Chapter 1

Rebalancing the economy

Spain has recently exited a deep recession triggered by the global crisis. Growth is nevertheless expected to remain subdued as the economy still needs to correct part of the private sector imbalances built-up prior to the crisis despite a prudent macro-fiscal policy. Strong growth of private sector indebtedness, which reflected strong business investment as well as the overdevelopment of the residential construction industry, has led to a sizeable current account deficit, whose correction is underway. Rebalancing the Spanish economy and boosting potential growth will require full-fledged reforms, especially in labour and product markets. In particular, fostering competition in the service sector further could help reduce prices and improve competitiveness. Housing policies have advanced considerably in eliminating tax distortions in favour of housing ownership and removing barriers to the rental market, which can help support labour market adjustment and make a contribution to the absorption of the empty housing stock. However, the authorities should refrain from expanding the stock of social housing and favour instead means-tested benefits. Restructuring and reform of the savings banks has improved their resilience, although the role of regional governments in the savings banks' management should be further reduced.

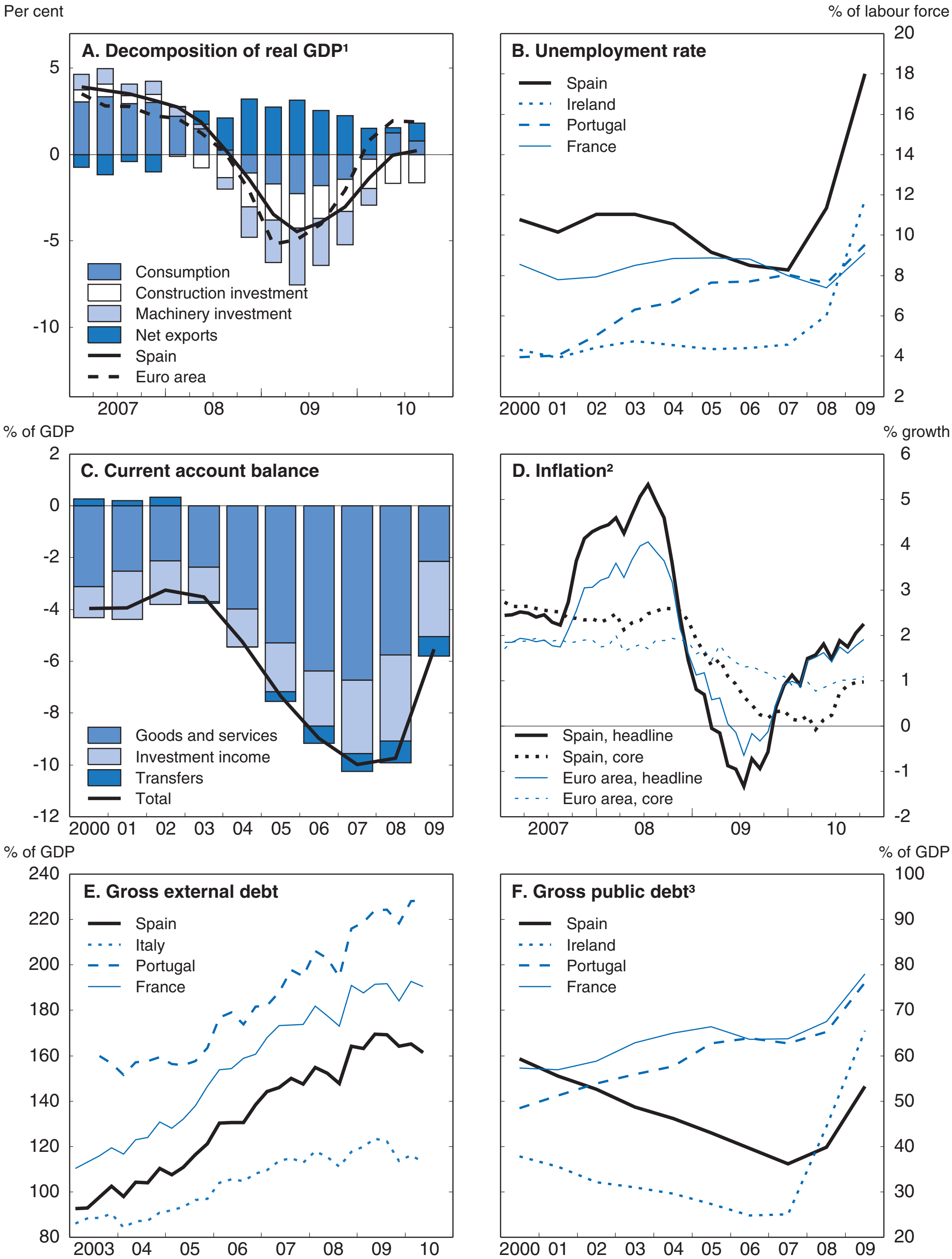
A cyclical downturn severely hit by the global crisis

After a decade of rapid growth, Spain entered a recession of unprecedented (in the last 50 years) depth and length, leading, in particular, to a steep rise in unemployment (Figure 1.1 and Table 1.1). The recession was triggered by the global crisis but has been compounded by the sharp domestic adjustment already underway related to the oversized residential construction industry. The crisis has accelerated the adjustment of the external imbalance built-up prior to the crisis, as a very dynamic growth of private sector indebtedness, which financed unusually high rates of business and residential investment, led to a sizeable current account deficit, despite both a prudent fiscal policy (several years of fiscal surpluses) and an adequate financial supervision framework (high bank capital and provision buffers).

The steep adjustment of the private sector led to an evaporation of fiscal revenues which, combined with discretionary fiscal stimulus, resulted in a sizeable budget deficit. Financial market tensions in the wake of the Greek crisis and financial investors' concerns on the capacity of the government to finance its fast-rising debt led to a steep rise in sovereign spreads over German 10-year bonds, which reached about 200 basis points in early May 2010 (Figure 1.2). While the banking sector proved resilient to financial market turbulence and exposures to the domestic housing market, financial investors' concerns about the condition of both financial intermediaries and the government mutually reinforced each other, with high credit default swap spreads moving in lockstep with the risk premium on long-term government bonds. The announcement of the European Financial Stabilisation Mechanism and the launch of the European Central Bank (ECB) Security Market Programme to buy government debt provided some relief, as did the decision by the government to frontload its fiscal consolidation and the publication of stress test results for almost all domestic banks. Steps to strengthen the resilience of savings banks (discussed below), as well as structural reforms, notably in the labour market, also helped improve confidence. The test scenarios included a severe hypothetical further deterioration of the domestic housing market. Nonetheless, spreads remain high by historical standards, emphasising the need for Spain to strengthen financial market confidence in the sustainability of government finances.

This first chapter of the *Survey* assesses the imbalances in more detail and the extent of the rebalancing that has already occurred. It also reviews developments in the two sectors more directly affected by the crisis, *i.e.* the housing sector and the banking system. Some policies to rebalance the economy, such as product market reforms, are also discussed in this chapter, but fiscal policy is more extensively covered in Chapter 2 while labour market developments and policies are assessed in Chapter 3.

Figure 1.1. **Recent macroeconomic developments**



1. Contributions to growth, year-on-year. The lines represent real GDP growth.
2. Inflation is measured by the year-on-year change in the consumer price index. Core inflation excludes food and energy.
3. Maastricht definition.

Source: OECD (2010), *OECD Economic Outlook: Statistics and Projections* and *Main Economic Indicators* (databases), November; and World Bank (2010), "Quarterly External Debt Statistics", *World dataBank*, November.

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Table 1.1. **Economic indicators**[1]

	Current prices, billion euros	Percentage change, volume				
		Outcomes		Projections		
	2007	2008	2009	2010	2011	2012
Private consumption	481.0	–0.6	–4.2	1.5	1.7	2.3
Government consumption	152.6	5.8	3.2	0.3	–0.8	–1.3
Gross fixed capital formation	235.3	–4.8	–16.0	–6.8	–1.8	2.0
of which: Residential	59.2	–10.7	–24.5	–16.6	–3.6	–0.3
Final domestic demand	869.6	–0.7	–6.0	–0.7	0.4	1.5
Stockbuilding[2]	2.6	0.1	0.0	0.0	0.0	0.0
Total domestic demand	872.2	–0.6	–6.0	–0.7	0.4	1.5
Exports of goods and services	245.1	–1.1	–11.6	9.3	8.2	10.4
Imports of goods and services	328.1	–5.3	–17.8	6.4	5.9	8.7
Net exports[2]	–83.0	1.5	2.7	0.5	0.5	0.3
Gross domestic product	797.4	0.9	–3.7	–0.2	0.9	1.8
GDP deflator	. .	2.4	0.6	0.4	0.2	0.3
Memorandum items						
Harmonised index of consumer prices (HICP)	. .	4.1	–0.2	1.5	0.9	0.3
Core HICP (excluding food and energy)	. .	2.4	0.9	0.5	0.8	0.3
Private consumption deflator	. .	3.5	0.1	2.3	1.0	0.3
Unemployment rate (%)	. .	11.3	18.0	19.8	19.1	17.4
Household saving ratio[3]	. .	13.4	18.0	16.9	16.0	15.4
General government financial balance[4]	. .	–4.2	–11.1	–9.2	–6.3	–4.4
Gross debt (Maastricht definition)[4]	. .	39.8	53.2	62.9	68.9	70.3
Current account balance[4]	. .	–9.7	–5.5	–5.4	–5.1	–4.8

1. National accounts are based on official chain–linked data which introduces a discrepancy between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods at *www.oecd.org/eco/sources-and-methods*.
2. Contributions to changes in real GDP (per cent of real GDP in previous year), actual amounts in first column.
3. Defined in gross terms, per cent of disposable income.
4. Per cent of GDP.

Source: OECD (2010), *OECD Economic Outlook: Statistics and Projections* (database), November.

Spain has started rebalancing its economy

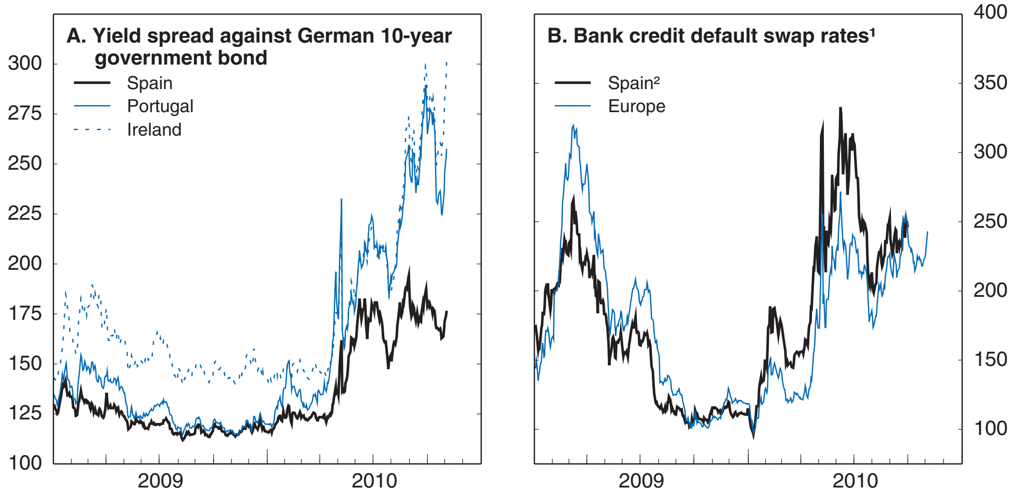
Spain entered the crisis with significant imbalances

Households and some businesses sectors are highly indebted

The debt burden of households relative to disposable income is high in comparison to other euro area countries (Figure 1.3). This largely reflects strong investment in housing, whereas savings were not unusually low (see further below). Net financial wealth relative to disposable income has fallen since 1998, albeit little below long-term averages, while the accumulation of housing wealth has boosted total net wealth. Nonetheless, the tightening of bank lending conditions as well as deteriorating labour market conditions contributed to the increase in the household savings rate from 12% in 2007 to 18% in 2009. The high savings rate should allow deleveraging to advance without further cutbacks in consumption. Nonetheless, household debt dropped by only 2% of disposable income in 2009, reflecting still high spending on residential investment and the accumulation of financial assets, in part because their remuneration was attractive relative to debt servicing costs and for precautionary purposes. Since interest rates on mortgage debt are typically indexed to short-term interest rates with a lag of about a year, households are likely to benefit from low debt servicing costs until 2011, easing the immediate pressures of the deleveraging process on consumption.

