

El Matador: A comeback?

The Spanish Economy: Opportunities for Investment and Challenges



Executive Summary

Labor

Unemployment remains a big concern in Spain with unemployment rate at **23.7%** in the last quarter of 2014 (10.93% is the historical average). Youth unemployment remains at extreme levels: **50.7%** in the most recent quarter. Accession rate remains low at **3.98%**, indicating long unemployment periods and poor matching efficiency.

Capital

Real capital stock of Spain is less than half of some of its peers such as Japan, but is growing faster. Strong capital growth has been mitigating the effects of labor growth stagnation. With room for future investment, capital growth will continue to have positive impacts on short-term GDP growth, but will become less important over time.

Institutions

Spain has shown improvements in quality of institutions and policies but is still a laggard in the world bank doing business rankings. “Starting a business” rank (2015): **74** and “doing business in” rank (2015): **33**. Improvements in institutional quality will drive stronger labor and TFP growth.

Trade

Machinery and automobiles form a large share of Spain’s exports at **23%**. Two thirds of all trading activities take place within the EU. China remains the largest Non-EU trading partner. Expanding Spain’s trading network and improving efficiency with current partners will support future GDP growth.

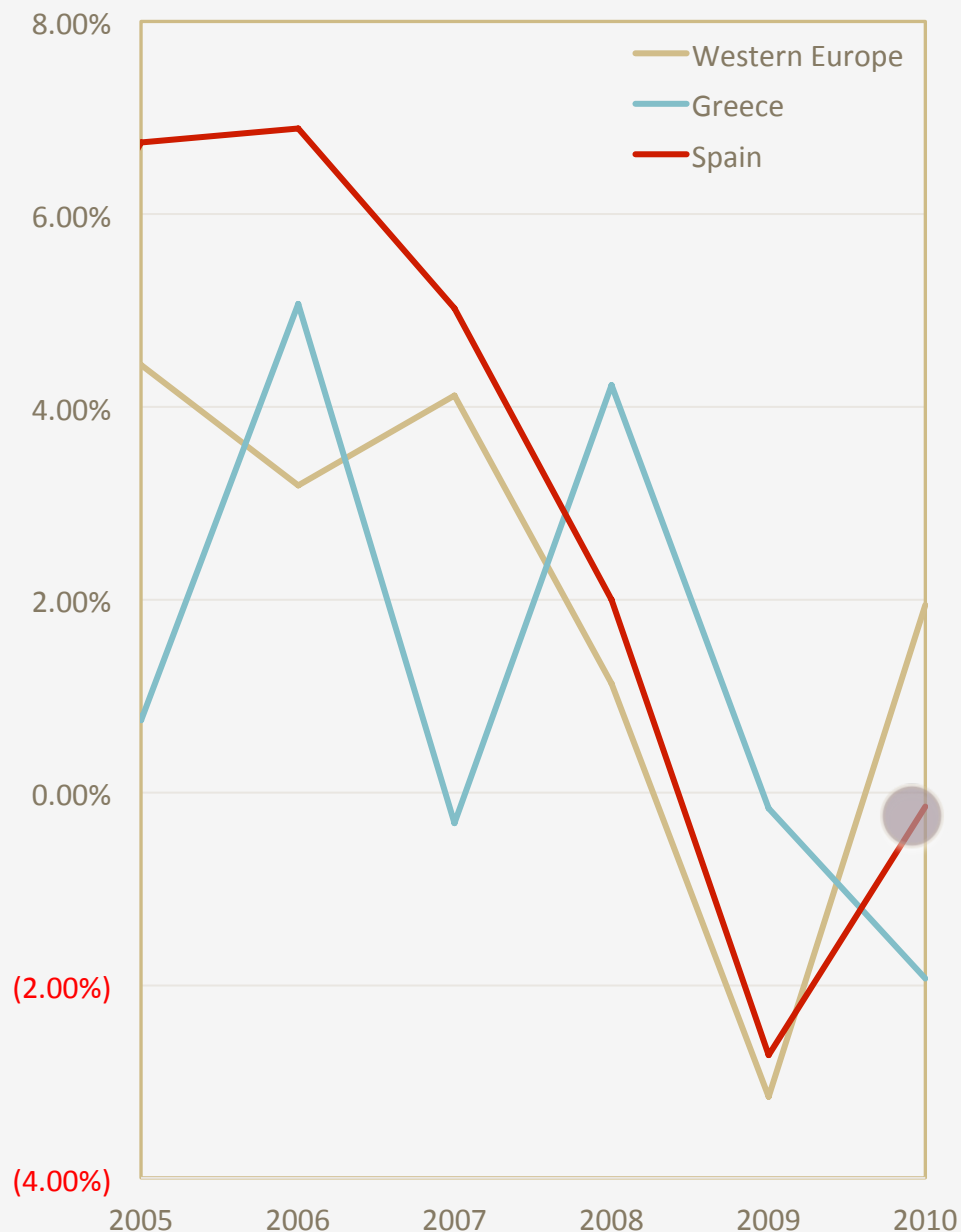
GDP Growth Accounting

Summary of Spain's GDP Growth Accounting

Timeframe		Y/N Growth	L/N Growth	TFP Growth	K/L Growth
1961	1971	5.49%	(0.22%)	3.61%	2.41%
1971	1981	2.54%	(1.79%)	0.62%	3.38%
1981	1991	2.38%	1.00%	1.23%	0.15%
1991	2001	4.24%	1.54%	2.28%	0.43%
2001	2011	1.29%	(0.39%)	(1.23%)	2.91%
Long-run		3.19%	0.03%	1.30%	1.86%

1961 – 2001: Despite political turmoil, Spain has had strong GDP growth relative to richer European countries. TFP and capital growth have been the primary long-run drivers. Labor participation growth has been stagnant.

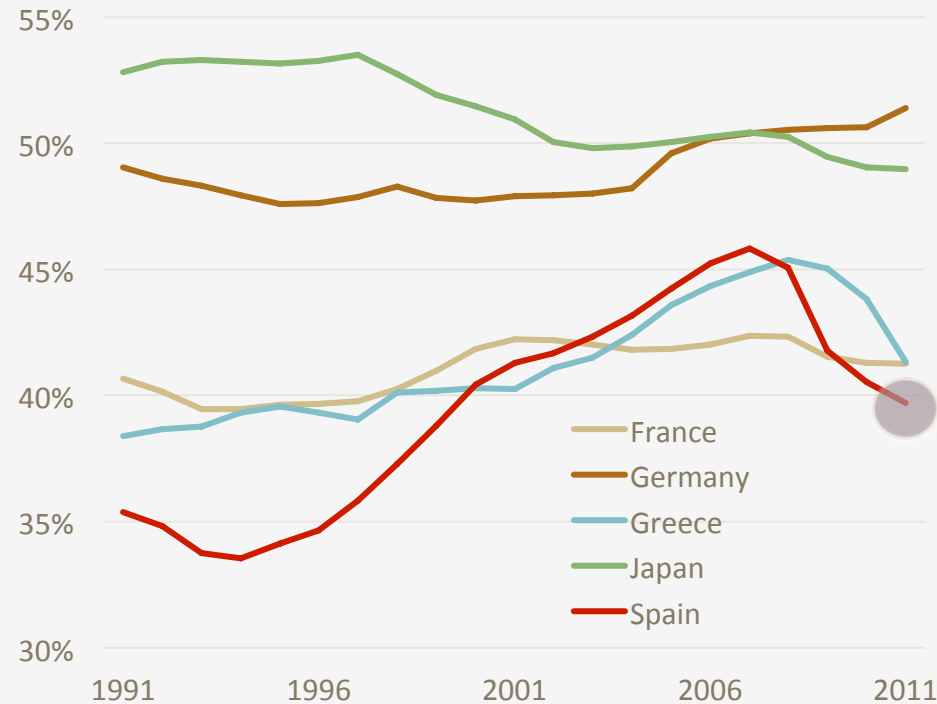
2001 – 2011: Despite boom years in 2004-2006, the decade saw two recessions and recovery has been weaker than that of other Western European economies.



