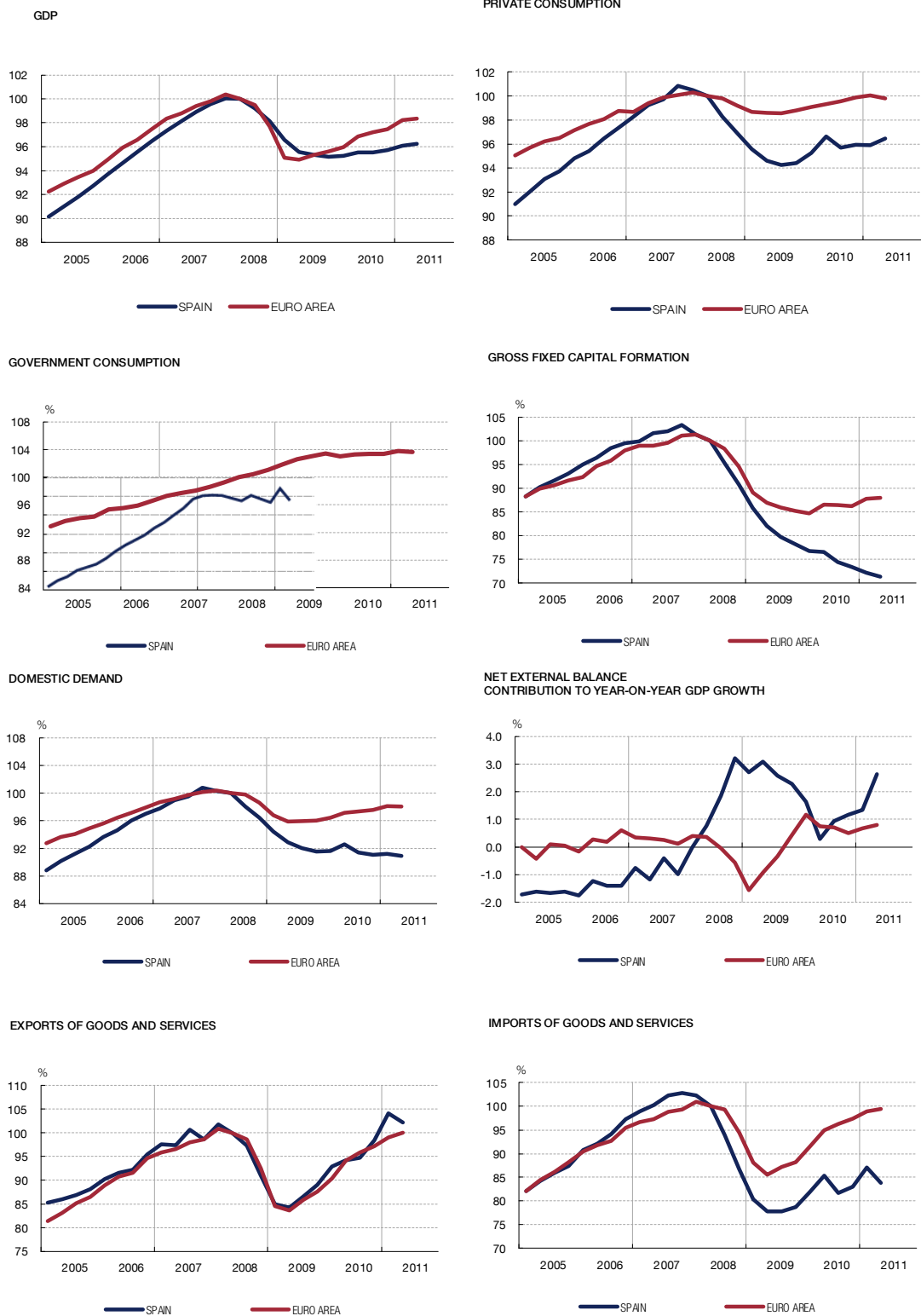
The scale of the contraction in 2008 and 2009 did not differ greatly from that in the main European countries. At the trough of the cycle, Germany and Italy had lost more than 6 pp of their pre-crisis level of output, while in France the related loss was only 3.5 pp. In this comparison, Spain stood out as the country that underwent the sharpest fall in its national demand, more than double that recorded in any of the other three economies (see Charts 2 and 3).

The duration of the contraction in Spain was six quarters in the case of GDP and around that figure for most variables (private consumption, investment in capital goods, exports and imports). But the fall in investment in construction and in its value added continues, after 15 consecutive quarters of decline, as it does with employment (see Chart 4).

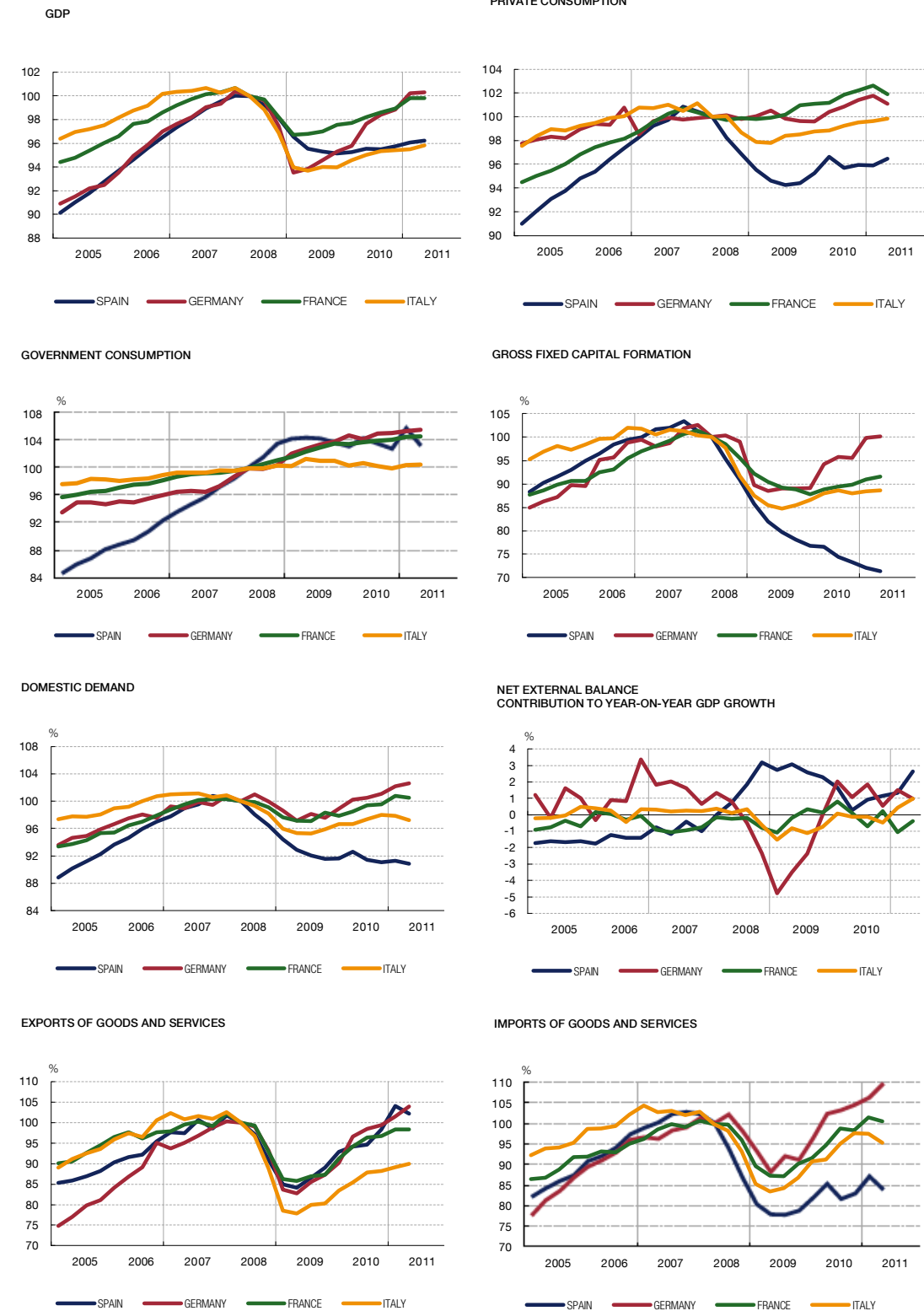
³ The figures used for the characterisation of the cycle in this section are from the National Accounts Base 2000 data. The National Accounts Base 2008 series, which were published in mid-November 2011, do not alter the trends or the order of magnitude of the cyclical oscillations of the different variables. They only entail changes in the classification of certain variables and, in particular, in gross fixed capital formation, which particularly affects the nominal and real values of residential investment, and its weight in GDP, as discussed elsewhere in this paper.



