ECONOMIC OVERVIEW

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Department of Economics
ESADE

Sabadell

Economic Overview

GLOBAL ECONOMY

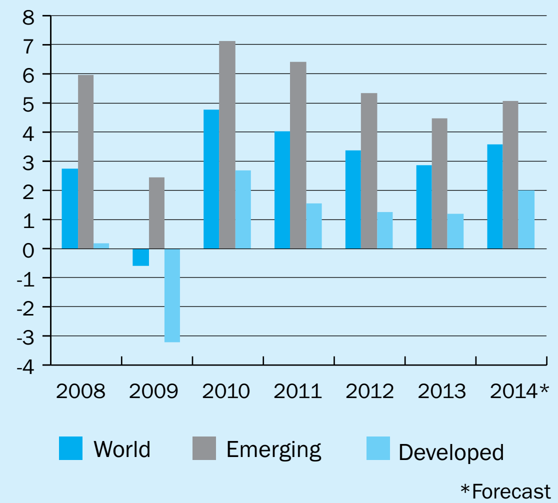
Some improvement at the global level

The global economy slowed down slightly in 2013 with an annual growth rate of 2.9%, somewhat lower than the rates of 3.9% and 3.2% seen in 2011 and 2012, respectively. This slowdown was seen both in developed and emerging economies, which grew by 1.2% and 4.5%, respectively (again, a few tenths of a percentage point lower than in previous years).

Worldwide economic growth is expected to be up slightly in 2014, to a forecasted level of 3.6%. This improvement will be seen both in developed and emerging economies, which are expected to grow by around 2% and 5%, respectively.

> Worldwide economic growth is expected to be up slightly in 2014, to a forecasted level of 3.6%

GDP GROWTH RATE (%)

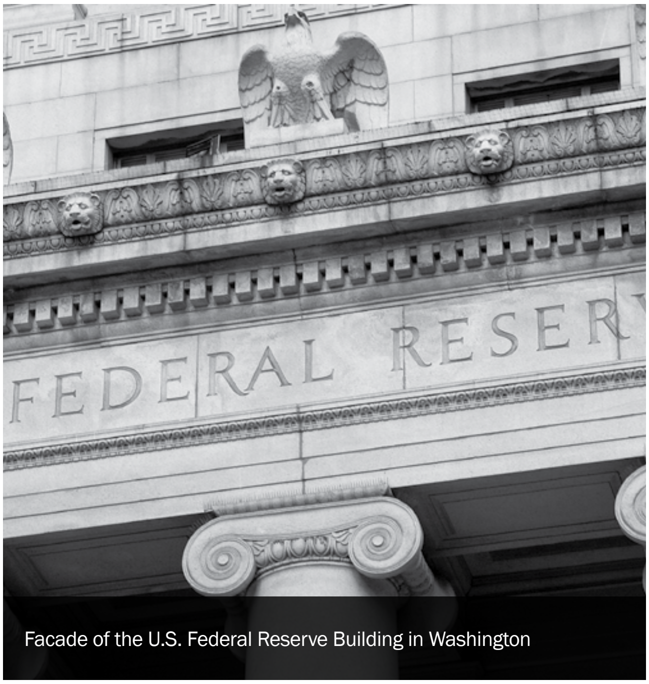


Source: IMF

In mid-2013, financing conditions briefly became more restrictive for emerging economies. The announcement that the Federal Reserve intended to shift its monetary policy by tapering off its liquidity injections had an immediate impact on financial markets across the globe. The interest-rate differential between public debt and private bonds grew, capital withdrawals increased, and stock-market indices fell. Calm returned to the markets after the Fed clarified its position in September.

The episode showed that the global economy – and emerging economies in particular – are extremely sensitive to monetary conditions in developed economies. Therefore, monetary policy must therefore be progressively normalised in the not-too-distant future.

The U.S. economy grew by just 1.6% in 2013, largely due to fiscal adjustments implemented during the year. In 2014, U.S.



Facade of the U.S. Federal Reserve Building in Washington

economic growth is expected to increase to 2.6%. American fiscal policy will become less restrictive after Congress manages to reach a budget agreement. U.S. monetary policy, meanwhile, will remain clearly expansionary, as the Fed announced recently. Other factors that will contribute to higher growth include the recovery of the real estate market (which will lift net household wealth) and the improved flow of credit with more favourable financial conditions.

U.S. fiscal policy will also contribute to an increase in economic activity. Fiscal adjustments were on the order of 2.5% of U.S. GDP in 2013, but this figure is expected to drop to 0.75% in 2014. Adjustments will be needed in the medium term to keep U.S. public debt sustainable; this process must be carried out in a well-planned, staggered manner. Budget sequestration has been an exaggerated, inefficient resource – a result of partisan jockeying rather than economic logic. Failure to raise the debt ceiling in the near future would have extremely negative effects on the U.S. economy and the global economy as a whole. The Fed has announced its intention to maintain the liquidity injections first introduced in 2007 and is expected to keep interest rates at their current 0% level for at least two more years.

After several years of deflation and stagnation, the Japanese economy grew by 2% in 2013, confirming the turnaround first seen in 2012. This growth was brought about by prime minister Abe's new approach to economic policy and the Bank of Japan's shift towards a clearly expansionary monetary policy. Fiscal stimulus on the order of 1.5% of GDP fostered growth in 2013 by boosting household spending and business investment.

> The Japanese economy will grow by 1.5% in 2014, confirming the turnaround first seen in 2012

In 2014, Japan's fiscal policy will be somewhat more restrictive – the sales tax will be increased to 8% and government spending on reconstruction will be slashed – with the explicit aim of shrinking the public deficit to 2.5% of GDP. As a result,

Shinzo Abe, Prime Minister of Japan

the country's annual growth rate will fall to between 1% and 1.5%. The depreciation of the yen, caused by the Bank of Japan's expansionary monetary policy, has allowed the foreign sector to attain positive growth figures.

In the medium term, Japan's challenge will be to maintain stable growth that generates expectations of inflation rather than deflation (a recurring phenomenon over the past two decades). Japan may eventually require more fiscal stimulus, so the country must give itself room to make such policies possible. It is therefore vitally important that the Japanese economy have a medium-term fiscal adjustment plan.

China's economy grew by 7.7% in 2013 and is expected to grow at a slightly slower pace (just over 7%) in 2014. This forms part of the Chinese authorities' new strategy of transitioning towards a more sustainable and balanced pace of growth. China's economic policy will focus on various necessary structural reforms rather than short-term stimulus measures. These reforms aim to address risks that have accumulated in recent years, such as an excess of credit and highly indebted local governments. The expansion of credit over the past decade has brought investment up to 50% of GDP. In order to achieve more balanced growth, China needs to shift more of its production towards consumption.

> China's new strategy will transition towards a more sustainable and balanced pace of growth, shifting more of its production towards consumption

The Chinese authorities have made reforming the country's financial system a high priority. These reforms are intended to increase the system's security and make credit allocation more efficient. Another priority, the liberalisation of China's service industry, is meant to improve the provision of healthcare and education services.

LATIN AMERICAN ECONOMY

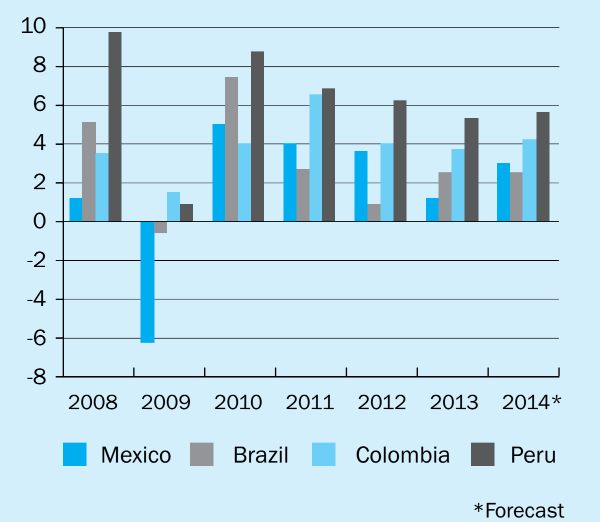
Prospects

The Latin American economy is expected to grow by around 3.5% in 2014, slightly more than the previous year, when this figure fell just short of 3% (one of lowest growth rates posted by the region in the past decade). Given Latin America's sharp upturn following the global crisis of 2008-2009, the recent moderation was, to some degree, expected.

