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OECD Economic Surveys: Spain

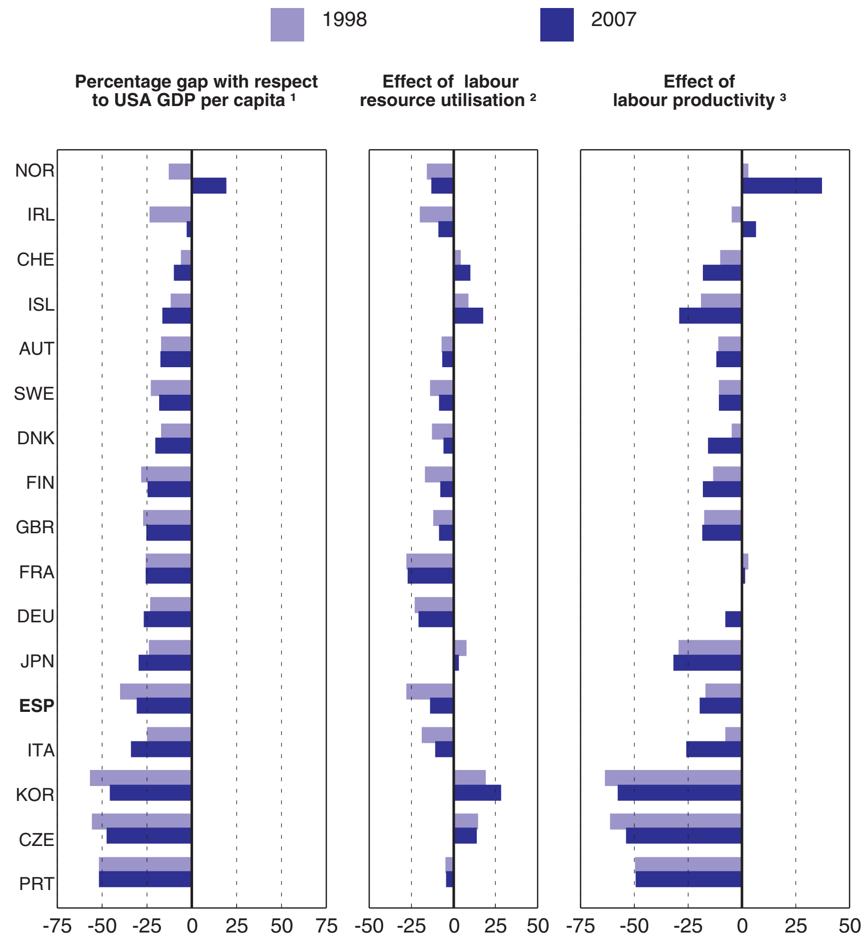
Chapter 1

Main challenges, macroeconomic developments and policies

Residential construction is slowing sharply towards a level which is sustainable in the long run and investors and consumers are also adjusting strongly to a marked deterioration in financial conditions in the wake of the international financial crisis, as well as to deteriorating job prospects. The slowdown is already having a significant impact on unemployment. Beyond this downturn some of the drivers of historical strong performance may weaken, notably vigorous credit growth, unusually low real interest rates in the wake of the adoption of the euro, exceptionally strong immigration and rapidly rising female labour force participation. An overall robust financial system in international comparison will help limit the economic consequences of shrinking housing-market activity and international financial market turbulence; and the ongoing large rise in tertiary attainment provides a significant potential to raise productivity growth, which has been weak on average over the past decade. However, in part as a result of strict employment protection for incumbent workers and low mobility, young qualified workers are often not employed in jobs commensurate to their skills, the inflow of young workers with a low education level into the labour market remains very large, and these workers are seeing their employment prospects deteriorate. The challenges will therefore be to improve the matching of workers to jobs so as to help limit the impact of the downturn on the labour market and improve the placement of highly qualified workers. Further reforms of the education system are also called for in order to cut the number of drop-outs from lower secondary school and to raise efficiency throughout the system. Reforms to intensify competition in product markets would also raise productivity performance.

Since the creation of the euro area in 1999, Spain has advanced considerably towards convergence in income standards with the most economically advanced OECD countries. However, a 14-year-long period of virtually uninterrupted strong growth has now come to an end as the residential construction boom has drawn to a close. The deceleration of domestic demand has spread to consumption and business investment. Some driving factors behind earlier robust performance – low real interest rates, ample credit availability, rising female participation and enormous immigration –are likely to lose steam in the years ahead. The heavy indebtedness of households and firms, combined

Figure 1.1. **Decomposition of GDP per capita in PPP terms of selected OECD countries**



1. Based on current purchasing power parities and current prices.
2. Labour resource utilisation is measured as total number of hours worked divided by population.
3. Labour productivity is measured as GDP per hour worked.

Source: OECD, data derived from *Annual National Accounts database and productivity database.*

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with a prevalence of lending at short-term rates to households over increasingly long periods, have made the economy vulnerable to changes in such rates and the tightening of credit conditions in the wake of the global financial crisis.

Trend labour productivity growth has remained weak, notwithstanding rapid capital accumulation over the past decade, widening the gap *vis-à-vis* the United States, and this gap has not diminished either in comparison to other top-performing countries. Catch-up with living standards in highest-income countries in the OECD has been based on rising labour utilisation, where the gap *vis-à-vis* the United States and other highest-income countries has diminished (Figure 1.1). For convergence in living standards to continue, total factor productivity gains will need to improve. The expansion in tertiary education attainment is impressive. However, the inflow of unskilled young workers into the labour market is still large, and segmentation in the labour market between holders of permanent contracts on the one hand and temporary contract holders on the other hand, as well as weak internal geographic mobility, hamper the integration of highly qualified young workers. The unemployment rate has already risen steeply, hitting workers in low-skill occupations, including the immigrant population, particularly hard, even though the unravelling of the residential construction boom is still at an early stage.

Recent developments point to a significant cutback in economic growth over several years

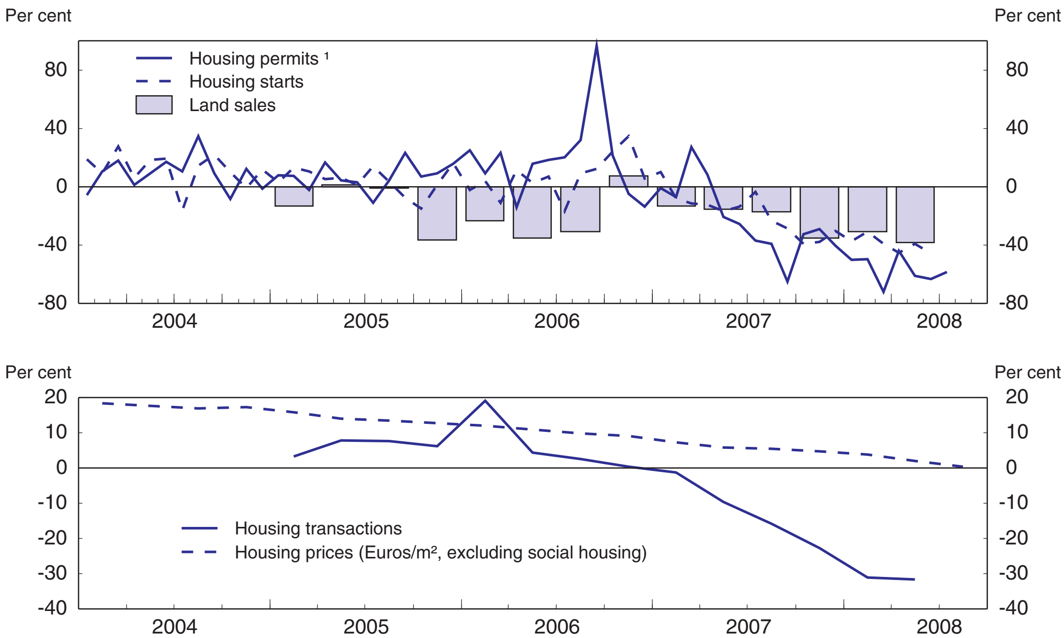
Housing construction will settle at a significantly lower level of activity

The rise in short-term interest rates, ongoing since 2005, has resulted in a significant decline in the demand for housing. The resulting deceleration of house prices has led to a revision of expectations of further increases, triggering the end of a residential construction boom that lasted for 10 years. As is typical for the early stage of the downturn in a residential construction cycle (see *e.g.* Catte *et al.*, 2004), the fall in demand has thus far manifested itself mostly in a significant drop in housing transactions as well as in a sharp fall-off in initiated housing construction projects (Figure 1.2), whereas the official house price index has not yet fallen year over year in nominal terms.[1] House prices typically lag the cycle, and the very large number of initiated housing projects in the year 2007, which are still coming on the market, will continue to act as a drag on house prices in 2009.[2] House prices in Spain have also been estimated to exceed fundamentals by between 20% and 32% (quoted in Girouard *et al.*, 2006b). Moreover, some of these fundamental determinants of house prices may contribute to lowering them in the future, as unemployment, real income and real interest rates appear to explain a significant share of historic house price developments in Spain, with interest rates exerting a sharply increasing role in shaping prices.[3]

Demographic developments are estimated to be consistent with a demand for additions to the housing stock of at least 315 000 per year between 2005 and 2010 (Banco de España, BdE 2008a), about 50% less than the increase in the housing stock observed in 2006.[4] This evidence suggests that the currently observed decline in housing starts of about 60% may be broadly in line with a level that could be sustainable in the long run.[5] However, the impact of demography on variations in housing demand in the short term is very low (*e.g.* García Montalvo, 2007, provides evidence for this in Spain). Moreover, these estimates are conditional on there being no oversupply in the existing stock.

Figure 1.2. **Residential construction indicators**

Year-on-year changes



1. Data in September 2006 and 2007 as well as March 2007 and March 2008 are affected by the introduction of a new building code, raising construction costs, in September 2006 and March 2007.

Source: Ministerio de Vivienda.

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The total housing stock – about 560 units per 1 000 population – appears to be larger than in other countries that likewise attract a large foreign demand for second homes, such as France and Italy.[6] However, the share of housing used for tourism purposes – 22% – may be higher than even in these countries. For this and other reasons international comparisons of housing stock figures are fraught with limitations. The share of unoccupied housing may have reached up to 6% of the total in 2006.[7] Few countries report substantially lower rates of unoccupied housing (see the international comparison made available by Ministry of Infrastructure of the Italian Republic, MIIR, 2006).[8] This suggests that speculation on rising house prices had not resulted in a large build-up in the number of empty homes prior to the beginning of the housing downturn in 2007. However, more recently, on account of the drop in demand, the share of new dwellings entering the market which remain unsold more than doubled year-on-year, reaching close to one half of the pre-crisis level of annual purchases of new housing in October 2007 (latest data available), only a few months after the onset of the housing market slump.[9] Most estimations suggest that excess supply is now large.