Figure 1.2. **Recent financial market developments**

Basis points



1. Mid-rate spread between the entity and the relevant benchmark curve.
2. Unweighted average of the four main banks.

Source: Datastream.

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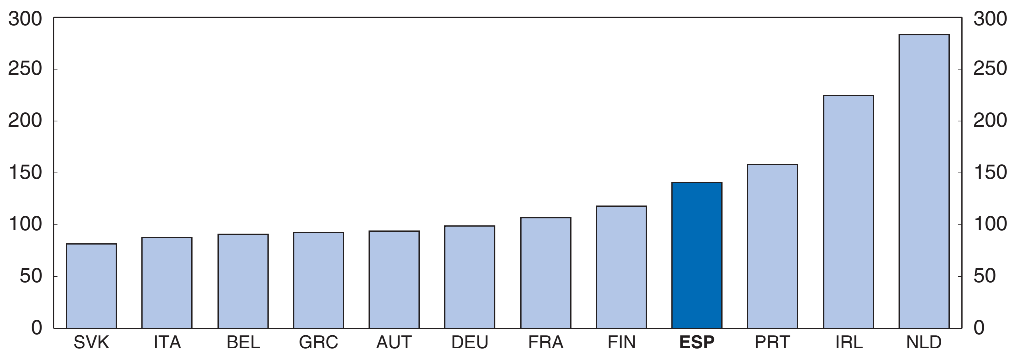
Figure 1.3. **Household debt in the euro area**[1]

Per cent of disposable income, 2009[2]



1. Total liabilities of the household sector including non-profit institutions serving households, non-consolidated stock.
2. 2008 for Greece.

Source: OECD (2010), *OECD National Accounts Statistics* and *OECD Economic Outlook: Statistics and Projections* (databases), November.

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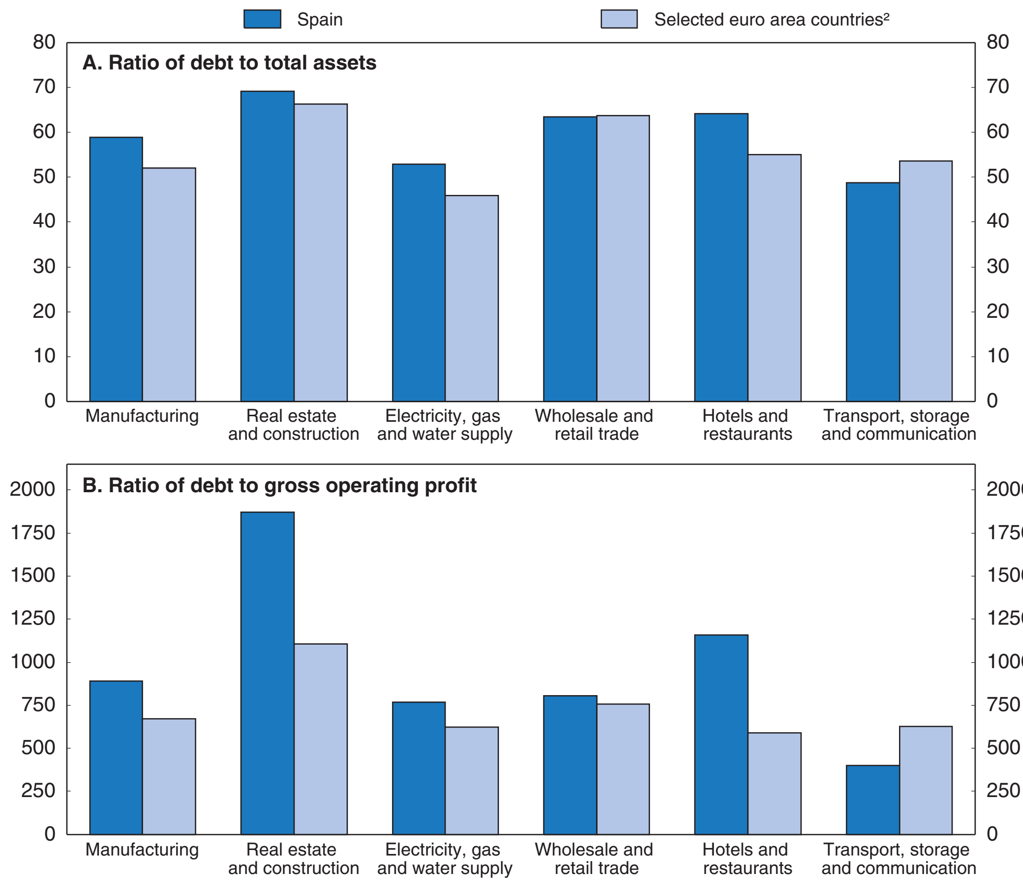
Strong business investment before the onset of the crisis contributed to making Spanish businesses somewhat more leveraged than in other euro area countries. According to estimates by the Banco de España, in 2008, business debt amounted to 62% of total assets, compared to 59% in a weighted average of five euro area countries excluding Spain[1] (Figure 1.4, Panel A). The difference in business indebtedness between Spain and other euro area countries is more marked if measured relative to profits, especially in the housing sector (Figure 1.4, Panel B). This development reflects the sharp impact of the downturn, notably in the housing market, as the decline in sales reduced developers'

Figure 1.4. **Debt burden of non-financial enterprises by sector**[1]

Per cent, 2008



1. Debt includes commercial credit.
2. GDP weighted average of ratios for Belgium, France, Germany, Italy and Portugal.

Source: A. Fraile Izquierdo and C. Martínez Carrascal (2010), "El endeudamiento de las sociedades no financieras españolas. Evolución temporal y comparación con el área del euro", *Boletín Económico*, Banco de España, May.

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ability to repay their debt and lowered profits. As a result, overinvestment in housing has resulted in debt write-offs by banks (see below).

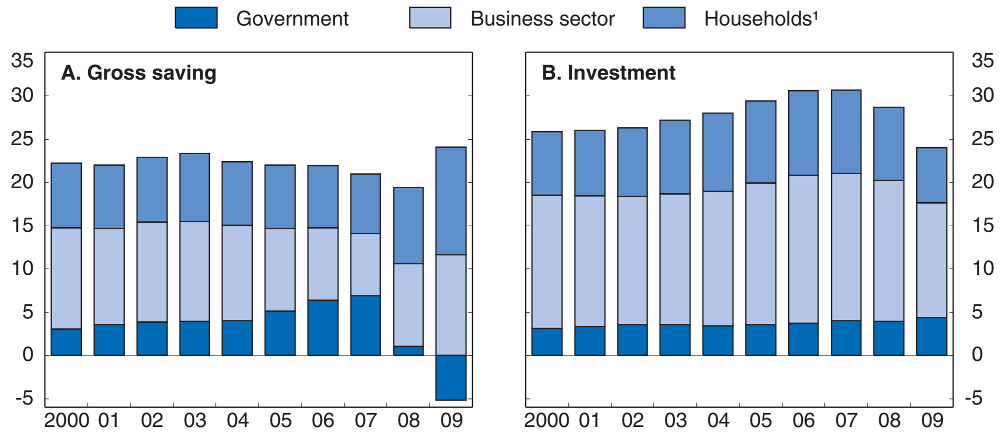
Among the non-construction sectors with a large weight in the economy, indebtedness appears relatively high in manufacturing and in tourism-related sectors.[2] By contrast, in sectors producing predominantly non-tradable goods and services, notably transport, communication, wholesale and retail trade, which may be more likely to face low product demand growth in future years, leverage does not appear to be particularly high. Aggregate data from business income accounts indicate that cash-flow has recovered to healthy levels in the course of 2010, and is now not much below pre-crisis years, suggesting that the ability to repay debt has improved. In part, this can be explained by the ease with which businesses have been able to lay off workers on temporary contracts at low cost.

Reliance on external financing has fallen

During the boom years, national savings remained substantial, notably sustained by rising public savings (Figure 1.5). As evidenced by a recent study on current account

Figure 1.5. **National saving and investment**

Per cent of GDP



1. Includes non-profit institutions serving households.

Source: OECD (2010), *OECD National Accounts Statistics* (database), November.

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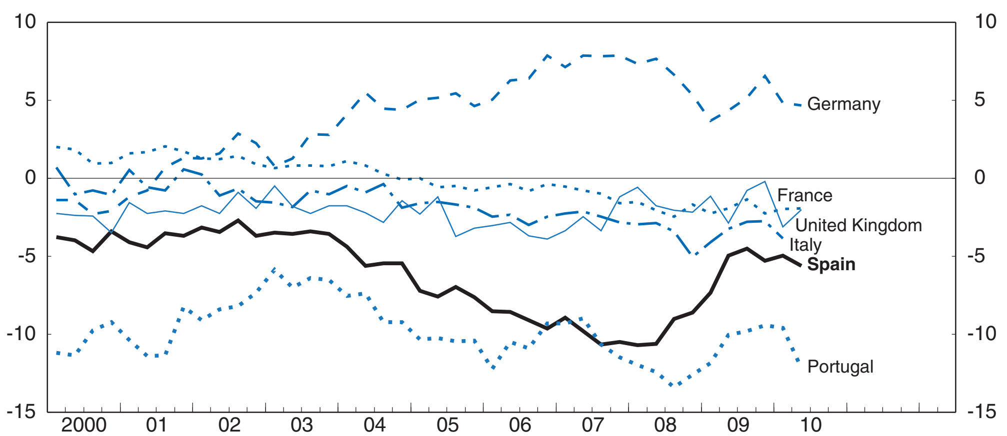
imbalances (Jaumotte and Sodsriwiboon, 2010), in the southern euro area, the fall in private saving compared to northern euro area economies was smaller in Spain than in other southern euro area economies (except Slovenia). However, unusually high investment rates significantly exceeded national savings, due both to businesses and the residential housing sector, resulting in a large current account deficit.

The drop of imports during the crisis has resulted in a marked narrowing of the current account deficit (Figure 1.6), even without substantial real exchange rate depreciation. To some extent this can be explained by the large contribution of business investment to the current account deficit in the boom period, as a large share of machinery and equipment investment goods is imported. Thus, falling purchases of machinery and equipment contributed strongly to the contraction of domestic demand in 2009 (Figure 1.1, Panel A).

Figure 1.6. **Current account balance**

Per cent of GDP



Source: OECD (2010), *OECD Economic Outlook: Statistics and Projections* (database), November.

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Pro-cyclical lending conditions, with real interest rates below those observed in other euro area countries in the boom period, played a particularly significant role in residential construction, where they were magnified by tax subsidies, which further encouraged speculation on rising prices (see OECD, 2007 for a description of the subsidies).[3] Conversely, the large contribution of business investment to the deficit before the outburst of the crisis can to some extent be attributed to structural factors. Firstly, the decline in real interest rates following euro adoption also encompasses a structural component (*e.g.* owing to the better macroeconomic framework of the European Monetary Union). Secondly, the large trend increase in female labour force participation, which can be attributed to structural reasons, as well as large immigration flows, which are unlikely to be mostly accounted for by cyclical factors, raised labour supply substantially. This development raised the desired level of the capital stock. As shown in the 2008 *Economic Survey*, the strong business investment observed prior to the crisis was merely sufficient to avoid a widening of the gap in the capital intensity of labour between Spain and other euro area countries (OECD, 2008) since the mid-1990s.

The current account deficits have led to an accumulation of gross external debt of 165% of GDP (2009), which is moderate in international comparison.[4] The net external investment position of –87% of GDP in the second quarter of 2010 is, by contrast, relatively large. It reflects a smaller stock of Spanish financial and other foreign investment assets than in more mature economies. The recently observed current account deficits are higher than the level consistent with a constant net external investment position in the medium-term, although the gap of about 1-2 percentage points is not substantial.[5] As a consequence, the real exchange rate adjustment needed to bring back the current account deficit to a sustainable level may be limited.