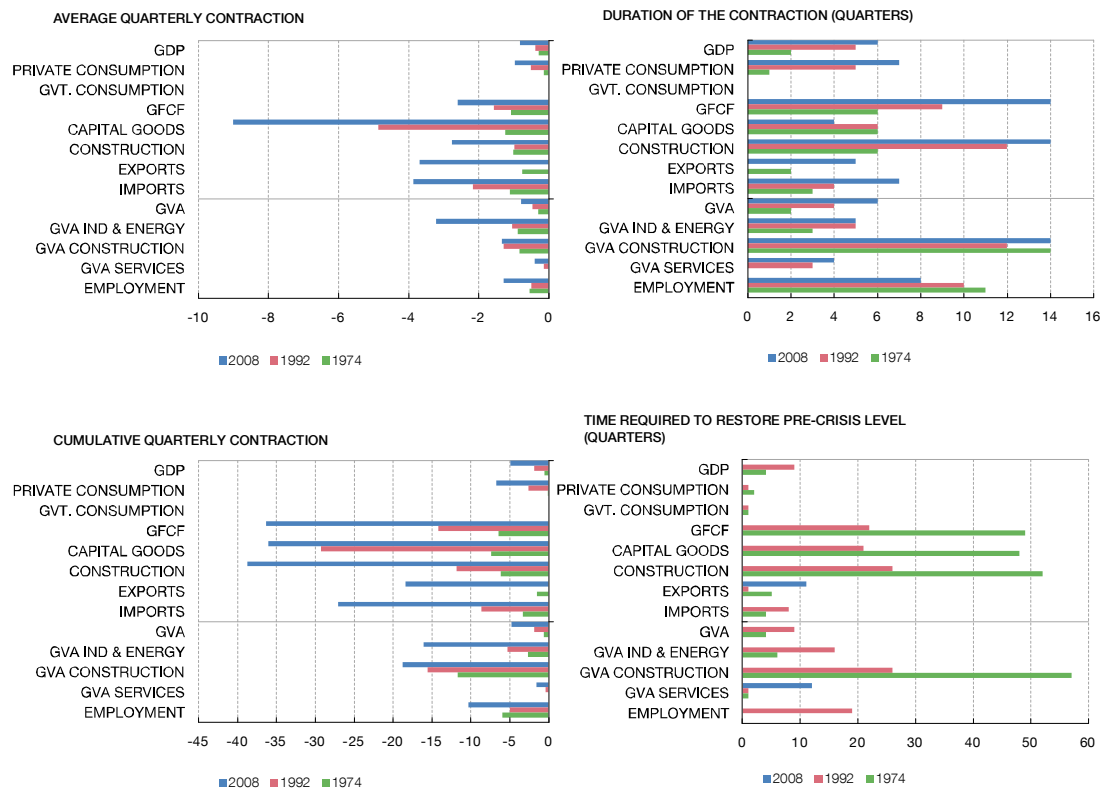
SOURCE: INE.



SOURCES: INE and ECB.



SOURCES: INE and ECB.



The Spanish recession was more acute than those in the mid-1970s and early 1990s⁴ (see Chart 5). Indeed, in the crisis that began in 1974, GDP scarcely declined, while in that in 1992, the cumulative decline at the bottom of the cycle was only 2 pp. Job destruction in the latest crisis is also approximately twice that observed in the two previous ones. Almost all the demand components have moved on a weaker trajectory in this recession compared with the previous two. The trend in investment is notable since it fell by 36% in this crisis compared with falls of less than 15% in 1992 and of around 6% in 1974. Under the investment heading, the most significant difference is in investment in construction, which had fallen by 40% up to 2011 Q3, compared with declines of 12% and 6% in the two previous recessions. Exports and imports also suffered to a greater extent in the latest recession, a fact related to the intensity of the adjustment in national demand and the international nature of the crisis in 2009, although the contribution of net external demand to GDP growth was greater than it was in 1992-1993. On the supply side, the three episodes analysed were characterised by a strong decline in gross value added (GVA) in construction, and a scant impact on the services branch, meaning that the differentiating factor of the latest recession is the significant fall-off in industrial GVA (see Chart 6).

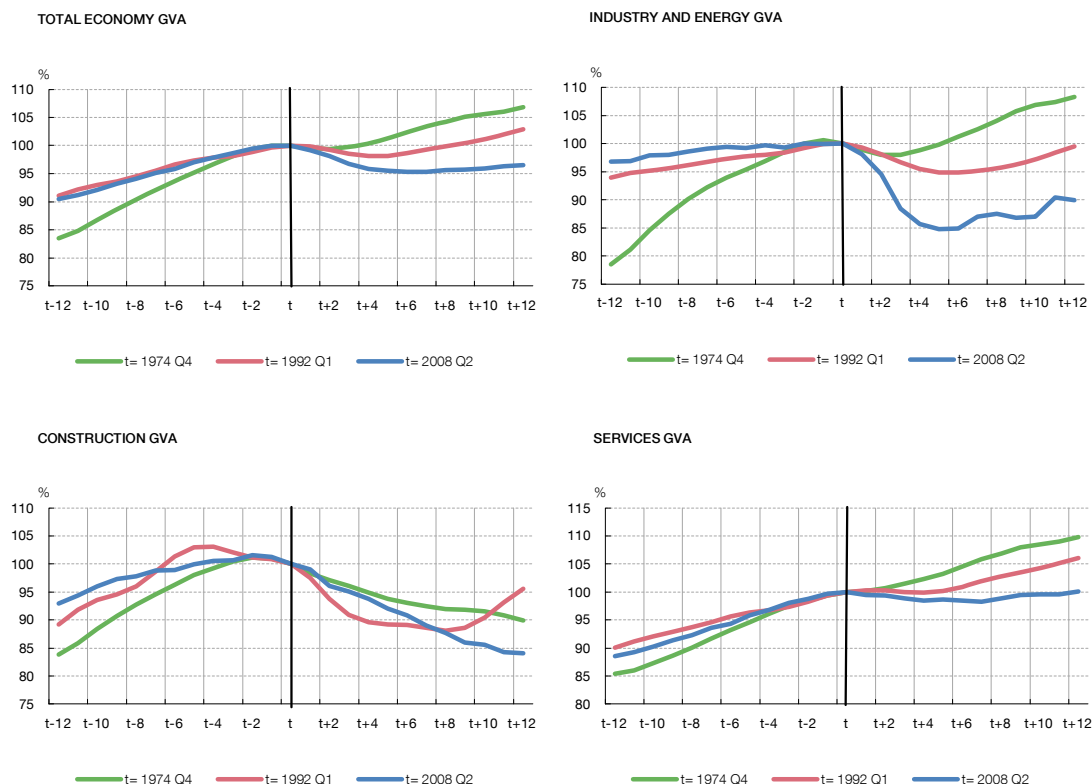
⁴ What are involved here are recessions which, given their magnitude and the availability of statistical information, are most suitable for making the pertinent comparisons. Nonetheless, both came about before the euro was in place and, therefore, under a very different macroeconomic regime than that currently prevailing.

MAIN MACROMAGNITUDES IN RECENT CYCLES IN SPAIN
 Index = 100 in the quarter prior to the beginning of the recession

CHART 5



SOURCES: INE and Banco de España.



SOURCES: INE and Banco de España.

2.2 The stagnation of 2010-2011

From 2010 Q1, when GDP began to post positive rates again, to 2011 Q3, economic activity picked up by scarcely 1 pp in cumulative terms. The sluggishness of the recovery is the result of the continuing process involving the absorption of the imbalances built up in the upturn, which has meant that residential investment continues to shrink and that private consumption is flat, given households' deleveraging needs and the uncertain economic outlook. Adding to these has been the fiscal consolidation process, which has required cutting public investment and halting the previous expansion of government consumption, as well as raising certain taxes. Thus, although GDP ceased to fall in late 2009, national demand has continued adjusting downwards since, and might continue to do so in the near future.

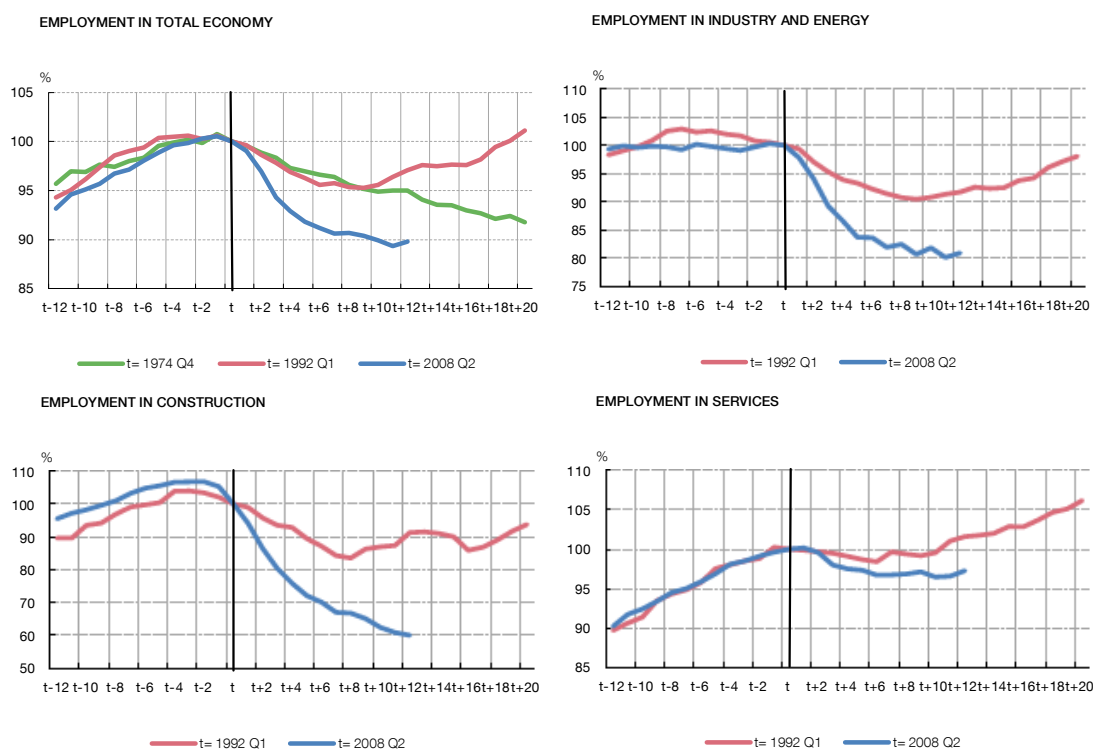
Accordingly, the pick-up in expenditure in this period has been underpinned exclusively by external demand, with strong momentum in exports and some containment of imports, which has provided for a substantial correction of the current account deficit from 10% of GDP in 2007 to an estimated 3.5% for 2011. If the external imbalance is analysed in terms of excess investment relative to national saving, the bulk of the adjustment has fallen on investment, the weight of which in 2007, with a ratio of 30.7%, was far higher (9 pp more) than that in the euro area. In contrast, national saving, which accounted in 2007 for 21% of GDP, was only 2 pp lower than the figure for the euro area and similar to that for some countries, such as France and Italy. In 2011, the weight of investment in GDP had fallen by

more than 9 pp from its peak to 21.5%, which chiefly reflects the decline in the residential investment component, while the national saving/GDP ratio had also fallen in this period, albeit to a lesser extent, by around 2.5 pp.

