

The report by the BBVA Foundation and the Ivie on growth and competitiveness (Informe Fundación BBVA-Ivie 2011 sobre crecimiento y competitividad) proposes a route map for Spain's economic recovery

Spain needs a stronger climate of social consensus to achieve growth based on employment, education and innovative entrepreneurship

- Spain has the strengths on hand to fuel recovery: a large stock of private capital and infrastructure, skilled human resources, leading companies in a wide range of sectors enjoying a solid position in world markets, and the welfare state of a developed European nation
- Its growth pattern, however, suffers from important weaknesses: high unemployment among young people and low skilled workers, slow-growing productivity, high private-sector indebtedness and large external and public deficits
- The Report proposes urgent changes in numerous areas while identifying five structural objectives: a change in productive specialization, the strengthening of business competitiveness, education and labor market reform, a return to normal functioning in the banking sector and the redrawing of key public policies
- Companies, the public sector and the banking sector will form the core of the reform process. The Report sets out 62 proposals, which immediate adoption will ensure their effects are noted sooner rather than later
- The Report warns that recovery will be slower and more painful without a social climate of trust and cooperation. It calls for a consensus on basic issues, encouragement of a culture of hard work, the defense of fair play and greater transparency in companies and institutions

Madrid, July 12, 2011.- Spain needs a root-and-branch modernization of its productive structure if it is to claim its place in the global economy and resume long-term growth along sustainable lines. Growth drivers will be those already deployed with success in other developed countries: improved efficiency, innovation, and the intense use of knowledge assets.

These are among the conclusions of the *BBVA Foundation-Ivie 2011 Report on growth and competitiveness of the Spanish economy* (Informe Fundación BBVA-Ivie 2011 sobre crecimiento y competitividad), which presents the results

of a broad-ranging research project on the performance of the Spanish economy from 1995 to the present day, and puts forward 62 measures to restore growth and embark on a new development stage that offers society new opportunities for progress. It is authored by a ten-strong team from the Valencian Economic Research Institute (Ivie), including four professors from the University of Valencia, under the leadership of Francisco Pérez, professor at the above university and also the Ivie's research director.

The report is a product of the Economic Research Program run jointly by the BBVA Foundation and Ivie over the past fifteen years to analyze the situation of Spanish economy and makes proposals for its improvement. The Program takes a long-term perspective, focusing on the pattern of Spain's growth and its place in the global economy, and has generated to date over fifty monographs.

The BBVA Foundation-Ivie 2011 report on growth and competitiveness examines the performance of the Spanish economy since 1995, a period characterized by some remarkable achievements but also major imbalances, many of them due to its **deficient adaptation to the new international environment**. Today's world economy is the result of an intense transformation fuelled by the entry of new competitors – the emerging nations – the advance of information and communication technologies (ICTs), gathering international integration, and globalization, which requires firms and countries to continually adapt their performance.

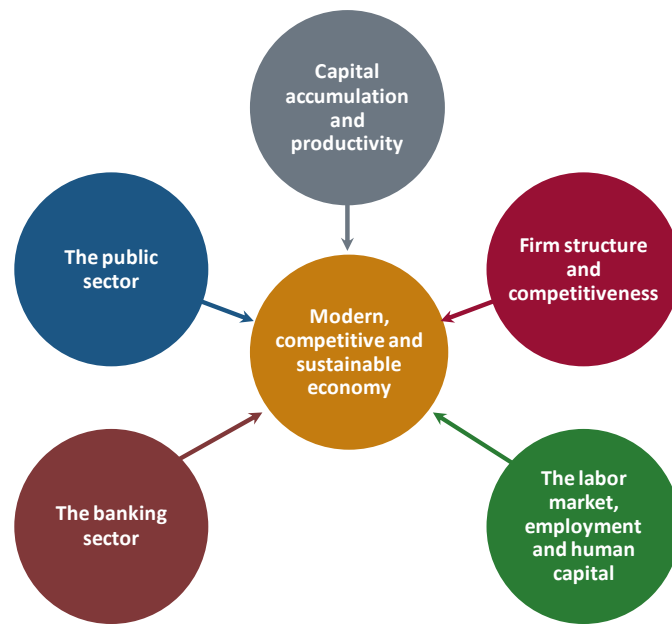
Strengths and weaknesses

Spain's position in the current economic map displays important strengths but also worrying weaknesses. Among its **strengths**, the Report highlights a large stock of private capital and infrastructures; a considerable advance in the quality of its human resources and the entry of university graduates in the corporate sector; the competitiveness of its exporters; the consolidation of an important group of Spanish multinationals, both financial and non financial, at the forefront of their sectors; and the development of a modern welfare state that provides ample coverage across many services, and plays a vital stabilizing role both socially and economically.

The report lists its main **weaknesses** as slow-growing productivity; a hefty external deficit; the predominance of micro enterprises in its business fabric; low technology-content activities and cycle-sensitive sectors; poor innovativeness and human capital use; high unemployment concentrated among young people and low-skilled workers; high private indebtedness and the laggard response to the capitalization needs of a section of the banking sector; and a major structural imbalance in public accounts compounded by inefficiencies in resource allocation and the management of public services.

The report stresses the **importance of adopting a comprehensive approach to these problems** so it is clear which group or institution must take ownership of each solution. To this end, it looks in depth at five key drivers of a modern, competitive, sustainable economy: investment geared to productivity; corporate structure and competitiveness; the labor market, employment and human capital; the functioning of the banking sector; and the public sector. On the basis of this analysis, it then puts forward a series of measures in all of these areas so crucial to the future of the Spanish economy.