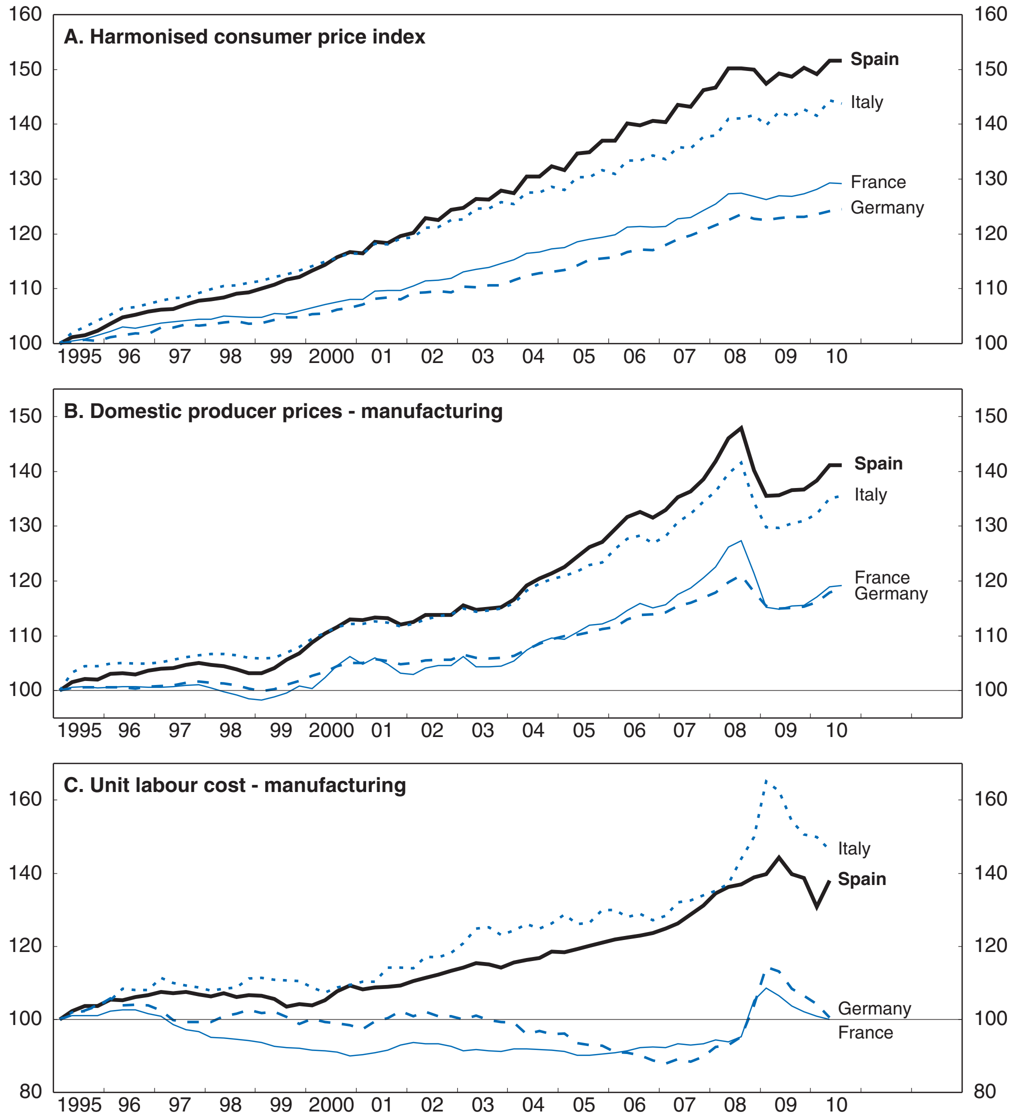
Looking forward, the current account deficit is projected to decline, on account of fiscal retrenchment, continued adjustment in residential construction and deleveraging among households and businesses. Structural funding needs may also diminish as labour supply growth is set to fall, immigration recedes and the scope for gains in female labour market participation will gradually diminish (see Box 1.2 below). Nonetheless, conceivably, convergence in the capital intensity of labour to rates observed in other European countries may yet require additional external funding. Policies to restore investor confidence, including through fiscal consolidation, are therefore essential, to ensure external funding remains accessible at moderate cost. They would allow some smoothing of the deleveraging process in the private sector, by allowing households and businesses to roll over part of their debt and to fund future investment needs.

Indicators of price and cost competitiveness have deteriorated over the past decade

The booming economy, along with the longer-term catch-up process, led to relatively high inflation of prices prior to the crisis (Figure 1.7). Several indicators suggest that prices and costs of the production of tradable goods have risen faster in Spain than in other euro area countries. This difference is particularly marked in cost indicators for tradable goods. While consumer price inflation (which includes the prices of non-tradable goods) have risen by about 15-20% relative to France or Germany, since 1995, relative unit labour costs in manufacturing have risen by 35% (Figure 1.7, Panel C) mainly due to low productivity growth. If there were a large overvaluation of the real exchange rate *vis-à-vis* other members in the euro area, it would be of particular concern, because it would have to be corrected through lower inflation than in the other countries of the currency area. With an inflation target of just below 2% for the euro area as a whole, a correction of a large

Figure 1.7. **Competitiveness indicators**

Index, 1995Q1 = 100



Source: OECD (2010), *Main Economic Indicators* (database), November.

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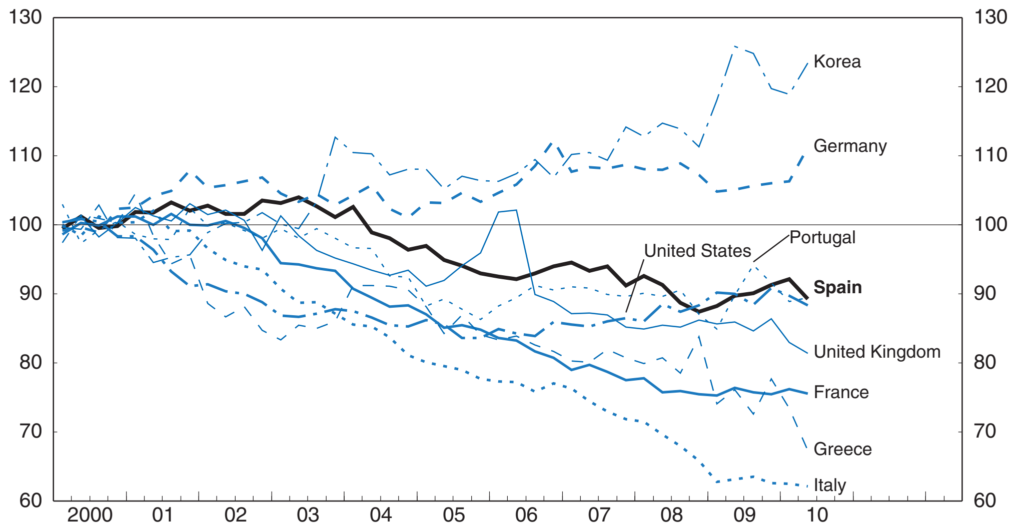
exchange rate overvaluation could require a long period of low inflation or even deflation, and hence a long period of weak activity to generate the required downward pressures on prices. The extent of output losses resulting from any needed real exchange rate realignment also depends on the extent to which policy settings encourage wage and price flexibility as well as productivity improvements (see further below).

Core inflation (excluding energy and seasonal food from the price index) fell below the euro area average in the course of 2009, reflecting the drop in domestic demand (Figure 1.1, Panel D). The headline rate has moved close to the euro area's recently, in part reflecting the bigger impact of rising oil prices on inflation in Spain, on account of a smaller tax component in fuel prices and more intensive oil use. The impact of the increase in value added tax (VAT) rates (from 16 to 18% for the standard rate, from 7 to 8% for the reduced rate) is estimated to raise inflation by about ½ percentage point from July 2010 onwards.

The need for continued unravelling of domestic demand over the next few years, notably on account of the needed budgetary consolidation and the continued adjustment of residential housing (see next section) suggest that some real exchange rate adjustment is needed, although this is likely to be moderate. Some arguments suggest that the adjustment will not need to be as large as to imply a return to levels near to those observed prior to the creation of the euro. Market shares of Spanish exporters have evolved relatively favourably in comparison to many other high-income countries (Figure 1.8). The expansion of non-tourism service exports has contributed to this development (OECD, 2008). The current account deficit diminished significantly without major real exchange rate adjustment. And an analysis of price level data from the OECD purchasing power parities database suggests that the level of prices of Spanish goods and services does not seem, on aggregate, higher than in other euro area countries, controlling for the effects of differences in income, productivity and indirect taxation (OECD, 2008).[6]

Figure 1.8. **Export performance**[1]

Index, 2000 = 100



1. Export performance is the ratio between export volumes and export markets for total goods and services. The calculation of export markets is based on a weighted average of import volumes in each country's markets, with weights based on trade flows in 2005.

Source: OECD (2010), *OECD Economic Outlook: Statistics and Projections* (database), September.

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Several factors can contribute to rising costs relative to trading partners but may not require correction. Countries specialised in exporting goods whose prices rise in world markets should experience rising relative unit labour costs, and such a development should not be interpreted as a deterioration of competitiveness. For example, countries exporting goods with relatively low technology content (such as Spain) rather than high-technology goods, such as information and communication technology (ICT) products, whose prices are falling fast, may experience rising export prices. Prices of Spanish exports have indeed risen more quickly than in main trading partners.[7] In addition, countries whose per-capita income levels converge to high-income countries typically experience real exchange rate appreciation reflecting differential productivity growth between tradables and non-tradables (Balassa-Samuelson effect)[8] as well as higher prices producers of tradable goods with market power charge in markets characterised by higher per-capita income. However, productivity growth differences between tradables and non-tradables may not have played an important role in Spain (Estrada *et al.*, 2009).

Empirical evidence also suggests that prices of goods and services have been more responsive to demand conditions in Spain than elsewhere in the euro area (Estrada *et al.*, 2009, citing evidence from the European Inflation Persistence Network). This finding would contribute to explaining high consumer price inflation in pre-crisis years and is consistent with a relatively competition-friendly stance of product market regulation (see further below). It suggests that prices of goods and services should also decline relatively quickly in response to weakening domestic demand and with lower costs in terms of output lost.

Unwinding imbalances may lead to protracted slow growth

While the rise in relative price and cost indicators will not need to be reversed in full, the downsizing of residential housing activity, which is estimated to detract 2½ points from GDP between 2009 and 2011 (see further below), combined with the necessary consolidation of government budgets by around 5% by 2011, constitute a substantial country specific shock. Overall, after the contraction of output in 2009, growth is expected to remain weak over the coming years, as projected in *OECD Economic Outlook,* No. 88 (Box 1.1).

Box 1.1. **Short-term economic prospects**

GDP growth is expected to recover slowly in 2011, driven by external demand, with exports accelerating on the back of rising world trade growth. Domestic demand will be held back by marked budgetary adjustments and continued downsizing of residential construction. Household consumption is expected to recover nonetheless, as disposable income will continue to be supported by low mortgage rates, and households will be able to reduce high savings rates to some extent, while continuing to reduce debt. Low capacity utilisation will damp business investment. The unemployment rate is expected to begin falling significantly in 2011. Headline inflation is set to fall to below ½ per cent when the effect of the increased value added tax rates drops out in 2011 (Table 1.1), while the current account is projected to fall further. GDP growth is projected to reach 1.8% in 2012 as world trade strengthens, budgetary consolidation needs diminish and the downsizing of the residential housing sector will have run its course.

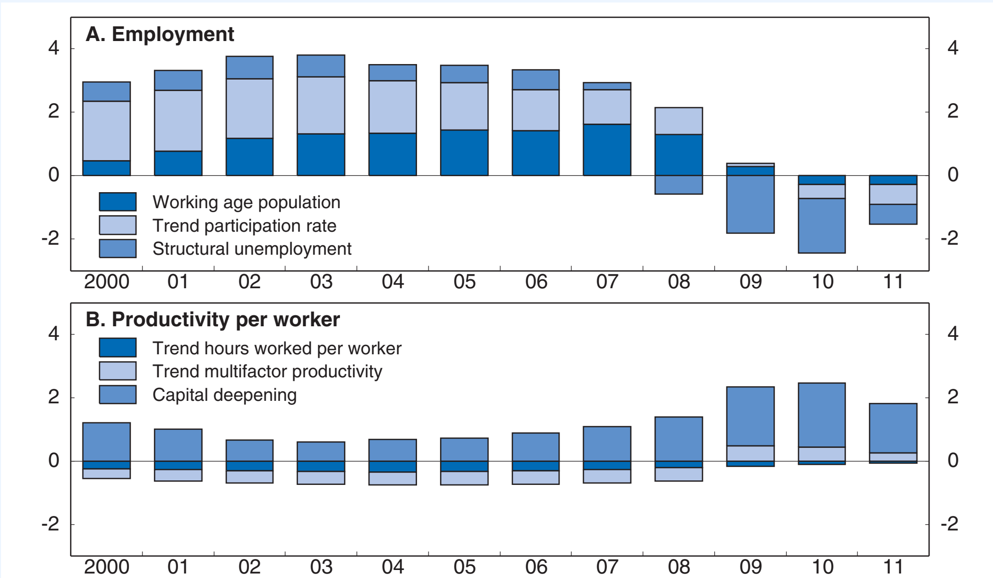
Policy initiatives to improve wage and price flexibility and strengthen productivity can facilitate the correction of these imbalances while minimising losses to activity. Labour and product market reforms also have an important role to play to boost potential growth, which appears to be declining, in part as a result of the economic and financial crisis (Box 1.2). Labour market reforms are necessary to lower high structural unemployment and foster the reallocation of workers who lost their jobs in the crisis. Product market reform would also expand productivity and employment in the medium term. Product market reforms are discussed below, labour market reform is discussed in Chapter 3. In a similar vein, further measures to improve education (the in-depth chapter of the 2008 *Economic Survey*) and training of adult workers (Chapter 3) would offset some of the adverse effects on human capital that result from increased long-term unemployment due to the crisis.