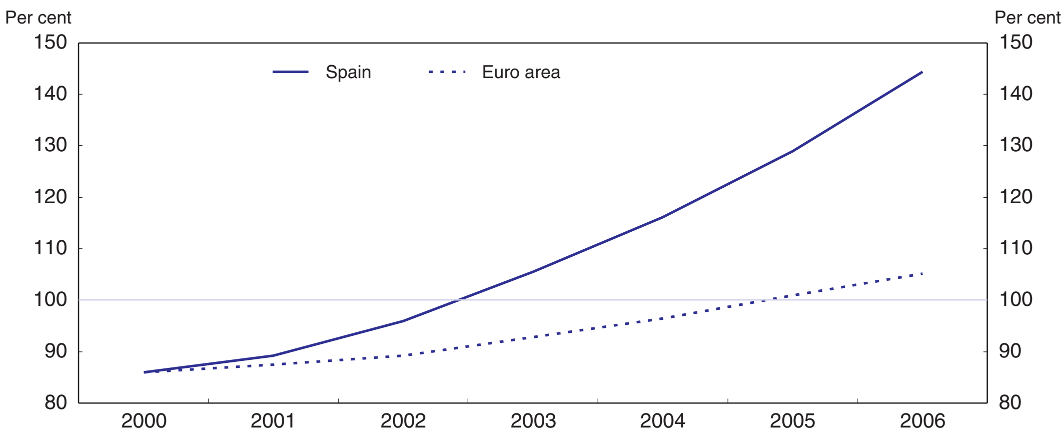
Some indicators point to potential demand that is not being satisfied at current market conditions: most young people aged 18 to 35 still live with their parents, and (as the 2007 *Economic Survey* pointed out) a significant share of low-income households are poorly housed. However, these individuals are unlikely to see their housing demand satisfied in the market place unless impediments to renting – which accounts for only 11% of main residences, a slight pickup in 2007 notwithstanding – are removed.

The cyclical slowdown has spread to consumption and business investment

Private consumption growth has also slowed markedly, in part reflecting changes in financial conditions. The marginal propensity to consume out of housing wealth in Spain is small (Girouard *et al*., 2006a), as much of the domestically owned housing stock is directly held by owner-occupiers, and little mortgage borrowing is used for ends other than the acquisition of housing, both of which result in low liquidity of the housing stock held in households' portfolios. However, household debt – three quarters of which consists of mortgages – has reached high levels (Figure 1.3), making disposable income sensitive to changes in interest rates, all the more so because almost all mortgages are contracted at variable interest rates indexed to short-term interbank rates, which are being affected by the global financial crisis. Moreover, residual average maturities of outstanding housing loans are long, and the level of real interest rates was still low at the onset of the marked slowdown of activity in the first quarter 2008, all of which magnify the relative impact of a given change in interest rates on debt-service payments. Most household savings are on aggregate, absorbed by gross debt repayments (BdE, 2008a). In addition, with tighter credit standards in the wake of the international financial crisis, households are likely to be forced to cut back on consumption, as they may, in the aggregate, not be able to refinance all debt falling due. The direct effect of residential construction employment cutbacks and the relatively large impact of earlier oil-price rises on the cost of living (see below) have also weighed on real consumer spending. Moreover, business investment is being hit by declining domestic consumption, decelerating activity world-wide and a high level of indebtedness, which firms will likewise find more difficult to roll over. Another negative factor is profits, which are weakening. In view of these forces, which have been apparent in the national accounts since the fourth quarter of 2007 (Figure 1.4), the OECD projects a decline in economic activity in 2009 and a modest recovery in 2010, entailing a significant increase in the unemployment rate (Box 1.1).

Figure 1.3. **Net household debt of Spain and the euro area**

As a percentage of net disposable income



Source: OECD, *Annual National Accounts and Eurostat databases.*

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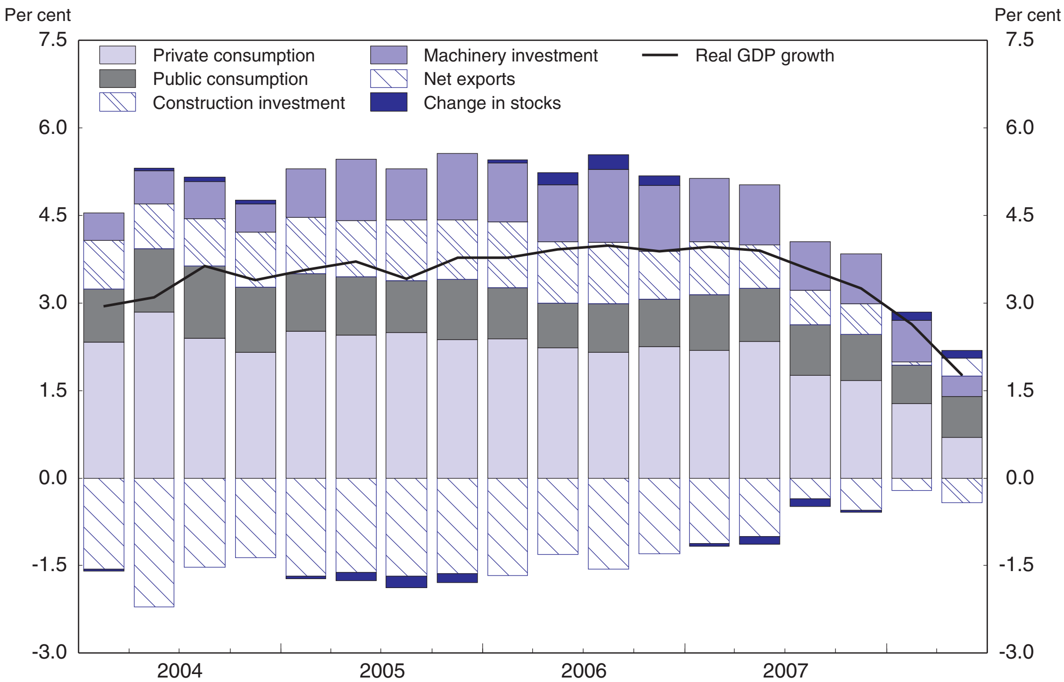
Figure 1.4. **Decomposition of real Gross Domestic Product**

Contributions to growth, year on year



Source: OECD, *Analytical database.*

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

Economic activity is expected to contract in 2009, followed by a slow-paced recovery in 2010. The sharp decline in residential construction is likely to persist, reflecting the continued steep drop in new housing permits, as house prices continue to fall. Moreover a significant overhang of unsold units will weigh on the number of housing projects that will be initiated over the projection period. Private consumption growth will be held back by restrictive financial conditions, employment losses and by declines in housing and stock market wealth, although much lower oil prices and falling interest rates are expected to provide some relief. Lower demand, tighter credit standards and falling profits will result in a substantial fall in business investment. Sluggish world trade in 2009 will limit export growth, although the fall in imports and in oil prices should reduce the current account deficit significantly In 2010, growth is projected to begin to pick up again as declines in housing investment ease, financial turmoil recedes and world growth resumes. Indeed, exports are expected to be the main driver of Spanish growth in 2010, which would help to further lessen the current account deficit. The unemployment rate is expected to rise to close to 15%, although immigration is assumed to moderate significantly. Core and especially headline inflation will fall to around 1¾ per cent as significant slack opens up and recent oil and food price decreases are absorbed. The public accounts deficit, which is likely to reach around 1½ per cent of GDP in 2008, will continue to deteriorate, reaching around 3% and 3.8% of GDP in 2009 and 2010, respectively.

Box 1.1. **Short-term economic prospects** *(cont.)*

Given the high level of household and business indebtedness and the prevalence of variable rate mortgages, activity remains particularly sensitive to changes in short term interest rates. Credit constraints could tighten further, pushing economic activity lower than projected, if the international financial crisis persists or in response to rising non-performing loans on account of the exposure of banking institutions to the domestic residential market, which would be aggravated if employment losses were larger than projected and/or house prices fall substantially.

Table 1.1. **Gross domestic product and spending**

	2005	2006	2007	2008[1]	2009[1]	2010[1]
	Current prices € billion	Percentage changes, volume				
Private consumption	525.1	3.9	3.5	1.2	–0.4	0.2
Government consumption	163.7	4.5	4.9	3.6	3.4	3.1
Gross fixed capital formation	267.0	7.1	5.3	–2.0	–9.2	–2.7
Of which residential	80.8	6.0	3.8	–9.8	–25.6	–14.8
Final domestic demand	955.9	4.9	4.2	0.7	–2.2	0.0
Stockbuilding[2]	2.0	0.1	–0.1	0.0	–0.1	0.0
Total domestic demand	956.8	5.1	4.2	0.7	–2.3	0.0
Exports of goods and services	233.4	6.7	4.9	3.2	3.7	5.6
Imports of goods and services	281.4	10.3	6.2	0.9	–1.6	2.6
Net exports[2]	–48.0	–1.5	–0.8	0.6	1.5	0.7
GDP	908.8	3.9	3.7	1.3	–0.9	0.8
Memorandum items:						
Harmonised index of consumer prices	_	3.6	2.8	4.4	1.8	1.5
Unemployment rate	_	10.3	9.6	10.9	14.2	14.8
Household saving ratio	_	10.3	10.2	11.2	12.7	13.8
General government financial balance[3]	_	1.8	2.2	–1.5	–2.9	–3.8
Current account balance[3]	–	–8.9	–10.1	–9.7	–7.4	–6.4

Note: National accounts are based on official chain-linked data. This introduces a discrepancy between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods)*.
1. Projections.
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
3. As a percentage of GDP.

Source: OECD Economic Outlook No. 84 database.

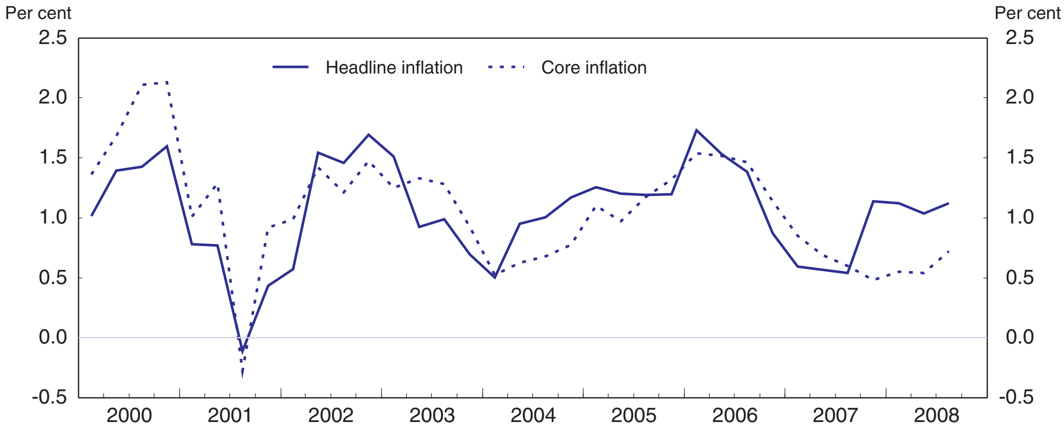
The inflation differential has allowed the price level to converge to that of the euro area

Inflation differentials *vis-à-vis* the euro area have persisted since Spain adopted the euro and widened in 2007, which largely reflects the higher share of consumer spending devoted to energy than in the euro area as a whole. The gap in core inflation (excluding energy and food) has fallen in recent years, reaching 0.7% thus far in 2008 (Figure 1.5) and is expected to fall further in 2009 and 2010.