Growth Accounting

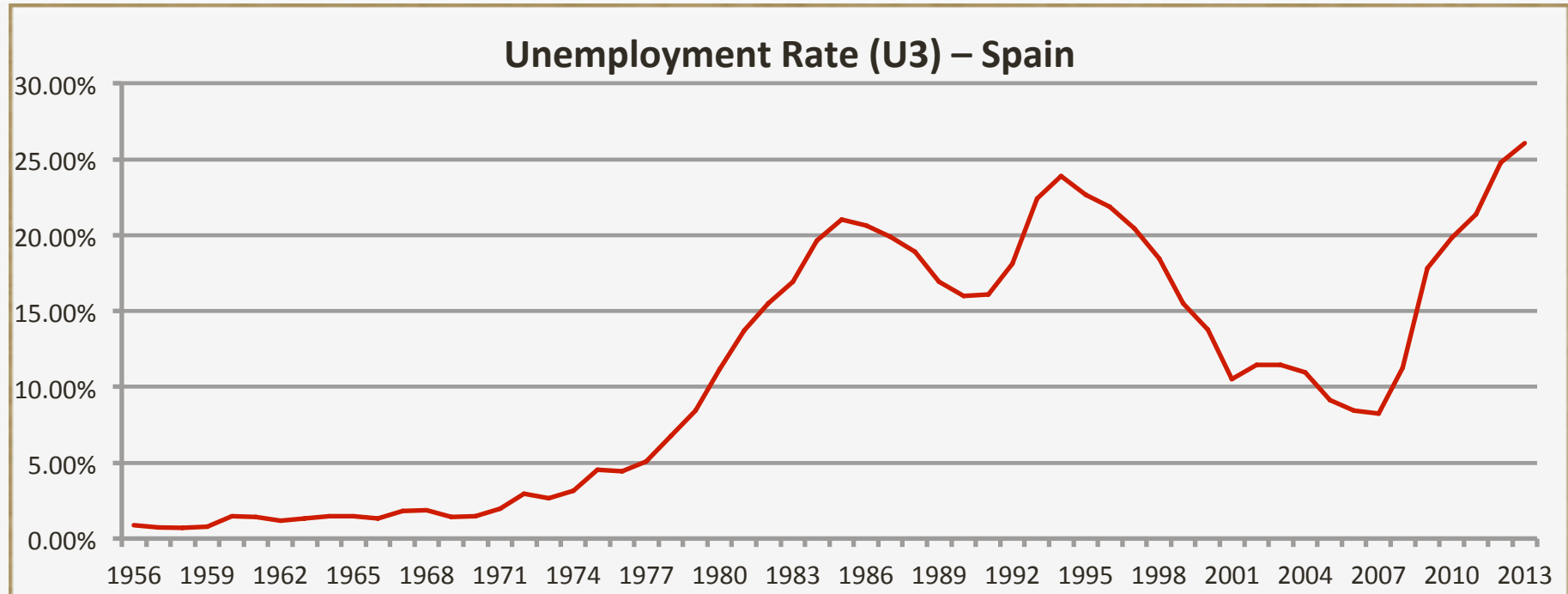
Post-Recession Comparisons

- Unemployment is dragging on GDP growth across Europe, but is significantly worse in Spain (and Greece).
- Higher Capital/Labor ratio reflects significant capital investment (steady state capital ~\$7 trillion) combined with weak labor numbers.
- TFP is contributing to growth, giving some hope for recovery.
- Still better off than Greece due to stronger capital and TFP growth.
- **Conclusion:** Large labor market contraction is the primary constraint on GDP growth.



