

## **The task ahead in Spain**

### **Xavier Vives**

From 1996 to 2007 Spain was the growth leader of the large European economies. Strong domestic demand, a boom in the building sector, high immigration of cheap labor, revenues generated from tourism combined with low interest rates propelled the country into a state of prosperity. A very high percentage of employment in Europe was created in Spain and construction got to account for more than twelve percent of value added. However, the introduction of the euro helped to finance Spain's real estate bubble more than to invest into long-term competitive advantages (such as technological development or quality education). The financial crisis put an abrupt end to this Mediterranean economic wonder. In its decade-long euphoria, the country lost focus on productivity and competitiveness, went way out of its depth with public spending, and accumulated a trade deficit of large proportions. Spain is now in a delicate position because of the sudden stop in capital inflows in the context of the euro sovereign debt crisis.

The Spanish economy has some assets. Spanish exports to the world have kept their share since the introduction of the euro while others like France's have fallen. For services, Spain's share in the world market has grown over the past decade, just like Germany's – while France's, in contrast, again fell behind. Spain has been building a solid reputation in architecture, construction and engineering services as well as financial services, and tourism. International corporations in utilities, banking and infrastructure, and even in the textile sector, have been performing well. Small and medium-sized companies, especially from Catalonia and the Basque country, have proven their international competitiveness in the production of industrial products and advanced services. So, yes, there is substance in Spain over and above the construction sector. The question remains, however, how policies have to change in order to heave the economy out of the crisis and allow to get back on a growth path. Here exports will have to play an important and increased role since domestic demand will likely remain weak for a period.

Spain can use the crisis as a catalyst for reforms. Up to now, Spain has done the home work only half way and under pressure from the international financial markets and the EU. The new government has a chance to put in place a package of reforms that leads back the country on a growth path.

Firstly, Spain needs to digest more quickly the real state and construction bubble and rehabilitate the parts of the financial system which are damaged. The adjustment of real state prices should not be

delayed to clear the stock of houses unsold and allow the construction sector to contribute again to growth. The balance sheet of financial institutions with a heavy real state overhang should be cleaned to allow credit to the private sector to resume under normalized conditions. For this restructuring of non-viable institutions should be accomplished with sound entities absorbing unsound ones. State support, under the rules of the EU, can help the process in some cases.

Secondly, Spain needs to consolidate public finances. Spain has an ambitious plan to get to a 3% deficit of GDP by 2013. It will not be easy to fulfill it without cuts in social spending, in infrastructure investment, and a deep reform of public service to improve efficiency. Spain has already endorsed the zero-deficit rule in its Constitution. The pension system needs to be put in firmer ground despite the recent reform to extend the retirement age to 67. The margin to raise taxes is not very large but there is some.

Thirdly, at an unemployment rate of more than 22%, Spain desperately needs to reform the labor market. Spain should put an end to the unjust and inefficient duality between regular employment contracts and temporary contracts. At the same time collective bargaining procedures should be changed and decentralized to the firm level.

In the long run, Spain needs to make sure that it increases its productivity. This requires deep reforms in the areas of public administration, justice, research and development as well as education.

Mr. Rajoy has just announced a plan which contains quite a few of the points above. Can the reform plan be accomplished? Spain is not Greece because of the quality of its public administration. Spain is not Italy because of its better working political system and lower public debt level. Spain is solvent if protected from debt speculators with liquidity help that keeps its borrowing costs at a reasonable level. Spain will need also enough international long term credit so that the reform program has enough time to succeed. Austerity alone will not lift the Spanish economy.

Spain has shown flexibility to adapt to difficult circumstances in the past, unions included; it should continue to do so in the future. Are Spaniards prepared to take drastic measures that will initially have negative effects on their personal well-being? We have an indication in the outcome of the recent general elections in Catalonia where the party leading the regional government had implemented already

substantial austerity measures and got the approval of the citizens. The new government should speak clearly about the situation and the sacrifices ahead, and should be daring and bold in the measures to be taken. This will improve both the prospects of Spain and the euro area.

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