As with national demand, the contraction in the labour market has not ended; employment has been falling for 15 quarters, with a cumulative loss of around 10% in the jobs existing at the start of 2008 (see Chart 7). By productive branch, employment in services has shown a more moderate cumulative decline, of 3%, given the weight of public-sector employment in this sector, where the adjustment has begun only recently. Conversely, both in industry (with the fall in employment standing at 19%) and in construction (where the decline rises to 40%) the adjustment has been most acute and, in the case of construction, has become sharper in recent quarters, given that the weakness of residential investment has been compounded by the more recent decline in public investment.

EMPLOYMENT IN RECENT CYCLES IN SPAIN
Index = 100 in the quarter prior to the beginning of the recession

CHART 7



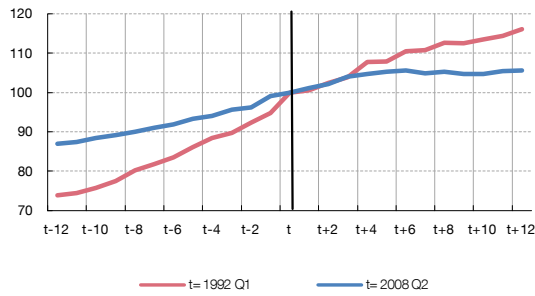
SOURCES: INE and Banco de España.

The pattern of weakness is apparent in the behaviour of all the productive branches: the rebound in industry — underpinned essentially by the expansion of exports — is not very different from that seen following the recession in the early 1990s, although now the starting point is a lower level of output, whereas value added in construction has continued falling and that in services is practically flat.

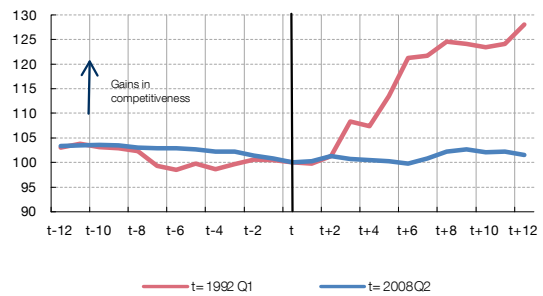
The intensity of the effects of the crisis in Spain has scarcely been tempered by the behaviour of prices and wages which, in fact, have contributed insufficiently to absorbing the shock and the adjustment of the economy. The average level of compensation per employee has increased by around 5% in cumulative terms since 2008, while over the same period productivity has risen by almost 10%, meaning that unit labour costs (ULCs) have slowed only modestly in the past three years. Admittedly, this variable increased during the crisis in the early 1990s, since wages were then growing more forcefully; but it should be taken into account that the Spanish economy was able at that time to regain short-term competitiveness through exchange rate depreciation (see the left-hand column of Chart 8). A similar picture is obtained observing the GDP deflator: in the current crisis, the deflator has scarcely increased, compared with a rise of almost 15% in the early 1990s. However, this relative price and wage moderation has far from allowed for a substantial improvement in competitiveness. In terms of the real effective exchange rate (REER) vis-à-vis the developed countries, calculated on the basis of relative ULCs, a depreciation of 8% was brought about between 2008 and 2011, while in the 1992 crisis the figure amounted to 23% in a period of scarcely three years (see the right-hand column in Chart 8). In any event, the past experience of a large number of advanced economies and Spain's own experience in recent decades show that countries with a flexible exchange rate — and which, therefore, have the possibility of devaluing their national currency — are no more successful in maintaining or increasing competitiveness in the medium and long term than those that adopt a fixed exchange rate regime.⁵

⁵ A summary of the evidence in this respect can be found in Nuño (2011).

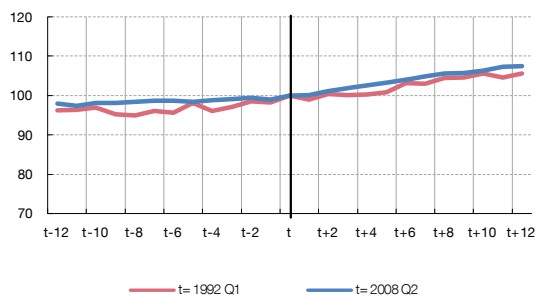
COMPENSATION PER EMPLOYEE



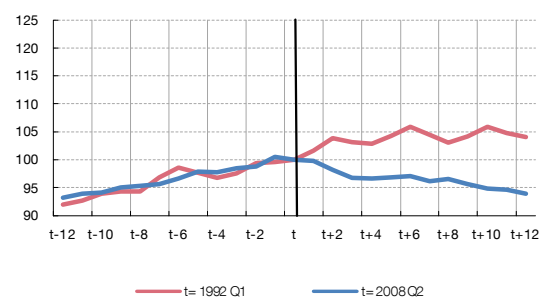
Inverse of the NEER vis-à-vis developed countries



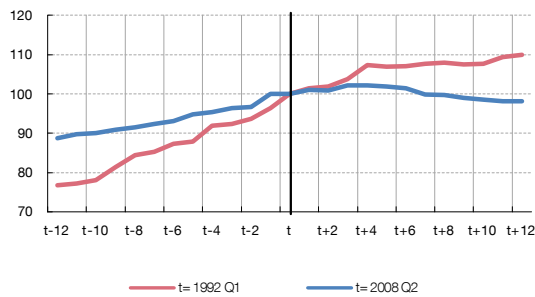
PRODUCTIVITY



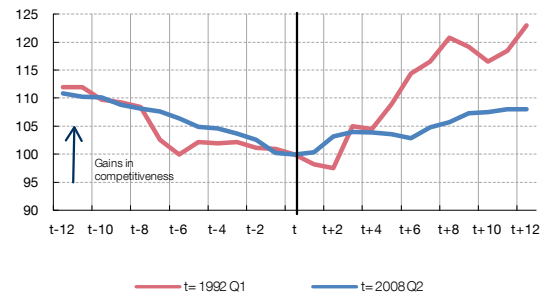
Relative ULCs



UNIT LABOUR COSTS



Inverse of the REER vis-à-vis developed countries with economy-wide ULCs



SOURCE: Banco de España.

3 Determinants of the crisis and of the macroeconomic adjustment in Spain

The intensity of the effects of the economic crisis in Spain and the sluggishness in exiting the crisis are related to the scale of the imbalances accumulated and to the virulence of the shocks undergone, including most notably the protracted euro area sovereign debt crisis, which is giving rise to powerful contractionary effects on financing conditions and on confidence. Furthermore, however, the adjustment phase is being influenced by certain idiosyncratic developments in the Spanish economy, whether because of its exposure to shocks that have affected it asymmetrically compared with other European countries, or because of certain institutional characteristics bearing on the mechanisms for adjusting to these shocks. In this respect, it is worth considering the characteristics of the ongoing correction of the excesses in the real estate sector, the labour market adjustment and the functioning of the competitiveness channel.

The collapse in housing investment is an essential factor for understanding the dynamics and depth of the crisis. Investment in housing, which had expanded most sharply in the boom period, exceeding 12% of GDP, has seen its weight in GDP cut to less than 7% in 2011. This is below its previous low and part of a trajectory that has probably not yet run its course.⁶ Indeed, the interaction of the slowdown in activity in the residential construction sector with the effects of the financial crisis prevented real estate excesses from being corrected more gradually. On the contrary, all the channels through which developments in the real estate sector spread to the rest of the economy were activated, contributing to amplifying the recession. The slowdown in household demand for housing in response to tighter financing conditions and to the downturn in confidence prompted a decline in housing starts and in residential construction, and a turnaround in house prices, which began to fall in 2008 Q2. The subsequent economy-wide reduction in output and employment coupled with the fall in real estate prices had a direct contractionary effect on disposable income and wealth. That triggered a series of second-round effects on residential investment, on activity in the sector and its ancillary industries, and, once more, on employment.⁷

Further, the particular characteristics of the residential construction sector, which is strongly leveraged and where the housing production period is prolonged (no less than two years), meant that, in 2008 and 2009, housing started before the beginning of the crisis continued to be built and real estate firms took on heavy debt as the firms could not — following the usual cycle — free themselves of their financial burden through the sale of this real estate.⁸ As a result, a large stock of unsold housing emerged in those years, which depressed prices and erased prospects of a prompt recovery in the sector, leading to a collapse in the number of housing starts. These circumstances saw substantial increases in

⁶ These figures correspond to data from the new National Accounts (base 2008) which, compared with the base 2000 series, increase the weight of investment in housing in GDP by between 2 pp and 3 pp, given that they now include within this category the capital goods incorporated into a dwelling and the expenses linked to the purchase of a house formerly viewed as investment in other products, such as legal costs, architecture-related expenditure, engineering, and transfer tax.

⁷ The description of the adjustment of the real estate sector and the relative significance of the various channels can be found in Marqués et al (2010).