	Annual Growth Rates 2008-2011			
	Y/N	L/N	TFP	K/L
Spain	(1.89%)	(4.22%)	0.64%	5.06%
Greece	(3.36%)	(3.12%)	(0.86%)	1.85%
Germany	0.32%	0.57%	(0.45%)	0.59%
France	0.15%	(0.86%)	0.09%	2.76%
Japan	(0.46%)	(0.86%)	0.30%	0.31%

Effects of Unemployment



Steady State Unemployment

Accession Rate (newly employed): $a = 3.98\%$

Separation Rate (newly unemployed): $s = 2.03\%$

Steady state unemployment: $u_{ss} = s/(a+s)$

Spain $u_{ss} = 2.03\%/6.01\% = \mathbf{33.78\%}$

Duration of Employment: $1/s = 49$ months

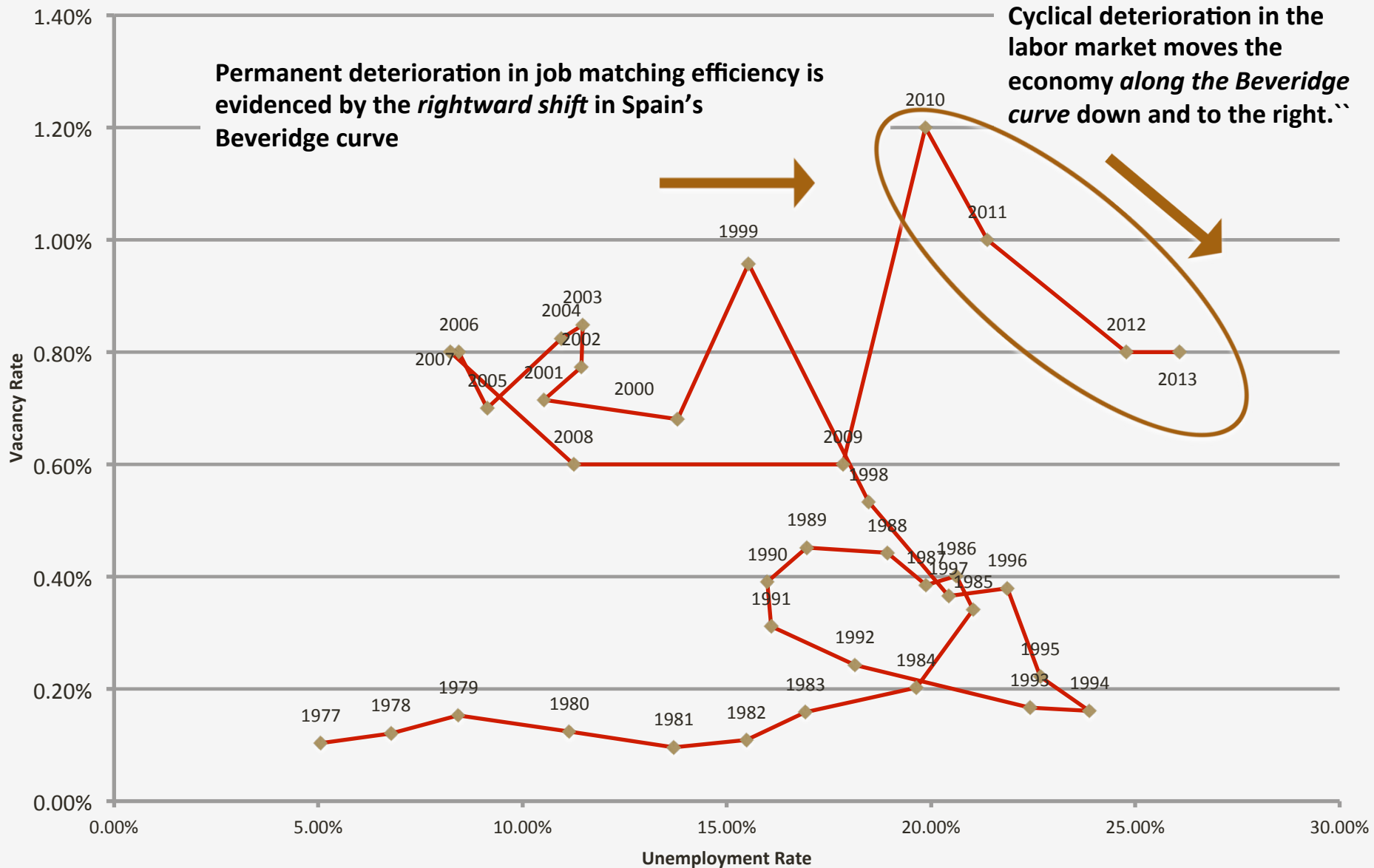
Duration of Unemployment: $1/a = \mathbf{25}$ months

Data from: Federal Reserve Bank of New York Staff Reports, "Job Finding and Separation Rates in the OECD". Staff Report no. 298, August 2007.

