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Opening remarks

12th CompNET Workshop

Jose Luis Malo de Molina

General Director of Economics, Statistics and Research

1 Introduction

It is a great pleasure to welcome you all to the 12th CompNet meeting at the Banco de España, here in Madrid.

I do not think I need explain to you how important competitiveness is. You are the experts on the matter.

Let me just say two things. **First**, the lack of competitiveness is one of the most important weaknesses of the euro area. **Second**, Spain is the right place to address this issue. There are a number of lessons that can be drawn from our bitter experience that has a lot to do with problems of competitiveness.

Let me share with you some thoughts on our experience:

It is a well-known fact that the Spanish economy accumulated a sizable number of imbalances during the expansionary period before 2007: Substantial competitiveness losses, a huge current account deficit, over indebtedness of the private sector, excessive growth of house prices and oversized financial and real estate sectors.

All these imbalances left the Spanish economy in a very vulnerable position when the sovereign debt and euro crisis broke. To the point that the Spanish economy was on the verge of needing to be rescued by the European institutions like other distressed euro area economies. In summer 2012, there were capital outflows of around EUR 400 billion, when we needed at least EUR 300 billion a year to finance the high net external debt position, which was close to 100% of GDP.

This delicate situation was overcome thanks to a number of factors. **First**, the sizable finance from the ECB to the Spanish economy through the Spanish Banking System (ECB lending to Spanish banks reached at that time the record figure of EUR 600 billion). **Second**, the significant progress made at the European level in defining a new road-map towards a more complete and genuine monetary union. **Third**, the gains in competitiveness achieved by the Spanish economy through a remarkable internal devaluation process, which has been crucial for the current recovery of the Spanish economy.

We are publishing today the Banco de España's Projections for 2015-2016. According to them, GDP growth is forecast to be 2.8% in 2015 and 2.7% in 2016, well above the euro area average.

Let me confess that many of us had significant doubts about the ability of the Spanish economy to undertake such a difficult process as internal devaluation. Traditionally, the competitiveness shortfalls had always been absorbed through exchange rate devaluations, whose impact had a temporary nature, as far as they were not accompanied by the required reforms.

In relation to the difficulties of this task, let me tell you an anecdote. In 2009, Agustín Carstens, the Banco de Mexico Governor, said in this same room that implementing an internal devaluation process was like painting a house without moving the painting brush but moving the whole house instead. Almost an impossible task. I think that this was a very illustrative image of the enormous difficulties involved. Agustín Carstens was here again in the Bank just two

weeks ago and he acknowledged and admired the fact that this almost impossible task was already done.

Let me now explain with some more detail the Spanish experience with regard to its competitive adjustment process and the challenges ahead to increase growth.

2 The sizeable competitive adjustment process of the Spanish economy

As I already said, the restoration of competitiveness has been an essential part of the adjustment of the Spanish economy and crucial for its recovery. The magnitude of the adjustment is well illustrated by the correction of the external balance since 2007. In terms of the Nation's borrowing requirement, the deficit fell more than 10 pp of GDP, from 10% of GDP in 2007 to a surplus of 2,1% in 2013 and 0,5% in 2014. The success of this adjustment is also reflected in increases both in market shares and in the export market base.

This rebalancing has been triggered by relative cost and price adjustments which have been driven by two differing forces: the sharp contraction in activity and employment, on the one hand, and the impact of structural reforms.

Over the course of this process of competitive adjustment, we can distinguish different stages. In an initial stage, the reduction in unit labour costs was based almost exclusively on productivity gains (due to sharp employment contraction) while the adaptation of wages and the cost pass-through to prices was delayed. Nominal rigidities lay behind this development.

In a subsequent stage, wages and prices have adjusted against their euro area counterparts, partly due to the effects of the labor market reform and other structural reforms, aimed at making wage-determination process more flexible and increasing its sensitivity to the prevailing economic conditions.

Since 2012, labour costs initiated a path of wage moderation and, as a result, the Spanish economy managed to recover, according to different measures, the bulk of losses of competitiveness accumulated during the expansion.

I want to emphasize that this has been the first time that the Spanish economy has been able to recover external competitiveness through the direct adjustment of relative costs and prices. This adjustment has been of a similar magnitude to that achieved in past episodes through nominal devaluations, but this time it has followed a more gradual pattern and will foreseeably have longer-lasting results.

Notwithstanding these positive developments, the high external debt requires to persevere in recording current account surpluses in order to reduce our debtor position to more comfortable levels, highlighting the need to maintain the adjustment in external competitiveness as a priority.

However, these further competitiveness gains need to be achieved in a still-challenging environment of the low inflation environment at the euro area level which makes competitiveness gains more difficult to realize.

Let me focus now on the challenges ahead.

3 The challenges ahead.

As in most developed countries, current estimates of potential output growth of the Spanish economy are relatively low compared to historical standards. Apart from the negative impact of ageing, which is common to most countries, these perspectives are particularly conditioned in the case of Spain by low productivity dynamics and high structural unemployment.

It's a well known fact that during the expansionary period previous to the crisis, Spanish growth was mainly based on labor and capital accumulation, rather than on productivity gains. In fact, total factor productivity growth during this period was one of the lowest among developed countries. These negative productivity developments were not only the result of a sectoral specialization of economic activity towards low productivity sectors or the huge increase in employment of low productive workers. It was also associated with a deterioration of the process of allocating efficiently resources, leading to an excessive share of unproductive businesses.

A number of factors might be behind these negative developments. Regulations in certain product market artificially increased barriers to entry and reduced competition in some sectors. Labour market regulations also led to low incentives for both workers and firms to become more efficient. Just to mention the most relevant ones.

On unemployment, it's also well known that the crisis hit the Spanish labour market in a very severe manner. The risks for the dramatic increase in unemployment to become structural are significant, given the high level of long-term unemployment (62% in 2014), the deterioration in exit flows from

unemployment, in particular for workers with low education levels, and the increase in the degree of skill mismatch between labour demand and supply, caused by the concentration of job destruction among the lesser-skilled.

Increasing productivity and lowering structural unemployment should be therefore the priority for the years to come in order to improve the growth prospects of the Spanish economy. This is also a very challenging task.

4 Final remarks

I would like to round off these introductory words by highlighting the importance of the work is being done by this Network on Competitiveness. Competitiveness is indeed a complex issue. Contributions aimed at enriching the tools for analysis, together with analytical rigour, are very much appreciated. This Network encompasses different views and angles, combining the most traditional indicators at the aggregate and sectoral level with microeconomic information, allowing for firm heterogeneity. An approach of this nature allows a deeper analysis and the design of adequate policies. This database may become a milestone for innovative research and new insights.

Notwithstanding, significant challenges remain ahead. There is room for improvement in homogenizing concepts and databases to make them comparable and to ensure their correct utilisation. This is especially needed in those cases in which the database is intended to be used for conduct cross-country comparisons with a view on drawing policy conclusions or producing inputs in the context of policy-oriented work. And of course relevant caveats

and limitations should be clearly stated in order to avoid an incorrect use of the dataset in future projects.

The organisation of this event here in Madrid and the hosting of this workshop shows the support being offered by the Banco de España to the goals of this Network. We are therefore looking forward to further contributions on these issues. And we wish you a very productive meeting.