The persistent inflation differential *vis-à-vis* the euro area does not yet appear to have pushed up the level of prices of domestically produced goods and services above levels observed in other euro area countries, after allowing for the impact of differences in productivity levels, indirect taxation, and income per capita on the price level. If prices

Figure 1.5. **Core and headline inflation differential between Spain and the euro area**

Differences in year-on-year changes



Source: OECD, *Analytical database.*

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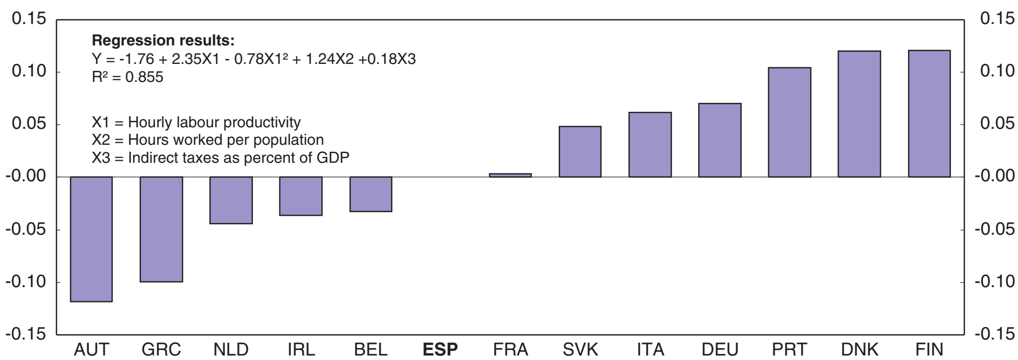
were to lie much above an equilibrium defined in this way,[10] the real exchange rate against euro area countries could be considered overvalued (Figure 1.6[11]). In this case a protracted period of disinflation would be needed to restore equilibrium inside the common currency area. However, still high headline inflation is expected to feed significantly into higher nominal wage growth in the near term, with the attendant risk that the combination of adverse aggregate demand and supply shocks could result in both persistent inflation differentials as well as a more pronounced downturn in activity and employment. Indeed, *ex post* indexation of wage growth to inflation already pushed up collectively bargained wage outcomes in 2007, and this effect may strengthen in the course of 2008. In the first two quarters, underlying year—on-year hourly compensation growth rose to 6.3% and 4.6%, respectively, up from 4.5% on average in 2007. This increase has contributed to an accelerated deterioration in relative unit labour costs in manufacturing *vis-à-vis*

Figure 1.6. **Price level comparison**

After controlling for productivity, income per capita and indirect taxes, 2005



1. The figure shows differences in the level of prices for goods and services representative of GDP *vis-à-vis* Spain (expressed as a per cent of the price level in the United States), in euro area countries and countries linked to the euro through fixed-exchange-rate regimes.

Source: OECD, *Annual National Accounts and Purchasing Power Parities databases* and OECD calculations for hours worked.

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competing developed economies (BdE, 2008c). Reforms that would reduce the feedback effects of inflation on wages and raise the intensity of competition in non-tradable services, where the productivity record in Spain is weak, notably in retailing, could help damp price and wage inflation. Such steps would strengthen competitiveness in sectors producing internationally tradable goods and services, helping to offset the impact of the decline in domestic demand on activity (Chapters 2 and 4).

Fiscal policy has turned expansionary

Against the backdrop of a sharp deceleration in economic growth, the government has taken a number of expansionary fiscal policy measures, worth a total of 0.8% of GDP. On the revenue side, these include a tax rebate amounting to around ½ per cent of GDP. On the spending side, a new child benefit, payable at birth worth around 0.1 percentage point of GDP, was introduced (in part already in 2007), and the government committed to a faster implementation of its existing infrastructure projects. The government made available an extra €10 billion (1% of GDP) worth of credit guarantees for the issuance of AAA-rated mortgage-backed securities, tied to the condition that the funds raised through the issuance be used for the development of social housing projects. Additional guarantees have been issued by regional governments. A further government credit line, worth €3 billion in the first instance, was made available to housing developers for the purpose of debt rescheduling in August 2008, tied to the condition that developers taking up the loans offer their unsold units for rental. Subsidised loans were also made available on a temporary basis to enterprises to replace vehicles. The impact on the budget of these loan programmes should, however, be small.[12] Moreover, personal income and corporate tax reductions, legislated in 2006 (see OECD, 2007b), as well as a further adjustment of tax brackets and the basic income tax allowance to account for higher inflation, are reducing government revenues by about 0.8 percentage point of GDP from 2008 onwards. All in all, the discretionary fiscal stimulus in 2008 amounts to 1½ percentage points. Automatic stabilisers are having a further significant impact on the government's fiscal position. In addition, further technical changes in corporate and value added tax rules, which are unlikely to have a significant impact on economic activity, lead to revenue losses in the government accounts of 0.6 percentage point of GDP in 2008 only. All told, revenues have fallen sharply in the first eight months of 2008, while unemployment-related spending is rising. The general government budget deficit is expected to reach about 1½ per cent of GDP in 2008.

The central government has proposed a budget for the year 2009 which limits spending growth to 3.3%, (about 2% excluding transfers to social security to fund unemployment benefit outlays) implying nearly constant spending in real terms. Defence spending and transport subsidies, in particular, have been cut, as have budgeted outlays for non-wage consumption spending across all ministries. The spending growth restraint in the central government budget may not ultimately be fully reflected in an improvement of the general government structural budget balance. In particular, lower transfers to sub-national government levels may raise their deficits, and reductions in planned expenditure on wage subsidies for specific groups hired on permanent contracts reflect the cyclical downturn in the number of hires. On the revenue side, the elimination of the wealth tax, which has already been legislated, will result in revenue losses of 0.2% of GDP, offsetting some of the restrictive impact of expenditure restraint. With sub-national levels of government taking measures, in some cases, to cut their wage bills, general government budgetary policy is likely to be broadly neutral in 2009. Overall the central government projects that its budget deficit will reach 1.5 % of GDP, similar to the expected budget outcome in 2008.[13] However, this projection is based on a more optimistic scenario for real GDP growth of 1% in 2009, which is well above the consensus view.

As in 2008, the expected central government budget deficit lies well above the legislated ceiling of 0.4% of GDP.[14] The central government is therefore obliged to present a plan outlining how the target budgetary balance is to be reached by 2011.[15] Regional and local governments will be close to their deficit ceiling of 1% of GDP, which would, in principle, require them to present adjustment plans as well. However, they have been allowed not to present such plans so as to avoid fiscal policy turning restrictive in the following years. As pointed out in previous Surveys (see Table 1.A.1, OECD, 2007b), the deficit ceilings on the various levels of government imposed in Spanish legislation, which became effective with the 2008 budgets, do not adequately take into account the operation of automatic stabilisers.

The counter-cyclical fiscal policy stance taken this year was appropriate to take out insurance against the risk that decelerating activity, job losses and declining house prices reinforce each other, bringing about a vicious circle. This consideration is especially relevant as the housing–market correction is to a substantial extent a country-specific shock, to which no monetary policy response can be expected. However, further scope for expansionary fiscal policy is limited. Indeed, policy makers' attention needs to turn to the medium term, as the pressures on the fiscal position of the government are likely to mount beyond the current cycle:

- On the revenue side, the elasticity of revenues with respect to nominal GDP were considerably larger than unity up to 2006 (see the 2007 *Economic Survey*), and some of the large windfall gains in direct (especially business) tax revenues relative to GDP observed since 2005 (Table 1.2), while recorded as structural revenue gains, are likely in fact to be cyclical. Indeed, unusually high profits contributed much to strong income tax revenue growth up to 2007, and this effect is reversing. In addition, economic growth will need to shift from domestic demand to less tax-revenue–intensive net exports. The structural surplus is therefore likely to be substantially overestimated. This argument is reinforced by the fact that immigration inflows, which have contributed considerably to budget surpluses, notably in the social security system, may diminish as the economy grows more slowly. Moreover, the scope for further expansion of female labour supply is likely to shrink (see below).[16]
- On the expenditure side, while government spending relative to GDP is still low in international comparison, non–interest spending relative to GDP has been on a vigorous upwards trend, reflecting, in particular, rising government employment at sub–national government levels and, recently, high pay increases for some government workers, as well as increased government spending to support research and development. The central government has announced that it will take measures to lower payroll spending in 2009, although the expected savings are small (€250 million). A marked increase in old-age dependency ratios from 2025 onwards will generate substantial spending pressures (see OECD, 2007b). These will be further increased by the recent introduction of long-term care benefits for the elderly. This programme has so far had a minor budgetary impact, but spending on long-term care is expected to eventually rise to 1% of GDP per year. Discretionary increases in minimum pensions in recent years have been

Table 1.2. **General government accounts**

As a percentage of GDP

	2000	2005	2006	2007
Current receipts	**37.6**	**38.6**	**39.8**	**40.6**
Direct taxes	10.2	10.9	11.7	12.9
Household	7.0	6.9	7.4	8.1
Business	3.2	4.0	4.3	4.8
Indirect taxes	11.4	12.2	12.4	11.8
Social security contributions	12.9	12.9	13.0	13.0
Other	3.2	2.6	2.8	2.9
Current expenditure	**36.1**	**35.2**	**35.1**	**35.4**
Government consumption	17.2	18.0	18.1	18.4
Subsidies	1.1	1.0	1.0	1.0
Social security outlays	12.0	11.6	11.5	11.6
Property income paid	3.2	1.8	1.6	1.6
Other	2.6	2.7	2.8	2.7
Net lending	**–1.0**	**1.0**	**1.8**	**2.2**
Memorandum items:				
Structural primary balance	1.1	2.6	3.0	3.2
Structural revenues	37.7	38.7	39.8	40.6
Structural current expenditure, excluding interest	33.4	33.3	33.5	34.0
Budget balance of:				
Central government	–1.0	0.2	0.6	1.3
Social security	0.5	1.1	1.3	1.2
Local and regional government	–0.4	–0.4	–0.1	–0.3

Source: OECD *Economic Outlook 83*, and Bank of Spain (2008), Boletín Estadístico, May.

easy to fund from social security contributions revenues, in view of the large inflow of young immigrants and women in the labour market. While these increases help damp marked poverty among pensioner households, they will raise pension spending permanently. More spending has also been committed to improve active labour market policies, integration of immigrants (Chapter 2) and student grants (Chapter 3). Spending contingencies may result as well from a future international burden-sharing agreement to combat global climate change.