⁸ The fact that houses started before the collapse in demand continued to be built in the following years may have contributed to softening in some way the effect of the real estate crisis on economic activity, but at the expense of making the ensuing declines more prolonged, by having continued to increase the debt of real estate developers and by having depressed the outlook for the sector in the medium term, insofar as the supply overhang increased.

real estate company defaults and the bankruptcy of some, while certain banks' balance sheets were impaired. The adjustment of house prices is proving greater than that recorded in the cycles of the late 1970s and early 1990s. The strong volatility of residential investment and of house prices, along with the cyclical implications entailed, are key aspects for drawing lessons about the future, which are examined in section 4.

The workings of the labour market are also an essential factor for understanding the dynamics and depth of the crisis. As indicated, the average level of compensation per employee has increased moderately since 2008; but behind this growth lies highly expansionary wage behaviour in the years in which economic activity most fell (2008-2009), with annual growth exceeding 5%, followed by practically zero increases, although the latter have come about owing to the reduction in public-sector wages. Yet over the same period, employment has declined by more than 2 million people and the number of unemployed has risen, placing the unemployment rate at over 21% at the close of 2011. As often reiterated⁹, the wider scale of the employment response in Spain, along with the more inertial behaviour of wages seen once again in this period, reflects a historical pattern underpinned by certain institutional characteristics of the labour market, such as the excessive difference in the degree of protection afforded to permanent and temporary contracts, and the scant adaptability of collective bargaining arrangements to economic circumstances, to firms' situation and to productivity gains.

As is well known, the monetary union in Europe has a single monetary policy and currency, limits on fiscal policy discretion and frictions in the area-wide functioning of the factor and product markets. Against this background, adjustment channels must work efficiently to correct the potential disequilibria that may arise as a result of the misalignment of competitiveness or to absorb the emergence of shocks with the least possible upheaval. As earlier indicated, the Spanish external deficit had reached excessive levels in 2007 of close to 10% of GDP in the wake of the real estate boom and of the surge in corporate and household debt. In turn, national demand had come to account for almost 107% of GDP, meaning that net external demand detracted forcefully from growth and that there were highly significant domestic price strains. The pressing task of correcting this imbalance involved the immediate activation of the adjustment channel through which competitiveness operates. According to this, in a monetary union the countries with most inflation will undergo losses in competitiveness that ultimately reduce exports and increase import penetration. The subsequent decline in demand should exert downward pressure on prices and wages, which will promote the depreciation of the real effective exchange rate, restoring the competitiveness lost. The effectiveness of this adjustment mechanism is obviously related to the flexibility of cost- and price-setting systems, which was — as mentioned — rather limited in Spain.

Since 2007 the external deficit has been substantially corrected, with a significant rise in goods and services exports, the share of which in world markets has increased. The weight of national demand has fallen to 101% of GDP in 2011, meaning that the external balance of goods and services has almost moved into equilibrium.¹⁰ Nonetheless, this correction of the deficit has largely been based on the marked weakness of domestic

⁹ See, *inter alia*, Estrada et al (2009), Cuadrado et al (2011) and Banco de España (2009).

¹⁰ This is not the case for the balance of transfers or, above all, for the incomes balance, which shows a marked and increasingly negative sign, as a result of the accumulation of liabilities to the foreign sector.

demand and, therefore, of imports¹¹, while the REER has depreciated only moderately and, moreover, has done so on the back of an acute adjustment in employment, which has led to an increase in apparent productivity. This improved productivity has not therefore been the result of a build-up in gains in productive efficiency, which is crucial for achieving lasting increases in competitiveness, in the broadest sense of the term. The overriding impression is that in Spain, as in other euro area countries, the adjustment channel operating on competitiveness has functioned only partially over these years.¹²

¹¹ The external goods and services deficit fell from 6.7% of GDP in 2007 to around 1% in 2011. Of this improvement, almost 60% was due to the decline in the weight of imports in GDP, and 40% to the increase in exports.

¹² Malo de Molina (2011b) points out that the malfunctioning of the competitiveness channel has indeed been one of the main weaknesses of the euro area from the outset.

4 Lessons from the crisis

Sustainability of the external deficit in a monetary union

Spain has persistently posted an external deficit of some size. This was due, at least in part, to the fact that the Spanish economy was less developed than its main European peers, which meant greater investment opportunities in the country (or a bigger return on such investment projects) and a shortfall in national saving to cover these investment possibilities. Yet at the same time, the external deficit was an expression of the economy's inability to avail itself of a sufficient degree of macroeconomic stability, which led to a regular loss of competitiveness in upturns and to a widening of the external deficit, which had to be corrected with likewise regular devaluations of the peseta, the mechanism for temporarily re-balancing the external shortfall (see Chart 9).

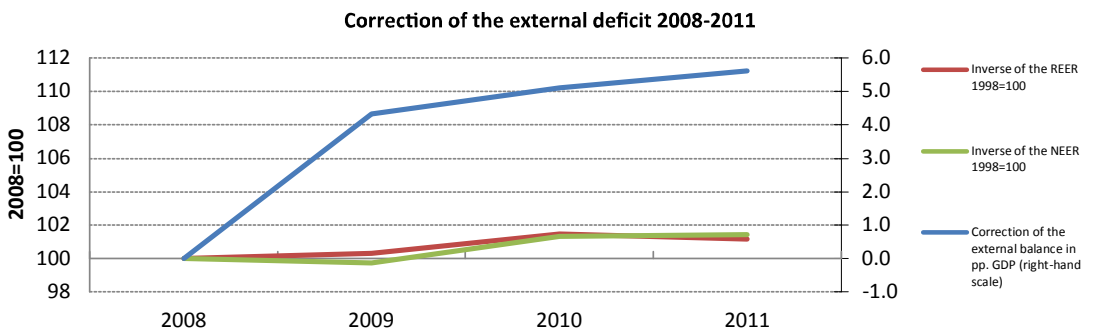
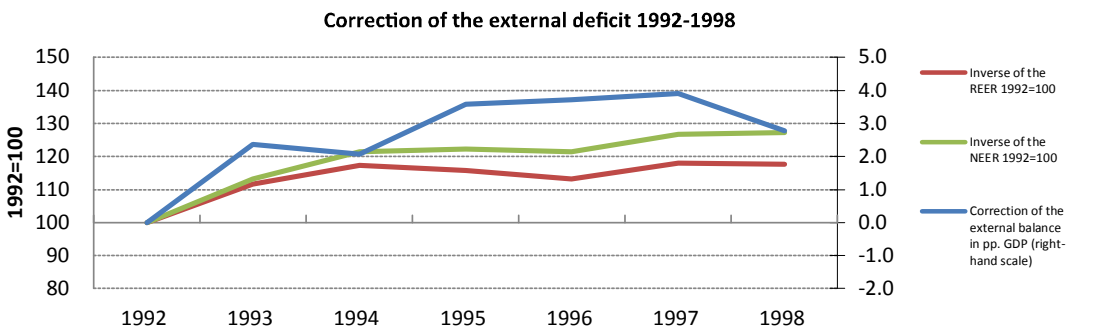
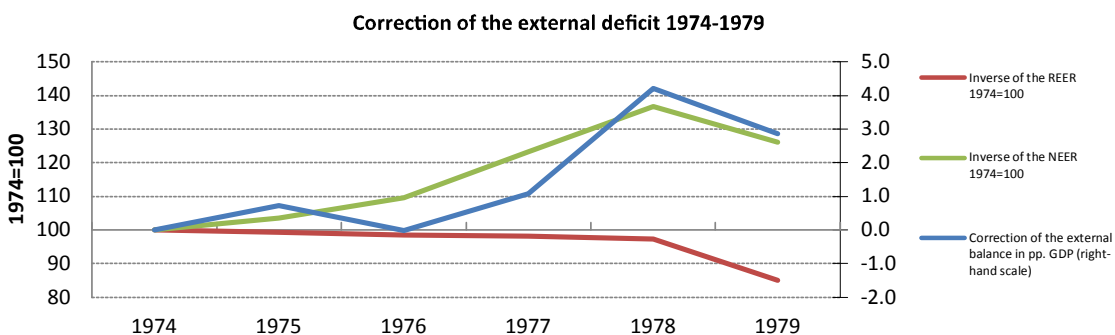
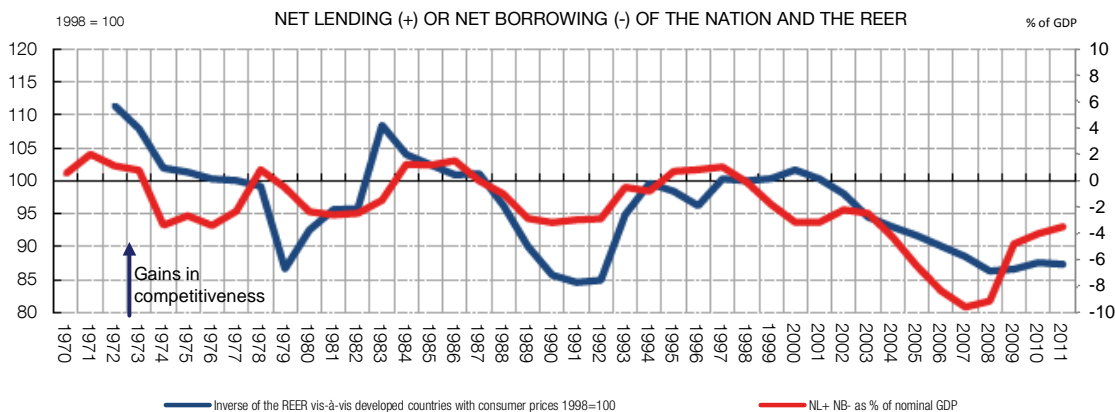
EMU membership in 1999 involved in this respect two fundamental elements. Firstly, Spain was joining a union with a single currency and fully liberalised capital movements, leading to anticipation that investment opportunities arising in Spain would be more readily taken advantage of through resort to external saving, since the euro would provide for confidence in the Spanish economy by eliminating the possibility of devaluation. The external constraint would not therefore be as demanding as when the peseta was in place, and nor would there be such an evident external deficit limit which, once exceeded, were to set in train speculative attacks or pressures on the national currency.¹³ Secondly, EMU membership removed the possibility of regularly correcting the country's competitive position through resort to devaluations. Accordingly, the financing of any future external deficits in Monetary Union would be more straightforward; but it had to be borne in mind that, if such deficits reached a high level, if competitiveness worsened substantially or if net external demand detracted significantly from growth, then the exchange rate could not be used as an instrument to swiftly improve the competitiveness of domestic production, to correct the external deficit and to promote export-led activity. The absence of this instrument would thus require flexible cost and price developments that were to ensure the competitiveness of domestic production.

