SPAIN

The world's 13th largest economy is back on track, six years after the global financial crisis struck. Miguel Cardoso reports on the Spanish recovery

The Torre Agbar tower, Barcelona

PHOTO: MIRENSKA OLGA/SHUTTERSTOCK

For the first time since the beginning of 2008, Spanish economic forecasts have an upward bias. A year and a half ago, 25% of forecasters thought that Spanish GDP was going to contract in 2014. Today, no one foresees a contraction, and there is an increasing probability that growth could accelerate over the next quarters to levels of around 2% on an annual basis. Overall, growth should average above 1% in 2014 and around 2% in 2015. All of this reflects the huge turnaround that Spain has undergone over the past year and points to the fact that the country is ready to start what should be a sustainable recovery, although some challenges still remain.

The most important reason for this improvement has been the swift and decisive action taken by European and Spanish institutions. The "whatever it takes" pledge by European Central Bank president, Mario Draghi, in July 2012 has built a bridge that has allowed European governments to take steps towards breaking up the vicious cycle linking sovereigns and the financial sector.

In the case of Spain, it has allowed the country to restructure and recapitalise a part of its financial sector, as well as to implement growth-enhancing reforms. In particular, Spain has taken huge steps towards correcting the imbalances that were accumulated before and after the global financial crisis.

For example, the country's current account has gone from a deficit of around 10% of GDP to a surplus of 0.8% in 2013. Meanwhile, the fiscal deficit has been lowered from 11% of GDP to around 6.5%, which has been particularly difficult to achieve during a recession. Finally, the private sector has undergone an ambitious deleveraging process, moving from demanding significant resources from the rest of the world (14% of GDP in 2007) to generating a surplus of resources of around 5% of GDP on average since 2009.

Despite the adverse impact that these adjustments have had on domestic demand, economic activity and employment in Spain are beginning to show solid improvement. Current information shows that for the fourth quarter in a row, GDP will grow in the second quarter of 2014 (+0.4% quarter-on-quarter), and for the first time since 2008, the economy is displaying net job creation. The recovery has been, and will be, supported by export growth. Since 2012, Spanish exports have outperformed those of the EU (+12.1% versus 2.1% since Q1 2012). Spanish exporters have been especially successful at diversifying both the destinations they export to and the type of products they export (75% of export growth during the crisis can be attributed to these factors), but they have also been able to gain competitiveness, as evidenced by a negative inflation differential with the European Monetary Union (EMU) during the crisis (average of around 1% year-on-year with respect to the core eurozone countries since the beginning of the crisis).

Competitiveness gains have been led by productivity growth coupled with wage moderation, thanks to increased flexibility in the Spanish labour market (gains in terms of unit labour costs have reached 14% since the pre-crisis peak).

In particular, thanks to an ambitious labour market reform, businesses have been able to use more efficient adjustment mechanisms, which have allowed them to continue in existence while saving jobs. In fact, the reduction in real wages per worker that the Spanish economy experienced in 2012 is likely to have prevented the destruction of around 220,000 jobs in 2012 and 2013. The labour market reform makes it more likely, therefore, that competitiveness gains are permanent – unlike the reversals observed

Country file

Population size: 47.2 million **Area:** 505,370km^2

Type of government: Parliamentary constitutional monarchy

Official language: Spanish

Co-official languages: Galician, Catalan, Aranese and Basque

Capital and largest city: Madrid

GDP (PPP) 2012: $1.322 trillion*

Govt debt as a proportion of GDP: 93.9%

% growth in 2013: -1%

Currency: Euro

Currency rate against the dollar: 1.37

* SOURCE: WORLD BANK

Madrid skyline with Metropolis Building in the foreground

PHOTO: SYLVAIN SONNET/GETTY IMAGES

TOP TIPS FOR DOING BUSINESS IN SPAIN

1. **Be straightforward. People will appreciate it.**
2. **Take some time at the beginning of meetings to build some rapport.**
3. **Lunch is a good place to talk business. Face-to-face meetings are normally preferred for discussing serious issues.**
4. **Be on time – punctuality is becoming more appreciated every day.**
5. **Avoid politics as an ice-breaker.**

after past crises, when they were achieved through temporary instruments such as exchange-rate devaluations. Furthermore, it could also boost job creation in the future by ensuring that wages evolve according to productivity.

Other reforms that have been introduced recently have also played a key role in improving long-term growth forecasts. Specifically, an ambitious reform of the pension system practically guarantees its solvency, by linking expenditures to revenues, and by increasing the retirement age (to 67 years). Moreover, the government has also put into place certain mechanisms to control the deficit of regional and local governments, which was a huge source of uncertainty in the past.

Savings banks have been recapitalised, and quality reviews by independent auditors under the supervision of the European Central Bank, the European Commission and the International Monetary Fund have dispelled doubts regarding their balance sheets. As solvency doubts have been left behind, the financial system has begun to contribute positively to the recovery. Indebtedness needs to be reduced still further, since certain sectors and certain parties still show excessively high levels, but debt repayments will remain above new credit flows (implying the stock of credit will still fall). The latter are starting to show a turnaround and this has been increasing over the past few months. Successful recoveries after a financial crisis like the one Spain has experienced show the relevance of these new credit flows to supporting economic activity.

These changes have attracted investors, as can be evidenced by the strong capital flows experienced over the past year that have considerably lowered interest rates on public debt.

But financial markets are not the only ones attracting investors. The boom in the export sector is now transferring to productive investment (in machinery and equipment). While this area of domestic demand has only increased in Europe by 8% since its lowest level, in Spain it has gone up by almost 20%, and it is now close to its peak when taken as a ratio of domestic demand. This shows both the improvement in perceptions owing to the strong reform effort, and the ability that Spanish businesses have to export, differentiating themselves from other European competitors.

Moreover, the government is planning on more reforms that should boost the attractiveness of the economy going forward. In particular, a reform of the tax system is in the works. The intention is to make it simpler, more efficient and more consistent with the new growth model (promoting savings, foreign direct investment and job creation), while also keeping in mind the fact that the public deficit still has to be reduced. In addition, the introduction of more competition on the provision of services should also help to boost competitiveness.

Finally, the government is reducing the costs of doing business and cutting red tape, thereby making it easier and cheaper to start a business and unifying regulation across Spanish regions.

Challenges remain, since some imbalances will take time to be absorbed. A 25% unemployment rate is unacceptable. Public debt will stabilise at around 100% of GDP. The net investment position is still above 90% of GDP. Meanwhile, the residential construction sector shows an oversupply of new homes that will not allow it to contribute positively to growth as in previous recoveries.

All these, along with the early success of the reforms already taken, should give the government enough reasons to keep on improving the economy. Nonetheless, in the future, Spain will probably show a growth rate above that of EMU, making it one of the most attractive countries to invest in throughout Europe.

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