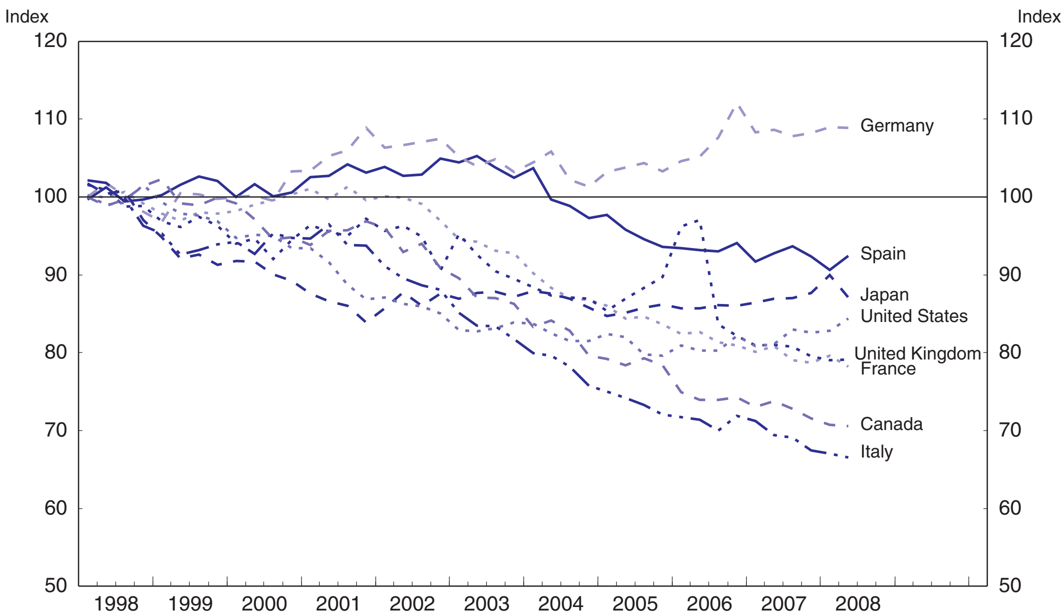
While the relatively low debt and expenditure levels favour the sustainability of government finances, budgetary policy will have to adjust to these changes in the medium-term outlook. On the expenditure side, this situation makes it urgent to identify and eliminate spending that is not conducive to raising potential growth or is poorly targeted at reducing poverty, as some reforms may take some time to implement,. Some such spending areas include housing policies and wage subsidies (Chapter 2). The new credit guarantees for social housing may, moreover, contribute to oversupply of total housing, with the attendant risk of prolonging adjustment in the housing market. Some progress has been made in raising the transparency of sub-national government spending, which accounts for close to one half of total spending (OECD, 2005), including off-budget operations (Annex 1.A1). However progress is still needed, for example, in reforming the system of regional government funding so as to strengthen incentives to contain expenditure pressures. On the revenue side, the current policy of freely allocating greenhouse gas emission permits foregoes the opportunity to raise government revenues worth about 0.4% of GDP per year that would arise if such permits were auctioned in full, without the deadweight losses associated with taxation, and risks undermining the incentives for pollution abatement the scheme intends to strengthen (Chapter 4). However, a ceiling of 10% still applies to the share of permits that can be auctioned according to EU rules.

The current account deficit largely reflects strong domestic investment

The current account deficit reached a historically high level of more than 10% of GDP in 2007. Most of the current account deterioration observed over the past decade is accounted for by the trade balance, reflecting the impact of increasing domestic absorption on imports, while net factor income outflows have made a modest contribution. Export performance has held up relatively well, for example in comparison with G7 countries, except Germany (Figure 1.7),[17] demonstrating that relatively high inflation has not undermined competitiveness excessively to this point.[18] At the same time, export prices have evolved relatively favourably, rising more strongly than in either Germany or France.[19] The euro area still absorbs about 45% of Spanish goods and services exports, whereas fast-growing markets, notably in East Asia, still play a minor role, also in international comparison (IMF, 2008). Goods export performance has been sustained by a relatively strong presence of sectors that have exhibited strong demand growth world-wide so far, notably transport equipment and its components. The weight of manufacturing industries for which world-wide demand growth has been relatively weak, such as textiles, clothes and apparel, is low. The small share of these industries in Spanish exports also helps to explain the limited exposure of Spanish producers to competition from suppliers in emerging economies and sets Spain apart from other South European countries, including Greece, Italy and Portugal (IMF, 2008). Services have contributed heavily to export growth in

Figure 1.7. **Export performance**[1]

Index, 1998 = 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 2000.

Source: OECD, *Analytical database*.

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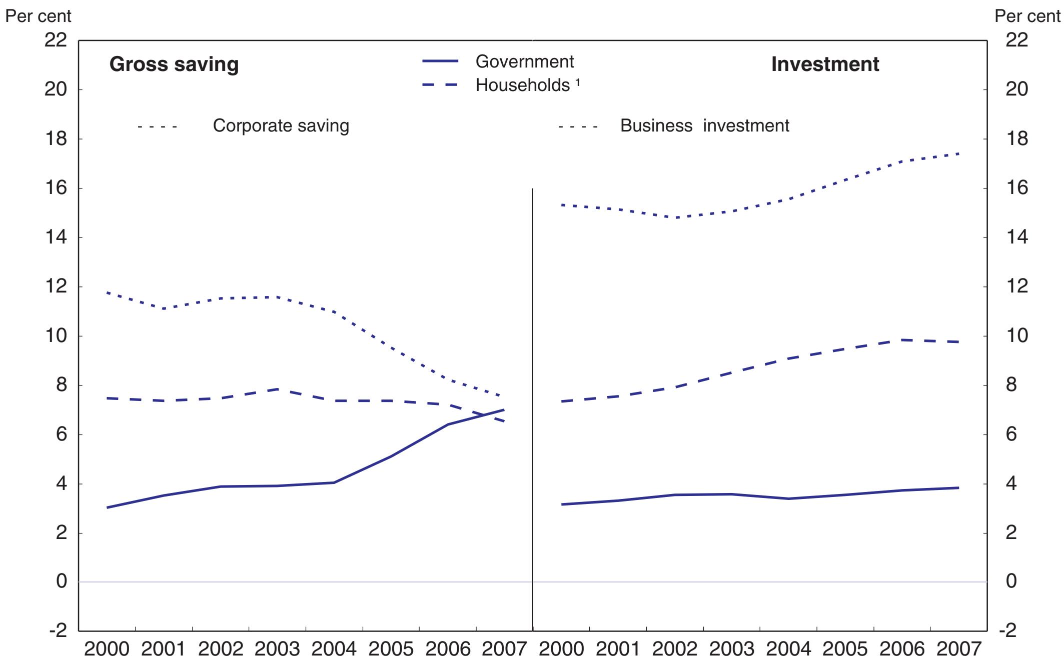
recent years, and these have been characterised by significant diversification. Tourism services have contributed little to the expansion, and their weight in services exports has now fallen below 50%, whereas financial services and intermediate business services have taken on larger roles. The export share of these services, in which labour productivity tends to be high, is however still modest in comparison to more mature economies.

Over the past decade, the large current account deficit has reflected a very large share of investment in GDP, including both business and residential investment. This capital spending has exceeded high savings by households, enterprises and the government (Figure 1.8). Apart from low real interest rates, strong employment and population growth have been a driving force behind both high business and residential investment rates. Indeed, although the business investment rate has been very high in international comparison, capital intensity has advanced somewhat more slowly than in European OECD countries or the United States, resulting in a somewhat more modest contribution of capital stock growth to labour productivity gains (see below). The tightening of financial conditions and the cooling of the housing cycle are likely to add to the savings from a lower oil import bill and result in a marked correction of the current account deficit, although business investment may yet have to stay fairly strong to allow capital intensity to catch up with other advanced OECD economies.

Figure 1.8. **National savings and investment**

As a percentage of GDP



1. Households and non-profit institutions serving households.

Source: OECD, *Annual National Accounts database*, and Eurostat.

StatLink http://dx.doi.org/10.1787/485885724177

The banks are overall relatively well placed to handle the downturn in residential construction

The exposure of Spanish banks to lending to the domestic housing sector is large. A significant share of bank assets (21%) consists of loans for the purpose of home purchase, whereas this share is only around 11% for the euro area as a whole. Moreover, the international financial market crisis creates a more difficult environment by limiting the ability of global financial markets to supply liquidity. The impact of housing market developments on the portfolio of existing mortgages held by Spanish financial intermediaries is, however, attenuated by various factors.

Loan-to-value ratios have remained modest, even at the peak of the lending boom in 2007, averaging 65%, and less than 10% of new mortgages granted in recent years have exceeded 80% of estimated house values. Mortgage borrowers' liability is not limited to the mortgaged property but also encompasses all other sources of income and assets, and recourse to mortgaged property is supported by a functioning property register. In addition, most have been asked to supply supplementary guarantees to lenders in case of high loan-to-value ratios, although in the majority of cases these are provided by relatives, while insurance against loss of employment appears to be relatively rare. However, unusually among OECD countries (see Catte *et al.*, 2004) house prices used in assessing loan-to-value ratios do not reflect actual transaction prices but prices as estimated by professional estimators (*tasadores*). Recent changes in legislation have strengthened requirements to separate activities of professional estimators from banks and the estimators are subject to supervision. However, incentives for estimators to overestimate prices may also result from contractual relationships with banks, as lower reported loan-to-value ratios may reduce provisioning costs and limit the need for borrowers to provide additional guarantees, even if banks have not shifted risks associated to mortgage lending off their balance sheets, which may limit their incentives to undervalue house prices.

The relatively prudent loan-to-value ratios may well reflect particular safeguards in banking regulation, which are not common in all OECD countries, including the prohibition for banks to move assets off their balance sheets when they remain subject to the risks associated to these assets. Since Spanish banks have, in fact, kept those assets on their books, which have been used to collateralise bond issues, it appears that Spanish banks have not passed on risks to other economic agents (BdE, 2007a). Virtually all mortgages have been issued by deposit-taking banks, which are subject to stricter rules than non–bank lenders. These practices should help preserve lenders' incentives to maintain relatively stringent assessments of borrowers' expected ability to repay debt. Moreover, access to mortgage products for equity release is limited, as is accessibility to mortgages for households that provide information on income only by self-certification or which are credit-impaired (Catte *et al.*, 2004).