Box 1.2. **Potential output after the crisis and beyond**

Over the past ten years, GDP growth in Spain has been driven mainly by strong growth of labour utilisation (Figure 1.9). Since the 1990s, Spain had experienced continuously large inflows of net migration which had not only increased population, but had helped to keep wage growth down encouraging job creation in particular in low-skilled sectors such as construction and services. Furthermore, a strong increase in female labour participation has contributed to increased labour utilisation (Figure 1.9). In contrast, productivity growth advances have been weak, in part due to a sectoral concentration on low-productivity growth sectors such as construction and certain services, but also due to small improvements in within-sector multifactor productivity growth (MFP) (OECD, 2008).

Figure 1.9. **Potential output growth**

Percentage point contribution to potential growth[1]



1. Projections for 2010 and 2011.

Source: OECD Economics Department calculations.

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In the aftermath of the crisis, potential growth prospects risk being lower in the medium term owing to reduced potential labour input growth. *First*, labour force participation may fall due to discouraged-worker effects, in particular among the young and the older workers. The past strong expansion of female labour supply cannot continue at the same pace in the longer term. *Second*, although the 2010 labour market reforms should help the absorption of the unemployed workers, some of the increase in unemployment risks being long-lasting and not completely reversed in subsequent recoveries. This may increase structural unemployment as workers who remain unemployed for a long period may become less attractive to employers (OECD, 2010). At the same time the decline of the residential construction sector has reduced the supply of jobs with modest qualification requirements, while the share of workers with low qualifications is large. *Third*, the future net inflow of immigrant population is uncertain. On the one hand, immigration has fallen significantly during the crisis, and adverse labour market conditions may keep immigration inflows low for some time. On the other hand, few immigrants have taken up

Box 1.2. **Potential output after the crisis and beyond** *(cont.)*

financial incentives to return to their home countries. This may reflect some factors which are supportive of immigration, such as high income differentials between Spain and the countries of origin.

The downsizing of low-productivity activity related to residential construction seems to have pushed productivity growth up temporarily, offsetting the negative prospects on potential growth to some extent. Further MFP improvements may be achieved in the medium term as further low-efficiency activities are discontinued and resources shifted to more productive uses within as well as across sectors. Lagged effects of the substantial reforms of product market regulation in recent years should also boost productivity in the near future as should the large gap in educational attainment between young workers entering the labour market and retiring workers.

Ongoing product market reform should help speed up the adjustment

Reform of product market regulation can help strengthen export-led growth and invigorate the non-traded sector. Such reform lowers mark-ups in prices and promotes higher rates of productivity growth, thereby improving competitiveness in the tradable sectors directly. Moreover, reforms in the regulation of non-tradable services which are used as intermediate inputs have particularly marked effects on aggregate performance by strengthening competitiveness in downstream sectors, including in sectors producing tradable goods and services (Conway *et al.*, 2007).[9] By damping consumer price inflation, more intense competition in non-tradable services also contributes to moderating bargained nominal wage growth. Empirical evidence for Spain shows that reducing barriers to competition in retail trade, for example, would have a marked impact on consumer price level in Spain (Matea and Mora-Sanguinetti, 2009). More generally, product market reforms can help tap new sources of potential output, by raising trend total factor productivity (TFP) growth which has been weak over the past decade (see Figure 1.9 and the 2008 *Economic Survey* for the past productivity trend). This is important in view of the end of the large-scale expansion of labour supply, which has driven potential growth in the past.

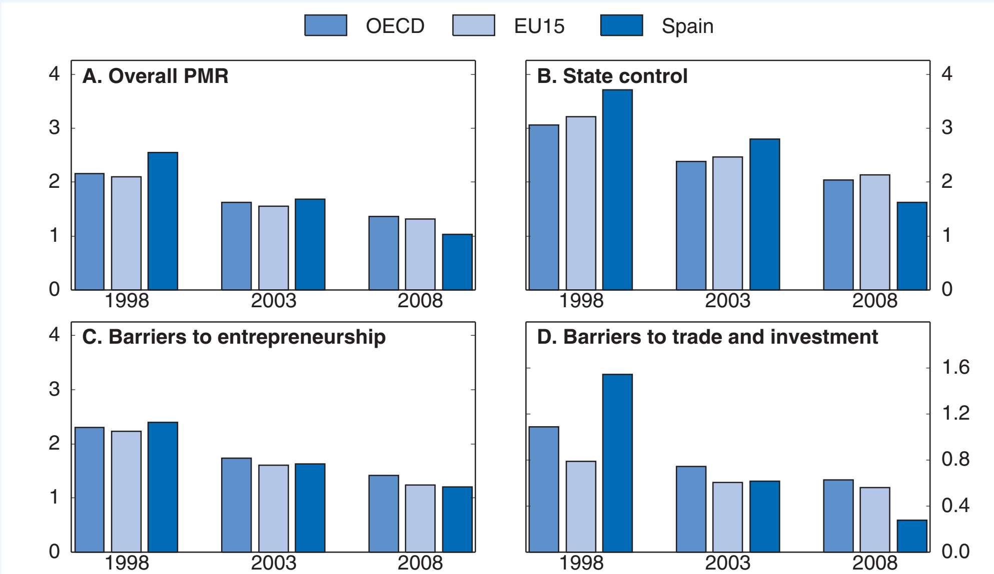
Over the past decade, Spain has undergone a relatively deep, widespread and sustained process of reform that has made many markets more open to competitive pressures in comparison to other OECD countries (Box 1.3 and 2008 *Economic Survey*). This has included less state intervention in business sector activities, liberalisation of access to many domestic markets and further integration into world markets. The experience of other countries suggests that performance gains from these reforms may not yet have materialised.[10] The reform efforts that have been introduced since 2009 have the potential of significantly reducing remaining barriers to competition (Box 1.3). The introduction of e-government application in addition to single contact points can substantially reduce the administrative burdens for setting up a business. The increased independence of sector regulators in energy, telecommunications and postal services should help to provide firms with reliable rules that are insulated from short-term political pressures and would hence foster investment. Finally, the reduction in the restrictions of professional services should increase entry and foster competition, thereby increasing the variety and reducing the prices of the services provided.

Box 1.3. **Spain's reforms of product market regulation since 1998**

According to the OECD system of indicators of product market regulation (PMR, see Wölfl *et al.*, 2009, for more detail), reforms in Spain have been deeper than in the average OECD country. Starting from a 1998 situation in which policies restricted competitive pressures more than in the average OECD (or EU15) country, Spain's product market reforms had by 2008 made policies more friendly to competition than in the average OECD country (Figure 1.10, Panel A). However, the indicators should be interpreted cautiously: they do not capture restrictive regulations imposed by subnational government levels in full. If transfers of competencies to subnational governments result in retained or tightened regulation, as has occurred in Spain with respect to retail regulation, the indicator values may underestimate the level of existing regulation.

Figure 1.10. **Product market reform in Spain: deep, widespread and sustained over time**

Level in index points, with 0 = least and 6 = most restrictive



Source: OECD (2010), *OECD Regulatory Database*.

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Reforms in Spain have been widespread across the economy: starting from a relatively restrictive position in all domains covered by the indicators, Spain has eased restrictions to product market competition by reducing state control over business sector enterprises (Figure 1.10, Panel B), by reducing domestic barriers to entrepreneurship (Figure 1.10, Panel C) and by reducing barriers to trade and investment (Figure 1.10, Panel D). Moreover, Spain has been one of the few countries in which substantial changes in product market policies have occurred in both the 1998-2003 and 2003-08 periods. In most other countries, a significant slowdown in the reform process has been recorded over the most recent period (Wölfl *et al.*, 2009).

Progress has been marked in the following areas and sectors:

- Markets were liberalised in crucial network sectors. Several former monopolies have been opened up to competition, in accordance with (and sometimes going beyond)

Box 1.3. **Spain's reforms of product market regulation since 1998** *(cont.)*

EU directives. Spain has strongly liberalised the gas, electricity and telecommunications markets. Essential vertical separation requirements are in place and decisive steps have been taken to create a level playing field between incumbents and market entrants in recent years. In other network sectors, Spain has opened up to competition, particularly air and road transport – albeit from a relatively restrictive situation in 1998 as compared to other European countries.

- Where needed, regulation has been made increasingly light and has been based on incentive mechanisms. Coming from a very restrictive regulatory environment in 1998, some of the reforms undertaken were such as to get the general regulatory conditions closer to best practice. In the PMR indicators this is illustrated through less use of command and control regulation, which reflects a move towards incentive-based (as opposed to coercive) regulation in general and in specific service sectors, as well as much less use of price controls.
- An important element of Spain's drive to increase product market competition was further opening up to trade and foreign direct investment. Spain has lifted several barriers to foreign ownership, for instance by lowering the limits to foreign acquisition of shares in publicly-owned firms. Furthermore, Spain has caught up with other European countries in terms of non-tariff barriers to trade, in particular in terms of an increased commitment to international harmonisation of regulatory procedures.

Since 2009, different reform efforts are being introduced that aim at reducing remaining barriers to competition:

- A general framework law has been approved by Parliament and sets the stage for more specific reforms at the sectoral level, such as implementing the Services Directive of the European Commission. A central component of this framework law is to further ease the process of complying with the legislation, for instance through the introduction of e-government applications as well as of "liaison points" in addition to existing single contact points such as to increase co-operation between administrations at the national and European level. Furthermore, it eliminates barriers to entry to the services' market except those based on overriding reasons relating to the public interest.
- As concerns specific sector regulation, the *Ley de Economía Sostenible* includes policy measures to strengthen the independence, accountability and powers of sector regulators for several network sectors. There are no longer entry restrictions to road passenger transport services. In the postal services, draft legislation eliminates the legal monopoly on selected services for the incumbent. Entrants can use the postal network under terms and prices (*ex post*) monitored by the Postal Sector Regulator (fully operative since 16 July 2010). In professional services, certain restrictions on the joint exercise of two professions as well as on advertising and prices set by professions are being eliminated. Furthermore, draft legislation aims at lowering entry barriers by eliminating the compulsory membership to the profession's association and a recent Royal Decree Law (August 2010) reduces substantially the number of cases in which professional services providers need to request special licenses for service provision. Finally, a recently passed law (2010) eliminates the national threshold limit of opening a large retail outlet and removes the requirement for a national license. However, under overriding reasons relating to the public interest the establishment of outlets may still require a regional authorisation.