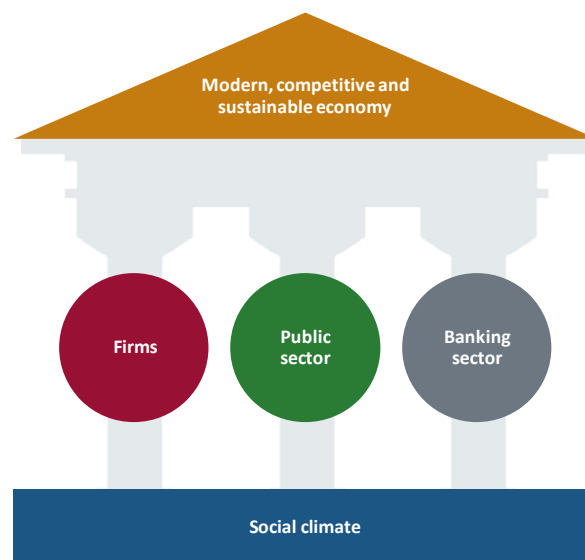
Diagram 1. Five key drivers of Spanish growth



Source: BBVA Foundation-Ivie Report (2011)

The report points out that the only way to counter the bleak outlook for the Spanish economy is to act urgently on its productive structure and **reform a wide range of institutions**, with decisive measures involving the public, corporate and financial sectors. Such actions must be anchored on a social climate favorable to reform and the shared effort of all agents and organizations.

Diagram 2. Proposals to improve productivity and competitiveness

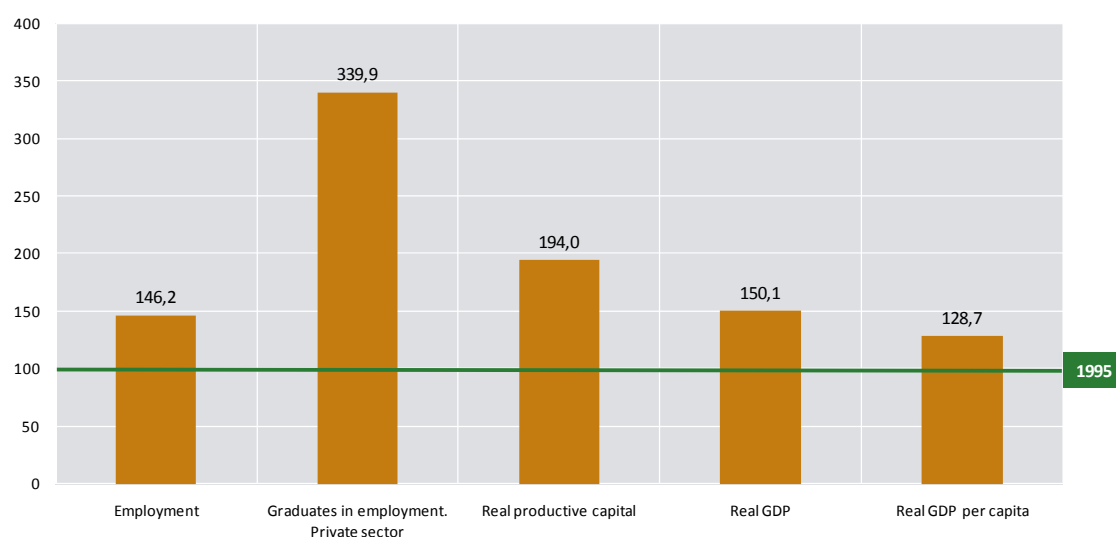


Source: BBVA Foundation-Ivie Report (2011)

The authors admit that “sacrifice” will be needed to embark on a new development strategy adequate for both Spain’s characteristics as an advanced nation and the circumstances of the world economy. But they also emphasize that, despite the hard times, the Spanish economy can rely on more resources and individual and collective capacities than it could hope to in earlier crises. Thanks to the progress made in these last fifteen years, the country’s level of development, income and employment is far higher than in 1995. As we can see from figure 1, the Spanish economy employed 50% more people in 2010, tripled the number of university graduates working in the corporate sector, the country’s productive capital almost doubled, and production was up by 50% and exports by 180%.

Figure 1. The achievements of the Spanish economy: 1995-2010

1995 = 100



Source: BBVA Foundation-Ivie Report (2011)

The report puts forward five key objectives to improve the competitiveness of the economy and restore it to lasting growth: a change in Spain’s productive specialization, the strengthening of company competitiveness, the reform of education and the labor market, the recovery of our financial system, and the redefinition of key public policies. There is no reason why these changes should be seen as undermining the welfare state: their purpose rather is to maintain and improve it, making it more sustainable, efficient and equitable.

The authors warn that many of the reforms needed are structural in nature and will only bear fruit in the medium term. Spain must however apply them without delay or else run the risk of slipping down the international ladder and squandering the opportunities that come with its present level of development.

Productivity, the heart of the matter

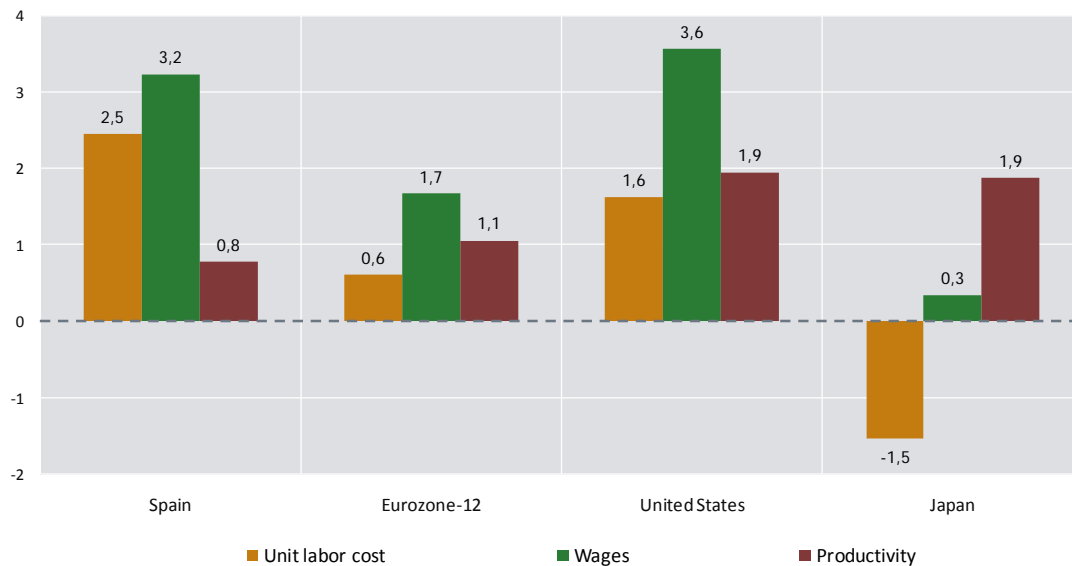
The report refers to education-employment-enterprise as the key to Spanish competitiveness, and of a growth pattern in which productivity gains favor wage improvement, secure employment and low unemployment rates.