Spanish banks have been subject to tighter provisioning rules than those in other OECD countries, obliging them to make provisions for loans over and above those to cover for specific default risks.[20] These have increased the banks' cushion to absorb losses. The general provisions reach almost 1% of bank assets. While provisions are not included as part of banks' capital in calculating solvency ratios, capital and reserves are nonetheless higher relative to assets than in other large European countries, except Italy (BdE, 2008a); and banks' aggregate solvency ratios are considerably higher (about twice) than those required by the Bank of Spain. Moreover, the supplementary provisioning rules are likely to

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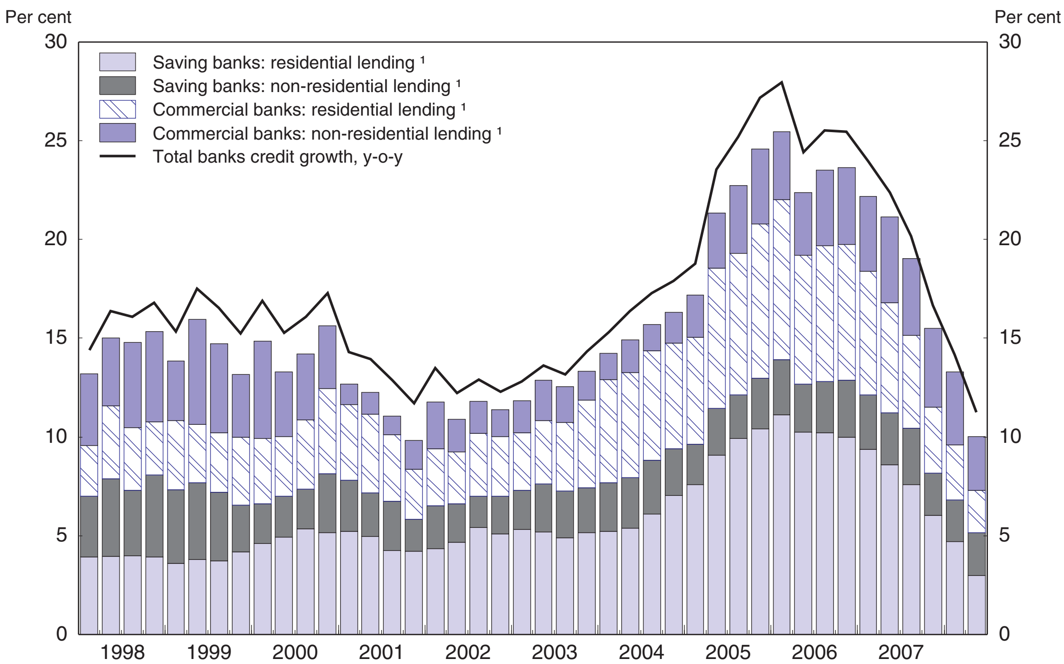
have helped limit the magnitude of the pro-cyclical lending boom that followed the creation of the euro area in 1999.

Credit expansion continued to pick up steam until 2006 (Figure 1.9). Credit growth to construction firms and housing intermediaries was particularly strong, reaching 36% year on year in June 2007. While the ratio of deposits to assets is, at above 80%, higher than in many countries (BdE, 2007a), credit growth has exceeded deposit growth in recent years, prompting Spanish banks to resort increasingly to wholesale funding, notably through the issuance of mortgage-backed securities (the interbank market has not played a significant role as a funding source) (BdE, 2008b). These securities are subject to a considerable degree of over-collateralisation. In particular, the volume of *cédulas hipotecarias* is limited to 80% of the mortgage loans serving as collateral, and mortgages are permitted to serve as collateral only if their loan-to-value ratios are below 80%.

Figure 1.9. **Growth of credit granted by savings banks and commercial banks**



1. Contributions to total credit growth. Residential lending comprises loans for home purchase as well as loans to firms in the real estate service (including property development) and the residential construction sector.

Source: Banco de España (2008), Boletín Estadístico.

StatLink http://dx.doi.org/10.1787/486000162800

In the wake of the global financial crisis, banks world-wide have found it increasingly difficult to obtain liquidity, for example, by issuing bonds. In response, in some countries, governments have injected equity into banks facing losses from depreciated assets. The Spanish government has taken a number of steps, mostly aimed at supporting bond issues by Spanish banks (Box 1.2), in line with the measures that euro area governments agreed to take in a coordinated effort to restore confidence in financial markets. Overall the government committed funds amounting to about 15% of Spanish GDP for purchases and guarantees of new bond issues.

Box 1.2. **Measures taken by the Spanish government to support lending institutions**

- A fund was set up to purchase highly rated securities newly issued by banks and other lenders that are backed by loans given to resident households and non-financial enterprises and tradable in Spanish bond markets. The fund is initially worth €30 billion with a maximum set at €50 billion (about 5% of GDP). The purchases of assets will be made on the basis of competitive tendering. 25% of the assets purchased in each auction will be assigned to banking institutions according to their contribution to aggregate new lending, at prices equal to the minimum prices determined in the auctions.
- The guarantee of deposits has been raised from 20 000 to 100 000 euros.
- The government will issue guarantees for further new issues of securities with a maximum maturity of 5 years, until 2009. For 2008, the guarantees are limited to 100 billion euros (about 10% of GDP). Banks will have to pay fees for these guarantees, according to the risks assumed by the government in each operation. The guarantees are not limited to highly-rated issues but may be subject to conditions regarding solvency of banks, as determined by the Bank of Spain. The guarantees will not in the first instance comprise interbank lending, although the government may extend them to other liabilities.
- The government will assume powers to acquire equity stakes in Spanish banks, including the special securities savings banks can issue (*cuotas participativas*). There are no plans to make use of these powers for the time being.
- The creation of the fund will not contribute to the government deficit, although it will add to gross debt while the guarantees will have a budgetary impact only if they need to be exercised. The net financial position of the government will ultimately only be affected significantly as a result of these measures if assets purchased or guaranteed depreciate significantly below the purchase or guaranteed price. The risks of this occurring appear larger for the guarantees, as they are not limited to highly rated bond issues. The risks incurred by the government will also depend on the procedures chosen to select and price eligible issues.

Default risks are concentrated among property developers and recent home purchasers

While the share of non-performing loans (2.5% in August 2008) is still low in international comparison, the heavy exposure of Spanish banks to this sector is likely to result in a significant rise in loan delinquency. Indeed, non–performing loans typically rise with a considerable lag after the onset of a housing market downturn (see Greenlaw *et al.*, 2008, for example). Risks are likely to be concentrated in lending to property developers, as these will be the most directly affected by the shrinking volumes of housing transactions and declines in the transaction prices of new housing. Stress-testing conducted by the Bank of Spain (Banco de España, 2008b), suggests that the impact of rising defaults among property developers on aggregate bank balance sheets would be very small, absorbing only about 60% of provisions, so would not even have any direct impact on reported profitability. However, the default rates were assumed only to reach levels attained in the preceding housing market downturn in 1993 (13%), while a considerably larger decline in residential construction must be expected on this occasion, which, arguably, could result in a higher share of loans being in default. The recovery rate of non-performing loans was assumed to be 50%. Residential construction activity declined by 4% at its yearly trough in 1993. However, the OECD projects a decline in housing construction of 20% in volume terms in 2009. Nevertheless, as stated by the regulator, the Bank of Spain (2008a), other factors might argue against a sharper increase in non-performing loans, such as improved credit management risks by banks. Lending for activities related to residential construction appears to be particularly concentrated among savings banks, which account for about half of banking-sector assets but have a larger market share in loans related to residential construction. The exposure of savings banks to property developers amounts to 14% of total assets at end-2007 (BdE, 2008c), almost twice as high as among incorporated commercial banks. As outlined in Chapter 4, savings banks are subject to some limitations in raising external equity. They may therefore be more likely to respond to any losses on their assets by reducing balance-sheet growth should they seek to reduce leverage in such an event, although resulting macroeconomic effects could be mitigated if other institutions were to step in to fill the gap.

While the risks of mortgage defaults stemming from depreciation of housing assets are moderate overall, as outlined above, mortgage default risks would be higher should employment losses become large. The risk of such employment losses is particularly significant among households with young heads, owing to the very high share of young workers on temporary contracts (see further below). The weight of this segment of mortgage holders in the banks' mortgage portfolio is, however, limited by the fact that 64% of people aged between 18 and 35 do not live in their own main residence and hence do not form their own household, but instead in many cases live with their parents (BdE, 2008a), with most of the remainder owning (rather than renting) their main residence. However, the debt burden of households with a young head is high. In 2005 – the last year for which survey evidence is available – 47% of households whose head was less than 35 years old had contracted debt for the purpose of the purchase of a main residence. Total debt of these indebted households (mostly mortgage debt) amounted to about twice the level of their yearly disposable income, and for 36% of them this ratio was at least 300% (BdE, 2007b). Almost a quarter of these indebted households had debt to gross wealth ratios higher than 75%, with most of their gross wealth consisting of housing wealth, and this share is likely to have risen since. A decline of housing prices by 20% – which may bring housing prices close to their estimated fundamental value[21] – would put some of these households into a negative-equity position, especially if transactions prices for repossessed houses lie significantly below market prices. They may therefore be exposed to the risk of defaulting on their mortgages if, at the same time, one wage earner in the household loses his/her job. Moreover, these households are heavily exposed to interest rate risk. Continued declines in short-term rates from recent highs could provide relief for their financial situation. Unlike in many European countries, Spanish bankruptcy law does not include specific procedures for consumer bankruptcy. This lacuna makes it more difficult for households to obtain access to a "fresh start", in which – under restrictive conditions – insolvent households can be fully freed from debt. This would slow re–insertion in the labour market of over-indebted individuals who have lost their jobs.

Better matching of workers to jobs can soften the impact of the downturn and raise the contribution of qualified workers to economic performance

On aggregate, employment fell over the last year, by 1½ per cent, according to payroll data from the Social Security office for September. Job losses were particularly heavy in construction but also occurred in manufacturing, real estate services, and retailing. With labour supply continuing to expand, the unemployment rate has quickly reflected the deceleration in activity. The unemployment rate reached 10.4% of the labour force (according to internationally comparable survey data) in the second quarter, 2½ points more than a year earlier. Immigration contributed about 2¼ percentage points to the growth of the population of working age in 2006 and there appear to be no signs of immigration flows abating as yet.[22] The female participation rate is still increasing, albeit at a declining pace.

The potential for further increases in female labour supply is likely to diminish in the years to come. The female participation rate in the group of 25 to 29 year-olds is now only 8 percentage points short of the equivalent male participation rate and is close to the highest rates observed in OECD countries. Female participation in high age groups, by contrast, is much lower than in best-performing OECD countries, held back by cohort effects and low educational attainment. The replacement of older age cohorts with low participation rates by young women with high participation rates will however continue to be a source of rising labour supply.

The quick response of construction employment to the incipient downturn reflects both its intensity and the high share of workers with precarious work status, in particular workers on temporary contracts and many self-employed, often working for just one firm, who are especially important in the construction sector. Over the past year the unemployment rate has risen more strongly among workers aged 20-29, in comparison to other age groups. The recent increase in unemployment has also been considerably more pronounced among immigrants than among natives (Table 1.3). The share of young people and immigrants with temporary contracts is particularly large (Chapter 2). Therefore, this trend may well become more marked in the near term, as more and more temporary contracts terminate and as employers adjust to deteriorating employment conditions by cutting back on hiring.

Table 1.3. **Unemployment rates by immigration status**

Per cent, not seasonally adjusted

	2006				2007				2008		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Average	9.1	8.5	8.2	8.3	8.5	8.0	8.0	8.6	9.6	10.4	11.3
Native born	8.6	8.0	7.7	7.7	7.8	7.3	7.4	8.0	8.7	9.3	10.2
Foreign born	12.3	12.0	10.9	12.0	12.6	12.0	11.8	12.4	14.7	16.5	17.4

Source: National Institute of Statistics, Labour Force Survey.