> The Latin American economy is expected to grow by around 3.5% in 2014, slightly more than the previous year

The falling cost of raw materials and the rather restrictive fiscal conditions in many Latin American countries kept the region's economic growth below its potential last year. The region's growth was also hampered by increased volatility in the global financial markets after the Federal Reserve announced that it would soon abandon the policy of liquidity injections intro-

GDP GROWTH RATE (%)



Source: IMF

duced in 2007. The announcement caused a spike in the risk premiums on Latin American public debt during a period of widespread capital outflow from both the fixed- and variable-income markets. The region's main stock-market indices suffered as a result. Most Latin American currencies suffered a year-on-year depreciation of between 5% and 15%, prompting some central banks to intervene in the foreign-exchange market in order to cushion the fall. In September, when the Fed announced that it would be postponing its policy change, the situation went back to normal.

This episode showed that Latin America's economies are stronger now than they were in the 1990s, when some countries in the region experienced severe crises. Better fiscal and financial fundamentals, plus more credible economic policies, have made the region less vulnerable to external events. Latin American economies also benefit from flexible interest rates that allow adjustments to be made by means of currency depreciation.

> Latin America's economies are stronger now than they were in the 1990s, when some countries in the region experienced severe crises

The entire region faces downside risks. If the emerging economies of Asia grow less than expected, the price of raw materials would fall unexpectedly, hampering growth in Latin America's largest economies. Likewise, lower-than-expected growth in the global economy could hurt Latin American exports. It is also possible that new shifts in U.S. monetary policy could lead to tougher financing conditions. If any of these risks were to materialise, monetary policy would be the first recourse to stimulate economic growth in Latin America.

Mexico

Mexico's economy grew by just 1.3% in 2013. The country's economic activity was hurt by falling oil prices and by lower-

Mexican twenty-pesos bill

than-expected economic growth in the United States. Growth is expected to return to nearly 3% in 2014 on the strength of higher government spending and rising U.S. demand. Mexico is expected to consolidate an annual growth rate of between 3% and 4% in the medium term.

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This higher growth rate will be bolstered by increased public investments and government spending on social protection; this will be possible because Mexico's legislature voted to increase the deficit limit to 1.5% of GDP.

The reform process initiated by the current administration will also contribute to economic growth. Fiscal reforms to eliminate tax deductions and raise the income tax on top earners will lead to higher revenues. In order to maintain its anti-cyclical fiscal policy, Mexico must adopt flexible goals, allowing an unbalanced budget during slow years (like 2013) and capping spending in times of expansion. Mexico's energy reforms should allow an increase in oil production, which is currently at 1998 levels. Such reforms will be based on the principle of public ownership of oil reserves, with the possibility of privatising certain activities in order to increase efficiency.

Brazil

After stagnation in 2012, the Brazilian economy grew by 2.5% in 2013. Similar growth is expected for 2014, confirming the gradual economic recovery seen last year.

With a year-on-year rate of 6.7% in mid-June, inflation was slightly above the target set by Brazil's currency authorities. The country's central bank was therefore forced to increase the interest rate from 7.25% to 9.5% between April and October. During the second half of the year, the central bank kept depreciation under control by regularly selling off U.S. dollars.

In general terms, Brazil's economic growth was hampered by changes in inflation, interest rates and credit. Rising inflation led to lower household disposable income, which will continue to drag down consumption in the future. Rising interest rates on public debt presented additional difficulties, giving the public sector less room to manoeuvre in terms of growth-stimulating fiscal policies. However, the depreciation of Brazil's currency during 2013 should boost the country's exports.

Brazil's current-account deficit increased to 3.6% of GDP as the country's positive balance of goods and negative balance of services both fell. This foreign deficit is financed largely – though not fully – by the inflow of direct investment. In the short term, this is not a problem; however, Brazil must bring down its current-account deficit in order to preserve its external position.

Peru

Peru is one of Latin America's fastest-growing economies, with a growth rate of 5.4% in 2013. This figure, while high, is one percentage point lower than in the previous two years. A downturn in the country's foreign sector was responsible for this slowed growth. Investment and government spending, Peru's main drivers of growth, increased by 12% and 8.5%, respectively, in 2013.

Thanks to the strength of the Peruvian economy, the country's unemployment rate has reached a historic low of 6% and real wages have increased by 3%. These two factors have led to higher household consumption. Private investment also grew by 8% in 2013, thanks in part to foreign investment inflows, which are expected to remain at similar levels at least through 2015.

Peru is one of Latin America's fastest-growing economies, with a growth rate of 5.4% in 2013

Peru's foreign sector experienced negative growth as the country's exports experienced a greater slowdown than its imports. As a result, Peru nearly posted its first current-account deficit in ten years.

In 2014, the Peruvian economy is expected to grow by 6% – approaching figures from recent years – thanks to robust consumption and investment, but also because foreign demand will reduce the foreign sector's negative contribution. The main risks that could hamper Peru's growth are a larger-than-expected drop in the price of copper and other metals on the international markets and a global decrease in demand; either of these scenarios would worsen the contribution of Peru's foreign sector.

Colombia

The Colombian economy grew by 4% in 2013. Growth picked up during the second half of the year after flagging slightly in 2012 and the first half of 2013. This change was largely due to improvements in Colombia's foreign sector.

> Colombia is expected to maintain its strong economic trajectory throughout 2014, with GDP growth reaching 4% due to improvements in the foreign sector

Headquarters of the Central Bank of Colombia in Bogota

Colombia is expected to maintain its strong economic trajectory throughout 2014, with GDP growth reaching 4% or even slightly higher. Domestic consumption and investment will grow at a rate similar to that of the economy as a whole. However, investment will not reach the peak rates seen in 2011 and 2012 due to uncertainties surrounding investment in the oil industry.

Colombia's central bank was able to keep the official interest rate at 3.25% throughout 2013. This was possible because the 6% depreciation of the Colombian peso in 2013 did not push up inflation, which remained steady at 2.4%. With growth close to its potential, Colombia's economic activity is solid and inflation will surely rise. Therefore, the country's official interest rate will probably need to increase by late 2014, even if the central bank brings it down earlier in the year in response some sort of difficulty. The central bank will also maintain its current policy of purchasing U.S. dollars.

EUROZONE ECONOMY

Prospects for 2014

After a year and a half of negative growth, the eurozone posted positive growth in the second quarter of 2013 and is expected to grow by around 1% in 2014. This figure is below the region's potential; unemployment is therefore expected to remain high. Furthermore, the disparity between the core and peripheral countries will remain significant: Germany, France, Austria, Finland, Belgium, Luxembourg and Ireland will grow by 1% to 1.5%, but Italy, Spain, Portugal, Greece and the Netherlands will grow by around 0.5%. Growth will remain negative in Cyprus and Slovenia. Only the emerging economies of the eurozone – Estonia, Slovakia and Malta – will grow by more than 2%.

