

**Executive Summary of the
Report Fundación BBVA – Ivie 2011**

CRECIMIENTO Y COMPETITIVIDAD

**TRAYECTORIA Y PERSPECTIVAS DE
LA ECONOMÍA ESPAÑOLA**

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www.fbbva.es

ISBN: 978-84-92937-13-4

Executive summary

This *BBVA Foundation-Ivie report on competitiveness and growth* looks at how the Spanish economy performed in the period 1995-2010. It aims to identify which factors in Spain's pattern of growth could determine recovery, the success of which depends on mitigating the negative effects of accumulated imbalances and laying the foundations for a more competitive economy.

The Report is divided into three parts. The first two review the Spanish economy and its place in the international arena with reference to five key issues: productivity; corporate structure and competitiveness; the labor market, employment and human capital; the functioning of the banking sector; and the public sector. The third part offers a summary of the main conclusions along with proposals for action in all these areas, which are so important to the future of Spain.

The review

The three main drivers of recent change

The international setting has changed enormously in the past two decades and Spain has had to rethink its competitive advantages because of the following:

- New competitors from Eastern Europe and especially Asia have established themselves in manufacturing production and in attracting investment. Their wealth accumulation and growth have turned these markets into an opportunity for investors and exporters the world over.
- New technologies have become the motors of business innovation and productivity, particularly in the most advanced economies where competitive capacity is above all efficiency driven.
- The process of globalization and regional integration has generated more interdependence and a greater complexity in economic relations. This is especially the case in financial markets.

The crisis has brought to light a serious undervaluation of the risks accompanying these changes, and revealed the pitfalls of rapid growth based on short-term objectives financed by indebtedness. The dense web of international financial and trade connections has spread imbalance through mechanisms that have been poorly managed. These risks have affected Spain directly, revealing its preventive controls to be insufficient and forcing the country into radical adjustment.

Contrasting features of Spain's growth trajectory

Spain has advanced a great deal but its pattern of growth proved to be excessively fragile and unsustainable over the past decade. Since the onset of the crisis, Spaniards have had to face up to the very different implications of living in a time of expansion or stagnation. Among the obstacles to recovery is the fact that economic agents and authorities – at all levels – have not

adapted sufficiently to changes in the international scenario and their numerous consequences:

- Capital accumulation and job creation were significant, but productivity gains were minor in almost all sectors.
- Productive specialization has not favored the advance of innovative and high-technology content enterprises corresponding to an advanced economy, but rather favoured that of traditional sectors like construction with a strong cyclical component.
- Spain has lost international competitiveness despite export growth led by part of the corporate sector. Proof of this is the increase in imports.

Salient among the risks and imbalances built up during the expansion and real estate boom are a burgeoning current account deficit and high external indebtedness, which have left Spain extremely vulnerable to the impact of the international crisis. Spain's response to globalization has relied too heavily on the short-term advantages of belonging to the Euro area. The country has also put off introducing the necessary reforms to compete in the new international setting and to mitigate the drawbacks of no longer having its own interest and exchange rates. We are now finding out that being competitive in Europe does not necessarily mean being competitive in today's world.

Productivity, a key factor

Labor productivity in Spain has progressed very slowly since 1995, while total factor productivity has been negative. During the real estate boom, many investment projects based their short-term profitability on expected asset appreciation rather than productivity. The consequences of this misalignment of incentives have been:

- Productivity problems, most markedly in the construction industry, have affected almost all activities despite the increase in capital stock per worker over the years.
- The Spanish economy is burdened with grave shortfalls in productive efficiency in industry and services, while other economies are progressing on both these fronts.
- The intense incorporation of human capital has not been optimally exploited, while there have been less investment efforts in ICT than in other developed economies.
- The slow advance of labor productivity in relation to wage growth has pushed up unit labor costs and eroded competitiveness.

Labor productivity has risen during the crisis as a consequence of job destruction, above all in construction, but the objective must be to advance simultaneously in both these variables.