Modestly educated workers, who are in still large supply, still have high employment rates, relative to their more educated counterparts, in international comparison (OECD, 2007a).[23] But they are also seeing their employment prospects deteriorate relatively sharply. Indeed, past business cycles have been accompanied by much more marked increases in unemployment rates among unskilled workers than on average. Moreover, beyond the current downturn, construction, a significant employer of such workers, is unlikely to absorb many such workers in the years to come. At the same time, poverty is relatively marked among families with children in which at least one adult works (Table 1.4), reflecting both the still large supply of modestly educated workers and a

Table 1.4. **Relative poverty rates among households with a working individual,[1] 2006**

	All households:	
	without dependent children	with dependent children
Belgium	4	4
Germany	6	5
Greece	11	17
Spain	**6**	**14**
France	5	7
Italy	5	14
Portugal	11	12
Sweden	8	7
United Kingdom	6	10

1. Share of households earning less than 60% of household equivalised median income.

Source: Eurostat.

comparatively high tax burden on such families (Chapter 2).[24] Steps to reduce this tax burden could both alleviate poverty and strengthen employment prospects among workers with modest education.

Labour market segmentation between workers on temporary contracts, on the one hand, and workers with permanent contracts on the other hand, contributes importantly to limiting access of young workers – of whom many are now highly qualified – to jobs which are commensurate with their skills (see further below). The lack of access of young workers to housing binds them to the parental home and also contributes to the mismatch of their skills and those required by the jobs they hold.

Labour market policy thus faces the following challenges (Chapter 2):

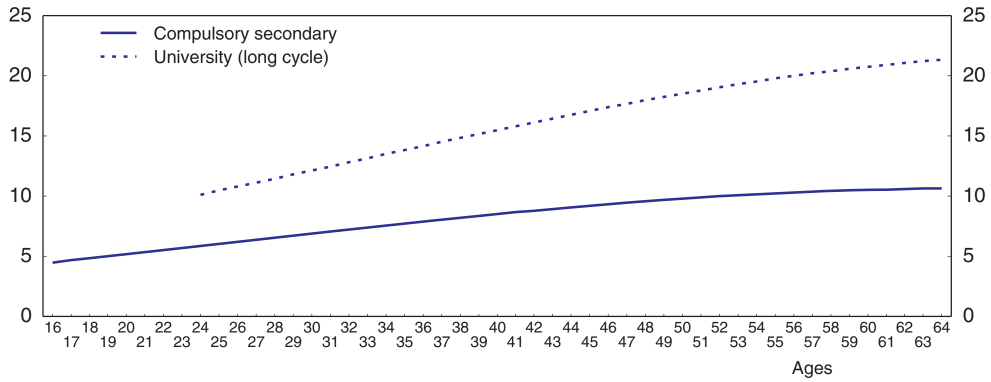
- Improve the placement of the unemployed in jobs. Experience across OECD countries shows that effective activation policies help make the labour market more resilient to adverse shocks. Activation policies rest on sound principles, but scope for improvement remains, especially with regard to low-skill workers and immigrants. Steps to improve employment incentives for low-skill workers can also help reduce poverty rates.
- Improve the matching of qualified workers to jobs. This requires a fundamental reform of employment protection legislation for incumbent workers. Measures have been taken to improve mobility of young students and workers, but housing policies need to be more consistently geared towards reducing impediments to mobility.

Rising education outcomes could make a bigger contribution to economic performance

Tertiary education attainment has risen dramatically over the past decade, with almost 40% of workers aged 25 to 35 possessing a tertiary degree, considerably more than in the OECD on average, and 20 percentage points more than among 45-to-55-year-olds. This vast increase in the supply of highly educated workers is much reinforced by the fact that the more educated young cohorts, who have entered the labour market recently or are about to enter it, are relatively numerous. Indeed, the age cohort of 25-to-34-year-olds is more than 43% larger than the age cohort of-50-to-59-year-olds.[25] The economy has not yet experienced all of the benefit of this huge inflow of highly qualified workers. Indeed, wages rise more strongly with experience for highly qualified workers than for poorly qualified workers (Figure 1.10). Moreover, this effect does not reflect cohort effects resulting from younger workers having lower returns to education but, instead, reflects steeper experience premia in the wages of tertiary graduates. Indeed, Table 1.7 shows that returns to tertiary education are not lower for young workers than for their older counterparts. This evidence suggests that their contribution to productivity growth has yet to be exhausted.

Figure 1.10. **Age-earnings profiles for university graduates and lower secondary graduates**

Euros per hour in 2005



Source: García Montalvo, J., J.M. Peiro and A. Soro Bonmatí (2006), *Los jóvenes y el mercado de trabajo de la España urbana: resultados del Observatorio de Inserción Laboral 2005.*

StatLink http://dx.doi.org/10.1787/486012011155

While steeper experience-earnings profiles are a feature also observed in other OECD countries, young workers' integration into the labour market is more difficult in Spain, with attendant productivity losses for the economy, given the relatively high educational attainment of young workers. The prospects for young people to gain access to occupations that reflect the skills they have acquired are poor. Only 40% of tertiary graduates aged 25-34 have access to professional and managerial positions, whereas this share reaches 60% for older graduates. This gap is much larger in Spain than in most other EU countries for which comparable data are available, whereas the share of middle-aged and older graduates in such positions is in line with the share observed in other EU countries, Other international comparisons provide similar results.[26] Access to positions with adequate skill requirements is equally difficult for young graduates from upper secondary education (Table 1.5, Panel A), even though the supply of such workers is low in international comparison (see further below), indicating that the mismatch between worker skills and job skill requirements does not reflect an oversupply of skilled workers. The share of qualified young workers whose skills are not fully utilised is much larger for workers on temporary contracts than for those on permanent contracts (Table 1.5, Panel B). Low age, temporary contracts and lack of geographical mobility have proven to contribute significantly to explaining the likelihood of over-qualification in econometric models. According to García Montalvo *et al.* (2006), workers aged 16-30 are more than 50% more likely to occupy jobs which underutilise their skills if they live at the parental home and more than twice as likely to occupy such jobs if they are on a temporary contract, controlling for other individual as well as job characteristics. The precarious work status to which young workers are subject may well compromise their earnings over their lifetime,

Table 1.5. **Match of worker qualifications and job qualification requirements, 2005**

	Panel A. By level of education		
	Lower secondary	Upper secondary	Higher
Broadly adequate	76.67	55.06	61.28
Job requires higher qualifications	2.78	1.83	0.91
Job requires lower qualifications	20.56	43.12	37.80

	Panel B. By type of contract	
	Permanent contract	Temporary contract
Broadly adequate	75.00	57.85
Job requires higher qualifications	2.25	1.88
Job requires lower qualifications	22.75	40.27

Note: The results relate to workers aged 16-30, the Survey was conducted in municipalities with a population of more than 50 000 inhabitants.
Source: Garcia Montalvo *et al.* (2006).

as there is some evidence to suggest that workers on temporary contracts are less likely to participate in employer-provided training activities (OECD, 2006). Reforms to raise worker mobility and lower the degree of labour market segmentation between holders of permanent and temporary contracts would help to make the most of the skill potential of highly educated young workers (Chapter 2).

A key priority for education policy is to lower the large inflow of unskilled youth into the labour market. As outlined in Chapter 3, the proportion of youth failing to complete lower secondary education is extremely high in international comparison, reaching 30%, and many of these youths are unlikely ever to attain upper secondary credentials. As a result, upper secondary graduation rates also remain low, especially for vocational degrees. The economic consequences in terms of employment and earnings prospects are severe. Indeed, the returns to education are particularly high in the vocational upper secondary pathway (Table 1.6), even though they have diminished for young workers.

Learning outcomes in compulsory schooling, as measured by PISA, are somewhat below OECD averages, especially in reading. However high school failure cannot be attributed to poor learning outcomes, as the distribution of these outcomes is relatively compressed, with the share of pupils attaining very low competencies not much higher than in other countries. While modest PISA performance can in part be attributed to relatively low educational attainment in the parental generation, considerable scope remains to improve education outcomes through further reform of the school system.

At the tertiary level, returns compare unfavourably with those of other OECD countries (Oliveira Martins *et al*, 2007). Returns to vocational education are lower than for university courses, although this difference is considerably less marked for workers who have received such education in more recent years (Table 1.6). However, tertiary graduation rates are particularly high in vocational courses, whereas they have stagnated in university education at a level below the OECD average of late.

Hence the challenges facing education policy are as follows:

- Reducing the large number of youths who leave schools without upper secondary education credentials.
- Improving learning outcomes of pupils in compulsory education.

Table 1.6. **Rates of return to education**

	Panel A. Taking into account the probability of employment	
	1995	2002
Lower secondary	2.61	2.71
Vocational upper secondary	13.55	14.32
Academic upper secondary	9.85	9.46
Vocational tertiary	–2.41	3.87
University short degree	15.65	11.64
University long degree	15.66	14.18

	Panel B. Evolution of returns by age group, conditional on being in employment		
	Age group 16-35		Age group 16-65
	1995	2002	2002
Lower secondary	–0.67	1.00	1.67
Vocational upper secondary	10.50	7.50	12.00
Academic upper secondary	11.71	6.57	10.57
Vocational tertiary	1.33	6.00	2.67
University short degree	8.29	8.57	8.86
University long degree	15.00	12.50	12.50

Note: Returns are per year of schooling completed relative to the educational phase that normally precedes it. For example, returns to tertiary degrees are based on gross hourly wage differences between tertiary degree holders and academic upper secondary degree holders. Income in case of non-employment is assumed to be zero. Earnings data are gross wages. Estimates are based on Mincerean wage equations and take into account only the opportunity costs of education resulting from forgone earnings. Panel A also takes into account the impact of education on the probability of employment.
Source: García Montalvo (2008).

- Raising the returns tertiary education generates for graduates in the form of higher earnings and employment outcomes.

Removing regulatory barriers to competition can raise productivity performance

Comparatively weak productivity growth has hindered convergence of living standards in Spain relative to the highest-income countries in the OECD. To a small extent, this weakness is accounted for by the expansion of construction activities, including related real estate services (Table 1.7). The rising share of construction in economy-wide value-added has damped aggregate productivity advances, as value-added per hour worked in construction is only about two thirds of the average level in the economy. However, this effect has been offset by the expansion of real estate services, where value

Table 1.7. **The impact of the expansion of construction sector activities on productivity growth**

Contribution to hourly productivity growth in sectors, in percentage points, yearly average, 1996 to 2005

	Within sector	Shift effect
Construction	–0.15	0.33
Real estate services	–0.55	0.51
Other sectors	n.r.	–0.50
Sum	–0.70	0.34

Note: n.r. = not relevant.
Source: *EU Klems database*, March 2008.

added per hour worked is several times the average level in market sectors. Overall, the shift effect between the construction-related sectors and other sectors of the economy is positive, albeit small. This finding corroborates recent comparative work on the impact of shifts in the composition of output on aggregate productivity in European countries and the United States, which suggests that such shifts have, overall, had a similar, small positive impact on productivity growth between 1995 and 2004 in Spain as in other OECD countries (van Ark *et al.*, 2008).

Both construction and real estate services have also exhibited negative productivity growth, with some impact on aggregate productivity growth. The decline in labour productivity growth in real estate services appears to be accounted for by an inflow of labour attracted by a steep increase in the prices charged for such services, which are likely to be linked to prices for real estate. Between 1996 and 2005 –0.7 percentage point of the weaker productivity growth performance *vis-à-vis* other European countries[27] is attributable to the negative within-sector productivity growth contributions in construction and in real estate services. The combined shift and within-sector effects of the construction-related sectors was almost -0.4%.