> The eurozone is expected to grow by around 1% in 2014

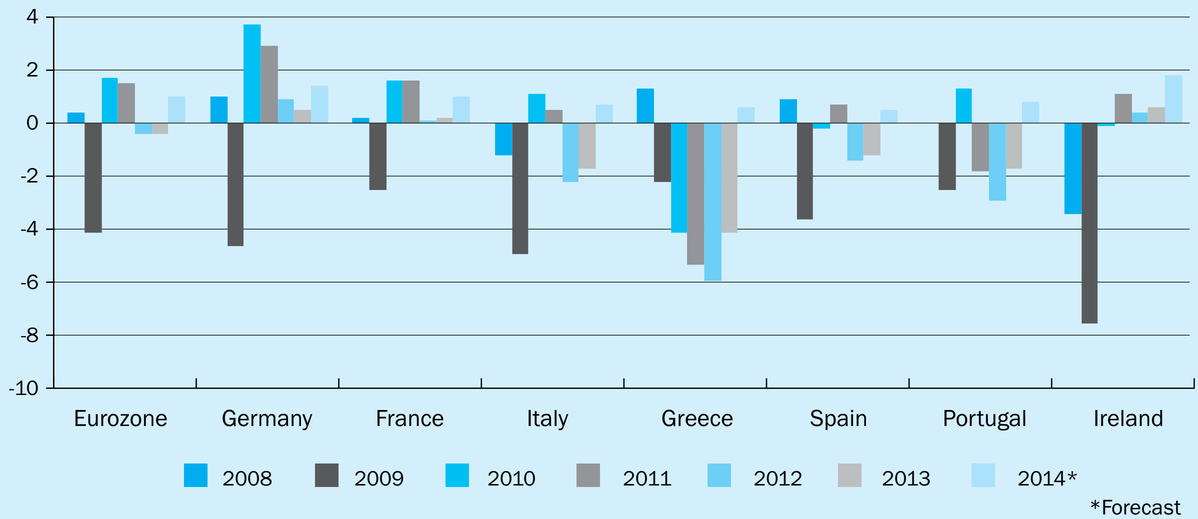
Although it appears that activity will cease to drop in the eurozone periphery, growth will remain low in these economies. Therefore, 2014 will be the seventh consecutive year of recession or stagnation in the periphery. Economic growth, albeit weak and wavering, will once again be seen in the core countries. Various factors will keep growth below its potential. In the peripheral countries, the simultaneous deleveraging of the private and public sectors will weaken demand considerably. Although the pace of budget adjustment has slowed, fiscal policy continues to be contractionary.

The eurozone's economic growth is too weak to merit speculation as to whether it could continue on its own, without corrections to the dysfunctions of the eurozone and its constituent economies.

The public deficit of the eurozone was reduced by 1% of the region's GDP in 2013, but this figure is expected to drop to 0.5% in 2014. The problem is that deficit reduction is not uniform: it is primarily occurring in the periphery, where growth is lower and stimulus measures are more necessary.

GDP GROWTH RATE (%)

Eurozone total & selection of countries



Source: European Commission and compiled by the author

Inflation remains at around 1.5%, below the European Central Bank's medium-term target of 2%, showing that deflationary effects remain. It will be necessary to monitor the economy closely to keep it from backsliding into deflation and deepening the crisis.

Fragmentation of financial and credit markets

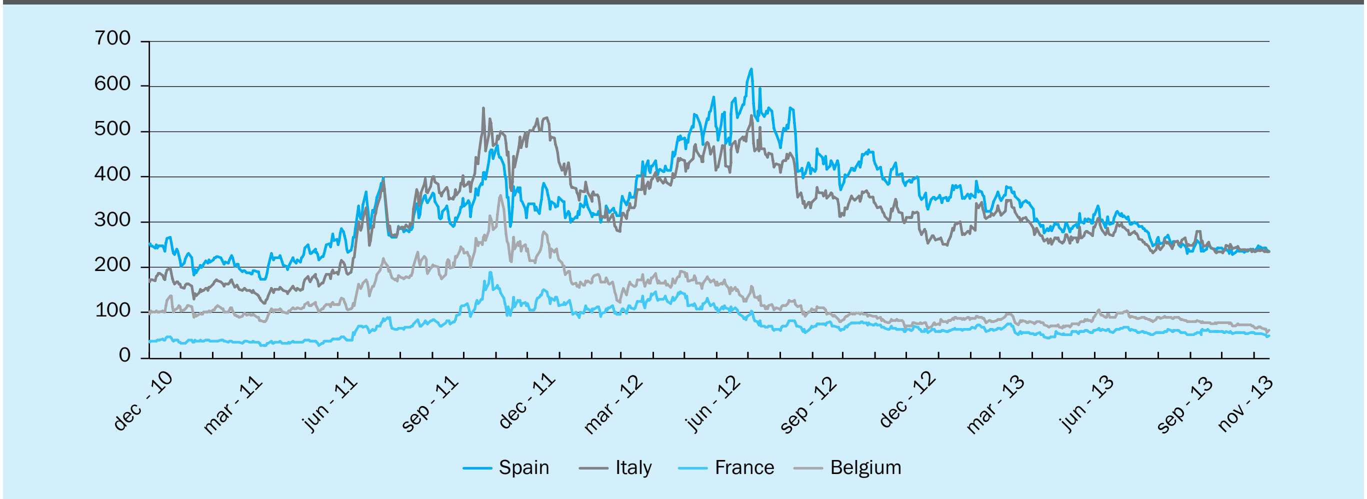
Since the ECB launched its Outright Monetary Transactions (OMT) programme in September 2012, interest rates on public debt have returned to levels last seen in mid-2010, before risk premiums started to rise as a consequence of the Greek public-debt crisis. The volume of bank deposits has been stabilised and the capital outflow from financial institutions in the periphery to those of the core has been stemmed. Larger private companies have seen their financing conditions improve as the risk premiums have dropped.

Despite these improvements, there are still large differences between the financing conditions in the various eurozone countries. Interest rates on household and business loans remain higher in the periphery than in the core, with a difference of about 300-400 basis points. This shows that the mechanism by which monetary policy is transmitted does not work properly for the periphery: the ECB's low-interest-rate policy has not reached the periphery, where companies and families are forced to pay high rates. This poses a serious obstacle to economic recovery.

> The fragmentation of the financial markets is the reason for the higher interest rates paid by companies and families in the peripheral countries

There are various reasons for higher interest rates in the peripheral countries, but the most important reason is the fragmentation of the financial markets. The flows of financing between banks in different countries – in particular, between the core and the periphery – have slowed consider-

RISK PREMIUM
Sovereign spreads compared with 10-year German bond

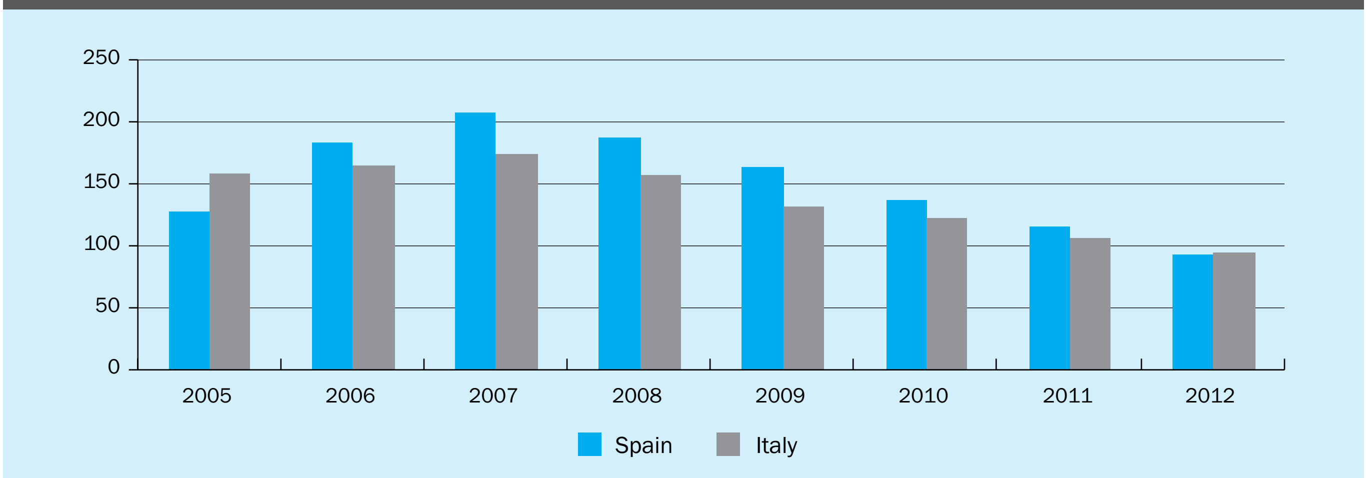


Source: European Central Bank & Bank of Spain

ably due to the perception of greater risk, the expectation of possible losses for various types of creditors ("bail-ins"), and regulations enacted by certain countries to isolate their banks from the rest of the system. In addition, many institutions have had trouble staying profitable due to higher delinquency rates, larger provisions and lower volumes of business.