The data contained in its pages show that poor production efficiency has been a problem of the Spanish economy throughout its expansion years, affecting

numerous sectors and many companies. Spain has invested heavily in ICTs but on a smaller scale than other developed economies and to less competitive advantage. Nor has it sufficiently exploited the human capital incorporated in this period, judging by the slow advance of labor productivity (figure 2), whose poor progress relative to wage growth has also pushed up unit labor costs and eroded companies' competitiveness in domestic and foreign markets.

Figure 2. Growth of unit labor costs, 1995-2010.

Annual change



Source: BBVA Foundation-Ivie Report (2011)

The crisis has not solved Spain's problems of productive efficiency. Labor productivity may have risen in construction due to intense job destruction, but only modest progress has been seen in the remaining productive sectors. Further, productivity growth via job destruction is not the path Spain should follow, the authors stress. What is needed is simultaneous growth in labor productivity and employment, and a reduction in real costs drawing on gains in total factor productivity (TFP).

- **The report recommends** an ongoing drive to enhance business productivity through more efficient use of investment, and wage rises linked to productivity gains as a route to increased competitiveness.

Firms, key agents of change

Firms hold the key to the economy's competitiveness and their first stop on the way to improved productivity should be to follow the best practice examples in their own areas of activity. The report insists that moving onto a new growth pattern does not mean dispensing with the present and future potential of crisis-hit industries like construction or, until a few months back, tourism. Each sector is home to a great diversity of companies, and the goal is to emulate the most efficient, because their success shows what can be done, the study underlines.

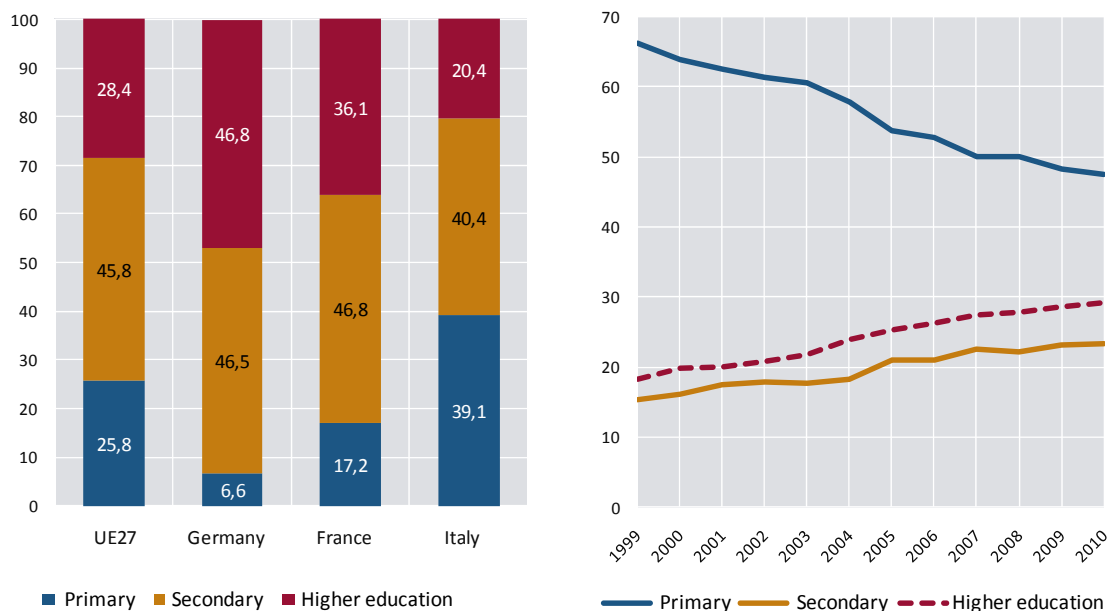
Efficiency gains should be achieved from adjustments enabling higher value-added generation and the reduction of costs. The authors warn companies

that achieving these goals will call for changes in their specialization, size and management.

Micro enterprises make up a comparatively large part of Spain's business fabric. And although they create a lot of jobs, they suffer from lower productivity and, generally, lower levels of entrepreneur qualifications relative to other countries (figure 3).

- **The report proposes** the removal of obstacles to companies growing in size – often rooted in proprietors' reluctance to share the reins with management specialists. This will mean professionalizing their executive teams, improving management models and access to finance, and combating the fragmentation of local and regional markets.

Figure 3. Entrepreneurs' educational level. Percentage



Source: BBVA Foundation-Ivie Report (2011)

Despite improvements in the last ten years, Spain still lags behind in the educational level of its entrepreneurs (less so in that of its senior managers). This is a significant disadvantage in its current economic development phase when a company's competitiveness rests increasingly on knowledge and the ability to manage complexity.

Another consequence of the shortcomings in company size and entrepreneur qualifications is that exporters are underrepresented in the country's productive fabric. For many firms, competing abroad is a big challenge of forbidding proportions, as well as fending off foreign competitors in the domestic market. For those who already export, the goal must be to reduce the European bias in their foreign sales.

If these globalization challenges cannot be met, there is little hope that firms will assimilate the profound changes that are sweeping the markets in the different world regions. "If we want to be competitive, it is no longer enough just to be in Europe", the report warns.