▪ **Unemployment at 34% will be a reality without improvement in accession rate**

- Avg accession rate in OECD countries = 13.69% (2007)
- Spain's 3.98% accession rate suggests it is difficult to get a job → higher "natural" unemployment rate → longer durations of unemployment
- Avg separation rate across 23 OECD countries = 1.23%
- At 2.03%, it is easier to lose a job in Spain, which leads to higher steady state unemployment and shorter duration of employment

Spain Beveridge Curve 1977-2013



Institutional Quality Assessment : Spain

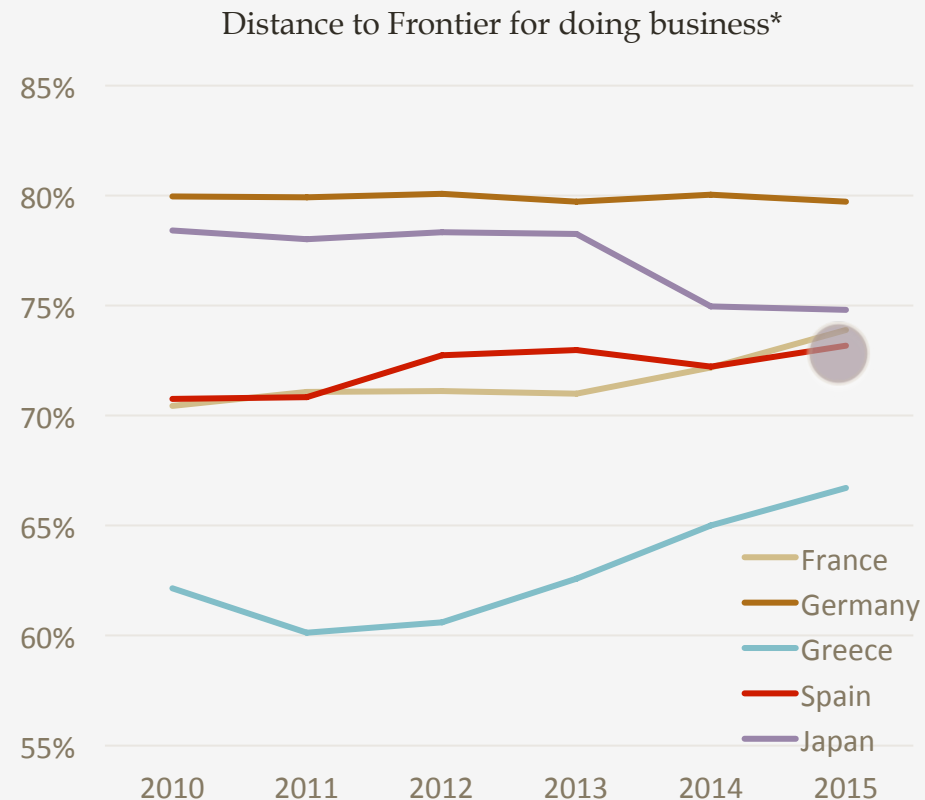
Spain has shown progress over the last 5 years in improving conditions for doing business through reforms:

- **Starting a business:** Introduced an electronic system linking public agencies simplifying business registration. Reduced the cost to start a business by decreasing the minimum capital requirement.
- **Registering Property:** Made transferring property easier by reducing the property transfer tax rate.
- **Resolving Insolvency:** Made easier by introducing new rules for out-of-court restructuring and workouts. Amended its regulations with the aim of reducing the cost and time.