The difficulty of securing financing and remaining profitable have prompted institutions to increase interest rates on house-

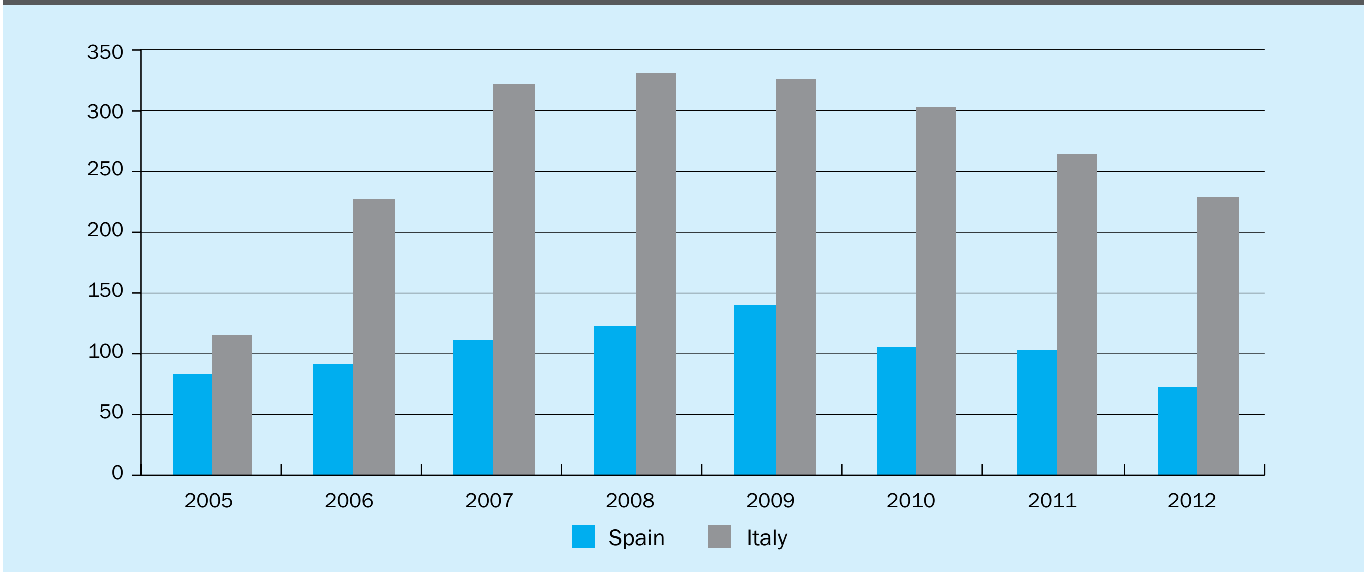
GERMAN BANK EXPOSURE TO SPAIN AND ITALY **€ Billions**



Source: Bank of International Settlements

FRENCH BANK EXPOSURE TO SPAIN AND ITALY

€ Billions



Source: Bank of International Settlements

hold and business loans while considerably reducing the flow of credit. This has important implications for economic activity, given that bank loans account for 90% of non-financial debt while the remaining 10% corresponds to large companies.

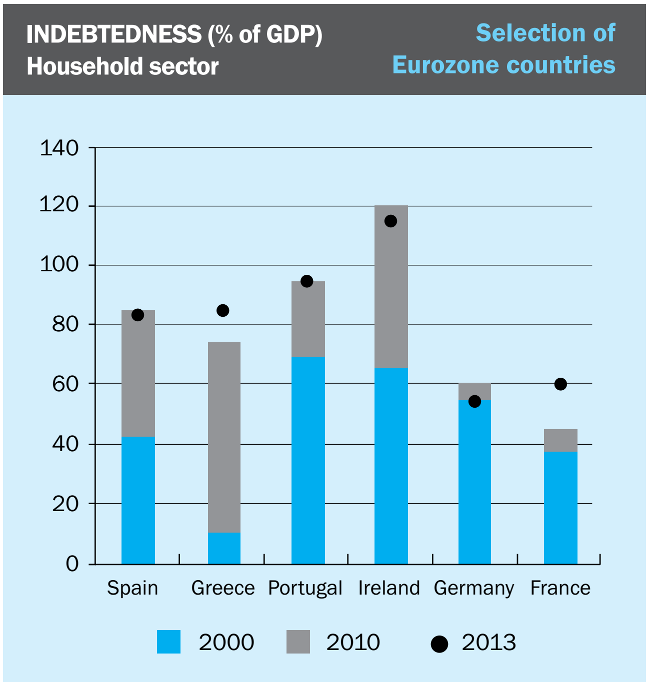
In order for economic recovery to reach the entire eurozone, monetary policy must start working again and the flow of credit to small and medium-sized enterprises must be restored.

The weight of debt

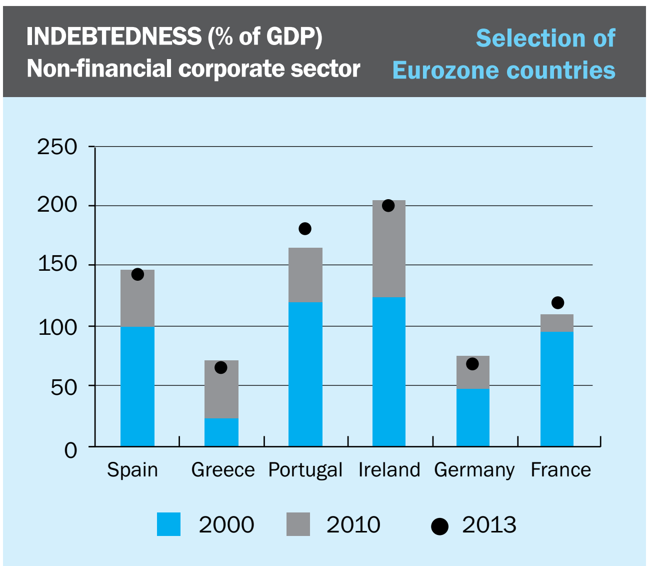
Debt accumulation played a clear role in triggering and shaping the eurozone crisis. This phenomenon encompasses the accumulation of public debt and foreign debt as well as the volume of private debt incurred during the boom years following the creation of the euro. Indeed, the countries where debt levels grew most sharply between 2000 and 2007 have seen lowers levels of economic growth between 2008 and 2013. In countries where household debt grew quickly between 2000 and 2007 – Portugal, Ireland, Greece and Spain – consumption has been lower between 2008 and 2013. The economies in which non-financial businesses were highly indebted in 2007 – Spain, Ireland, Portugal and Estonia – have since seen higher increases in unemployment. In countries that had a highly leveraged financial sector before the crisis – Ireland, Portugal, Greece and Spain – interest rates on loans have since risen more sharply, making it more difficult to end the recession.