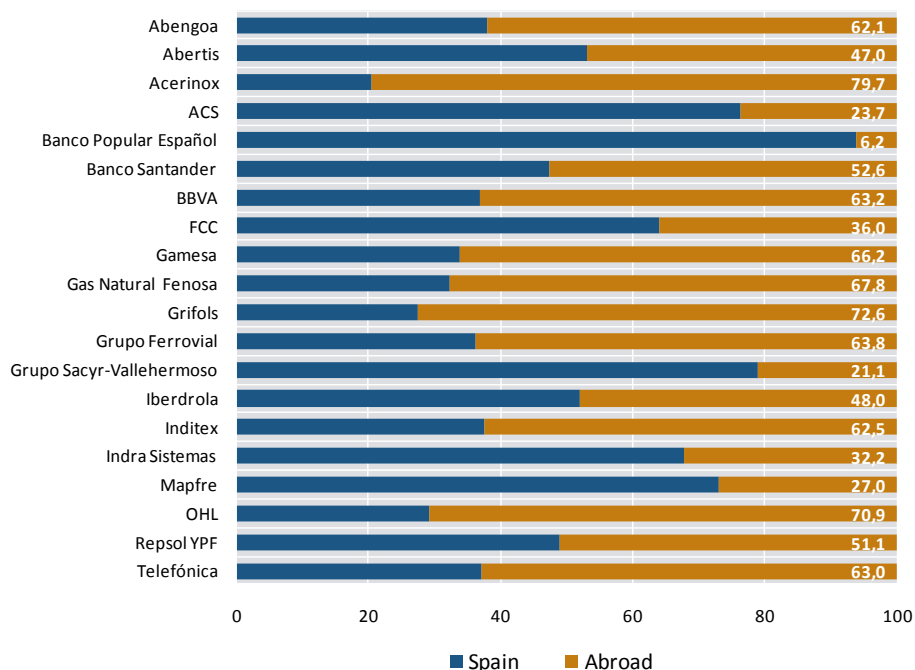
- **The report proposes** increasing both the number of exporting firms and the geographical diversification of exports, so more companies find their way to dynamic regions like Asia and Latin America.

Companies wishing to step up their internationalization and re-gear their productive specialization towards innovative activities of higher technological content should follow the example of firms in other advanced economies and those most competitive in Spain. Proof that this is possible comes from the position attained by Spanish companies that are successfully riding out the crisis thanks to the importance of their exports sales. An example of this are Spain's multinational companies, which consolidated their standing in diverse sectors during the last expansion phase, and can be viewed as the advanced experiences of the new growth pattern.

According to the study, Spain's growing body of multinational companies can do a lot to improve its competitiveness through their pulling of the other firms. As a rule, they base their performance on the intense use of human capital and the high-level skills of their executive teams. On these strengths, they have proved their ability to manage the complexity of markets and the sophistication of their products and business models. They are thus in a position to lever the opportunities of openness (figure 4) and broad geographical distribution, and to better manage their investment and debt rates.

- **The report recommends** promoting the productive use of knowledge, intensifying the take-up of human capital and ICTs in all companies, and ensuring that professionals and businesses have access to the best practice of successful firms.

Figure 4. Geographical distribution of the turnover of 20 Spanish multinational firms, 2007. Percentage*



*Turnover share of international sales

Source: BBVA Foundation-Ivie Report (2011)

Lack of jobs, education and training

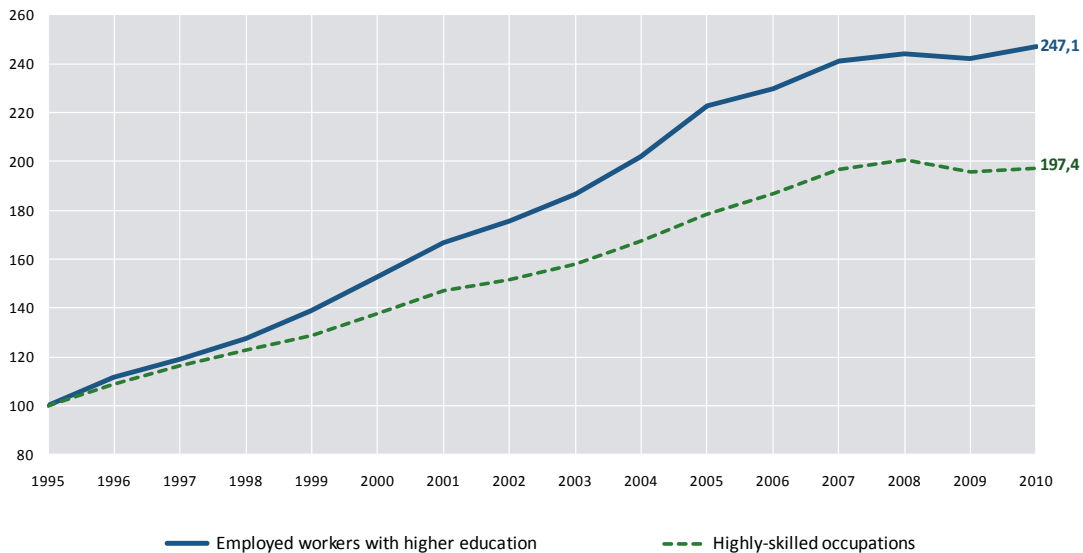
The report points out the reform of Spain's obsolete labor-market structure as a "maximum priority". The market's functioning betrays a series of deficiencies. Duality between permanent and temporary employment contracts means flexibility is essentially confined to the young and the least skilled, as well as accentuating the employment cycle and increasing the numbers of long-term unemployed. Also, wage bargaining hampers business competitiveness through its failure to link compensation with productivity, which varies widely from one company to another.

- **The report recommends** narrowing the range of contracts currently in use and removing uncertainty over the fair or unfair nature of dismissals. Companies should also be more transparent about their productivity figures that should be the key factor in wage bargaining.

To maximize the return on human capital and boost productivity, it is important that the growing supply of highly-skilled and qualified labor can find the kind of skilled work that can only be generated by a more knowledge-intensive economy. In Spain, improvements in the qualifications of workers have not been matched by a similar increasing availability of highly-skilled jobs, due to the country's productive specialization and the small size of numerous firms (figure 5). This mismatch has increased the problem of overqualification among university graduates.