According to the *Doing Business* in website:

Improvements in institutional quality by decreasing its distance to frontier over the last 5 years, however there is room for improvement:

- Doing business 2015 rank: **33**
- Doing business Distance to Frontier* (% points): **73.17**
- Starting a Business rank: **74**
- New Business density: **2.71** (U.K: 11.04, France 2.88)
- Number of new Limited liability companies: **84399**



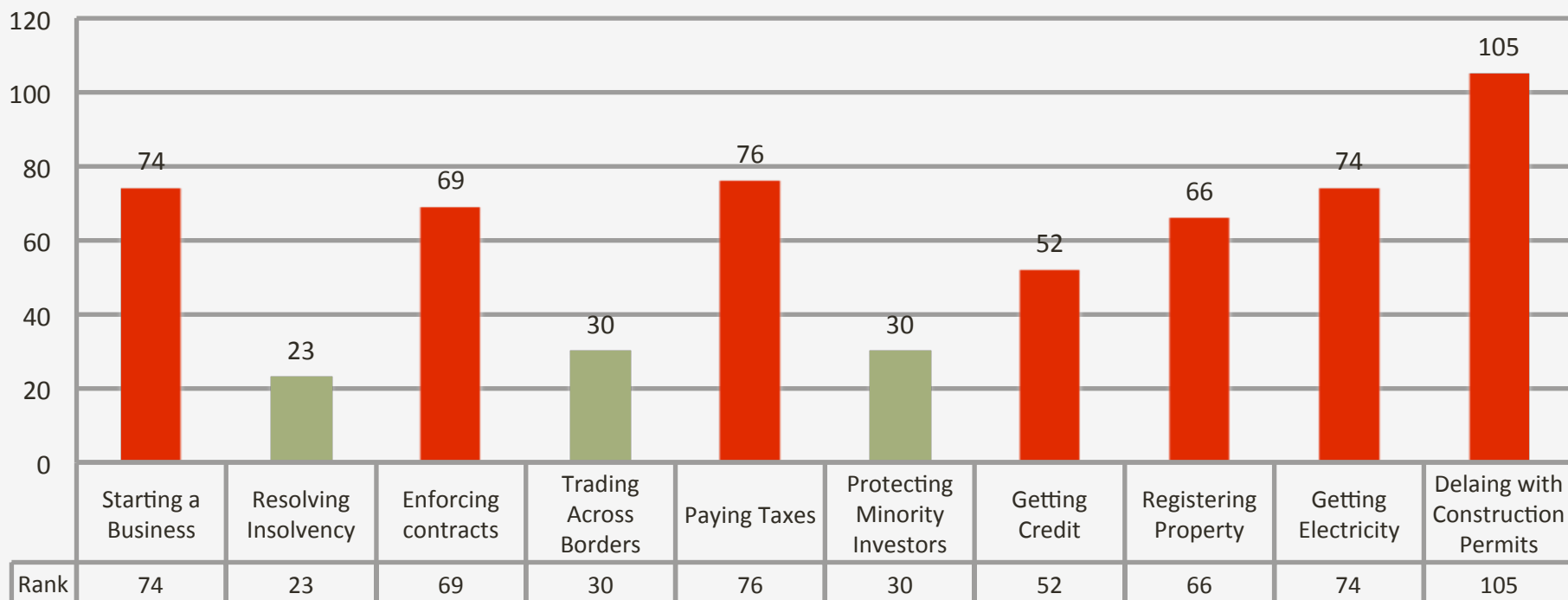
Institutional Quality: Areas of Improvement

Doing Business Rank in the middle of it's peer group (33). Germany (14) , United States (7), France (31), Italy (56), Greece (61). Need to address issues around: starting a business (74), construction permits (105), taxes (76), enforcing contracts (69), getting electricity(74) and getting credit (52).