The volume of debt in the eurozone varies considerably between countries and sectors. In Ireland, Portugal and Spain, debt levels are high in households, non-financial companies and the public sector. In Greece, debt is concentrated in households and the public sector, whereas in Cyprus households and non-financial companies have the highest debt levels. As a result of these imbalances, all of the aforementioned countries have accumulated significant levels of foreign debt.

Increases in nominal GDP and nominal wages have historically been the means by which debt ratios are reduced. It is gener-



Source: IMF



Source: IMF

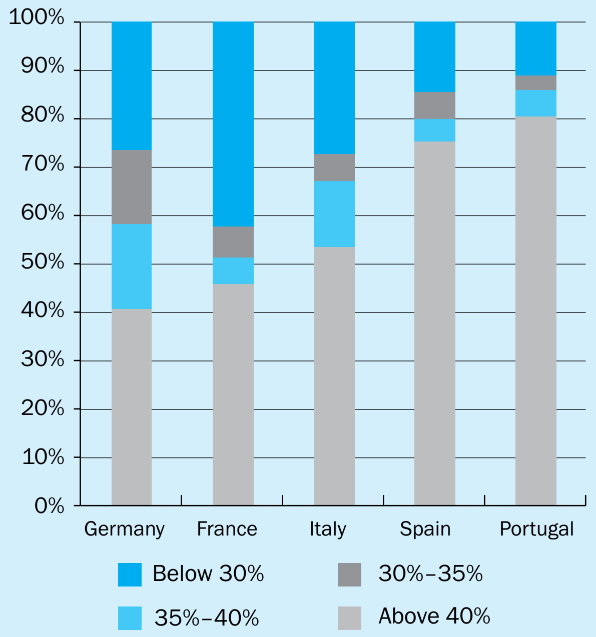
ally considered that 75% of the reduction is due to inflation and 25% is due to real income growth. Today, however, inflation is very low and, since 2010, negative economic growth has brought gross income down by 3.4% in Spain and by 1.8% in Portugal. As a result, the debt-reduction process has been slow and complex throughout the eurozone, particularly in the peripheral countries.

Debt reduction and economic viability

The fragmentation of the eurozone's financial system has given rise to a negative feedback loop between bank risk, business health and sovereign risk. The combination of over-indebted companies with low profits, banks with balance-sheet problems, and highly indebted states has led to this vicious cycle. Perceiving the weakness of their own balance sheets, the banks have expanded their "safety cushions", increased their interest rates and decreased the number of loans they grant. Companies have therefore found it harder to refinance their debt and their profits have suffered as a result. Consequently, more companies have begun to default on their loans, thereby hurting the banks' balance sheets. The situation in the public sector poses an added difficulty. The high level of indebtedness and the public sector's status as the ultimate guarantor of bank deposits has put upward pressure on public-debt interest rates and risk premiums. This has hurt companies because it has pushed up the cost of obtaining financing in the bond market, and it has hurt banks because it decreases the value of public debt, which the banks hold in large quantities. The overall result is a weakened credit flow, lower growth and greater difficulties for the economy.

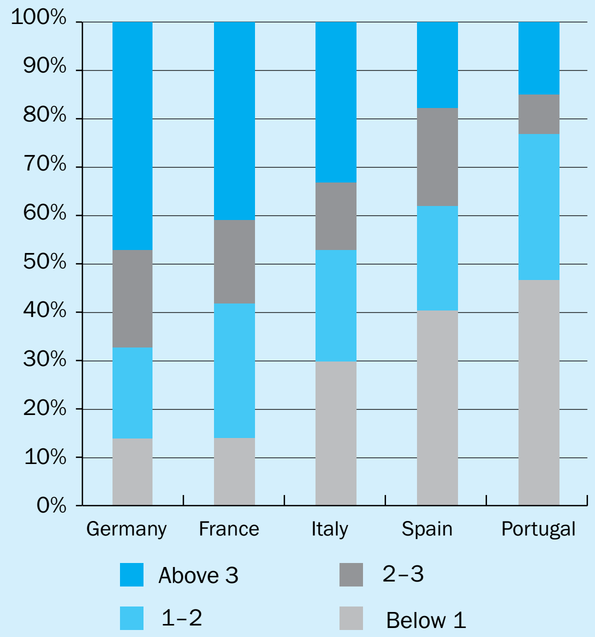
At the same time, companies' problems have exacerbated the troubles of the strongest banks. As a consequence of pre-crisis debt accumulation, more than 75% of the debt held by non-financial companies in Spain and Portugal is in the hands of highly leveraged companies with debt/asset ratios of 40% or higher. In Italy, 50% of company debt is held by highly leveraged companies. Because of these high levels of debt, combined with lower profits as a result of the crisis, companies

SHARE OF DEBT AT FIRMS WITH VARIOUS DEBT-TO-ASSETS RATIOS



Source: IMF

SHARE OF DEBT AT FIRMS WITH VARIOUS INTEREST COVERAGE RATIOS



Source: IMF

have had difficulty making their interest payments and the delinquency rate on bank loans has increased.

This difficulty meeting obligations as a result of high indebtedness has cast doubt on the viability of many companies and put high-debt economies at risk.

The viability of highly leveraged companies can be measured in terms of interest coverage ratio, which is defined as a company's earnings before interest and taxes divided by its interest expenses. An interest coverage ratio below 1 indicates that the company is not generating enough income to meet its interest expenses. Companies in this situation can only make their interest payments by reducing their debt or capital costs – and, consequently, their interest expenses – or by increasing their earnings. The "at-risk" debt of a particular economy is the percentage of all business debt held by companies with an interest coverage ratio lower than 1. In Portugal, 45% of business debt is held by companies with an interest coverage ratio of less than 1. In Spain and Italy, the percentages are 40% and 30%, respectively. By way of contrast, this figure is below 15% in Germany and France.

> The percentage of business debt held by at-risk companies is 40% in Spain, 45% in Portugal and 30% in Italy

Policies to facilitate debt reduction

Countries that, like the United States, took steps early to shore up financial institutions' balance sheets have made greater progress at reducing debt levels. If mechanisms for restructuring debt – of both banks and the private sector – are used generously, uncollectible debts can be removed from banks' balance sheets more easily; as a result, uncertainty can be reduced more quickly and credit flows can resume sooner.

For the debt-reduction process to be quick and effective, the financial sector must be reorganised. The first step is to recapitalise weak institutions and remove uncollectible debt from balance sheets; only then can the banks restructure the debt of delinquent creditors. The eurozone has nearly finished the process of reorganising troubled financial institutions, so it should be possible to carry out the debt-reduction process over the course of 2014.

Another possible way to accelerate this process is to restructure business debt. This can take several forms: renegotiation of deadlines, renegotiation of interest rates, acceptance of partial payment, or writing off debts. However, this approach can entail high costs: it sets a bad precedent and creates a moral hazard; it threatens debtor-creditor relations, leading to uncertain future repercussions; and it can harm third parties, including investors, who would shun the region in the future. It is therefore preferable to take steps to guarantee the availability of credit to companies that, with access to reasonably affordable credit, would be in a position to begin reducing their debt.

Credit stimulation measures

During recessions, government intervention to mitigate credit-restricting factors is not usually necessary. However, in especially severe recessions – like the present one – intervention can be very useful at preventing these factors from exacerbating the recession.

In Ireland and Spain, 25% of small and medium-sized enterprises consider restricted access to credit to be their largest obstacle; in Germany and Austria, this figure is just 8%.

