**STRUCTURAL REFORM PROGRESS IN SPAIN-
COMPARISON WITH PORTUGAL, IRELAND, GREECE, ITALY AND FRANCE***

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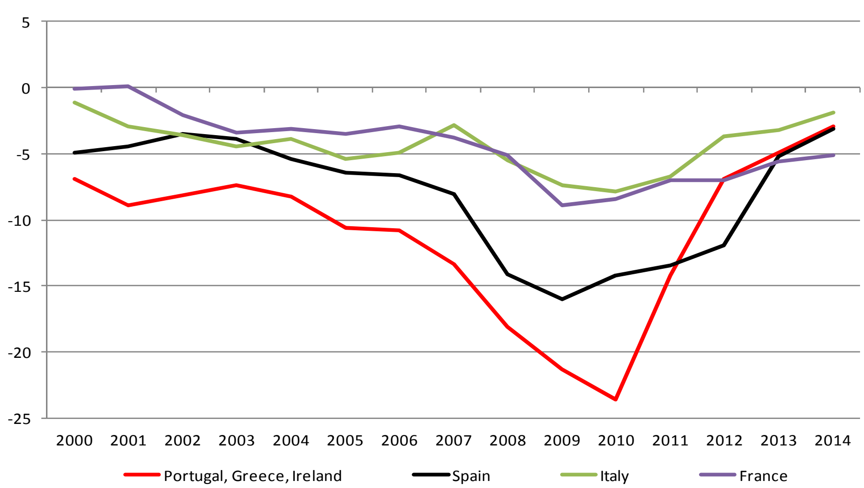
This note assesses the progress that the economic policy reform agenda in Spain has made in delivering the proper outcomes in the last years. This exercise is done in relative terms to the performance of, on one hand, the EU countries under Economic Adjustment Programs (Greece, Ireland and Portugal) and, on the other hand, the other two largest EU economies which are more similar to Spain, i.e. France and Italy. The note covers also the policy measures adopted in each country relying on the 2014 Annual Growth Strategy prepared by the European Commission.

1 Economic performance

1.1 The end of economic imbalances

Since the beginning of the economic and financial crisis, the top policy priority within the EU and the Euro Area has been the reduction of the economic imbalances, both external (current account) and domestic (public deficit). Figure 1 reports the combined deficit (current account plus public deficit) for Spain, Italy, France and the average for Portugal, Ireland and Greece.

Figure 1. Combined Current Account balance and General Government deficit, as % of GDP (estimates beyond 2012)



Source: IMF WEO

* The author thanks Xavier Vives for comments. The usual disclaimer applies.

It is clear that:

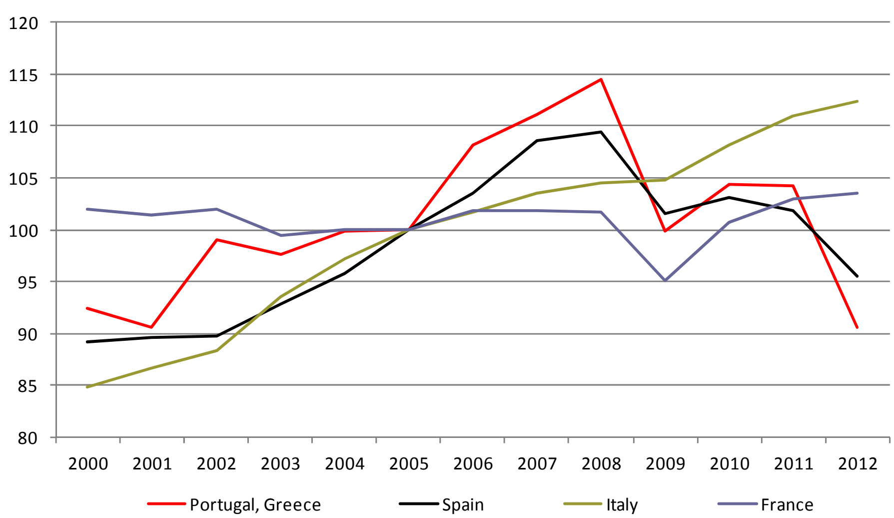
i. Spain's economic imbalances never became as nearly as severe as those of the countries under the Economic Adjustment Programs (EAP) in the pre-crisis period
ii. Spain is removing its economic imbalances as swiftly as the EAP countries, and even more strongly than other non-EAP economies like France which, according to the IMF, is forecasted to have in 2014 a current account deficit of 1.5 % of the GDP and public deficit of 3.5 % of the GDP, in contrast with current account surplus of 2.6 % and public deficit of 5.3 % in Spain.