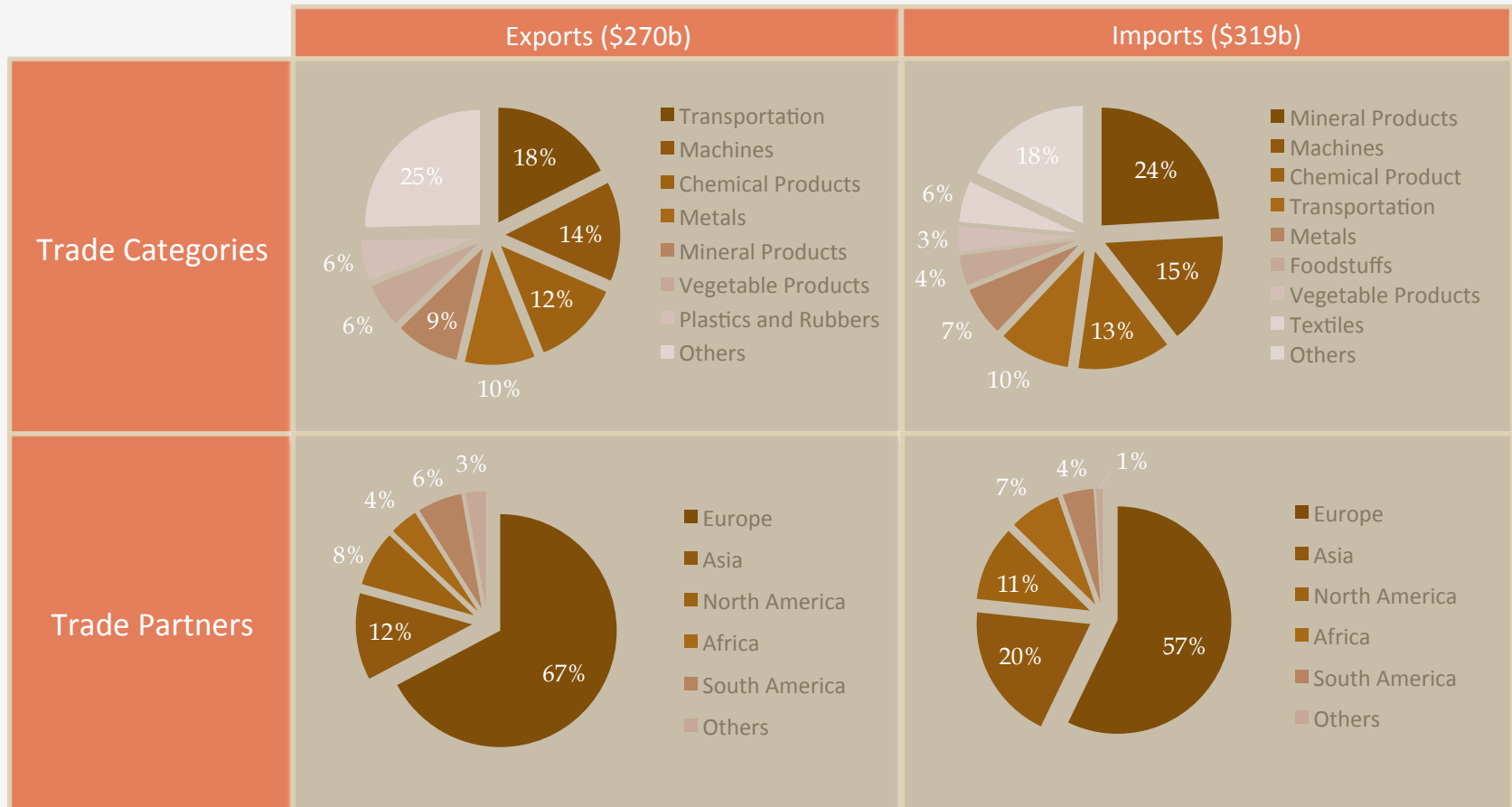
Other areas to improve on:

- Number of procedures required (6.0), OECD average (4.8)
- Time to Register a Business (13.0,) OECD average (9.2)
- Cost as a % of Income per Capita (4.6), OECD average (3.4)