There are several possible ways to improve access to credit for small and medium-sized enterprises. Greater development of the market for bonds backed by loans to SMEs would increase the flow of bank credit to these companies. The market for eurozone-based bonds has a volume of €1 trillion, and just 14% of these bonds are backed by loans to SMEs. Meanwhile, the volume of bank loans to SMEs is much greater: €1.5 trillion. It would also be very useful to create programmes by which governments back loans to SMEs. Tax incentives for the issue of "mini-bonds" related to loans to SMEs have already been successfully introduced in Italy. It would also be possible to introduce tax benefits on bank income derived from loans to SMEs, accompanied by measures to ensure that such loans did not hurt the banks' balance sheets.

Finally, another option is to create funds whose objective is to grant loans directly to SMEs, whether through public institutions, venture-capital firms, investment funds or business-development companies.

European Central Bank policies

In order to unblock the flow of credit, it will be necessary to restore the health of banks' balance sheets, break the feedback loop between sovereign risk and bank risk, solve the problem of the fragmented financial system, and create a banking union. These objectives will not be achieved for some time. In the meantime, to make economic recovery possible, steps will need to be taken to foster credit availability.

The ECB must provide weak financial institutions with liquidity. It can do this by means of long-term refinancing operations (LTROs): loans at low interest rates (1%) maturing after three to five years. Alternatively, it can accept more types of assets as backing for loans, or discount a smaller percentage of the value of collateral securities. Because market-based financing was hard to come by, banks in the peripheral countries made extensive use of the LTROs granted in early 2012. Extending this source of liquidity would be a good strategy.

The ECB could also take direct measures to ensure that liquidity reaches small and medium-sized enterprises. It could consider a system by which financial institutions would gain access to credit in exchange for providing loans to SMEs (as the Bank of England has done). Alternatively, it could link access to LTROs to the provision of SME loans.

It is essential that the ECB take direct measures to ensure that liquidity reaches small and medium-sized enterprises

Banking union

The European Union is now working on the first stages of the banking union approved by the European Council in 2012. The single supervisory mechanism will be launched in November 2014. The EU is considering how the European Stability Mechanism (ESM) should proceed in its efforts to directly recapitalise troubled banks and is also drafting a bank recovery and resolution directive. At some point it will also need to create some sort of deposit insurance shared by all banks in the region.

It should be noted that the first steps towards the banking union have not solved the financial sector's fragmentation problem; indeed, they have exacerbated it by making the differences between the core and the periphery more obvious. Measures to counteract this fragmentation – basically, the introduction of common deposit insurance – are slated for implementation at a later date. It is therefore crucial that this process move forward quickly and decisively.

SPANISH ECONOMY

Prospects for 2014

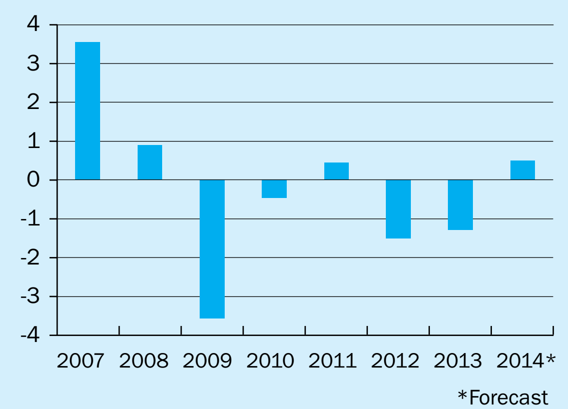
The Spanish economy is expected to grow by 0.5% to 1% in 2014. Despite this return to positive figures, growth will be very modest – just enough for a small amount of job creation. The unemployment rate will remain nearly stable at around 27%. This will be the seventh consecutive year of recession or stagnation.

The Spanish economy is expected to have moderate growth of 0.5% to 1% in 2014

In 2013, the inflation rate fell to 1.7%. This drop began in the third quarter, by which time the direct effect of the September 2012 increase in VAT and medicine costs on the CPI inflation rate had become diluted. As a result of this decrease in inflation, Spain's inflation differential relative to the eurozone average became negative in late 2013.

In 2014, household consumption will continue to be held down by the high unemployment rate and falling wages.

GDP GROWTH RATE (%)



Source: Bank of Spain and compiled by the author

Spanish exports will continue the four-year growth streak that increased their market share to 33% of GDP at the end of 2013. The volume of Spain's imports will continue to be conditioned by the behaviour of domestic demand. As a result, Spain's net exports will remain the country's largest source of economic growth.

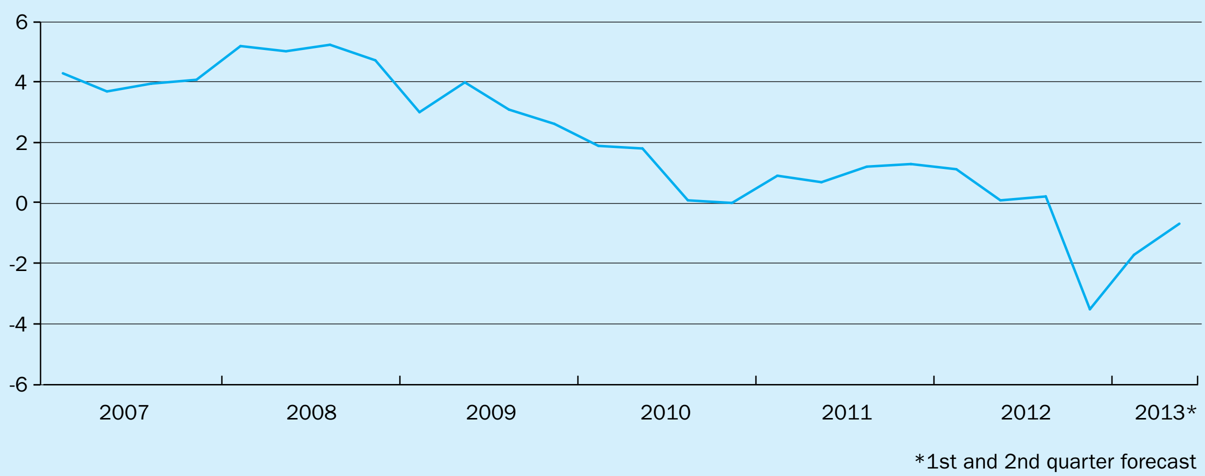
It will not be possible, however, for Spain to make a full economic recovery based solely on the foreign sector. For the country's economy to return to sustained growth, domestic demand must also increase. It is vitally important that Spain regain the conditions that will allow household consumption and business investment to increase. For household consumption to rise, families will need to have better access to credit, unemployment will need to drop, and expectations will need to improve. For business investment to increase overall, investment in capital goods will need to rise and investment in construction will need to stop falling. In order for the slight improvement in household consumption and capital-goods investment seen in late 2013 to become consolidated, the flow of credit will need to be restored, the interest rates paid by families and companies will need to decrease, and expectations will need to improve overall.

Internal devaluation

Thanks to the process of internal devaluation, the Spanish economy is regaining some of the competitiveness it lost in the run-up to the crisis. In other words, it is becoming competitive again as prices and wages drop below the eurozone average. This is a slow, costly process that requires a long period of recession or stagnation.