These special construction effects are unlikely to recur and will probably be reversed more quickly than they have built up, boosting productivity over the next few years, as residential construction contracts. However, even after making allowance for these special construction-related effects, productivity advances have been modest. This weakness is largely accounted for by a paucity of total factor productivity improvements. The accumulation of capital per hour of labour employed has also been somewhat slower than in other OECD countries (Table 1.8), especially with regard to equipment of workers with ICT capital goods. Moreover, the weakness in productivity growth cannot be attributed to a lack of accumulation or poor use of human capital. Indeed, changes in the skill composition of employment – as measured by the skill and age composition of workers, weighted by relative compensation levels[28] – appear to have contributed at least as much to hourly productivity growth, on average, as in other countries included in Table 1.8. This development reflects the large differences in educational attainment between workers who are retiring and those entering the labour market after completion of full-time

Table 1.8. **Accounting for labour productivity growth in Spain, European countries and the United States**

Market economy, annual average growth rates, in percentage points, 1995-2004

	Labour productivity	Labour productivity growth contributions from:			
		Labour composition	ICT capital per hour	Non-ICT capital per hour	MFP
Spain	**0.2**	**0.4**	**0.3**	**0.4**	**–0.9**
10 EU countries	1.5	0.2	0.5	0.5	0.3
United States	3.0	0.3	0.8	0.4	1.4

Note: Labour composition is measured as changes in the composition of employment across three education levels, three age groups and the two sexes. "ICT" is information and communications technology and includes information technology hardware, communication equipment and software. Non-ICT capital goods include machinery and equipment, transport and non-residential construction structures. The productivity contributions of an input are measured as the growth rate of the input, relative total hours worked, weighted by the appropriate income shares. MFP is the residual. The 10 European Union countries are Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Spain and United Kingdom. Numbers may not sum exactly due to rounding.
Source: van Ark *et al.* (2008).

education. However, as argued above, much scope remains to raise the productivity growth contribution from a highly educated workforce.

As noted above, sectoral reallocation effects cannot account for the relatively weak productivity growth performance in Spain. Moreover, in international comparison, the Spanish economy does not appear to be specialised in sectors in which productivity growth is low, except in those that are construction-related.[29] The causes for weak productivity growth must therefore be sought within sectors, including within those not related to construction. Table 1.9 below shows a comparison of within-sector productivity gains (after accounting for the contributions of the factor inputs listed in Table 1.8) in a wide range of sectors in Spain, the United States and selected European countries. Productivity gains in Spain have been weaker in many industries, in both manufacturing and services. In services, weak productivity growth has been remarkable in post and telecommunication services[30] as well as transport. In both post and telecommunications services and a few ICT-related manufacturing sectors included in electrical and optical equipment manufacturing, a part of the difference in productivity growth is accounted for by differences in the growth of implicit value-added deflators, which appear relatively large in Spain. In these sectors, price-measurement issues can also play a role, although the weight of these sectors in the economy is not significant enough to have a large impact on aggregate productivity performance. The productivity growth gap in wholesale and retail trade has a significant impact on economy-wide performance because of their large shares in total value added. The evidence from other OECD countries shows that easing restrictions on entry of large-scale retail outlets encourages more intensive use of information and communication technology and raises total factor productivity growth (van Ark *et al.*, 2008).

Table 1.9. **Differences in total factor productivity growth in selected sectors**

In percentage points, 1996-2005

	With respect to 10 EU countries[2]	With respect to the United States
Total manufacturing	–16.5	–56.9
Of which:		
Electrical and optical equipment	–53.0	–273.4
Electricity, gas and water supply	–1.9	11.4
Wholesale and retail trade	–14.0	–34.3
Hotels and restaurants	–9.7	–20.9
Transport and storage	–23.5	–28.6
Post and telecommunications	–75.7	–42.7
Renting of machinery and equipment and other business activities	2.5	–6.8

1. Total factor productivity is measured as indicated in Table 1.8.
2. The countries listed in the footnote of Table 1.8.
Source: EU Klems database.

Output per worker accelerated in 2006 and 2007, both in market services and in manufacturing, although this may largely reflect high capacity utilisation as the output gap peaked, although convergence of private sector R&D spending relative to GDP as well as patenting towards high-income countries in recent years may perhaps be interpreted as a sign of some improvement in underlying productivity performance, although the pace remains moderate and the performance gaps are still significant. Chapter 4 investigates how reforms designed to enhance competition and to improve product market regulation can contribute to raising productivity performance.

Notes

1. The house price index published by the Housing Ministry is based on estimates of market prices of professional estimators (*tasadores*), rather than transaction prices. An additional index has recently been introduced by the National Statistics Office, based on transaction prices, which shows a slight year-on-year decline in the second quarter (–0.2%)
2. The average duration of a residential construction project is two years according to BBVA (2007). Rodriguez López and Fellinger Jusué (2007) estimate an equation predicting changes in house prices as a function of changes in the housing stock and changes in the user cost of residential capital (net of tax and including backward-looking expectations term on house prices), which generates predictions of house price declines in real terms of between 1 and 3% in each of 2008 and 2009. However, this equation does not take into account the role that forward-looking expectations and credit conditions may play, and the resulting predictions are conditional on interest rates which are below levels observed in June 2008. Indeed, since variations in housing stock growth are small and changes in interest rates cannot be predicted, such equations cannot predict significant changes in house price growth.
3. See García Montalvo (2007). The relative weight of these variables depends on the period considered.
4. This demand could be somewhat stronger if the trend decline of household size towards levels in other European countries observed in recent years continues (Banco de España, 2008a).
5. This estimate covers domestic demand for second residences. The contribution of purchases from non-residents was estimated to be 30 000 in 2007 (Rodríguez López and Fellinger Jusué, 2007). Should housing starts throughout 2008 fall by 50% with respect to the previous year, the number of housing starts would reach 380 000. New homes will also need to cover depreciation of existing housing stock, which is estimated at about 56 000 a year (about 0.2% of the housing stock; Ministerio de Vivienda, 2008a), implying that the resulting net change in housing stock may be consistent with the demographic determinants of demand.
6. In MIIFR (2006) the housing stock in France was estimated at 516 per 1 000 inhabitants.
7. According to data provided by the Spanish housing ministry, about 3% of the housing stock is declared empty without being declared available for sale or renting, while another 3% is on offer for sale or renting without being declared occupied.
8. A share of 16% was cited in the 2007 *Economic Survey*, on the basis of the housing census in 2001, which appears to have been subject to statistical flaws.
9. The stock of new housing on offer was estimated to amount to 4.5 units per 1 000 inhabitants (Ministerio de Vivienda, 2008c).
10. The equilibrium price level can be assumed to be determined by approximate parity in tradables prices (net of taxes on goods and services purchased domestically), while prices in non-tradables would vary according to differences in productivity gaps between tradable and non-tradable sectors across countries. If differences in economy-wide productivity mostly result from differences in productivity in the tradables sector, there is a positive relationship between economy-wide productivity and the level of prices in all goods and services. See *e.g.* Obstfeld and Rogoff (1999). Moreover, differences in income per capita could influence price levels, as a result of imperfect competition in tradables markets, which may result in deviations from parity, for example, because producers charge higher prices in high-income countries. Figure 1.6 reports the residuals of a regression of the price level on variables capturing the influence of these variables on the price level.
11. The residuals reported in Figure 1.6 can give only a rough indication, in view of the fact that they are derived from an equation with unknown functional form. In particular, the relationship between economy-wide productivity and prices may well not be linear, for example, because countries with the highest average productivity may be more likely to have competition-friendly regulation in non-tradable goods and services markets, which would *lower* their relative prices. To account for such non-linearities, a squared productivity term was introduced. Hours worked per population was included to control for differences in income levels, which may be correlated with price levels because of imperfect competition and price discrimination in tradable goods markets. Also, since purchasing power adjustments are made on both sides of the equation, measurement

errors in these could bias the productivity coefficient. Instrumenting productivity on educational attainment and introducing product market regulation indicators in the equation did not change the results with respect to Spain's position much (which is not true for all other countries). All variables are expressed relative to the United States. The regression was run for all OECD countries for which data were available.

12. Additional stimulus measures include, *inter alia*, increased social assistance to people who have recently become unemployed, fiscal incentives to the rehabilitation of housing and additional guarantees for loans to small and medium-sized enterprises.
13. The 2008 budget outcome is affected by negative one-off effects on government revenues, related to changes in VAT repayments to enterprises and accounting changes in corporate taxation, amounting to 0.6% of GDP.
14. The ceiling includes an allowance for infrastructure and R&D spending. See OECD (2007b).
15. This assumes that real GDP growth will remain below 2% in 2011. If growth is higher, the budget is required to reach balance.
16. Declining inflation may also reduce revenue growth through slower bracket creep, but this effect is already being offset by partial indexation of tax brackets (see the 2007 *Economic Survey*).
17. IMF (2008) reaches similar conclusions, with the comparison of market share developments covering other south European countries, notably Portugal and Greece.
18. Demographic developments have also sustained Spain's relative export performance, with population of working age growing more strongly than in the other countries. However, these cannot fully account for the relatively favourable outcomes. Population of working age grew at a rate similar to Spain's in the United States, but 0.7 percentage point faster per year than in the United Kingdom and 1.5 points faster than in Germany or Italy.
19. The export price index has risen by about 20% since 1998, compared to 10% in Germany, whereas it has stagnated in France. Very strong export price growth was, however, also registered in Italy (Banco de España, 2008c).
20. These include "statistical" provisions, which have to be calculated on the basis of fixed percentages for each asset class, with each percentage representing the net specific provisioning that has historically been necessary, on average over the cycle, for specific provisions. The statistical provision is charged if it exceeds specific provisioning. If specific provisioning exceeds the statistical provisioning required, accumulated statistical provisions can be lowered. See, for example, Mann and Michael (2002).
21. There is clear evidence of significant house-price overvaluation, with an estimated range of 24 to 31% in 2004, as quoted in Girouard *et al.* (2006b). This may have risen further by 2007.
22. According to the Labour Force Survey, the increase in the stock of foreign nationals in the population of working age did not decelerate significantly up to the first quarter 2008.
23. To some extent, however, this is due to the age composition of the population, as young worker cohorts are numerous and unskilled workers' employment rates drop off sharply with age.
24. Cash benefits and tax breaks for families were worth 0.5% of GDP in Spain in 2003, while they reach or exceed 1.5% in most high-income OECD countries, according to the OECD Family database.
25. This is according to population estimates of the National Statistics Institute. Less than half of the difference is accounted for by immigrants (and these are included in educational attainment statistics).
26. See Eurostat (2005) An analysis of careers of tertiary graduates in 1999, cited in García Montalvo *et al.* (2006), indicates that 18% of Spanish university graduates were employed in positions which did not require tertiary-level skills, compared to 8% in 10 EU countries.
27. In EU countries, average productivity growth in construction and real estate services was close to zero between 1996 and 2005.
28. The skill composition variable distinguishes three different education levels.
29. Between 1995 and 2005 the sum of the productivity growth contributions of all market economy sectors does not change significantly if they are weighted by their shares in value added observed in 15 EU countries rather than by their actual shares.
30. In both post and telecommunications services and a few ICT-related manufacturing sectors included in electrical and optical equipment manufacturing, a part of the difference in

productivity growth is accounted for by differences in the growth of implicit value added deflators, which appears relatively high in Spain. In these sectors, price measurement issues can also play a significant role.