There are nevertheless still some areas with scope for further reform (the 2008 *Economic Survey* provides a more detailed discussion):

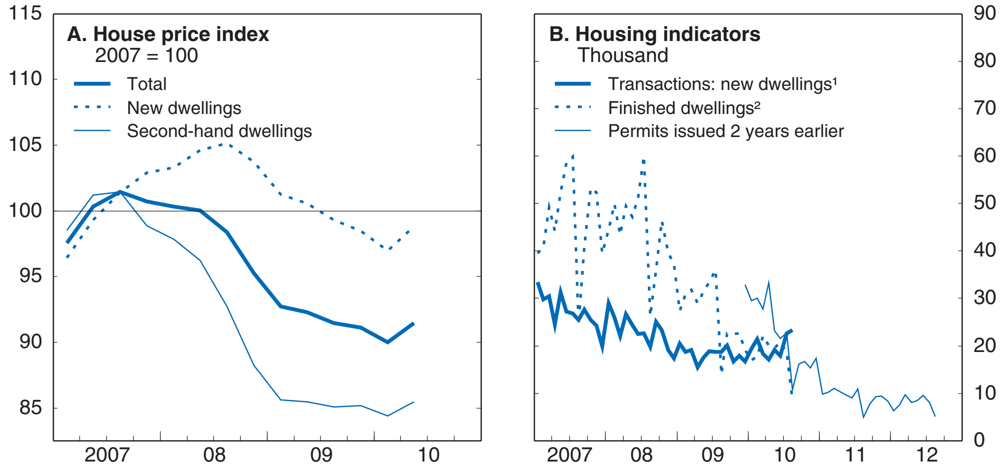
- Entry barriers at the regional level on *large-scale retail outlets* continue to depress productivity and raise prices in retail trade with a significant impact on aggregate outcomes. While the national threshold for setting up a large retail outlet has been eliminated, regional governments are able to impose a special licensing requirement for large outlets as long as this can be justified by criteria of public interest taking into account the principles of proportionality and non-discrimination. Regional governments should limit entry restrictions of large retail outlets.
- The national framework regulation establishes that regional governments cannot restrict the overall number of hours that shops can be opened to less than 72 hours per week. Several regional governments apply restrictive limits to opening hours. Shop opening hours should be liberalised in the regions where restrictions still exist. The government may also consider changing the national framework regulation so as to increase the minimum limit. This is one of the policy areas where regional governments' policies can be better aligned with country-wide economic objectives (see Chapter 2 on regional budget balances, Chapter 3 on public employment services and Chapter 4 on governance in water policy).
- Despite the most recent reforms (Box 1.3), the range of *professional services* for which Spanish regulation requires specific qualification requirements to be met is unusually large in international comparison. The number of such specific requirements should be reduced as they may generate barriers to entry.
- In *postal services*, competition is still hampered because market entrants have to individually negotiate access to intermediate service inputs from the incumbent, which are subject to natural monopoly conditions. Competitors should have an appropriate level of access to the public postal network and to the address databases of the postal services incumbent.
- In *road transport*, constraints involved in obtaining a road freight haulage operating license should be removed and the authorisation process should be reformed to make consolidation of firms easier. It should also be ensured that road passenger transport licenses are tendered on a competitive basis without favouring incumbents.
- In *rail transport*, the operation of regional passenger rail transport services should be put out to tender on a compulsory and regular basis and the incumbent should make its rolling stock available under non-discriminatory conditions.

The adjustment of the housing market will be long

The housing market remains depressed

Housing demand, as reflected in the number of housing transactions, peaked in 2006. The resulting fall in house prices, together with the adverse impact of the world financial and economic crisis and declining domestic activity and lending conditions further depressed the sector. The sharp drop in demand has led to the accumulation of a large stock of empty housing, reflecting the average duration of housing construction projects of approximately two years (Figure 1.11). The Banco de España (2010a) estimates a range of 750 000 to 1.2 million unsold units (2.8-4.4% of the total housing stock), about 600 000 units (2.5% of the total housing stock) more than in 2005 at the end of 2009. The Ministry of Housing has estimated that the stock of unsold new housing was around 700 000 at the end of 2009.

Figure 1.11. **Housing market**



1. *Registradores*.
2. Finished housing approved by the Surveyors College. Excludes housing promoted by co-operatives, physical persons and owners' communities.

Source: Banco de España (2010), *Síntesis de Indicadores*, November and INE (2010), "Construction statistics", *INEbase*, Instituto Nacional de Estadística, November.

StatLink http://dx.doi.org/10.1787/888932363349

The stock of unsold housing is likely to have peaked in the course of this year, as the number of finished housing units has matched the number of transactions of new homes (Figure 1.11).[11] The level of transactions remains depressed, a small recent increase notwithstanding, in spite of considerable improvements in the affordability of housing purchase, due largely to low interest rates. Land transactions, which are an early leading indicator of housing market developments, have barely recovered. If transactions of new housing remained at the current level, it would take three years for the surplus of empty housing to be absorbed by demand. According to official statistics, real house prices have fallen by 12% since the peak on average, somewhat less than most estimates of house price overvaluation in recent years (Table 1.2). This figure may however be an underestimate, because prices of transactions of new housing are recorded with a substantial lag. Prices have been falling more slowly in recent quarters, especially for used houses, but the estimates of oversupply suggest that there is still room for further declines.[12] Other segments of the real estate market do not appear to be characterised by large-scale oversupply. The office market in

Table 1.2. **Studies estimating the price overvaluation in the Spanish housing market**

Author and year	Year of estimation	Estimated overvaluation
Balmaseda *et al.* (2002)	2002	28
Ayuso and Restoy (2003)	2002	20
Martínez-Pagés and Maza (2003)	2002	8-17
IMF (2004)	2003	20
IMF (2005)	2004	20-30
OECD (2005)	2004	13
ECB (2006)	2004	30
Ayuso and Restoy (2006a, b)	2004	29
IMF (2008)	2007	20
Sosvilla (2008)	2007	7-15

Spanish cities appears to have behaved in a broadly similar fashion as in other European countries, although more recently the recovery of office rent prices appears to have been smaller in Spanish cities, reflecting the slower economic recovery.

Construction spending amounted to 18% of GDP before the onset of the recession, of which close to one half was accounted for by residential construction. While housing investment fell to 5% of GDP, half of its pre-crisis level, in the first quarter of 2010, it will have to fall further to adjust to oversupply, although the negative growth contributions are diminishing. In addition to the direct contribution of residential investment to GDP growth, the drop in housing demand has broader multiplier effects on activity, for example, by depressing employment through wealth effects resulting from lower prices. Including such effects, a simulation by the Banco de España (2010a) indicates that the housing crisis reduced annual GDP by about 3½ percentage points in 2009 compared to 2007, and may reduce output by a further 2½ per cent of GDP by 2011, when activity in the sector is expected to stabilise. These effects were simulated on the assumption that no resources would be reallocated from the residential construction sector to other sectors.

Further housing reforms are needed, including for the well-functioning of the labour markets

The large oversupply of empty new housing coexists with a substantial amount of potential demand which remains unsatisfied because of an underdeveloped rental market. Sixty-five per cent of 18-35 year olds (this age cohort comprises 12 million individuals) live with their parents, with the number of young people living with their parents being much higher than in other European countries.[13] Moreover past *Economic Surveys* reported that low income households are poorly housed. Both the young and the poor are likely to obtain access to housing more easily by renting. In 2008, only 13% of dwellings were rented, an increase of almost a third with respect to the previous year, but still among the lowest in the OECD area. Poor rental market mobility reduces labour mobility. Taxes on housing transactions, set by regional governments at rates of around 7%, contribute to high mobility costs among owner-occupiers.

The government has recently taken several measures to remove barriers to the rental market. At the end of 2009, new legislation simplified legal procedures for the eviction of tenants.[14] Indeed, poor enforcement of rental contracts, especially on account of complex and time-consuming eviction procedures, were a significant hurdle to the provision of rental accommodation.[15] It will be important to monitor the effectiveness of the measures taken to improve rental contract enforcement. The government has also presented draft legislation to Parliament to put the treatment of rented and owner-occupied housing in personal income tax on an equal footing, doing away with most of the current tax subsidies for owner-occupied housing (Chapter 2).

Central, regional, and local governments provide subsidies to social housing, including for new construction. While the central government housing plan (*Plan Estatal de Vivienda y Rehabilitación 2009-2012*) has provided some measures to subsidise the conversion of free to social housing[16] it also widens access to subsidised loans for development of new social housing.[17] In 2011, the plan will be modified, limiting subsidies for developers of social housing to only rental housing and eliminating direct subsidies for buyers of social housing. Government-promoted social housing projects risk adding to oversupply. This consideration is especially relevant in view of the fact that housing oversupply (as reflected in the extent of price reductions) seems fairly widespread. Moreover, the current downsizing of the residential construction industry can be expected to be largely permanent, suggesting that it should not be offset by subsidised construction projects. In 2008 and 2009, 135 000 new social housing units were completed. Expanding supply may exacerbate the needed adjustment of prices with adverse effects on household and bank balance sheets. Social housing is subject to an income test, but nonetheless risks being poorly targeted at low income households because of the difficulty of evicting tenants whose income situation improves over time. Targeting is further weakened because most social housing in Spain is, ultimately, available for sale, although, as part of recent efforts to cut public spending, these subsidies are increasingly targeted to social housing for rent. Moreover, owing to the long waiting periods for applications, it reduces worker mobility.

Public funds provided to support social housing should be redirected to a means-tested cash benefit for low-income households, earmarked to their rent payments. Such a means-tested benefit should also replace the planned modified income tax allowances for housing. The income limits notwithstanding, they are not well targeted as they provide little benefit to households which pay little income tax. A means-tested benefit would also have the advantage of providing scope for taking demographic household characteristics into account and would generate less deadweight loss. A housing benefit for young people, introduced in 2008, appears to have had significant success in mobilising housing demand, with support given to more than 200 000 rental contracts.

Difficulties in the banking sector have been confined to some savings banks

Banks' cushions to absorb losses are substantial but vulnerabilities remain

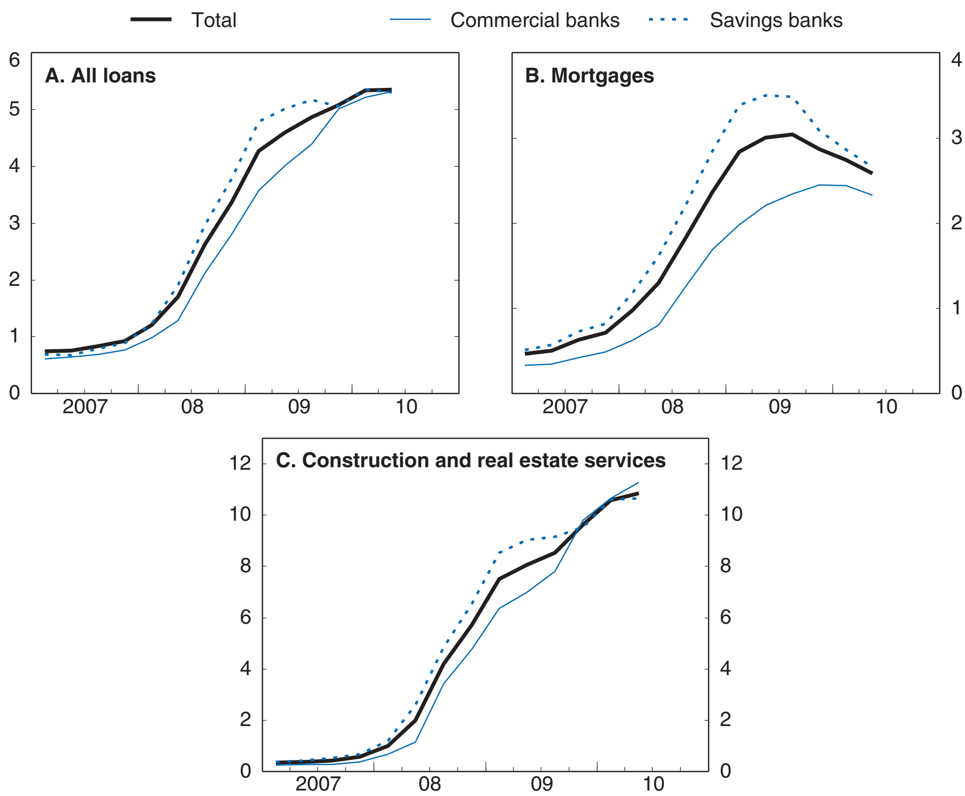
Non-performing loan (NPL) ratios continue to rise (Figure 1.12), but remain below the ratios observed during the 1993 recession. NPL ratios have fallen in the household mortgage loan sector. Several factors contribute to explaining this relatively favourable outcome, in view of the sharp housing market downturn and the huge employment losses: interest rates are low; employment is bottoming out; loan-to value ratios remained modest even in the peak of the lending boom; and borrowers' resources are comprehensively assessed for repayments. For example, banks have often required supplementary guarantees from borrowers (*e.g.* from family members; see OECD, 2008). Nonetheless, persistent unemployment constitutes a risk for the mortgage loan books of the banks, especially if this coincides with rising interest rates as the recovery takes hold in the euro area. NPL ratios continue to rise for loans to housing developers and construction companies. The total exposure of banks to these loans amounts to 442 billion euros, 43% of GDP.