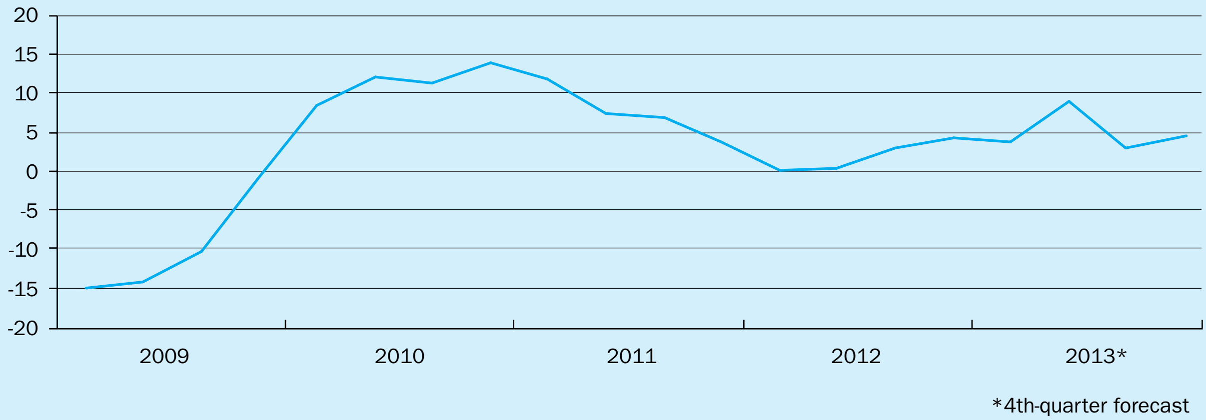
Structural reforms introduced in 2010 reduced unit labour costs and made the labour market more flexible, which in turn boosted Spanish exports and attracted foreign tourism. The decrease in wages has shown that Spain's labour costs are sensitive to the economic cycle – an essential condition for a speedier recovery. This sensitivity is a result of the 2012 labour reform.

LABOUR COSTS
Annual percentage change



Source: Bank of Spain

EXPORTS OF GOODS AND SERVICES
Annual percentage change



Source: Bank of Spain

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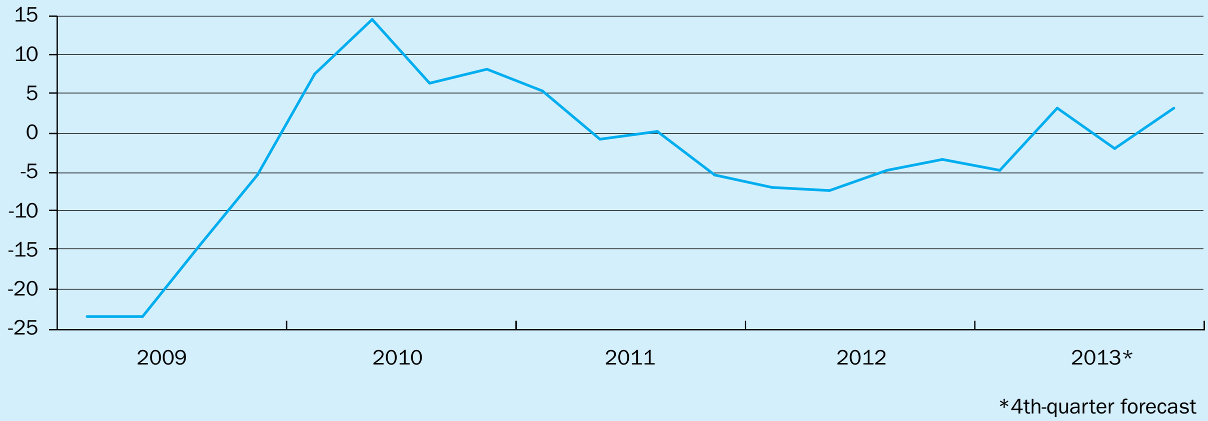


Source: Bank of Spain

Measured in terms of real exchange rates, the competitiveness of the Spanish economy dropped by 14% from the introduction of the euro to the onset of the economic crisis in 2008; since then, however, it has bounced back by 4%.

Spain's labour costs have become sensitive to the economic cycle

Deleveraging underway

History suggests that deleveraging and debt-reduction processes are slower and have a greater impact on growth when all sectors of the economy – households, businesses and the public sector – are highly indebted. Unfortunately, this is precisely the case of the Spanish economy at present.

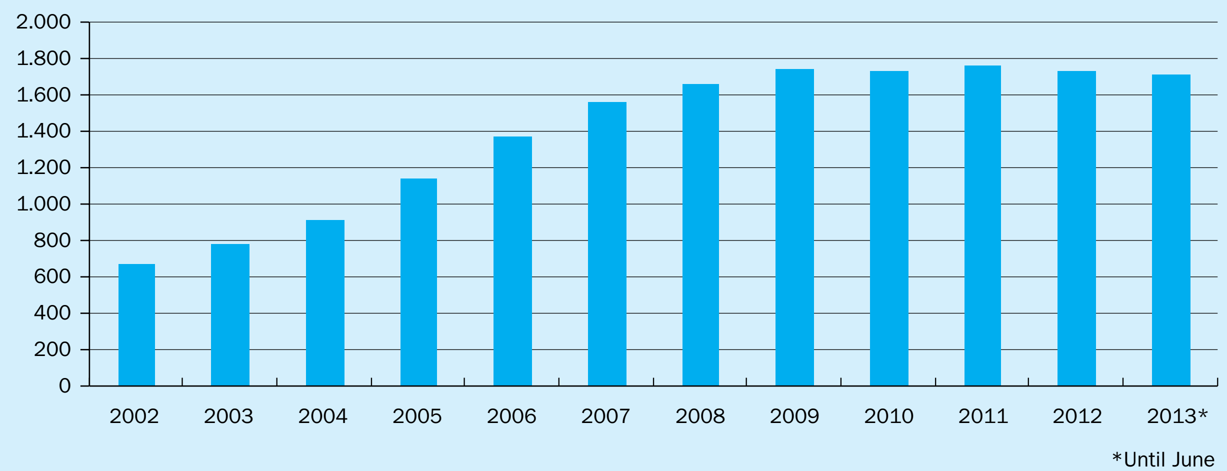
Because of the magnitude of the debt held by the private sector, the deleveraging of this sector is vitally important to Spain's economic recovery. In 2010 – a critical moment in the debt-accumulation process – the total debt held by Spanish households was equivalent to 85% of the country's GDP. By 2013, this figure had dropped to 79%.

The lack of growth and the low inflation rate make the debt-reduction process slower and more difficult

Debt ratios have historically been reduced by passive means, particularly the growth of nominal GDP or nominal wages. It is generally considered that 75% of the reduction is due to inflation and the remaining 25% is due to real wage growth. However, because inflation is currently very low and gross income has fallen by 3.4% in Spain since 2010, amortization is the only way to reduce debt. This makes for a slower, more difficult process that has negative effects on the economy.

In addition, although the volume of debt is gradually decreasing, lower wages mean that debt payments account for a larger share of household income, and this drags down con-

EXTERNAL DEBT € Billions



Source: Bank of Spain

sumption. Spain has the eurozone's highest ratio between debt-servicing expenses and total household income (19%), ahead of Portugal (16%), France (13%) and the Netherlands (13%); the eurozone average is less than 12%.

Spain's non-financial companies reduced their debt from 148% of GDP in 2010 to 143% in late 2012. In 2000, when the availability of credit began to grow sharply, the debt of Spain's non-financial companies was the equivalent of just 60% of GDP. According to empirical studies of other historical periods marked by high debt levels, a sharp increase in business debt should be followed, on average, by a reduction to two-thirds of the previous amount. For this to happen, Spanish companies would need to reduce their debt to 50% of GDP.

Steps should be taken to facilitate the reduction of business debt. Resources now being used to refinance nonviable companies should be reallocated to help viable companies that are capable of creating jobs and investing. For this to be possible, insolvency and bankruptcy legislation should be reformed to allow help to reach viable companies quickly and to accelerate the liquidation of nonviable ones. Debt-restructuring agreements – especially for small and medium-sized enterprises – should also be facilitated, but first the financial sector must be brought back to full health.

In the public sector, the debt-reduction process has not yet begun. The volume of public debt as a percentage of GDP will continue to rise until the public deficit falls below 3% and higher growth rates are consolidated. Spain's ratio between public debt and GDP is not expected to stabilise until it reaches 110%-120% around the year 2017. With a risk premium of around 200 basis points and interest rates in Germany of 1% to 2%, debt-interest servicing for the public sector accounts for approximately 3% of GDP. Therefore, keeping debt levels stable requires generating a primary surplus of 2% to 3% of GDP. Because the government has not even managed to eliminate the primary deficit, Spain will continue to see considerable restrictions on public spending in the future.