Figure 5. University graduates in employment and highly-skilled occupations*.
Spain, 1995-2010

1995=100

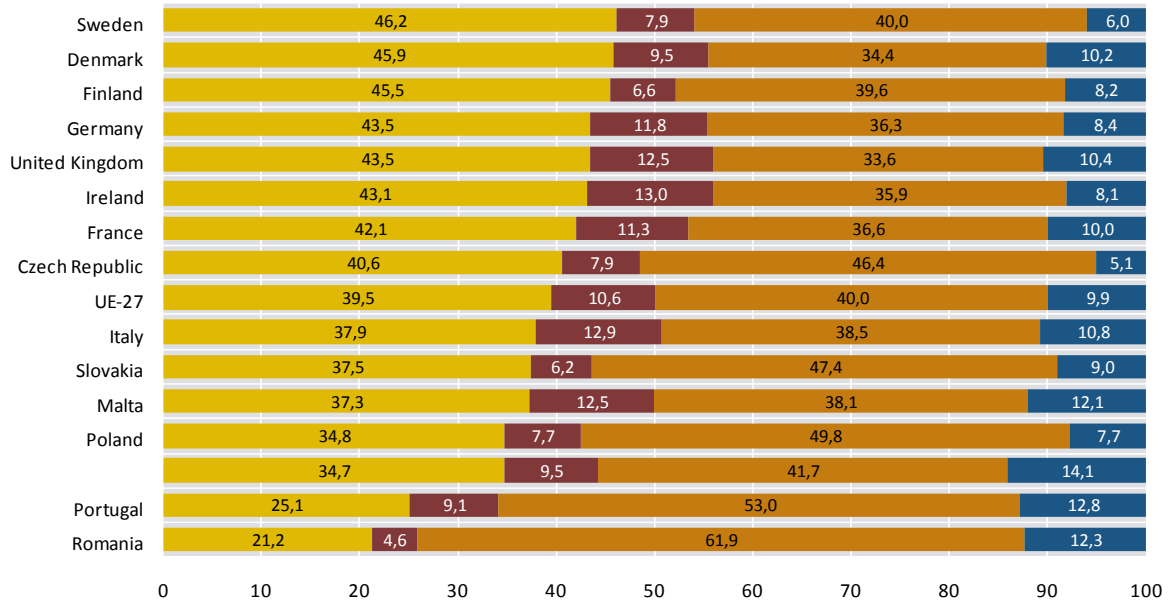


*Highly-skilled occupations are those between codes 1 and 3 of the CNO-94 (Spanish standard classification of occupations)

Source: BBVA Foundation-Ivie Report (2011)

As we can see from figure 6, although 35% of jobs in 2010 correspond to highly-skilled occupations, this proportion is closer to 50% in the most advanced countries. Demand for more skilled workers will tend to increase over the coming decades, reducing the risk of overqualification for a large percentage of graduates.

Figure 6. Distribution of workers by type of occupation. EU countries, 2010
Percentage



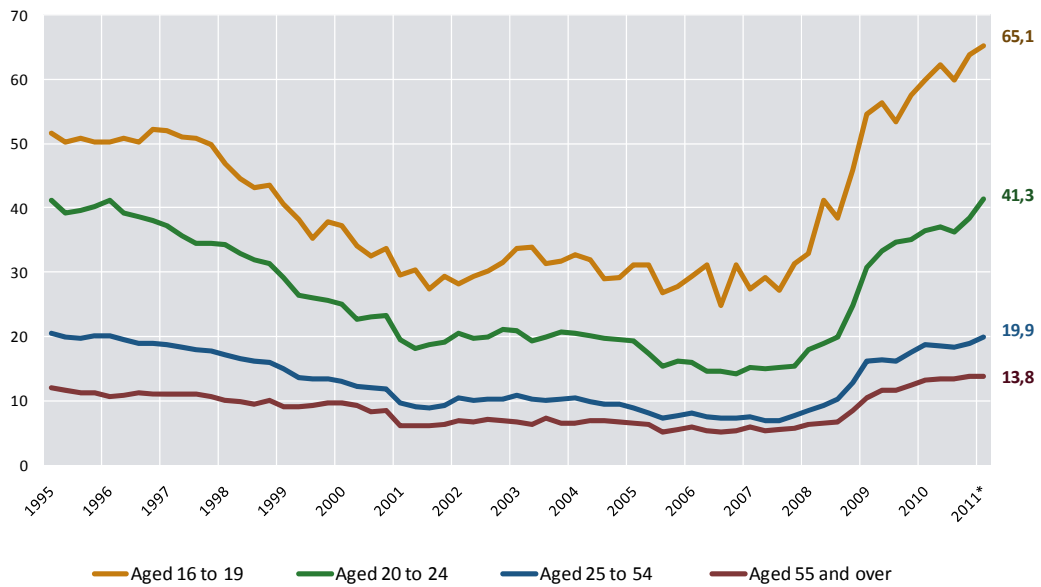
■ Highly-skilled workers (CNO 1-3) ■ Clerks (CNO 4) ■ Workers in manual activities (CNO 5-8) ■ Unskilled workers (CNO-9)

Note: Countries listed from highest to lowest weight of highly-skilled occupations

Source: BBVA Foundation-Ivie Report (2011)

Less skilled young people have low employability and are at risk of suffering long periods of unemployment that may descend into social exclusion. Unemployment hits especially hard at the young age group (figure 7) while long-term unemployment affects a high number of unskilled workers with problems of labor-market reinsertion (figure 8).