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ANNEX 1.A1

Progress in structural reforms

This annex 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 2006
Managing fiscal policy in the medium and long term	
Incorporate a more systematic inflation adjustment of the tax brackets and allowances in the income tax code.	In 2008, tax brackets and personal and family allowances were indexed to an inflation target of 2%.
Reconsider the tax incentives for private pension plans.	None.
Improve co-operation between fiscal and police authorities to increase the effectiveness of tax-fraud investigations.	None.
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.	The evaluation agency is required to make the results of its analysis available to the general public.
Develop a comprehensive strategy to tackle future deficits in the pension system and raise incentives to work at old age, including parametric reform, for example by increasing the contribution period to qualify for a full pension and basing benefits on life-time earnings ,as well as raising public savings.	None.
Encourage the disabled to return to work by introducing invalidity in-work benefits. Consider extending the employer-paid sickness period.	In-work allowances for active disabled workers were increased in 2008.
In the new Fiscal Stability Law, set thresholds on economic growth used to determine government balance requirements at the national and sub-national levels relative to potential output growth, and have a reputable, impartial entity compute it. Avoid a too mechanical implementation of the law, which could result in a pro-cyclical budgetary outcome. Avoid favouring tangible over other forms of productivity-enhancing expenditure resulting from the exceptional exclusion of increases in public investment.	None since the introduction of the Fiscal Stability Law.
Base spending caps set in the central government's budgetary process on estimated potential GDP.	None.
When designing the fiscal strategy, keep using a prudent assessment of future macroeconomic conditions. Investigate the reasons behind the large tax elasticity observed in recent years.	None.
Public sector reform	
Improve transparency of sub-national government budgets and audit them by an independent body to avoid the expansion of off-budget operations through public enterprises.	In 2007 a stocktaking of all entities that depend on the regional governments was published.
Ensure that the regional financing mechanism does not unduly increase the central government's burden, and make sure that it is 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.	None.

Recommendations in previous *Survey*	Action taken since December 2006
Develop benchmarking for services provided by sub-national governments, including in regional hospitals, and make results public. Promote the sharing of experience among these governments. Relax the obligation for regional governments to spend a minimum amount on health care.	A report issued by a working group (with government participation) on the analysis of health care expenditure includes a benchmarking exercise on health care spending and on measures taken to control health care spending.
Avoid using earmarked grants or at least increase transparency on the amounts and criteria used to allocate them across regions.	None, although earmarked grants are a small share of regional financing in international comparison.
Reduce the bias in favour of less developed regions in allocating central government investment. Use more effective instruments in supporting poor regions' growth potential, such as education policies.	None.
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	
Phase out the deductibility of mortgage payments from taxation.	Maximum thresholds for deductible mortgage payments are not adjusted for inflation.
Improve the legal security in the landlord-tenant relationship.	Six new judicial courts have been opened in areas where the number of eviction processes is high.
In the medium term, evaluate the need for the public rental agency. Reassess the existing rent assistance programmes. Revise the cost-effectiveness of the system of social housing, relying on a system of vouchers for disadvantaged groups.	An evaluation of the public rental agency is planned, and rent assistance programmes will be revised in the new housing plan 2009-12.
Increase the resilience of the economy	
Reform the collective bargaining system by allowing firms to opt out of regional and/or sectoral outcomes. Eliminate *ex post* indexation clauses linking wage growth to inflation.	None.
Increase incentives to reduce the energy content of production.	Industrial sectors covered by the European Directive comply with GHG emission limits and operate in the European Trading System.
Strengthen innovation policy	
Allow more than one government-backed project per principal researcher.	None.
Improve the budgetary, managerial and administrative independence of public research centres.	A new law has been approved (*Ley de Agencias*) that facilitates the management of public research centres, giving them more autonomy.
Improve the quality of public sector research by raising researchers' remuneration and basing their recruitment to a greater degree on evaluation.	The Ministry of Science and Innovation is currently developing a researcher career path that will reward quality. The government intends to significantly increase researchers' remuneration.
Improve co-ordination among innovation-oriented programmes within central government and among the regions so as to facilitate access to information by firms, and particularly SMEs.	Initiatives taken include the setting up of electronic information access points for all information on R&D support programmes.
Assess the various incentives aimed at encouraging private research and innovation expenditure and at diffusing ICTs.	A programme was launched to evaluate all R&D initiatives in the INGENIO programme. A new scheme was launched (AVANZA) to foster catch-up in use of ICT technologies.
Strengthen higher level education	
Improve statistical information on the functioning and results of universities as well as dissemination.	ANECA will work with universities to set up evaluation schemes.
Place more weight to applied research and technology transfers to firms in the researcher assessment system, and apply it to non-civil-servant researchers. Publish the results of the national quality agencies' assessments on a regular and comprehensive basis.	With the 2007 University Law, applied research and technology becomes a main function of universities.
Strengthen the system of income-contingent loans for students. Raise university spending per student, financed partly by raising tuition fees. Link university funding to performance.	In 2007 such loans were introduced for postgraduate studies.
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.	Professors can take sabbaticals to work at firms. Universities are allowed to create joint research institutes with firms.

Recommendations in previous *Survey*	**Action taken since December 2006**
Introduce joint public-private financing of training projects.	None.
Improve the framework conditions for entrepreneurship	
Reduce the regulatory obstacles to institutional investors' participation in venture-capital companies.	None.
Consider the introduction of a single work contract with moderate increases in severance payments according to length of service. Step up activation measures in exchange for less protection of permanent employment. Reduce the uncertainty in the application of EPL and the obstacles to the mobility of workers.	None.
Labour market issues	
Continuous evaluation of ALMPs should be independent and provide feedback for improving measures.	A new framework for evaluation of ALMPs is in place, an external evaluation of public employment services will be done every three years, and internal evaluations will be conducted yearly.
Restrict eligibility conditions for subsidies for unemployed rural workers to enhance regional labour mobility.	None.
In order to raise female participation, increase day care facilities for young children and health- and home-care provision for dependent elderly.	A new system of public support for elderly dependents is gradually being implemented in co-operation with regional authorities.
Improving the functioning of product markets	
Adopt the draft reform of general competition law, in particular the leniency programme.	Implemented.
Raise the independence of sectoral regulatory bodies.	None.
Be more active in assessing the impact on competition of certain sectoral regulations, as in professional services.	The regulation of professional services is partially affected by the implementation of the European Services Directive. Evaluation of additional professional services regulations is currently under way.
Reduce the market power of the vertically integrated electricity companies. Eliminate barriers to the establishment of new firms, including foreign ones. Encourage the use of forward bilateral contracts. Adjust tariffs in a more transparent and rapid way on the basis of production costs.	Virtual power plant auctions have taken place since mid-2007 and the use of bilateral contracts has increased. Tariffs (net of transport costs) reflect wholesale electricity prices and are updated on a quarterly basis.
Lower the ceiling on the *gas companies'* stake in *Enagas* Encourage the emergence of a secondary wholesale gas market.	The first auction to allocate gas storage capacity took place in April 2008. Storage capacity can be sold in a secondary market on a bilateral basis.
Give the telecommunications regulator responsibility for consumer protection.	None.
Implement the European directive on services to reduce the regional barriers to new hypermarkets. Relax regional regulations, at least the criteria for defining a hypermarket, to which special license requirements are attached. Remove local obstacles to the opening of petrol stations in super- and hyper-markets.	The European Services Directive is being implemented. As a result, some regional barriers to new hypermarkets are likely to be dismantled, and other barriers will be replaced by less restrictive measures.
Amend the excessive and sometimes discriminatory restrictions in the *pharmacies* sector.	None.
Make the tender of freight and regional passenger transportation services compulsory.	None.
Abolish the remaining unwarranted constraints involved in obtaining a *road freight haulage* operating license.	Geographic barriers to operating licenses were abolished.
Remove the import restrictions on *cement*.	None.
In *public procurement*, take active steps to strengthen the Internet portal so as to reduce management costs and improve transparency. Lower the thresholds making open public tenders obligatory.	New regulation on public procurement increases the use of electronic procedures to rationalise costs and speed up tenders.
Further liberalise postal services.	A new independent regulatory body, the *Comisión Nacional del Sector Postal*, was created.

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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Spain were reviewed by the Committee on 29 September 2008. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 13 October 2008.

The Secretariat's draft report was prepared for the Committee by Andrés Fuentes and Eduardo Camero under the supervision of Peter Jarrett. Research assistance was provided by Sylvie Foucher-Hantala and Cristiano Cantore.

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BASIC STATISTICS OF SPAIN (2007)

THE LAND

Area (1 000 km^2)		Major cities (thousand inhabitants)	
Total	506.0	Madrid	3 132
Cultivated (2005)	178.4	Barcelona	1 595
		Valencia	798
		Seville	699

THE PEOPLE

In thousands		Employment (thousands)	20 356
Population	45 283	Employment by sector (% of total)	
Net natural increase	79	Agriculture	4.5
Net migration (2006)	834	Industry	16.0
Number of inhabitants per km^2	89.5	Construction	13.3
		Services	66.2

PRODUCTION

Gross domestic product (GDP)		Gross fixed capital investment	
Million €	1 050 595	% of GDP	29.5
Per head in $	23 413	Per head in $	7 260

THE GOVERNMENT

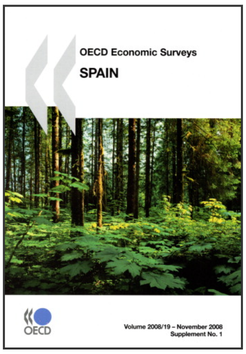
% of GDP		Composition of Parliament (seats in March 2008)	350
Consumption spending	18.3	Spanish Labour Socialist Party (PSOE)	169
Revenues	40.6	Popular Party (PP)	154
Budget balance	2.2	Convergence and Union (CIU)	10
Fixed investment		Republican Left of Cataluña (ERC)	3
(% of gross fixed capital formation)	12.4	Basque Nationalist Party (PNV)	6
		United Left (IU)	2
		Other	6
		Next general elections: 2012	

FOREIGN TRADE

Exports of goods and services (% of GDP)	26.5	Imports of goods and services (% of GDP)	33.3
Exports as a % of total goods exports		Imports as a % of total goods imports	
Foodstuffs	11.4	Foodstuffs	5.7
Other consumer goods	25.4	Other consumer goods	21.8
Energy	3.6	Energy	14.9
Other intermediate goods	50.0	Other intermediate goods	47.4
Capital goods	9.6	Capital goods	10.3

THE CURRENCY

Monetary unit: Euro		Currency units per $, average of daily figures	
		Year 2007	0.730
		September 2008	0.697



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