Firms compete... and countries too

Although the nature of Spain's productive fabric is key when it comes to the country's failings in productivity and competitiveness, the environment for business is also a factor:

- Unlike the world's leading economies, the weight of micro enterprises is considerably more significant than larger companies, and thus has a negative effect on average competitiveness and productivity ratings.
- Smaller firms face greater difficulties in recruiting human capital, specializing in high-technology content activities and separating ownership from management, as well as numerous constraints on deploying competitive strategies in external markets.

- Spanish firms are working to improve the training of their senior management and increase their use of knowledge-intensive assets, but still lag behind their advanced country competitors in the average educational level of entrepreneurs, use of ICT, as well as R&D intensity and innovation efforts.
- The majority of Spanish firms make less use of the levers that serve advanced countries to compensate their higher costs: efficiency and innovation.
- The weaknesses that have the biggest impact on business competitiveness are the legislative framework for labor relations, governmental and regulatory inefficiency and limited access to finance.

However, Spain's productive fabric is also strongly heterogeneous and some of its units are very powerful. For the first time, Spain is home to multinational companies which occupy leading positions in their field and can exert a spillover effect that favors other firms' competitiveness and global strategies.

Lack of jobs, education and training

The education system and the labor market play key roles in how the economy functions and both of these show significant weaknesses. These became apparent during the expansion phase in the limited use of human capital and the slow advance of productivity in the form of job destruction during the crisis:

- Spain has yet to converge with advanced economies in education levels. This remains true of even the latest generations, of whom a lower percentage goes on to post-compulsory secondary education.
- The results of the education system have not improved at the same rate as human and financial resources per student, showing functional inefficiencies at all levels.
- Although the use of human capital in Spain's productive fabric has increased, it continues to be poorly exploited due to shortfalls in training and in the size, specialization and organization of many Spanish firms.
- Duality between permanent and temporary employment contracts means flexibility is essentially confined to the young and the least skilled workers, and also accentuates the employment cycle. Alternatives like short-time working or part-time employment are barely touched upon.
- The predominant wage bargaining mechanism fails to link compensation with productivity and hampers business competitiveness.

Unemployment figures have risen again and labor market problems are in urgent need of a solution. Long-term unemployment affects a high number of unskilled workers with problems of labor market reinsertion and young people, whose situation can all too easily descend into social exclusion. At the same time, labor market segmentation means that this unemployment coexists with wage growth and loss of competitiveness in the corporate sector.

The banking sector: the crisis and its challenges

In the last two decades the Spanish banking sector has witnessed rapid growth and a far-reaching technological transformation through two channels: real estate-related lending, especially among the savings banks, and the internationalization strategies of leading banks.

The current situation shows that the credit expansion tied to the real estate boom is a major obstacle to recovery:

- The rapid growth in credit was mainly concentrated on funding the acquisition of assets whose current depreciation threatens the solvency of certain institutions.
- Abundant international liquidity and low interest rates meant risks remained undetected for too long.
- Excess liquidity in international markets encouraged firms and households to take on record levels of debt, to the extent that the economy must now confront a painful but necessary deleveraging process.

Delays in tackling the problems of a major part of savings banks have impeded a return to normal lending to households and businesses. Doubts about the scale of the decline in financial wealth are affecting the outlook for an economy which is heavily reliant on external financing, and which needs to grow in order to reduce debt but cannot find the right supports.

Public accounts and the efficiency of Public administration

The public sector suffers financial problems as well as being operationally inefficient. Given that these failings were not addressed during the expansion years, they have grown in proportion at a time when room for maneuver is considerably tighter:

- Although public spending in terms of GDP is no higher than in other developed economies, Spain suffers a structural deficit. The outlook for slow growth advises against tax hikes that would push up production costs. Instead every expenditure function and heading must be placed under close review.
- The biggest threats to budgetary stability derive from expenditure heads related to population ageing – health, pensions and dependence – where progressive expansion threatens unsustainable deficits.
- Care must be taken so expenditure cuts do not inhibit pro-growth functions like education and infrastructures. It is also important, however, to tackle inefficiencies in these areas to achieve improved results without spending more.