As the external imbalance progressively increased during the boom years, several reports and articles pointed out that the rising path of external debt was not sustainable. They likewise highlighted the problems that the real-terms appreciation was generating, the costs of correcting it in a monetary union and the heavy private-sector debt incurred, which reflected the intense resort to external saving.¹⁴ Emphasis was further placed on the need for early diagnosis and correction, given the perceived difficulties of reversing some of these imbalances within a monetary union. Other papers stressed the fact that only highly favourable expectations about future income growth could sustain the substantial increase in external debt, expectations that could hardly hold given that the build-up of imbalances in the Spanish economy was making the indefinite maintenance of strong growth unsustainable.¹⁵

¹³ The economic literature and Spain's own experience when it had its own currency suggest that deficits above 3% or 4% of GDP mark the start of pressures to correct such deficits [see Freund (2000)].

¹⁴ See L'Hotellerie and Peñalosa (2006) and Malo de Molina (2006).

¹⁵ See Campa and Gavilán (2006).

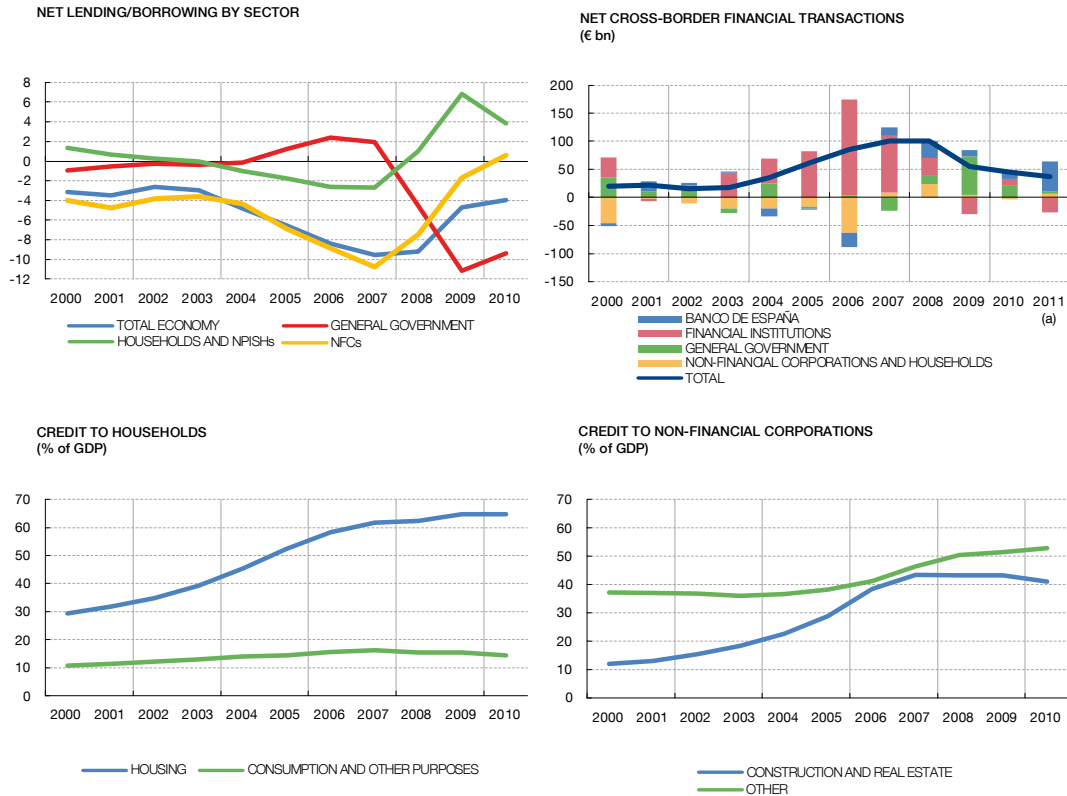


Sources: Ministerio de Economía, INE and Banco de España.

True, these considerations were present in the economic debate as from Spanish EMU membership. But the factor relating to the ease of financing external deficits in a monetary union was to some extent diminished by the absence of tensions on financial markets for a very lengthy period, which meant that the risks of that trajectory were underestimated. Nonetheless, subsequent events would show that the external constraint remained fully operative in EMU. The fact that the increase in the external deficit during the expansion was inextricably linked to the real estate boom and, in general, to the sharp increase in household and corporate debt is key to understanding this turnaround in the markets' perception of risk. Analysis of the breakdown of the nation's net borrowing in terms of the contribution of each institutional sector shows that the external deficit is basically due to the strong increase in the net borrowing of non-financial corporations and to the fact that the traditional creditor position of the household sector became a debtor position in the expansion years (see Chart 10). Admittedly, the role of the general government sector offset this to some extent, but insufficiently so to contain the external deficit and, as is analysed later, to ensure the sustainability of public finances when the extraordinary income underpinning that position petered out.

While households and non-financial corporations were the two institutional sectors in which a clear net debtor position was generated, it was credit institutions, in turn, which acted as intermediaries to obtain the external financing covering the external imbalance. As a result, there was a strong increase in households' and corporations' debt with Spanish credit institutions, while the latter resorted to external saving to finance it. The volume and speed of this process became notable, thereby substantially increasing the Spanish economy's vulnerability, especially if some event beyond the control of the authorities or of domestic agents were to affect the risk perception of the economy or its financial system.

The global financial crisis, the real estate collapse in Spain, deteriorating fiscal positions and growth prospects, and, finally, the inadequacy of European governance to confront the severe difficulties that arose in several countries as the effects of the crisis spread all shaped a scenario in which high debt, both vis-à-vis the external sector and on the part of the national private sector vis-à-vis banks, emerged as a considerable source of risk. Indeed, a change in the means of financing the external deficit began to be seen from 2008, with the funds obtained through the sale of government securities and short-term funds accounting for a greater weight relative to the resources raised through the issuance of covered bonds and asset securitisations, which were predominant during the years of the economic expansion. In parallel, external financing moved on a progressively costlier trajectory which left Spain vulnerable to the gridlock in funding flows that would arise recurrently thereafter. In other euro area countries, the source of the tensions was more closely linked, at least initially, to doubts over the sustainability of public finances or to the relative strength of banking systems. But irrespective of the ultimate causes of the vulnerability, when the markets perceived the contradictions between high debt, the deteriorating growth outlook and the shortcomings in the euro area's institutional arrangements to withstand such a scenario, the sovereign debt crisis arose, whose final act has yet to be played out.



SOURCE: Banco de España.

a. Cumulative data to October.

The upshot of all these developments was that country risk once more had a determining role on financial markets; instead of all the euro area economies being treated as regions of a single country, they are now considered as part of a not fully entrenched project with break-up risks, something which could not be foreseen in the expansion years. Consequently, the view that the external deficit had ceased to be relevant in a monetary union, since national economies could be considered as regions in the new monetary area, was now clearly questioned. Adding to that is the fact that the euro area did not have sufficiently powerful stabilising instruments, such as those existing in the United States, which range from a federal budget policy with inter-State income transfer mechanisms to far greater labour mobility within US territory.

The scale of the external deficit overshoot in Spain during the expansion and the difficulty of reversing it within the Monetary Union validates the recommendations that had been pre-emptively formulated. To assume the constraints imposed by membership of a monetary union, which are a logical counterpoint to the enormous benefits accruing, it would firstly have been necessary to prevent such an acute deterioration in the external deficit and, secondly, to have greater leeway with which to manage domestically controlled economic policy instruments in the event of tensions or the risks of a crisis arising. A more restrictive fiscal policy and greater liberalisation of the goods and factor markets would have been of fundamental assistance in tackling the events unleashed by the crisis: on one hand, because

they would have reduced national demand pressures, leading to a more balanced foreign trade account, with lower price and wage increases, and more favourable developments in competitiveness; and on the other, because into the crisis the room for manoeuvre of fiscal policy would have been greater and market flexibility would have provided for a better response to recessionary pressures, with a greater price adjustment rather than a volume-based adjustment, as was actually observed.¹⁶

In order to rapidly improve competitiveness within a monetary union, it is necessary to go beyond mere price and cost stability. A significant adjustment of the REER is unavoidable. This aspect comes to the fore when seeing how, in its recent trajectory, the Spanish economy had only managed to bring its external balance into equilibrium following significant devaluations of the peseta. To prevent the adjustment within monetary union from falling predominantly on real variables, the excessive downward stickiness of nominal variables must be overcome and the competitive environment enhanced so as to promote genuine productivity gains.