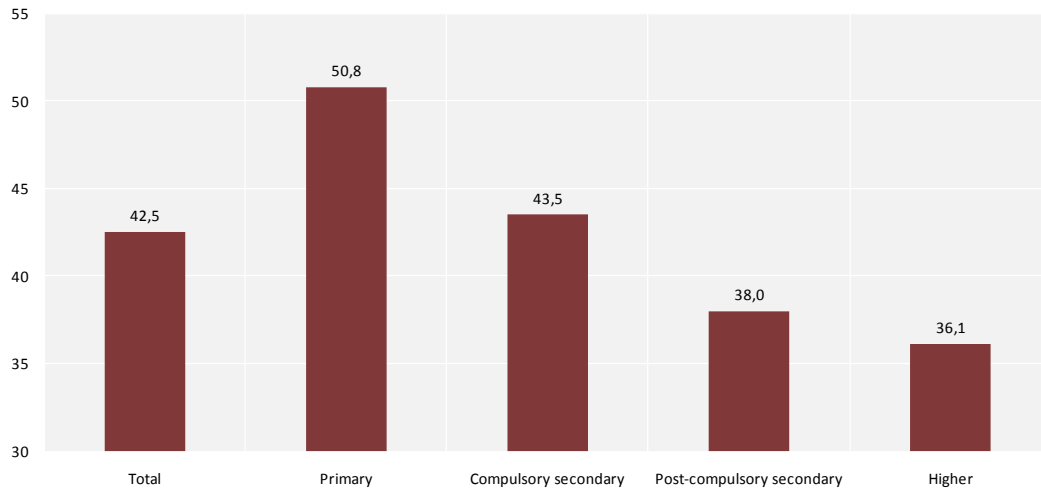
Figure 7. Unemployment rate by age group. Spain, 1995-2011*. Percentage



*1st term

Source: BBVA Foundation-Ivie Report (2011)

Figure 8. Long-term jobless by educational level. Spain, 2010

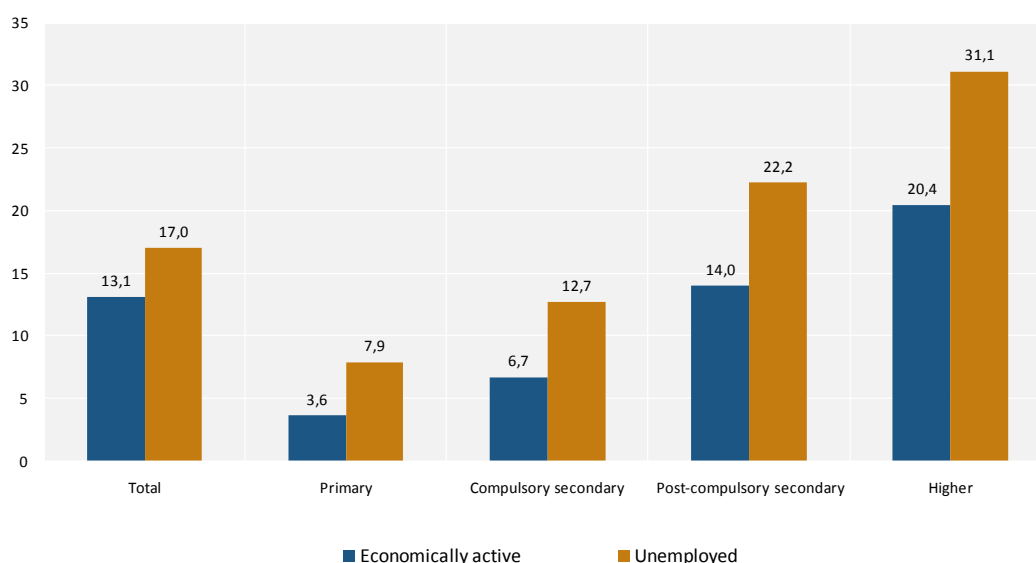


Source: BBVA Foundation-Ivie Report (2011)

The report recommends strengthening connections between the education system and firms, to achieve a better match between workers' skills and the needs of the productive system.

Only one out of every six unemployed workers is following some kind of training course (figure 9), despite the fact that many of them, both young and older workers, not only lack skills, but are trapped in situations of long-term unemployment at risk of degenerating into permanent social and labor-market exclusion.

Figure 9. The economically active and unemployed population engaged in training by educational level. Spain, 2010 Percentage



Source: BBVA Foundation-Ivie Report (2011)

Both workers and companies show scant interest in lifelong training. Only 47% of firms offer this kind of activity compared to a European average of over 60%, and the situation is worse still among temporal workers and small companies. In fact, the majority of Spanish workers cease regular training when they conclude their studies and enter employment. In 2010, only 13% of employed workers were engaged in some kind of training and the trend has been flat or slightly downwards in the past few years.

The report also highlights Spain's limited take-up of part-time working; a modality that helps spread employment and aids in the reconciliation of work with study and other activities. In developed countries, higher use of part-time working goes along with higher activity rates.

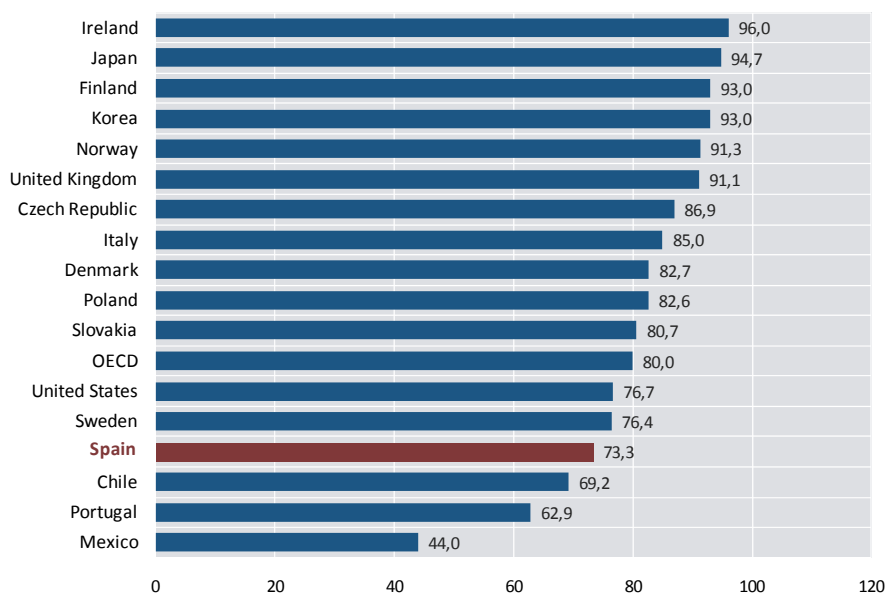
- **The report considers** that Spain has ample leeway to develop active employment policies, and proposes taking firm steps to expand training opportunities as a means to stimulate job search and combat structural employment. Action should also be taken to lever the potential of part-time working as a flexible employment instrument, and to fight unemployment.