The regulator, Banco de España (2009), pointed out that the gross operating surpluses of banks in 2009, 2010 and 2011[18] would be sufficient to cover losses equivalent to 40% of the outstanding total stock of loans to the construction and housing development sector. Given the collateralised nature of loans, a loss of 40% appears unlikely on average. The construction cost of the unsold stock of housing is likely to represent a fraction of the total amount of loans.[19] Some property developers diversified their business away from residential housing prior to the crisis, especially in the years preceding the boom. Moreover, as noted above, non-residential market segments of real estate, where loan losses tend to be the largest, are not subject to the same large-scale oversupply as observed in residential housing.

Provisions and equity provide additional buffers. Provisions can absorb losses of 15% on housing market exposures – including real estate assets acquired in exchange for loan

Figure 1.12. **Non-performing loan ratios**

Per cent of total loans



Source: Banco de España (2010), *Boletín Estadístico*, September.

StatLink http://dx.doi.org/10.1787/888932363368

cancellation – before current equity levels are affected (Banco de España, 2009). The regulator has required banks to provision in full non-performing loans more quickly and has strengthened safeguards to avoid that reported non-performing loans are kept artificially low by the transfer of real estate in exchange for loan extinction. Real estate acquired by banks must undergo a new valuation according to market conditions.[20] Banks have to provision 10% of this value upon acquisition of the real estate, a further 10% if they hold it for more than 12 months without selling it and an additional 10% (to a total of 30%) after 24 months.

Despite the robustness of the sector as a whole, perceptions of risks contributed to a sharp, albeit temporary, tightening of funding conditions. As the regulator pointed out (*e.g.* Banco de España, 2010b), exposures and losses on loans differ across individual institutions. Savings banks are more strongly exposed to the housing market, and, until the recently enacted savings bank reform (see below), they were subject to restrictions in raising external capital to offset losses (OECD, 2008). Uncertainty concerning the financial position of individual banks may affect perceptions of the risks to the sector as a whole, for example because of the financial links between banks. Moreover, perceptions of risks of the viability of banks are likely to have contributed to higher risk *premia* on interest rates on government bonds (Figure 1.2 above). Uncertainty about the viability of individual institutions was reduced by the results of the co-ordinated stress testing of banks in the European Union (Box 1.4). The testing was ambitious in Spain: almost the whole banking

Box 1.4. **Stress tests for Spanish banks**

The stress tests carried out for all European banks in July 2010 aimed to assess their solvency when confronted with a hypothetical stress situation. Specifically, the tests simulate the Tier 1 capital of the banks under a so-called "benchmark scenario" and under an "adverse scenario" to which further shocks were added (such as a sovereign risk shock). In Spain, they were conducted for all incorporated banks and all of the savings banks (27 institutions).

The adverse scenario

The adverse scenario assumes a cumulative decline of GDP by 2.6% in 2010 and 2011. The scenario assumes declines of 28% in the prices of finished housing, 50% in the prices of housing under construction and 61% in the prices of land from their maximum value in the last cycle until 2011. The tests added a further shock, notably on trading books, plus an additional haircut on government bonds on the trading book (an interest rate increase of 70% since 2009) and also an indirect effect due to an increase in interests (additional increases in the probability of default and loss given defaults). The hypothetical loan losses exceeded losses experienced in previous crises in Europe, such as in Sweden, by a multiple and are still more severe than the losses experienced by Korean banks in the 1997 banking crisis.

Results

The stress tests take as a reference a value for a Tier 1 capital ratio of 6%. This benchmark would define a minimum below which a recapitalisation is needed. The Spanish banking system as a whole would hold a Tier 1 ratio of 8.3% in the most adverse case. Only four relatively small savings banks* were below the set benchmark threshold of 6%. The capital needed to reach this ratio amounts to 1.8 billion euros (0.2% of GDP). Among the largest banks, the worst result was obtained by Júpiter (a group of merged savings banks lead by *Caja Madrid*), with a ratio of 6.3%.

* A fifth savings bank has been taken over by another savings bank.

sector was included in the exercise and the assumptions for the severest hypothetical scenario were tightened considerably in view of the domestic housing crisis.

Savings banks' resilience has been strengthened but further reforms are necessary

Savings banks face particular challenges in adjusting to diminished lending activity. They have a high density of branches, though not high employment levels. Mergers were hampered by the requirement that they be approved by regional governments, and the peculiar legal status of savings banks – they are private foundations – prevents mergers with other types of banks. The government has responded with two sets of measures to deal with these challenges. It created the Fund for the Orderly Restructuring of Banks (FROB, *Fondo de reestructuración ordenada bancaria*). Its task is to intervene in banks whose viability is at risk as well as to support mergers of institutions with capital injections, which has resulted in an extensive merger process among savings banks (Box 1.5).

Legislation approved in July 2010 addresses limitations that savings banks faced in raising external equity. The new law allows savings banks to issue voting shares and abolishes the limit on capital held by individual investors (previously 5% of external equity participations). It also allows savings banks to raise more than 50% of equity from new investors, provided the savings bank concerned transforms itself into a holding foundation which owns the remaining equity. Such a transformation has to be approved by two thirds

Box 1.5. **The Fund for the Orderly Restructuring of Banks**

The government created the Fund for the Orderly Restructuring of Banks (FROB) in June 2009 with a capital of 9 billion euros, of which 75% is provided by the central government and the remainder by the funded deposit insurance entities set up by the incorporated banks, the savings banks and co-operative banks, respectively. The FROB can potentially issue up to 90 billion euros worth of debt with government guarantees. The FROB's governing board is appointed by the Minister of Economy and Finance. Five members are proposed by the regulator (the Banco de España) and three members by each of the three bank deposit insurance funds.

The FROB can support restructuring of banks with weak solvency, provided they have exhausted recourse to private capital markets as well as to the banks' own deposit guarantee schemes. In this case, the FROB takes over the management of affected banks. This happened in the case of one small savings bank, which was supplied 800 million euros of equity by the FROB.* The FROB intervened after a merger attempt between this and another savings bank had failed. The FROB can also decide to liquidate the intervened institution.

The FROB can also support mergers provided the merged institution is fully viable and the merged banks provide a business plan which generates cost savings, including through a reduction of capacity, and which strengthens the stability of the financial system. The business plans are assessed by the Banco de España. The FROB supplies convertible temporary preferential equity participations, which must be repurchased by the merged institution after five years or in exceptional cases after seven years at the latest. They are remunerated at an interest rate of at least 7.75%. The deadline for applications to this fund expires at the end of 2010. Until this date, banks which remain solvent but present some weaknesses in their capital position can also be recapitalised.

Twelve mergers have been initiated since 2009, including 38 out of 45 savings banks, covering 92% of the sector's assets. Of these, seven mergers are supported by the FROB with 10.2 billion euros (1% of GDP) worth of capital. The largest mergers supported by the FROB imply a relatively light degree of organisational integration (Institutional systems of protection, IPS) and are temporary arrangements, with a minimum duration of ten years. However, these IPS are required to comply with minimum requirements on governance, risk control and mutual support among the institutions involved. The breakup of an IPS requires Banco de España's approval. The merged savings banks typically create a subsidiary in the form of an incorporated bank, which takes over strategic business decisions of the group, including risk management. The merged institutions have pooled their capital. However, each merged savings bank continues to manage its network of branches separately. A few mergers occurred among incorporated banks and in the small sector of mutual banks. None of these have requested support from the FROB.

* The authorities intervened another savings bank before the creation of the FROB, in 2009. The savings banks' funded deposit insurance scheme injected capital.

of the general assembly. This reform strengthens the resilience of savings banks substantially, widening their capacity to offset losses by raising equity.

However, progress in reducing the strong powers of regional and local governments in savings banks has been more limited. The new law reduces the ceiling on voting shares of public administrations from 50% to 40%. In addition, political appointments will be incompatible with membership in any of the governing bodies of the savings banks, and current individuals holding such political appointments must leave them within three years. Moreover, representatives of the regions and municipalities will be elected by their assemblies rather than the governments. However, practically, the decision to raise more than 50% of equity from external sources may still require regional or local government approval. Mergers among savings banks also continue to require approval by regional governments (they are now required to present a list of criteria which must be followed in such decisions). Thus, the requirement for regional governments to approve mergers of *cajas* should be eliminated. To simplify such mergers, the division of public-sector representation of the regions in the savings banks to be merged could be determined *ex ante*. In any case some time for monitoring the results of the reform is required.

Empirical evidence on savings banks' performance suggests that they have been more cost-efficient than incorporated banks, which may support maintaining them as a distinct type of banking institutions (see Annex 1.A1). However, there is also some indication that savings banks with the lowest costs may have been less successful in screening loans with respect to their risks, although this relationship is statistically significant only in one year. Empirical evidence (Cuñat and Garicano, 2010) also suggests that the professional qualifications of *cajas'* management are correlated with the performance of savings banks with respect to non-performing loans. The new legislation has taken some steps to improve management in savings banks by requiring that 50% of board members have professional experience. To further strengthen management and supervision by the board, independent selection panels could be created to supply a list of possible candidates for management positions in the savings banks, as recommended in the 2008 *Economic Survey*.

Box 1.6. **Recommendations to help the economy to adjust to macroeconomic disequilibria**

To improve confidence of investors, implement structural reforms, notably in labour and product markets, as soon as possible and implement ambitious budgetary consolidation (see Chapters 2 and 3 for details).

Foster competition in services sectors further

- Consider putting the operation of regional passenger *rail transport* services out to tender on a compulsory and regular basis. Require the incumbent to make its rolling stock available with non-discriminatory conditions.
- Remove the constraints involved in obtaining a *road freight* haulage operating license, and reform the authorisation process to make consolidation of firms easier. Ensure that road passenger transport licenses are tendered on a competitive basis without favouring incumbents.
- Ensure an appropriate level of access of competitors to the public *postal network* and ensure access to the address databases of the postal services incumbent.
- In *retail trade*, regional governments should limit entry restrictions of large retail outlets. In addition, shop opening hours should be liberalised in those regions where restrictions remain. The government may also consider raising the national minimum which applies to the limit that regions can impose when regulating shop opening hours.
- The range of *professional services* for which Spanish regulation requires specific qualification requirements should be reduced.

Box 1.6. Recommendations to help the economy to adjust to macroeconomic disequilibria *(cont.)*

Progressing with reform of the housing market

- Public funds provided to support social housing should be redirected to a means-tested cash benefit for low-income households, earmarked to their rent payments. Such a means-tested benefit should also replace the planned modified income tax allowances for housing.

Strengthening the resilience of savings banks further

- The role of regional governments in business decisions of the savings banks should be further reduced. The requirement for regional governments to approve mergers of *cajas* should be eliminated. To simplify such mergers, the division of public-sector representation of the regions in the savings banks to be merged could be determined *ex ante*.
- Independent selection panels could be created which supply a list of possible candidates for management positions in the savings banks

Notes

1. Belgium, France, Germany, Italy and Portugal.
2. Indebtedness is also high in the energy and water supply sectors but it makes a relatively small contribution to activity.
3. Indeed, oversupply of the scale observed in housing has not built up in the office market, for example.
4. Gross foreign liabilities vary substantially across OECD economies, for example, reflecting the extent of international activities of banking sectors and location decisions of multinational enterprises.
5. Assuming a trend growth rate of nominal GDP of 4%, a current account deficit of around 4% would hold the net foreign asset position of –100% of GDP broadly constant. With a trend growth of 3%, a current account of about 3% would stabilise the net external position.
6. Indirect taxes (such as VAT) are typically levied on imported goods but not on exported goods, so contribute to differences in price levels for goods and services between countries. High income countries typically also experience higher price levels because of Balassa-Samulson effects and because producers of tradable goods with market power may price-discriminate in favour of low-income countries.
7. Export price deflators (which include goods and services) remained broadly steady in France and Germany since 1995 while rising by 30% in Spain. Divergences in the terms of trade were less marked; they were steady in France and Germany on average and rose by 9% in Spain. Export price developments for goods compare somewhat less favourably if unit value indices for goods exports are compared. However, these indices are not calculated in ways that are consistent with national accounts data, In addition, they are affected by changes in quality of goods.
8. The Balassa-Samuelson effect on the real exchange rate need not be offset by the terms-of-trade effect mentioned above. It will not be offset if strong productivity growth in tradable goods is the result of higher productivity growth within exporting industries (because of catching up with the technological leader in each of these industries), rather than specialisation on industries which experience strong productivity growth worldwide.
9. For example, Bourlès *et al.,* (2010) show that over the 1995-2007 period, on average, eliminating regulatory burdens in upstream sectors would have increased MFP growth by up to 1.7 percentage points per year.
10. See for instance Megginson and Netter (2001) for empirical evidence of the impact of privatisation and liberalisation on productivity of firms, or Wölfl *et al.* (2010) on the effect of product market reforms on aggregate growth in GDP per capita. Both studies indicate substantial lags between reforms and resulting performance gains.