Looking ahead and judging by the events in recent years, the possibilities of situations of this type recurring have lessened considerably. First, because the financial markets are probably going to introduce, on a permanent basis, an element of discipline into economic policy conduct, discipline which was practically absent during the upturn. Second, because a procedure for monitoring macroeconomic imbalances in the euro area has been included in European governance mechanisms; and here, the external deficit, price-competitiveness indicators, the budget deficit and private-sector debt will play a key role. Finally, the mark the recent crisis in Spain has left, in the form of a burgeoning unemployment rate and a pressing need to resolve major imbalances, such as the fiscal deficit, should alter how we address future expansionary phases, paying greater heed to macroeconomic constraints and to the demands of forming part of a monetary union.

The real estate market

The weight in GDP of investment in construction in Spain increased from 15% in 1998 to 22% in 2007, but more than 70% of this increase was due to investment in housing. It is not easy to set a benchmark for the appropriate level of the housing investment/GDP ratio. In Spain, moreover, given the weight of the tourist sector and the frequent purchase of second homes by non-residents and nationals alike, the weight of residential construction might be somewhat higher than that of most of our European neighbours. Yet while the investment in housing/GDP ratio hovered around 6% in the euro area in the period 2000-2010, in Spain the related figure was double this in 2006 and 2007, when it stood above 12% of GDP. As analysed later, the excessive size of the real estate sector means that too large an amount of resources are being allocated to a relatively low-productivity activity, with the subsequent brake this entails on the expansion of total output.

Investment in housing is traditionally the demand component that tends to generate the most pronounced cyclical oscillations, not only in Spain but also at the international level.¹⁷ In the United States, for example, Leamer (2007) estimated that most recessions

¹⁶ Gavilán et al. (2011) estimate that supply-side and structural reform policies do not necessarily lead to a reduction in the external deficit; however, by improving the medium- and long-term growth outlook, they do reinforce the sustainability of the external position.

¹⁷ Although the investment in construction aggregate follows a clear cyclical path, its public investment and business investment components have less of a propensity to show sizeable variability or movements that respond to price expectations, as partly occurs in the case of residential investment. Moreover, both public investment and investment in construction are essential components for the development of the economy's productive capital and have an appreciable effect on long-term productivity. Accordingly, it is important in the analysis of the weight of construction to determine how much is due to investment in housing and how much to these other two components.

originated in a collapse of the real estate market, which then spread to the rest of the economy. Two characteristics of the housing market are essential: investment in this market is susceptible to show most substantial changes, since market expectations (in prices and in activity) may exert a considerable influence on market dynamics. Furthermore, it is a most employment-intensive sector and is linked to other productive branches and to other economic decisions, meaning that, when it goes into crisis, it not only has very powerful direct effects but also drags down certain industrial and services branches, and adversely affects household spending decisions.¹⁸

Adding to the volatility of residential investment, moreover, is the fact that crisis periods are usually more acute and briefer than expansion periods, which underscores the catalyst role of this investment component in recessions. In Spain's case, the weight of residential investment in GDP, which took 12 years to peak (in 2007), has needed only four years to return to its starting ratio (in 2011).¹⁹ This form of adjustment means that, in a short space of time, a large quantity of labour is driven out the market. And this, in the absence of buoyancy in other productive sectors, extensive labour market flexibility or a sufficient level of training on the part of the labour affected (pre-requisites which Spain clearly did not meet), gives rise unfailingly to a hike in the unemployment rate.²⁰ At the same time, these periods of traumatic adjustment have most adverse financial consequences, in that residential construction is a highly credit-intensive activity. As Chart 10 shows, most of the considerable dynamism observed in private-sector debt in the expansion years is linked to the real estate sector: hence, lending to households for house purchases doubled as a percentage of GDP from 2000 to 2007, climbing from 30% to over 60%, while credit for consumer goods purchases and for other purposes remained practically flat; in the case of non-financial corporations, it was financing for construction and real estate development activities that increased most markedly in this period, rising from somewhat over 10% of GDP in 2000 to above 40% in 2007. Following this build-up in debt, the private sector must now deleverage in what will foreseeably be a complex and prolonged process, and which will require achieving a less credit-dependent economic growth pattern.²¹

Admittedly, the depth of the current real estate crisis has been determined by the nature of the international crisis. This originated in the US housing market and spread through financial systems, which play a key role in underpinning residential activity and which today still face serious difficulties in the context of the euro area crisis. But, in any event, even in the absence of the severe international shock that broke in 2007, Spain would likely have ultimately undergone a real estate crisis, simply because the trajectory of prices and of real and financial resources concentrated in the sector was not sustainable. Once this dynamic has unwound, there is a risk that the excesses will be absorbed in a disorderly fashion, since this is a market where expectations, the behaviour of other agents and confidence play a vital role. And these latter variables are liable to change very quickly, triggering sharp movements in spending decisions and, in short, in the main macroeconomic variables, such as activity and employment.

¹⁸ Álvarez and Cabrero (2010) address the influence of the real estate cycle on developments in the aggregate cycle.

¹⁹ Regarding the status of the real estate sector adjustment at end-2010 and its macroeconomic implications, see Maza and Peñalosa (2010).

²⁰ For example, in the current crisis the countries that have posted a bigger increase in their unemployment rate are discernibly those that have had a real estate crisis.

²¹ See Malo de Molina (2012).

In sum, events in this crisis show the key role the real estate market plays in generating macroeconomic imbalances. A more rigorous mortgage lending policy and the establishment of other macroprudential instruments that have been under discussion in various international fora in recent years²², or the use of the tax system to ensure neutral tax treatment when it comes to buying or renting housing, are just two examples of the instruments available to the authorities to restrict the expansionary dynamic of the real estate cycle. Along with these, and as was the case with the external deficit, measures to make the labour market more flexible would be beneficial, enabling the potential labour surpluses in one sector to be relocated with greater flexibility in others and having wages transmit a clearer signal of relative labour shortages or surpluses in different sectors.

The role of fiscal policy

The budgetary policy stance has shown a relatively high degree of synchrony in recent years across the European countries, with a markedly expansionary thrust in the early years of the crisis that turned contractionary as from 2010, once the sovereign debt crisis began in Europe. This should not, however, mask the fact that debate continues to surround the actual stabilising capacity of fiscal policy, a debate that has been rekindled owing to the scale the debt crisis has reached. Questions such as the size of the fiscal multipliers, the measures that boost the stabilising capacity of fiscal policy and the conditions under which fiscal consolidations are most successful, are not free from controversy.²³ This debate is not addressed in this section but, in light of the experience of recent years, an attempt is made to briefly review all the factors underlying the swift, sharp deterioration in Spain's fiscal position during the crisis years and the challenges posed by the consolidation under way. Ultimately the aim is to define to what extent the economic and financial crisis has changed the perception of the stabilising capacity of fiscal policy. To this end, some stylised facts on Spain's fiscal policy stance in the period 2008-2011 are summarised hereafter.²⁴

Starting from a relatively comfortable budgetary position (Spain had a fiscal surplus of close to 2% of GDP and a public debt/GDP ratio of 36% in 2007), a series of discretionary, expansionary measures were adopted over the two years spanning 2007 and 2008 against a countercyclical fiscal policy background at the global level, promoted and supported by the international institutions in what was a coordinated response to the financial crisis.²⁵

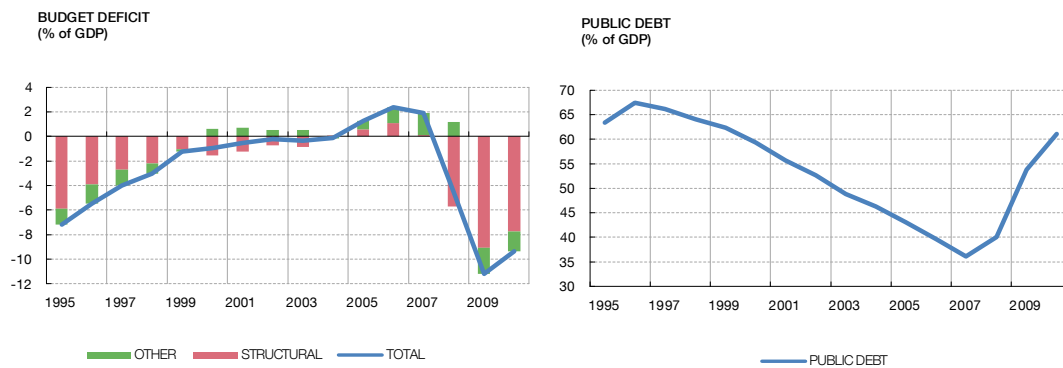
A rapid and sharp deterioration in the budgetary situation ensued thereafter. The budget deficit rose by more than 13 pp of GDP to 11% in 2009, and the public debt ratio by 18 pp to 54% of GDP that same year (see Chart 11). Overall, the fiscal deterioration was most acute and greater than anticipated, not only because the scale of the recession was greater than expected, but also because the extraordinary revenue to which the real estate boom had given rise disappeared. The increase in the debit position was chiefly structural, which raised the cyclically adjusted deficit to an unprecedented rate (almost 10% of GDP in 2009).

²² See Malo de Molina (2011a).

²³ See, for example: IMF (2010), Banco de España (2011), Hernández de Cos and Moral (2011) and Rother et al. (2010).

²⁴ An exhaustive analysis of this issue can be found in Banco de España (2011).

²⁵ See Banco de España (2009). In the EU, the European Commission launched its European Economic Recovery Plan in December 2008. The Plan advocated the implementation of fiscal packages equivalent to 1 pp of GDP, through transitory measures aimed at boosting public investment in strategic industries. Both the IMF and the OECD called for the adoption of expansionary fiscal measures in their spring and summer 2008 reports.



SOURCE: Banco de España.