Improvements in productivity and competitiveness require a more efficient, equitable public sector which makes good use of the resources it commands, along with greater transparency in relation to the financial position of each level of government. This will mean dealing with concerns about equal opportunities in access to public services and reviewing the results of the decentralization process.

PROPOSALS

To resolve its many problems, Spain must embrace change. The corporate, public and banking sectors are the three pillars on which to build a modern, competitive and sustainable economy, and also the priority areas for reform. But many of these measures must be founded on improvements in education and a supportive social climate, so that efforts and sacrifice are seen as being fairly distributed.

Improving competitiveness and productivity in the corporate sector

Our growth potential rests upon making continual improvements in business productivity and competitiveness. The solution cannot stop at changes in the sectoral structure of production: that is, improvements must be made across all economic activities so they go on contributing to generate value. In fact, given that there are bigger differences in productivity between firms in the same sector than there are between sectors, the first step must be to adopt correct business practice in each area. Launching new activities should not mean dispensing with the present and future potential of crisis-hit industries like construction or, until a few months ago, tourism.

The levers to improve productivity and competitiveness can be found within companies: that is, in their environment, their productive specialization and their intensive and efficient use of knowledge.

Changes within firms

A new pattern of growth calls for firms that are bigger, better and more productive, as well as being able to supply numerous markets with strong demands for quality, dynamism and international reach. The changes companies make to meet these objectives should be geared towards: **gaining size, professionalizing management, and internationalization.**

Changes in the business environment

The business environment must help and not hinder productivity, which means tackling the worst problems which impede the way it functions. The required changes are many: **making the labor market more flexible, adapting educational content to the needs of employers, facilitating enterprise creation and operation, fostering competition in service industries, making finance available for investment, increasing flexibility and competitiveness in factor markets, and harmonizing levels of environmental protection.**

Changes in specialization

Spain needs to raise the weight of higher value-added activities in its economy so as to adapt competitiveness to its existing stock of resources and costs. The following actions are required: **completing the adjustment in the construction sector, fostering higher value-added service activities, strengthening productivity in manufacturing industries, and promoting ICT-producing and ICT-using activities.**

Fostering the productive use of knowledge

Firms have greater potential to generate value-added when the goods and services are of quality with high technological content, innovative and differentiated. Ways to achieve this are: **fostering technological and process innovation and business R&D; intensifying the use of human capital; strengthening in-company training and ICT use and exploitation as a source of competitiveness.**

Fostering productivity and competitiveness in the public sector

The drivers of productivity and growth at the disposal of the public sector can be found at three levels: labor market regulation, the functioning of the education system and Public administration reform.

Labor market reform

The biggest challenge facing our economy is the reduction of unemployment and the generation of productive employment. The root of the problem is the way in which the Spanish labor market works and reforming its obsolete structure must be viewed as a top priority. Changes should be aimed at fostering job creation, reducing unemployment (particularly long-term), fighting against inequality in unemployment, and improving labor productivity. Actions should focus on: **reducing dual contracts among workers, reforming collective bargaining and strengthening the link between wages and business productivity, increasing the employability of the jobless, boosting the effectiveness of active employment policies, encouraging part-time working, stimulating job search, and combating structural unemployment through training.**

Improving the results of the education system

Education, employment and enterprise must be the basis for Spain's competitiveness and pattern of growth, in which higher productivity favors wage improvement, secure employment and low unemployment rates. This will mean keeping up economic and budgetary efforts in education while taking action to improve the efficiency of the educational process in the following fields: **promoting quality education, instilling a culture of hard work, increasing the percentage of young people with post-compulsory secondary education, ensuring the education system has incentives in place to improve its results, reorganizing the choice of vocational training and university studies, securing a better match between training and the needs of the employer, and strengthening the ties between universities and business.**