11. Some finished dwellings, notably for co-operatives, are not recorded as sold even though they are acquired by final users, which may overestimate the difference between sold and finished dwellings.
12. The declining trend in prices of used housing is consistent with trends observed in alternative databases such as those of web-based housing transaction enterprises or other private enterprises (*Sociedad de Tasación*, *Fotocasa* and *Expocasa*). All these sources also show that the decline is slowing. The Ministry of Economy and Finance expects a further decrease in prices of around 10% in 2010, a null variation of prices in 2011 and an expected increase in prices according to the consumer price index in 2012 and 2013.
13. Following Becker *et al.* (2010), over 65% of Spanish young people aged between 25 and 29 years are living with their parents, compared with 20-22% in France, the Netherlands or the United Kingdom.
14. Specifically, the new Law generalizes the use of the "oral" procedure (*juicio oral*) in order to solve an eviction. This ensures a less formal (and therefore faster) procedure than current procedures (Mora-Sanguinetti, 2010). The new legislation also allows owners to evict tenants within the minimum five year contract period if the owners' family members want to move in (this was already possible for the owner previously).
15. For example, Mora-Sanguinetti (2010) finds that an increase in the judicial efficiency of court procedures has a significant effect on rental market development. Regulation of the rental contracts itself, by contrast, does not appear excessively restrictive. After a minimum contract duration of five years, landlords can dispose of their property freely, *i.e.* they require no justification for eviction and can reset the rental price freely. Within the period, owners can evict tenants for own use as well as for use by family members; the rental price is indexed to consumer inflation.
16. All owners are now entitled to convert, rather than only developers, giving access to subsidised loans for purchasers.
17. It also fosters refurbishment as an alternative to newly constructed social housing to support activity in the sector while avoiding subsidies for the construction of new units.
18. The stability of operating surpluses can in part be attributed to the prominence of retail banking, as investment banking is subject to more volatile profits.
19. If the total amount of loans to the residential construction sector had financed the construction of the stock of housing which is now unsold, each unit would have to cost around 600 000 euros.
20. However, a few questions can be raised about the independent values, as their business clients are the banks themselves. Moreover, the valuation process is based on offer prices in the market, which, in its current depressed state, may be below transaction prices.

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ANNEX 1.A1

Cost efficiency of Spanish banks: A stochastic frontier analysis

Introduction

This Annex presents an empirical study of cost efficiency, comparing performance of the different types of banks within the Spanish banking sector, notably savings banks and incorporated banks. A more complete account of the results is available from the OECD.[1] The study on which this Annex is drawn also presents comparisons of efficiency scores of savings banks in several European countries; these results are not shown below.

The authors employ the stochastic frontier approach (SFA), introduced by Aigner *et al.*, (1977) and Meeusen and van den Broeck (1977) to generate cost efficiencies for each bank along the sample during the period under analysis. This specification allows for the control of general environmental factors by estimating simultaneously the parameters of the stochastic frontier and the inefficiency model.

Data and variables

The main source of data collection is the *Bankscope* database, from which the authors retrieve financial data for banks. Additional data are collected from Global Market Information Database (GMID), and the 2010 version of the World Bank Database on Financial Development and Structure (Beck *et al.*, 2000). The study covers the period 2001-08.

The authors adopt the value added approach, according to which earning assets as well as deposits are considered to have some output characteristics. That is, deposits provide for transaction and safekeeping output services and also add to input costs. In a value added context, deposits typically account for over half of all capital and labour expenses at banks and so, in this sense, output services are produced.[2] A cost function is estimated, in which costs depend on banking outputs, inputs and input prices. Costs and outputs are normalised by banks' equity to reduce heteroscedasticity and scale biases.

Accordingly, the authors specify three variable outputs: loans (composed of the value of home loans, loans to firms, etc.), other earning assets, and deposits (the sum of demand, saving and time deposits). Prices for two variable inputs are also specified. Consistent with previous studies, these are: cost of borrowed funds (W1), calculated as the ratio of interest expenses to customer deposits and short term funding; and the cost of non-financial inputs (W2), calculated by dividing the overhead expenses by total assets.[3] To impose linear homogeneity restrictions the authors normalize the dependent variable and all input prices by W2.

A time trend (T = 1 for 2001, T = 2 for 2002, ..., T = 8 for 2008) is included in each specification to allow for technological change, using both linear and quadratic terms in order to identify neutral technical change, and is also specified to interact with the output and input prices in order to identify non-neutral technical change (Caves *et al.*, 1981; Baltagi and Griffin, 1988). Following Berger and Mester (1997), the authors specify equity as a fixed input to control for differences in risk preferences, which may arise due to regulation, financial distress, or informational asymmetries.[4] The dependent variable is total cost defined as the sum of operating cost (including all expenditure on labour and equipment) and financial cost (*i.e.* interest expenses of deposits). Finally, the authors use dummy variables to control for different types of institutions (*i.e.* incorporated, savings and co-operative banks).

Empirical results

While the incorporated and savings banks have broadly similar market shares in loan and deposit markets, they are both much more important than the co-operatives, accounting together for more than 95% of the loan and deposits markets.

Table 1.A1.1 presents the average cost efficiency for all the Spanish banks, as well as for each one of the three types of institutions during 2001-08. The results show that savings banks, incorporated banks and credit co-operatives experience a similar trend along time in terms of cost efficiency.

Table 1.A1.1. **Cost efficiency scores**

Type of bank	2001	2002	2003	2004	2005	2006	2007	2008	Average
Savings banks	0.97	0.97	0.96	0.95	0.95	0.96	0.96	0.97	0.96
Incorporated banks	0.90	0.90	0.88	0.88	0.90	0.91	0.95	0.94	0.91
Credit co-operatives	0.97	0.97	0.95	0.93	0.95	0.96	0.96	0.98	0.96

Source: A. Lozano-Vivas and F. Pasiouras (2010), "Cost Efficiency of Spanish Banks: A Stochastic Frontier Analysis", Study commissioned by the Economics Department of the OECD.

Savings banks record the highest cost efficiency that is equal to 0.96, on average. This result can be interpreted as follows: on average savings banks could reduce their cost by around 4%, while maintaining the same level of output, if they all matched the efficiency of the most efficient banks. The average cost efficiency of credit co-operatives is roughly the same as that of savings banks. The average cost efficiency of incorporated banks is lower, being equal to 0.90. Incorporated banks could reduce their cost by around 10% (on average) while keeping their output constant, to match the performance of the most efficient banks. The higher performance shown in the results of savings banks respect of incorporated banks are in accordance with the results obtained by Grifell and Lovell (1997); Lozano-Vivas (1998) and Tortosa-Ausina (1999) among others.

Turning the attention to the evolution of cost efficiency over time, savings banks outperform incorporated banks during the entire sample period, 2001-08. At the same time, the market share of savings banks increased at the expense of the domestic incorporated banks' market share, with that of credit co-operatives remaining constant.

The authors also present cost efficiency scores for three different size classes (results not shown). The conclusions remain broadly the same for each size class. There is no marked relationship between bank size and efficiency. Among savings banks, efficiency scores are similar across all size classes.

Relationship between cost efficiency and non-performing loan ratios

The authors also investigate whether there is a trade-off between estimated cost efficiency scores and exposure to risk, as captured by non-performing loan ratios. As noted in the main text, savings banks are more heavily exposed to lending related to the housing market. For example, the share that savings banks hold in the mortgage loans of the industry is on average almost 60% higher than that of incorporated banks. The outputs considered in the analysis of cost efficiency include loans without taking into account the share that is non-performing or may be at a particularly high risk of turning into non-performing in the future. Over the sample period, savings banks experienced a bigger increase in non-performing loans than other banks. As noted in the main text, this gap closed subsequently. However, efficiency scores could not be calculated for later years because the data were not available.

To analyse whether there is a relationship between cost efficiency and exposure to risk, the authors calculate the Spearman correlation coefficient between cost efficiency and non-performing loan ratios across individual institutions for each year of the sample and for each type of institution. The results (not reproduced here) show that incorporated banks are characterised by a negative correlation between cost efficiency and non-performing loans although this correlation is only statistically significant for the years 2006 and 2007. This implies that more efficient incorporated banks are characterised by lower shares of non-performing loans. By contrast, for savings banks the correlation is positive and statistically significant in 2008, although correlations are of varying signs and always insignificant between 2001 and 2007. Arguably, the result obtained for 2008 is of particular interest, because this was the year in which risks resulting from the exposures to the housing market became increasingly apparent over the most recent housing cycle. A possible interpretation of the result is that the effectiveness of monitoring may vary across all institutions but has different effects depending on the type of institution. In the case of incorporated banks, monitoring by stockholders and board members for this type of institution has the desirable effects on cost efficiency as well as on exposure to risks (Anandarajan *et al.*, 2005) while monitoring by the general assemblies and boards of savings banks may not have these effects.

Notes

1. Professor Ana Lozano-Vivas, University of Malaga, and Fotis Pasiouras, Assistant Professor, Technical University of Crete, provided research and drafting for this annex.
2. Ignoring the output characteristics of deposits could penalise savings banks, since taking deposits is one of the main services that they provide.
3. Other studies include three input prices, one for labour (*e.g.* personnel expenses to total), one for borrowed funds (interest expenses to deposits) and one for physical capital (non-interest expenses other than personnel expenses to fixed assets). However, this approach would reduce the number of observations in the sample due to missing values. Therefore, the authors restricted this analysis to the two input prices discussed in the text. Our approach is similar to the one of Hasan and Marton (2003), Bonin *et al.* (2005) and Berger *et al.* (2009), among others.
4. Berger and Mester (1997) argue that failure to control for equity could yield a scale bias, while the efficiency of banks could be mismeasured even if they behave optimally given their risk preferences. For more in-depth discussions, see Mester (1996), Berger and Mester (1997) and Berger and Bonaccorsi di Patti (2006).

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ANNEX 1.A2

Progress in structural reforms

This table reviews action taken on recommendations from previous *Surveys*. Recommendations that are new in this *Survey* are listed at the end of the relevant chapter.

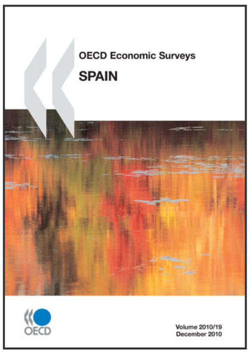
Recommendations in previous *Survey*	Action taken since December 2008
MANAGING FISCAL POLICY IN THE MEDIUM AND LONG TERM	
Reconsider the tax incentives for private pension plans.	No action taken since the reduction in the ceiling of tax-deductible contributions into private pensions and the elimination of incentives for lump sum withdrawals in 2006.
Grant the public policy evaluation agency a high degree of independence from the political process and ensure its findings are easily available to the general public.	None.
Develop a comprehensive strategy to tackle future deficits in the pension system and raise incentives to work at old age, including parametric reforms as well as raising public savings.	Pension reform options are under consideration in the *Pacto de Toledo* parliamentary commission. The government proposals include raising the statutory retirement age from 65 to 67.
Base spending caps set in the central government's budgetary process on estimated potential GDP.	The Ministry of Economy and Finance elaborates a report every year which includes the potential growth of the economy. This report is taken into account when setting the expenditure ceiling for the central government.
Ensure that regional financing mechanisms do not unduly raise the central government's burden; make it robust to demographic developments by making transfers more reflective of their average net budgetary impact. Provide incentives for regional and local governments to rely increasingly on their own taxing powers.	In 2009, a new financing system for the regions was passed which establishes a fund to cover the spending needs for basic services taking demographic variables into account on a yearly basis. The new system increases the share of regional governments in tax revenues and raises the tax-setting powers of regional governments.
Develop benchmarking for services provided by subnational governments and make results public. Relax the obligation for regional governments to spend minimum amounts on health care.	The minimum spending requirements have been abolished.
Reduce the bias in favour of less developed regions in allocating central government investment. Use more effective instruments in supporting poor regions' growth potential.	A new fund introduced by the 2009 reform of the regional financing system, allocates additional resources to less developed regions or to regions with negative demographic dynamics.
Improve local government's reliance on real estate tax and abolish the local business tax.	None.
Introduce means-tested co-payments on drugs for pensioners.	None
IMPROVE THE FUNCTIONING OF THE HOUSING MARKET	
Substitute subsidising social housing by means tested earmarked cash benefits. Abolish social housing for purchase. Phase out the tax deductibility of mortgage and rent payments.	As from 1 January 2011, subsidies for the purchasing of social housing will disappear. Draft legislation proposes to phase out tax deductibility of mortgage and rent payments except for low income families as from January 2011.
Implement in full the plans to speed up the resolution of conflicts between tenants and landlords.	New legislation simplifies judicial procedures as concerns the eviction of tenants.