Improve educational results

As well as lifelong training, the report also underlines the need to improve the results and efficiency of educational processes and strengthen ties between the academic and business worlds. In particular, it calls for action to avoid drop-out and increase the percentage of young people going on to post-compulsory secondary education.

Figure 10. Post-compulsory secondary education rates. OECD countries, 2008

Percentage



Source: BBVA Foundation-Ivie Report (2011)

Spain, in this respect, trails far behind most advanced economies, which have sought to meet the challenges of the knowledge society by progressing to the universalization of secondary education. The percentage of students in Spain with post-compulsory secondary education level stands well below that of remaining advanced countries (figure 10).

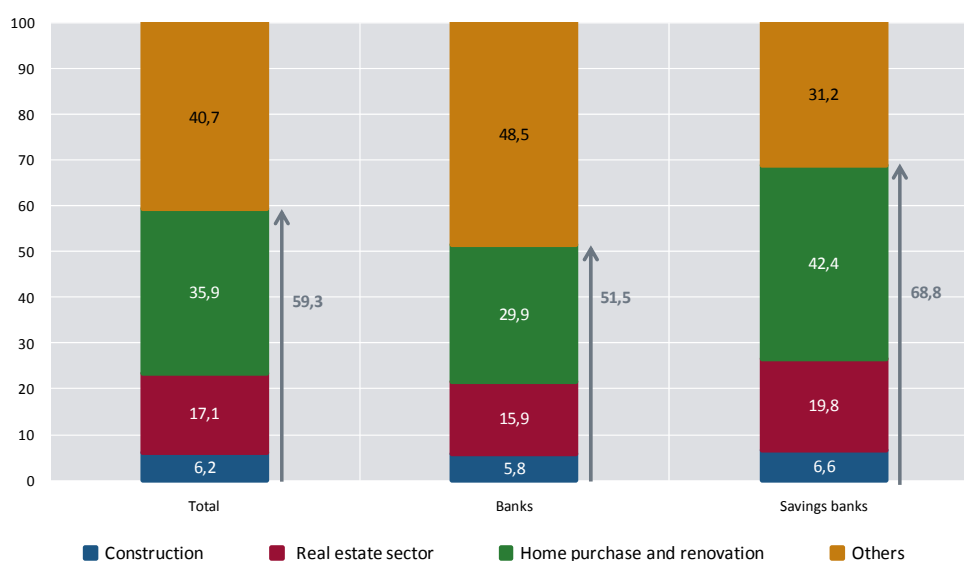
- **The report proposes** implementing incentive policies to improve the efficacy of the education system at all levels, reduce drop-out and increase the percentage of young people completing secondary studies.

The banking sector: back to normality

The speed of Spain's economic growth between 1995 and 2007 had much to do with construction and real estate developers sector. In this context, a part of the banking sector, particularly among the savings banks, relied heavily for its own expansion on construction financing, real estate development and home purchase loans, which raised their share of private-sector lending by 20 percentage points. The large banks, meantime, followed the way of internationalization. Lending to construction and real estate businesses, including mortgage loans to households, moved up from 40% of total lending in 1995 to 59.3% in 2010 (figure 11). Among the savings banks, exposure to these activities was substantially higher than among the banks (68.8% and 51.5% respectively at the 2010 close). In the lending segment experiencing the highest non-performing loan ratios – the financing of real estate businesses – the gap between the two narrows significantly (26.4% for the savings banks and 21.7% for the banks).

Figure 11. Construction, real estate and home purchase financing in Spain, 2010

Percentage of total lending to the non-financial private sector (other resident borrowers)



Source: BBVA Foundation-Ivie Report (2011)

The report stresses that among the pre-conditions for economic recovery and job creation is the resumption of normal financing, specifically, credit flows. The origin of the problem lies in the balance-sheet losses caused by the real estate bubble. However the authors also point out that capital needs are primarily located in certain savings banks and smaller banks which together account for no more than a third of the sector's assets.

But although the system can cope with these recapitalization needs, delays in tackling specific solvency problems are holding back the return to normal lending throughout the economy and, thereby, hindering recovery. Also, the difficulties faced by certain banks are placing the whole sector in a negative light. International markets, the report points out, do not distinguish between sounder banks from less sound, so the whole Spanish economy ends is harmed. In order to fully restore investor trust in the Spanish banking sector, the study underlines that what is needed is to accelerate the current restructuring process, trim the excess capacity installed and press on with balance-sheet write-downs.

- **The report recommends** proceeding decisively with the recapitalization of troubled entities and, in general, improving transparency so the weaknesses of a few do not tarnish the image of all the rest. It is also important to improve the governance and management professionalism of the worst hit banks and the most cycle-dependent, in order to minimize future risks and restore investors' confidence in the Spanish banking system.

The other side of the coin is that Spain's banking sector includes highly competitive institutions, some of them multinational. This group gives vivid proof of the benefits of efficiently harnessing technology and human capital at the

service of prudent risk management and the advantages of product and market diversification.

The public sector: austerity, efficiency and equity

Financial stability, greater spending efficiency and equal opportunities in access to public services: these are the three issues of the public sector reform proposed by the report to secure a more efficient and sustainable welfare state.

The latest data from the OECD do not support the view that Spain has an oversized public sector, in terms of either global spending or productive activity and employment. As we can see from panel a) of figure 12 below, the value-added of general government amounts to 14% of Spanish GDP while public employment is 16% of the total, broadly on a par with other large European nations and the United States. However the report also stresses the need to restore the financial equilibrium of public accounts and correct the structural deficit, while arguing that the big problem with Spain's public sector is not one of size but one of efficiency and equity.

The authors underline the need to avoid the risk of spending cuts undermining growth-supportive functions like education and infrastructures, while acknowledging the need to correct the considerable inefficiencies weighing on both sectors. Doing so, they argue, will deliver better results for the same level of spending or even less.

- **The report proposes** a financial stability pact for the public sector that takes in the following points: a legislative commitment to maintain a structural balanced budget; tighter spending controls in health services; more resources for the fight against tax fraud and the underground economy; and a review of the expenditure impact of early retirements.