Rankings on Doing Business



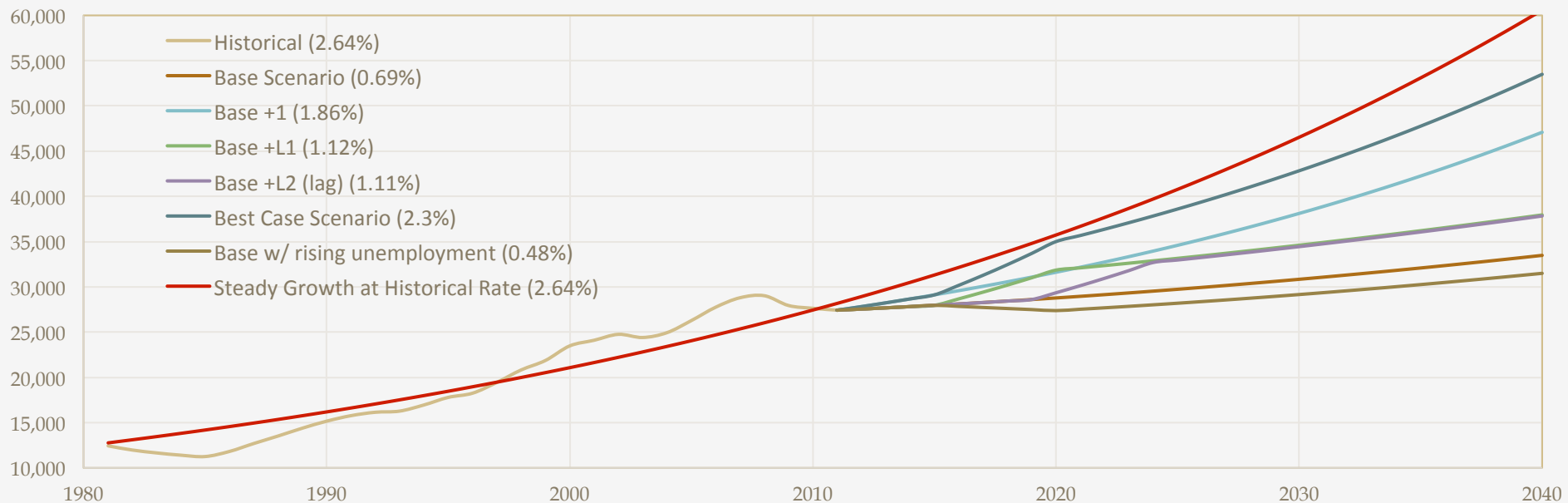
Trade Partners



- 18% of Spain exports are transportation of unrelated products such as cars, which represents around 9% of total exports. Second most exported category is machines standing at 14%.
- As for imports, around a quarter of Spain's imports are Mineral Products, such as crude and refined petroleum and gas.
- Almost two thirds of Spain's trade activities are with EU countries. France is the leading export partner commanding 15% of Spain's exports followed by Germany at 10%.
- Spain imports 11% from France and 11% from Germany. Spain imports 7% from China, the largest Non-EU trade partner.

GDP per Capita Growth Model Scenarios

- **Base (Historical Data):** Population growth = 0.69% TFP growth = 0.76% Investment rate = 23.49% Depreciation rate = 4.5%.
- **Base +1:** Base case +1% addition to TFP growth.
- **Base +L1:** Base case plus labor reform resulting in return to historical long-run unemployment rate of 10.93% over 5 years, effective immediately.
- **Base +L2 (Lag):** L1 case, but assuming 5 year lag between reform and initial effects on unemployment rates.
- **Best Case:** Combination of optimistic TFP growth (Base +1) and immediate labor reform (Base +L1).
- **Worse Case:** Base case assuming unemployment rates drop to steady state unemployment of 33.78% over next 5 years.
- **Optimistic growth rate: 2.3%. Pessimistic growth rate: 0.48%. Average of growth rate scenarios = 0.94%. Historical: 2.64%.**
- **Conclusion: Historical growth rate outperforms all projection scenarios. 25-year projections are weak at best.**



Recommendations

Labor

- Strengthen active labor market policies by improving vocational training, and strengthening of public employment services
- Improve innovation and increase spending in research and development and funding to universities

Institutions

- Focus on reducing red-tape and time taken to get permits and cost of permits.
- Access to financial capital needs to improve with a focus on lending to small businesses

**DO NOT
INVEST**

Trade

- Invest in improving competitiveness in export of machinery and automobiles, and expand beyond EU trading partners
- Falling oil prices should help reduce import bill and improve current account surplus shown since 2014

Capital

- Continue to invest in growing the capital stock, which is currently lower than some of its peers such as Japan
- Given high levels of government debt, private investments in capital stock is needed