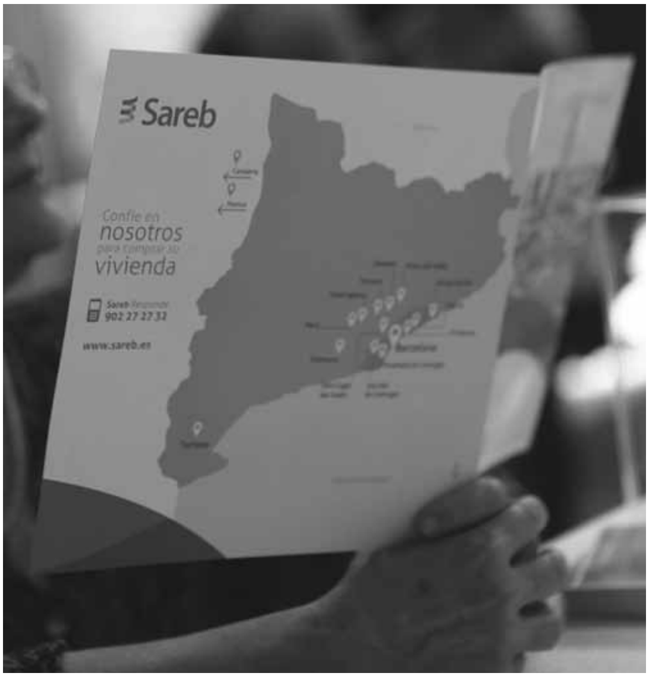
Fiscal policy

Even after the severe fiscal adjustments of the last four years, Spain has not yet completed the process of reducing its public deficit. In accordance with Spain's commitments to European authorities, the country's public deficit, which was more than 6.5% of GDP in 2013, must be reduced to 5.8% in 2014, 4.2% in 2015 and 3% in 2016.

Because a higher GDP will translate into somewhat higher revenues, Spain would not need to make many more budget cuts in order to achieve its target for 2014. However, stricter targets are required for 2015 and 2016. Given the high level of public debt and the resulting interest-servicing costs, Spain would need to have a primary surplus of 2% to 3% – not counting interest payments – in order to bring the deficit down to 3% of GDP. As a result, even if the economy starts growing again, considerable fiscal adjustments will be necessary. The targets set by the European authorities need to be flexible enough to adapt to growth fluctuations because additional budget cuts could hamper short-term growth and must be avoided. This short-term flexibility would be offset by Spain's inescapable medium-term commitment to reduce the deficit.

Financial system

The financial support provided by the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) has enabled Spain to speed up the reorganisation of its financial sector. Following independent stress tests and a meticulous asset-quality review, Spain's troubled yet viable banks have been recapitalised and the remaining entities have adopted restructuring or resolution plans. The viable banks were recapitalised by raising private capital and by transferring assets and liabilities related to the real estate sector to SAREB, Spain's so-called "bad bank". In the



meantime, the regulatory and supervisory capacities of the Bank of Spain have been enhanced.

Since the first measures were taken in 2009, the public sector has injected €63 billion into the Spanish financial sector (approximately 6% of GDP), €43 billion of which came from the EFSF and ESM. In addition, the public sector has guaranteed bonds issued by banks, including SAREB, for a value of €105 billion.

The overall volume of capital in the financial system has been increased. In mid-2013, Spain reached the minimum core capital ratio required by European regulations (9%). Provisions for doubtful debts have also been increased. The number of banks in Spain decreased from 50 in 2009 to 16 in 2013, and the number of branch offices and employees has dropped by approximately 14% in the same period.

In short, the Spanish financial system has been stabilised: it is now much more secure and has no solvency problems. Nevertheless, there remain some risks, essentially those derived from the difficult macroeconomic situation. Additionally, the flow of household and business loans has yet to improve.

> The solvency of the Spanish financial system has improved but the flow of household and business loans has not resumed

Good news in the foreign sector

Spain's current-account balance rose from a deficit of 10% of GDP in 2008 to positive figures in mid-2013. Of this notable improvement, 75% is due to an improved balance of exports of goods and services and more than 50% is due exclusively to the increase in exports.

In previous instances of current-account imbalance, the deficit had reached just 3% to 4% of GDP and adjustment was partially carried out by depreciating the peseta.

Exports increased steadily from 2010 to 2013. The number of exporting companies increased by 10% each year, indicating a growing level of internationalisation in Spanish industry.

The growth figures posted by Spain's trade partners, in combination with the current behaviour of imports and exports, suggest that the current-account balance adjustment is permanent (i.e. not due to cyclical factors).

> Exports increased steadily from 2010 to 2013 and the number of exporting companies increased by 10% each year

In recent years, Spain's current-account balance has been adjusted primarily through the reduction of costs, especially wages. Spain should continue this adjustment by dedicating more resources to exports, thereby increasing the size of the export sector as a share of the Spanish economy.

Final considerations

Having put its growth figures back into the black, Spain needs to avoid falling into multiple-year stagnation – a scenario that could easily arise from the present situation. The accumulated effect of stagnation and unemployment on various social groups could lead the public to increasingly question the eurozone in political and economic terms. The leaders of the core European countries need to understand this.

The events of recent years have shown that the Spanish economy has significant collateral effects on the eurozone economy as a whole, principally through the financial markets. Spain has shown that its economy, like Italy's, plays a systemic role within the EU. Therefore, trouble encountered by Spain on its path towards stable growth poses a danger to all eurozone economies and must therefore be avoided.

Efforts to reform the Spanish economy should continue. If the country's first positive growth figures do not lead to job creation, additional labour reforms must be undertaken. Such reforms should probably take the form of a single permanent contract with severance indemnity conditions that increase over time.

2015 could mark the beginning of a more solid economic recovery, though uncertainty is still high

In last year's Economic Report, we outlined a scenario in which it would be possible for the Spanish economy to return to positive growth in 2014. In the end, as explained in the present report, this growth will be very weak. However, if certain conditions are met, 2015 could mark the beginning of a more solid economic recovery. For this to be possible, the general scenario in Europe needs to improve and specific problems must be solved. Spain urgently needs solutions to the fragmentation of its financial system, the poor availability of credit, and its unemployment figures (especially among young people). These problems will not solve themselves: they require action on the part of the Spanish and European authorities.

There is no reason why Spain should go through a prolonged economic recession as a sort of Biblical punishment for past mistakes. Indeed, a prolonged recession is an inefficient response to those mistakes; the loss of production is unrecoverable and, in addition to the obvious social costs, it hurts Spain's ability to repay its debts. A return to growth in Spain – and throughout the periphery of the eurozone – should be a priority on the European political agenda.

Mariano Rajoy, Prime Minister of Spain, during the last press conference held in 2013

ABOUT THIS PUBLICATION

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ABOUT ESADE

Founded in 1958, ESADE now has campuses in Barcelona, Madrid, Buenos Aires, São Paulo and Munich and collaboration agreements with over 100 universities and business schools worldwide. Each year, more than 10,000 students participate in its courses (MBA and Executive Education, as well as undergraduate and master's programmes in law and business administration). Its business park, ESADECREAPOLIS, is a pioneering innovation centre where the university and business worlds unite. With a clear international outlook, ESADE was ranked near the top of the main business-school rankings in 2010 (*Financial Times, Wall Street Journal and BusinessWeek*). ESADE currently has a network of more than 44,000 alumni occupying positions of responsibility in enterprises around the globe. Since celebrating its 50th anniversary, ESADE has adopted "Inspiring Futures" as its institutional motto to illustrate the goal of fostering a spirit of renewal in the fields of business and law.

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