The public sector faces the dual task of promoting improvements in productivity and competitiveness, while fulfilling its redistributive function in an efficient, equitable manner. Reforms to improve results in both these domains should serve to consolidate the welfare state and facilitate its long-term viability.

- **The report proposes** the launch of an action plan on public spending efficiency which envisages, among other measures, the creation of a new culture of public investment based on criteria of efficiency, which prevents money being spent on underutilized infrastructures and facilities.

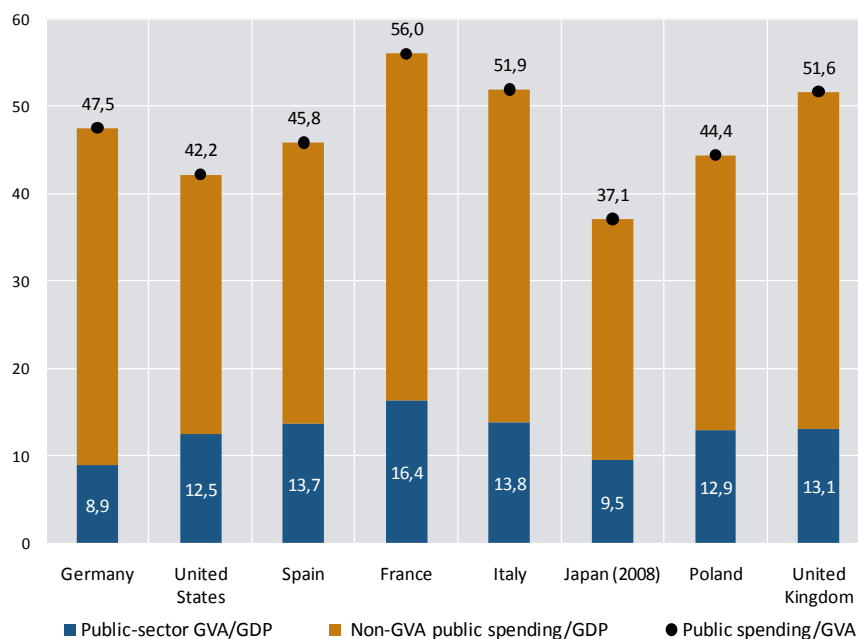
Numerous aspects of public service performance and delivery are open to scrutiny from an efficiency standpoint. The authors illustrate this point with some striking data regarding inter-territorial differences in expenditure (panel b of figure 12 below), which are greater within Spain than between Spain and other neighbor countries.

- **The report recommends** the launch of an equality of opportunities plan in public services aimed at reducing the differences in per capita spending between autonomous communities, and securing agreement from the authorities to coordinate policies that generate duplicated spending and impose spending commitments on other levels of government.

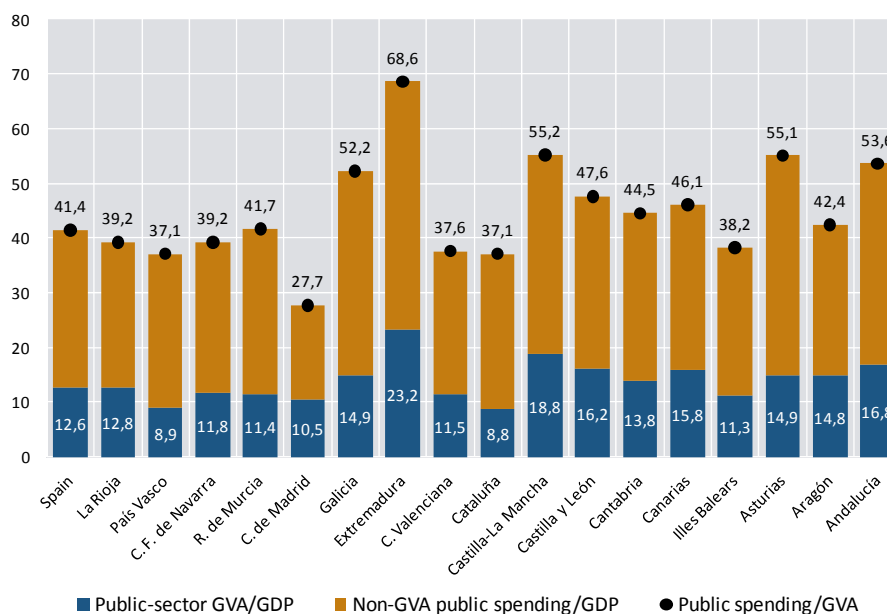
The report also discusses the quality of services, like education and health, with a significant impact on equality of opportunity. In both cases, it calls for an in-depth review of service functioning in order, fundamentally, to lever their full potential to boost economic growth and social wellbeing. The diversity of regional experiences in the functioning of health and education services – widely differing expenditure levels per inhabitant, delivery modalities and degrees of public-private partnership – should provide a useful testing ground for the application of best practice.

Figure 12. Weight of the public sector in GDP. Percentage

a) International comparison (2009)



b) A comparison by autonomous communities (2008)



Source: BBVA Foundation-Ivie Report (2011)

- **The report recommends** providing suitable incentives to improve educational quality at all levels, directed at both students and teachers (university fees, external assessments), and involving users and professionals in the control of health spending (appropriately designed co-payment instruments, management and information systems, cost-effectiveness analysis of services and benefits).

Changing the social climate: a non-negotiable task

The report stresses the importance of building a new social climate of greater trust and cooperation, in order to successfully confront the changes needed to get the Spanish economy back on the growth path. Part of this effort must be to promote values like the culture of hard work, fair competition, social regard for talent and innovation, a willingness to trust others, the transparency of companies and public institutions, the fight against corruption, and openness to the world and its cooperation opportunities.

A shift in social climate, the authors say, will facilitate the consensus the country needs to tackle reforms. It will also further economic recovery by strengthening firms and will help to ease the changes in the public sector, the education system and the labor market. The end result will be a more productive economy able to generate employment, the authors assure.

- **The report signals as priority** to foster a social climate favorable to change anchored on basic consensus, the encouragement of a culture of hard work, the defense of free competition, and greater transparency among companies and public institutions.

Fundación BBVA

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