Reforming Public administration

Spanish society and Public administration must make certain commitments to improve the public sector's contribution to social and economic development, through three steps: **a financial stability pact, a plan of action to improve spending efficiency, and a plan to ensure equal opportunities in terms of access to public services.**

The first will require a legislative commitment to maintain a structurally balanced budget, accompanied by measures to reduce expenditure and improve tax compliance: **reinforcing spending controls in health services, introducing plans to promote savings for retirement, reviewing early retirement qualifications, and intensifying the fight against tax and social benefits fraud and the underground economy.**

Efforts to improve public sector efficiency should focus on the following: **an efficiency drive in services (health, education, administrative and legal), reform of public sector workers' pay and conditions and human resources management, a new culture of public investment, public-private partnership, and the professionalization of public management.**

Standardizing the banking sector's contribution to growth

Spain needs a banking system that is able to finance economic growth and end the credit constraints weighing on households and non financial entities. The problems in the banking sector which must be tackled without delay are the following: **eliminating excess installed capacity, writing down impaired assets, strengthening solvency levels, improving access to funding in wholesale markets, making changes in the way savings bank are governed,**

reducing exposure to the business cycle, and improving the supervision and regulation of the financial system.

A SOCIAL CLIMATE FAVORABLE TO CHANGE

Spain's level of efficiency is what evidently separates it from the most advanced economies and societies. Among the causes which hinder improvement are certain characteristics of Spanish society and its values: Spain does not take full advantage of resources because it lacks the adequate social climate, both at an individual and a collective level. Mutual distrust pushes up transaction costs, reducing cooperation and productivity. The problem gets worse in times of crisis, because when people lose their jobs or find themselves with worthless investments it destroys the belief they had in their opportunities and their country.

However, firms, the public sector, the education system and the labor market would all work better in a more cooperative climate, leading to a more productive economy. In this environment, an individual who contributes with his effort, talent and initiative would run fewer risks because he can expect others to reciprocate by fulfilling their commitments and respecting the rules. If these values were held in higher regard, they would serve as a guarantee. The resources we have would be more easily mobilized and channeled in the right direction, and interaction and transaction costs could be reduced substantially. If we were all more reliable, there would be greater cooperation within organizations and contracts could be made more secure. In short, this greater trust would increase our social capital, improving our collective efficiency and productivity.

Despite their importance, these deficiencies receive no consideration from those who could eliminate them: that is, individuals, human groups and institutions. Or indeed politicians, who are influenced by electoral horizons rather than the progress of the country, and often exemplify distrustful behavior and short-term interests— to damaging effect since among their duties is to mobilize support and achieve consensus, building bridges between groups with different interests, whether or not they are their voters. The lack of such consensus means it is harder to make reforms that are of long-term benefit to all, but imply short-term sacrifices for some.

The final set of proposals in this report deals with the need to be aware of and act on these problems, by fostering values conducive to the right social climate for taking our country into the next stage of progress: **the culture of hard work, fair competition, social recognition of talent, a readiness to trust others, transparency in firms and public institutions, and openness to the rest of the world and opportunities to co-operate.**

IN SUM

Spain must adopt initiatives and reforms in numerous areas if it is to pursue a strategy of development consistent with an advanced country and adapted to the current circumstances of the world economy. This strategy is essential so that coming generations have a modern, efficient economy: an economy that allows them to progress in a globalized world, where an increasing number of societies and people are demanding their share of development.

There are many necessary changes, which affect individual and collective interests, and demand effort and sacrifice. But there are a great deal of individual and collective resources and abilities, even in these times of hardship. Despite the crisis and massive job destruction of

the past few years, Spain's level of development, income and employment is far higher than fifteen years ago. That is our starting point.

It is not only the government that faces this huge challenge but society as a whole. Indeed some of the key solutions will have to come from entrepreneurs, educators and families. They will depend not only on the right incentives, but also on the values that policies and reform require, making them more effective and therefore causing a less demanding sacrifice.