Recommendations in previous *Survey*	Action taken since December 2008
Improving the Functioning of the Labour Market	
Make severance pay for permanent contracts less generous, reducing the difference in the degree of protection between temporary and permanent contracts.	The reform of the labour market approved by law in September 2010 specifies the reasons for justified dismissals (implying severance costs of 20 days' wages per year of job tenure) and broadens the use of permanent contracts with reduced severance pay of 33 instead of 45 days' wages.
Consider the introduction of a single work contract with moderate increases in severance payments according to length of service.	None.
Allow firms to opt out of higher level collective agreements or replace the compulsory extension rule with an opt-in system that allows employers the choice of whether to adopt the agreement.	Opting-out is reinforced by the 2010 law on labour market reform. In particular, the agreement between the firm and its workers is enough to opt out. In case of disagreement a mediation procedure is available.
Encourage the elimination of inflation indexation clauses in collective bargaining or use at least an inflation measure that excludes oil and other commodity prices and further reduces the degree of indexation.	The multiannual agreement on collective bargaining signed in February 2010 postpones temporarily a revision with past inflation.
Redirect subsidies for hiring unemployed on permanent contracts to better targeted active labour market programmes (ALMPs).	The 2010 law on labour market reform has limited these subsidies to specific groups such as unemployed young people and long-term middle-aged unemployed workers
Implement a system of benchmarking of regional employment services, and make this information publicly available. Successful regional placement services should receive a financial reward.	Private companies are authorised to provide labour intermediation subject to conditions.
Make registration for placement a precondition for benefit payment and conduct a full interview already at registration. Shorten the job search reporting period of benefit recipients. Make participation in ALMPs compulsory after a defined period of unsuccessful job search.	Benefits continue to be paid retroactively following registration. A revision of ALMP's is on the way.
Increase health and homecare provision for dependent elderly.	Legislation that improves government funding for such services is being implemented.
Improving the Integration of Immigrants	
Improve the recognition of foreign qualifications through bilateral agreements with originating countries and an on-the-job skill assessment programme.	A 2009 Royal Decree allows certification of professional competences acquired by work experience.
Improve public language training. Adapt the national system of language certification to the needs of the labour market.	None.
Allow non EU immigrants (with a valid permit) to hold jobs in at least some parts of the public administration.	None.
Further Improving Access to and Quality of Early Childhood Education	
Disburse central government subsidies for accredited childcare facilities in the form of vouchers to low income households with children, covering the full cost of a place in accredited childcare facilities. Increase daycare facilities for young children.	Some autonomous communities subsidise part of private childcare education in the form of income-contingent vouchers. Central and regional government funding has been made available for the creation of 74 600 public places for children aged 0-3.
Maintaining an Inclusive Primary and Secondary School System	
Enforce the prohibition of raising fees from parents in publicly funded primary and lower secondary schools as well as of selection criteria. Ensure a level playing field in the rules assigning resources to public and publicly funded private schools.	Draft legislation aims to increase the resources assigned to public and publicly funded private schools which enrol a larger number of students with special needs.
Link the disbursement of subsidies to upper secondary schools to the obligation of offering schooling free of charge.	The introduction of a maximum fee for students in private schools equivalent to 10% of public funding is under consideration.
Raising the Share of Students Graduating from Upper Secondary Education	
Widen the choice of options at the final stage of compulsory schooling.	Separate academic and vocational streams are planned for the last year of compulsory schooling; new curricula have been designed for support programmes (*Formación professional inicial*) for weak-performing pupils.
Raise child benefits and make them conditional on continued attendance in full time education. Link payment of more generous benefits to an in-work benefit for low income families.	Access to grants is given to students over 16 from low-income families who participate in support programmes and who are at risk of abandoning lower secondary education. Public education for children between 3 and 6 years old is free as of 2008.

Recommendations in previous *Survey*	Action taken since December 2008
Use nationwide sample-based evaluations of education outcomes to evaluate the impact of regional educational policies.	In 2009 and 2010, representative national diagnostic assessments of students were carried out in 4th year of primary education and 2nd year of compulsory secondary education. In 2011, such assessments will be carried out in 6th year of primary education and 4th year of compulsory secondary education.
Extend external testing at the school level to all regions, and use this to benchmark performance against targets.	An agreement with regional governments to introduce such testing is planned.
Widen autonomy of schools, notably with respect to hiring decisions of teaching staff and curricular content and give schools powers to hire, reward and dismiss teachers.	Legislative action to widen the autonomy of schools is planned for 2011.
STRENGTHEN HIGHER LEVEL EDUCATION	
Publish the results of the national quality agencies' assessments on a regular and comprehensive basis.	Systematic publication of monitoring reports of university degrees that are carried out by the national quality agencies is planned.
Remove the obstacles to university teachers moving to the private sector and participating in spin-off firms. Increase the freedom of universities to recruit non-permanent professors and to adjust all professors' remuneration according to performance.	Draft legislation foresees introducing leave periods for professors and researchers who want to move to the private sector or to spin-off firms. It would give universities more flexibility to recruit prestigious researchers and to establish closer links between professors' remuneration and performance.
Introduce joint public-private financing of training projects.	The International Campus of Excellence Programme of 2009 seeks to promote co-operation of public and private institutions. Draft legislation allows the creation of Schools of Doctoral Studies that are funded through public-private partnership.
Introduce loans with income contingent repayments for all tertiary education students. Increase fees at public universities and introduce fees for tertiary vocational courses.	A new financing strategy for public universities is being developed that foresees that fees should more closely reflect education cost.
Link university funding more strongly to indicators of teaching output. Strengthen further the independence of universities, notably with regard to the setting of contract conditions and pay.	The planned new financing strategy of public universities proposes a performance-based funding based on indicators of teaching and research output.
Create a nationwide funding scheme, supplementing existing regional funding, to reward the creation of centres of excellence in university education.	Implemented.
RAISING THE ATTRACTIVENESS OF VOCATIONAL EDUCATION	
Evaluate vocational schools with respect to their success in the transition of graduates to qualified jobs.	From the academic year 2010/11 onwards, information is collected on students' acquisition of professional competence and their integration in the labour market.
Widen non-vocational education content in core competencies in upper secondary vocational education.	Since 2008, vocational education programmes offer teaching of foreign language, communication and entrepreneurship skills.
Improve opportunities for transferring from upper secondary to tertiary education.	Draft legislation (notably the Draft *Ley de Economía Sostenible*) promotes the mobility between upper secondary vocational and university education.
Open up the teaching profession in vocational schools more widely to practitioners.	The Draft *Ley de Economía Sostenible* increases the participation of companies in the design and implementation of vocational education.
Raise vocational schools' capacity to adjust curricular content more strongly to local labour market needs.	The Draft *Ley de Economía Sostenible* aims to adapt vocational training supply to the specific requirements of companies and to foster co-operation with local businesses.
IMPROVING THE FUNCTIONING OF PPRODUCT MARKETS	
Increase the independence of sectoral regulatory bodies and strengthen their powers.	This is expected to be implemented once the draft *Ley de Economía Sostenible* is approved by Parliament.
Eliminate barriers to the establishment of new firms.	2009 legislation removed a substantial number of authorisations at the national and regional level and simplified the procedures to ask for licenses. The Draft *Ley de Economía Sostenible* reduces time and costs to create small companies and removes local licences for innocuous activities. An Action Plan to reduce overall administrative burden on all new and incumbent businesses by 30% in 2012 (EU objective 25%) is being developed.
Reduce the regulatory obstacles to institutional investors' participation in venture-capital companies.	None.

Recommendations in previous *Survey*	Action taken since December 2008
Energy markets	
Streamline the authorisation process for new infrastructures.	A new legal framework is being developed to simplify the authorisation process for new generation, transport and distribution infrastructure.
Phase out regulated retail gas and electricity prices.	Since July 2008 or July 2009 respectively, retail gas and electricity prices are liberalised for consumption above 50 000 kWh per year or 10 kW.
Reform the current system of energy capacity payments by providing a variable payment that is linked to the use of capacity when capacity utilisation is high.	A reform of energy capacity payments is being prepared.
Telecommunications	
Give the telecom regulator responsibility for consumer protection.	None.
Allow the regulator, in an explicit manner, to mandate the functional separation of the incumbent as a measure of last resort.	None.
Ensure that the telecom incumbent is required to give sufficient notice to alternative operators when it plans to shut down exchanges.	A 2009 resolution of the national regulatory authority for telecommunications requires a notice period of at least six months.
Transport services	
Make the tender of regional passenger rail transport services compulsory. Require the incumbent to make its rolling stock available with non discriminating conditions.	The Draft *Ley de Economía Sostenible* requires competitive tender whenever the transport providers receives compensation for meeting universal service obligations.
Remove the constraints involved in obtaining a road freight haulage operating license. Ensure that road passenger transport licenses are tendered on a competitive basis without favouring incumbents.	The Draft *Ley de Economía Sostenible* reduces the duration of public services contracts of regular road passenger services in which there are exclusive rights.
Postal services	
Further liberalise postal services. Ensure an appropriate level of access of competitors to the public postal network and ensure access to the address databases of the postal services incumbent.	Draft legislation eliminates the legal monopoly on selected services for the incumbent. Entrants can use the postal network under terms and prices (*ex post*) monitored by the Postal Sector Regulator (fully operative since 16 July 2010).
Retail trade and professional services	
Relax regional retail trade regulations, at least the criteria for defining a hypermarket. Remove local obstacles to the opening of petrol stations in super and hypermarkets.	A 2010 retail trade law limits the authorisation for the opening of super or hypermarkets to specific cases. An authorisation to open a petrol station in super and hypermarkets is no longer necessary since 2009.
Amend the excessive and sometimes discriminatory restrictions in the pharmacies sector.	None.
Remove the import restrictions on cement.	None.
Review and narrow qualifications requirements for professional services, which are not covered by the Directive.	None.
SAVINGS BANKS	
Reform the regulation of acquisition of shares (*cuotas participativas*) by external investors, for example by removing the ceiling on individual holdings. Explore other ways for savings banks to increase their access to outside equity	Legislation approved in July 2010 allows savings banks to issue voting shares and abolishes the limit on capital held by individual investors. It also allows savings banks to raise more than 50% of equity from new investors if the savings bank concerned transforms itself into a holding foundation which owns the remaining equity.
Remove the requirement for regional governments to approve mergers of savings banks. Make approval by the Banco de España and the competition authority sufficient.	Regional governments are now required to present a list of criteria which must be followed in merger decisions.
Lower the ceiling on public-sector representation in *cajas'* General Assemblies.	The law reduces the ceiling on voting shares representing public administrations from 50 to 40%.

Recommendations in previous *Survey*	Action taken since December 2008
REDUCING GREENHOUSE GAS EMISSIONS	
Sell CO_2 emission permits through auctions as from 2012, and support the elimination of the EU rules that allow the sale of only up to 10% of the permits.	CO_2 emission permits will be auctioned between 2013 and 2020. In a phasing out process, some sectors will receive emission permits freely.
Conduct more studies on the cost effectiveness of the feed-in tariff regime for renewable electricity sources, comparing it with other abatement policies towards greenhouse gas emission reductions.	The government is reviewing the feed-in tariffs to adjust payments to delivery cost.



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