The heightening of the sovereign debt crisis during 2010 and the emerging doubts over the sustainability of Spanish public finances made it necessary to bring forward and step up the fiscal consolidation process begun some months earlier. As a result, the budget deficit stood at 9.3% of GDP in 2010, meeting the objective set at the European level. A target of 6% was set for 2011, although initial government estimates place the deficit at around 8% of GDP, which would entail a public debt ratio of over 70% of GDP, almost double that recorded four years earlier, and moving on a still-rising trajectory.

Experience from past recessions in Spain suggested that a budgetary policy going beyond the use of the automatic stabilisers would ultimately bring about a rapid deterioration in the public finances position. In this respect, the deficit overshoot in recent years has revealed the existence of certain fragilities in institutional arrangements and of errors in the diagnosis of the stabilising capacity of fiscal policy. It would be worth considering these in order to prevent their future recurrence.

Firstly, focusing on the diagnosis by international organisations of Europe's problems, at the onset of the crisis the room available to pursue countercyclical fiscal policies was overestimated. Generally, economic policy recommendations were not adjusted to the differences existing in underlying fiscal positions.²⁶ Nor were potential differences in the channels through which the crisis spreads, and, therefore, in the scale and persistence of the contraction, taken into account. In Spain, a not-inconsiderable portion of the tax revenue raised in the expansion years was known to be due to the buoyancy of real estate activity, but it was difficult to estimate the scale of such revenue with the usual fiscal balance breakdown techniques.²⁷ Indeed, the difficulty in accurately measuring the structural component of revenue led to the risks underlying the public finances position to be minimised, and limited the primary-expenditure-adjustment drive during the expansion years.

Furthermore, the existing fiscal discipline frameworks have proven insufficient to ensure compliance with budgetary targets. European supervisory procedures were unable

²⁶ See Pisani-Ferry et al (2011).

²⁷ De Castro et al (2008) estimated that this extraordinary revenue had risen, in cumulative terms, to more than 2 pp of GDP to 2007. This was similar to the estimate in Martínez Mongay et al (2007).

to promote any sustained consolidation of public finances during the expansion phase²⁸, which it is hoped to redress with the recently approved reform of the Stability and Growth Pact and with the deeper-seated changes to be implemented through the Intergovernmental Treaty that will be approved in 2012. On the domestic front, the budgetary stability legislation was not effective either in alerting, foreseeing and preventing the magnitude of the fiscal deterioration, especially in the case of the regional governments. The monitoring and control mechanisms proved to be insufficiently binding. The recent inclusion in the Constitution of ceilings on the deficit and on public debt aim to resolve these problems looking ahead.²⁹

As to the stabilising potential of fiscal policy, although it is difficult to calibrate the macroeconomic effect of the fiscal packages implemented in the different phases, some analytical approaches appeared to indicate that they had a moderate countercyclical effect. During the crisis years, against the background of prevailing uncertainty, part of the expansionary impulse was contained in a higher household saving ratio or confined itself to altering the pattern of expenditure, without affecting its underlying trend.

In any event, once very negative deficit positions have been reached, as was the case in Spain in 2009, the experience of recent years shows that the fiscal drive needed to resume healthy budgetary positions is on a most sizable scale, it feeds through only gradually to the deficit figures and it will be reflected with a much greater delay in the public debt figures. As indicated, Spain's budget deficit increased by 13 pp of GDP in only two years, while it is estimated that four years and a considerable consolidation drive will be needed to place the deficit at 3% of GDP in 2013. In the case of the debt ratio, the return to pre-crisis figures is not envisaged on the immediate horizon. And not only because of the lower foreseeable contribution of economic growth, but also because, as in the past, resort cannot be had either to a reduction in interest payments, which are moving on a clearly rising trajectory, or to the contribution of other sources of improvement, such as the extraordinary revenue from the past real estate boom.

In short, the risks expected potentially to arise as a result of discretionary fiscal measures going beyond the mere operation of the stabilisers have materialised. As indicated at the time, measures of that type might exhaust ahead of time the fiscal room for manoeuvre available to tackle, where necessary, adverse cyclical situations. In the worst case, it was warned that it might even be necessary to pursue restrictive policies at the least appropriate cyclical juncture, as has actually occurred as a result of the euro area sovereign debt crisis.

The labour market

A review of the labour market situation in the years prior to the 2007 crisis breaking might suggest that the Spanish labour market had overcome some of the endemic problems marking its behaviour for decades: low participation levels, scant capacity to generate employment and difficulties in reducing the unemployment rate, in particular its structural component.

Indeed, in 2007 both the participation rate and the employment rate stood at historical highs, while the unemployment rate was at a low.³⁰ The high participation rate

²⁸ Malo de Molina (2011b).

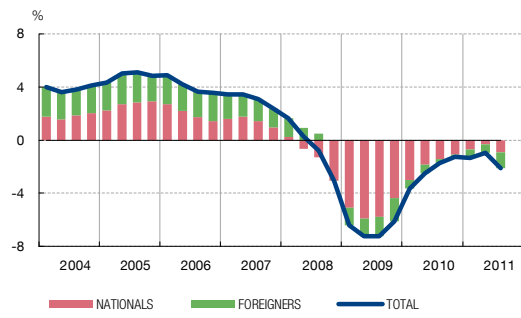
²⁹ Hernández de Cos (2011) reviews the shortcomings in the institutional frameworks in place and assesses what the inclusion of the fiscal rule in the Constitution represents.

³⁰ Moreover, the traditional gap between the male and female unemployment rate, between different age groups and between groups with different levels of training had narrowed to practically non-existent levels.

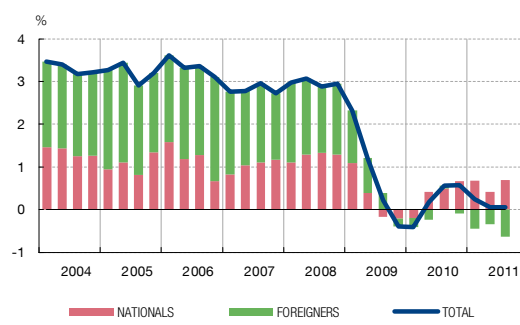
reflected the massive inflow of immigrants as from the year 2000, and the marked increase in the female participation rate, which affected all ages and levels of educational attainment (see Chart 12). The strong demographic impulse the Spanish economy experienced over these years can be adequately illustrated with some figures on the change in the composition of the population. From 1999 to 2007, Spain's population increased by over 5 million, three-quarters of whom were foreign immigrants, whereby the proportion of foreigners in the total population climbed from below 2% in 1999 to 10% in 2007. The surge in the employment rate (almost 20 pp up on 1995) was a result of the notable economic expansion in the 10 previous years, led by activity in the construction sector and, to a lesser extent, by certain services activities. The simultaneous expansion of labour supply and demand prevented the emergence of bottlenecks in the labour market and was conducive to relatively moderate wage behaviour at the aggregate level. Nonetheless, the temporary employment rate still remained very high, as a result, on one hand, of the type of productive specialisation, highly intensive in construction and in relatively unskilled labour. But, on the other hand, it also evidenced the failure of successive attempts to promote permanent hiring. This type of productive specialisation, along with scant progress in the efficiency of productive processes, meant very moderate productivity gains.

Year-on-year rates of change and contributions

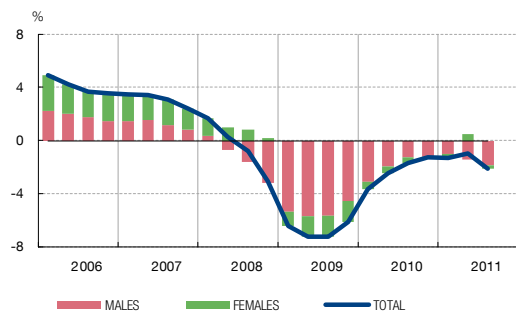
EMPLOYMENT. CONTRIBUTION BY NATIONALITY



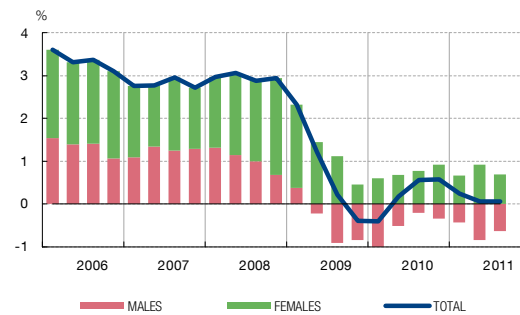
LABOUR FORCE. CONTRIBUTIONS BY NATIONALITY



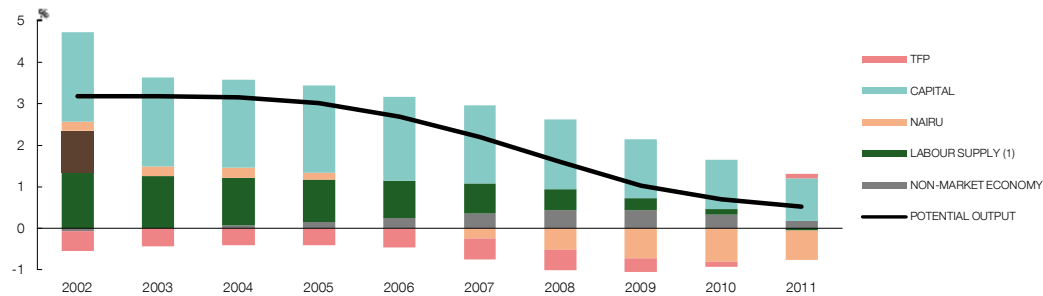
EMPLOYMENT. CONTRIBUTIONS BY SEX



LABOUR FORCE. CONTRIBUTIONS BY SEX



CONTRIBUTIONS TO POTENTIAL OUTPUT GROWTH



(1) The contribution of labour supply has been approximated by adding the contributions of the working age population, the participation rate and hours worked per person.

SOURCES: INE and Banco de España.

On the whole, the labour market situation in the pre-crisis years was a very buoyant one. Also, wage behaviour was less distorted than in the past, owing to the dynamising effect exerted by new labour market entrants during the expansionary phase, who showed greater wage flexibility and higher regional and sectoral mobility, along with a more active stance in the face of job loss. But this pattern was not sustainable; as the collective bargaining and hiring systems had scarcely been altered, the emergence of new shocks would foreseeably lead to a recurrence of the type of labour market adjustment seen in the past, with the bulk of the adjustment falling on employment and, in particular, on temporary hires. And that would have serious consequences since, given the underlying real estate excesses, only a rapid adaptation of relative wages, blocked by the institutional framework in place, would have been able to bring about a reallocation of labour from the clearly oversized construction sector to alternative activities.

The experience of recent years has confirmed the factors of vulnerability underlying the functioning of the labour market. While the essentially endogenous nature of the changes observed, closely linked to the boom under way, had been anticipated, the buoyancy of employment during the upturn had led to an overestimation of the real improvement in its fundamentals and, in particular, of its adjustment capacity in the face of shocks. There were serious consequences to this mistaken perception. For one thing, the scale of the contraction in employment that might accompany the adjustment of the real estate sector was underestimated, regarding both the size of the cut in employment in the sector and the indirect effects that the cut could trigger. Likewise, the role that employment as a whole could play as an amplifier of the effects of the crisis might have been underestimated.

But, above all, this view of the functioning of the labour market detracted from the importance of the need to see through the unfinished institutional and structural changes that smooth participation in EMU required. Even when the scale of the problem unfolding in terms of unemployment was evident, the aforementioned mistaken view led to a delay in acknowledging the need to adopt sufficiently ambitious measures. In June 2010 the first steps were taken to attempt to address the underlying problems, when a reform of hiring arrangements was approved, followed in July 2011 by that of collective bargaining. In both cases what were involved were partial reforms that have had a very limited impact, although their entry into force came about at a time the economic and financial climate was deteriorating notably. In any event, they illustrate the scant effectiveness of partial and fragmentary reforms.

Compounding the labour market inefficiency problems have been changes in the pattern of behaviour of labour supply, which has clearly moved into a slowing phase and has seen its possibilities of future expansion reduced. This is largely due to the response to the cyclical change by immigration, the rate of increase in which has been drastically cut in recent years, to the point of declines in net migratory flows being recorded in 2011. Partly offsetting this effect, the participation rate of the over-45s has been perceptibly more resilient, as has that of women, unlike traditional patterns in the past. The upward course of the female labour force is, in any event, limited. The resulting picture is one in which the contribution of the labour supply in the long run will detract momentum from the increase in potential growth, a negative aspect which will compound the impact of the high rate of structural unemployment.

Lastly, the abundant availability of unskilled labour during the expansion years helped entrench a pattern of productive specialisation that was very unbalanced and which, as indicated, would prove unsustainable. The development of this labour-intensive model of specialisation muffled the signals stemming from the far-reaching transformation of the productive structure at the global level and delayed the adjustments to processes required in an increasingly globalised and competitive world. As a result, the adjustment must now be greater and the possibility of restoring employment-generation levels similar to those before the crisis is more uncertain.

5 Conclusions

The economic crisis affecting the industrialised countries in recent years has been singular given its intensity, complexity and the difficulties in overcoming it. This is the first crisis of size to affect Spain since it joined EMU and, therefore, it arose in a situation in which the scope of economic policy instruments had narrowed significantly. That said, membership of EMU — a strongly integrated area, both economically and financially — did provide a safety net. Nonetheless, it was not known how it would respond to potential internal or more global shocks. During its first 10 years of EMU membership, the Spanish economy had built up significant macroeconomic and financial imbalances in certain areas (the real estate market, excessive debt and a loss of competitiveness), all of which were closely interlinked and which were evidently factors of vulnerability. But in other areas it evidenced apparently sounder fundamentals (as in the case of the budgetary position and labour market situation) that might endow it with some resilience.

Against this backdrop, the recession in the Spanish economy from 2008 to 2010 Q1 was sharper than those in the mid-1970s and early 1990s, with a very marked adjustment in domestic demand, which was partly offset by a positive contribution of net external demand to GDP growth. On the supply side, the recession had a virulent impact on construction, but it also severely affected industrial activity. The losses in terms of employment approximately doubled those witnessed in previous recessions.

A central aspect of the crisis is the Spanish economy's difficulties in recovering, which are greater than those faced by other European countries or those recorded in Spain in previous recessions. Up to 2011 Q3, scarcely 20% of the fall-off in the level of production since 2007 had been recovered, while employment, which continues to retreat following 15 quarters of declines, has lost about 10% of its early 2008 level. Set against this, the external deficit has undergone a drastic correction. Moreover, since last summer, prospects have turned down sharply and further declines in activity cannot be ruled out, although this is a more global phenomenon and one closely linked to the worsening sovereign debt crisis.

In Spain, emergence from the recession is conditional upon the imbalances previously built up being absorbed and upon the virulence of the shocks. The adjustment of the real estate sector is ongoing and the deleveraging of households and firms is moving ahead, albeit slowly, in a financial environment severely affected by the sovereign debt crisis, which reflects, *inter alia*, shortcomings in the euro area's initial institutional design. In addition, the adjustment of the Spanish economy continues to evidence a series of distinctive features — especially in price- and wage-setting — that reveal the insufficient adaptation of agents' behaviour to the macroeconomic stability EMU membership requires. Lastly, the need to redress the vulnerable public finances situation calls for ambitious fiscal consolidation plans, which also conditions the exit trajectory from the crisis.

The Spanish economy's experience over the past four years allows certain lessons to be drawn on the external sector, the real estate market, fiscal policy and the labour market. The external deficit is a variable of singular importance in a monetary union. The events of recent years show that the accumulation of excessive deficits will ultimately be punished by financial markets which, under certain circumstances, may re-establish country risk and, by this means, hamper the financing of deficits. And this all the more so if the external deficits

have largely been the consequence of a strong increase in private-sector debt geared essentially to residential investment, alongside persistent losses in competitiveness vis-à-vis the external sector. To cope with the limits imposed by membership of a monetary union, it would have been necessary during the expansionary phase to avoid such an acute deterioration in the external deficit. In this connection, a restrictive fiscal policy and greater liberalisation of goods and factor markets should have been pursued, thereby lessening demand pressures and allowing for a sharper adjustment of costs and prices. In the current circumstances a substantial competitive improvement is needed to accelerate and intensify the economy's reaction. Gradual and modest adjustments may prove insufficient, and there is a risk they will lead to a growth path persistently below potential.

It has been verified that the strong volatility of residential investment and of house prices may, under certain circumstances, have highly adverse cyclical consequences; accordingly, to maintain a suitable degree of macroeconomic stability, developments in the real estate market and in the productive and financial resources earmarked for housing investment must be closely monitored, with the authorities using the instruments available to them to curb the expansionary dynamic of the residential cycle. The Spanish case reveals, moreover, the difficulties of digesting household and business deleveraging processes that are strongly linked to real estate activities. And the latter, in turn, have adverse effects on bank balance sheets and, in general, on the financing conditions under which the economy necessarily operates.

As regards public finances, the experience in recent years has highlighted, first, the difficulty entailed in accurately determining their underlying situation (partly because of insufficient analytical tools, but also because of the influence of economic policy considerations); and, further, the failings in institutional monitoring and surveillance mechanisms both at the European and national levels. And this despite the fact that, in both cases, mechanisms were designed to provide fiscal buffers in boom periods that would allow the pursuit of countercyclical budgetary policies in recessionary phases. The changes to fiscal arrangements adopted in Spain in recent months and the amendment of the Stability and Growth Pact under way in Europe will correct these dysfunctions. In any event, the application of fiscal policies that go beyond the operation of the automatic stabilisers may ultimately prompt adverse effects, as has occurred in recent years, and the effort to turn around a negative fiscal trajectory will require a far-reaching budgetary drive that is all the greater the weaker the bases of growth should prove.

Lastly, the labour market has responded with unprecedented intensity to the shocks affecting the Spanish economy in the past four years. The dynamism of employment in the boom years, buoyed by the feedback loop between the expansion in construction and immigration, had led to an overestimation of the improvement in the fundamentals underlying the functioning of the labour market and in its adjustability to the shocks; and, accordingly, the potential extent to which this could amplify the effects of the real estate crisis, first, and spread to the rest of the economy, subsequently, was underestimated. As a result, structural unemployment has reached very high levels. And it will be very difficult to absorb it in the coming years unless measures endowing the economy with greater flexibility are introduced, in such a way as to smooth the cross-sector reallocation of surplus resources. Participation levels have shown some downward stickiness over these past four years, especially among the elderly and women, running counter to the most habitual patterns in the past. That said, the demographic impulse shows signs of petering out, which in turn will have unfavourable effects on potential growth.

In sum, the Spanish economy faces an extremely complex task that requires, along with resolute measures in the European arena to push forward the reform of the institutional framework of Monetary Union and the design of crisis-management mechanisms, compliance with the unavoidable commitment to fiscal consolidation and the introduction of ambitious reforms on various fronts. This would allow, on one hand, confidence to be restored and, on the other, the economic adjustment to be accelerated, having the adjustment channeled more through changes in prices and costs, and minimising its impact on employment and activity. The long expansion until 2007, the severity of the crisis and the difficulties in kick-starting the economy have left us several lessons. These warn, in particular, of the need to avoid complacency in economic policy management in boom phases and of the urgency of adapting the structure of the goods and factor markets and agents' behaviour in Spain to the requirements a monetary union imposes.

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