Put more bluntly, Spain as well as the EAP countries are no longer living beyond their means. Given that this is what appears to have been the top policy goal of the EU core countries and the European Commission, it is fair to acknowledge that their stabilization strategy has been successful in the short term. Of course, it remains to be seen which will be the medium and long-term the impact of austerity in the rescued and quasi-rescued economies.

1.2 Competitiveness Developments

An open question is whether these corrections of the imbalances are mainly cyclical and temporary or instead they are based on permanent changes that stem from the policy reforms that the countries have adopted. In other words, has there been an improvement in the fundamental competitiveness drivers in the countries under analysis over the past years?

Figure 2. Nominal unit wage cost in manufacturing vs the rest of EA17 countries, index 2005 = 100



Source: European Commission (Ecfin)

Figure 2 reports the real effective exchange rate (REER) of Spain, Italy, France and the average of Portugal and Greece (Ireland is left out because the behaviour of its exports is somehow atypical for idiosyncratic reasons) measured by the unit labour cost in the manufacturing sector, with data provided by the DG Ecfin of the European Commission. For each country, the unit labour cost is measured in relative terms to the rest of Euro Area countries, so that appreciations of the exchange rate are to be interpreted as the country losing price-cost competitiveness with respect to the rest of countries.

Figure 2 suggests that there are three types of trajectories in terms of competitiveness gains and losses across countries:

i. The competitiveness of France has remained rather stable since 2000, i.e. its products have not appreciated or depreciated, in real terms, with respect to the products of the other Euro Area countries
ii. The two countries under the EAP that are represented in the figure (Portugal and Greece) and Spain have had a similar pattern: massive competitiveness losses from 2000 to 2008 and then swift and important post-crisis improvements that have led them in a competitiveness position in 2012 which is almost the same one than in 2000. This is noteworthy given that in the case of the EAP countries, their products became between 2000 and 2008 nearly 25 % more expensive than those manufactured in the rest of the Euro Area countries (20 % for the case of Spain) and this competitiveness loss has been recovered in only four years.
iii. Finally, Italy is unfortunately showing no evidence of switching from competitiveness-losses to competitiveness-gains. The Italian products remain losing competitiveness vis-à-vis the rest of the Euro Area countries since 2000 and by 2012 they accumulate a real appreciation of 30 %.

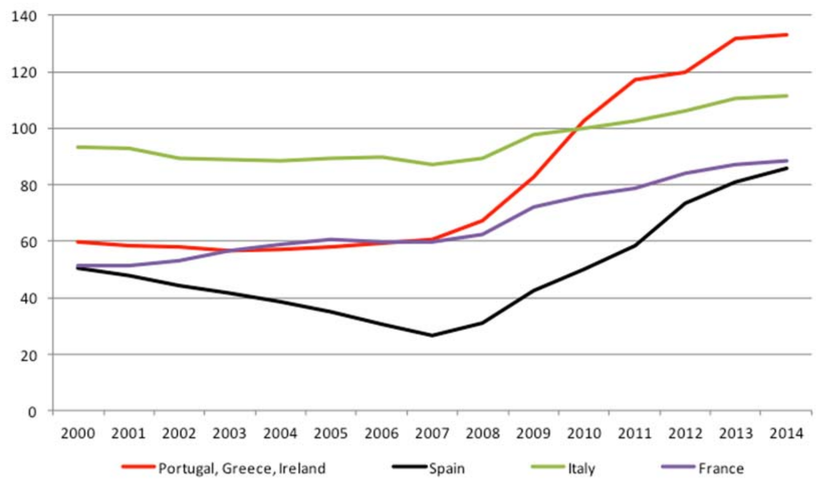
There is a good case for considering that the competitiveness gains in the EAP countries and Spain do reflect the effect of policy improvements adopted by national governments. In particular, those countries have reformed their labour markets and labour institutions and, more generally, they have experienced policy-driven internal devaluations. In contrast, Italy has not advanced in the internal devaluation front and the structural reforms the Italian Government has enacted are, according to most observers, relatively mild. In addition to this, of course, the high unemployment (see figure 4 below) that Spain and the EAP countries are experiencing is very likely depressing wages.

1.3 The legacy of the crisis and pending policy issues: unemployment and debt

However, it is clear that the global economic and financial crisis has left many EU countries, especially those analysed in this note, with severe burdens, mainly regarding unemployment and debt. As a general rule, most EU countries are exiting the crisis more heavily indebted and with more unemployment, but the point is that increases differ very much across countries.

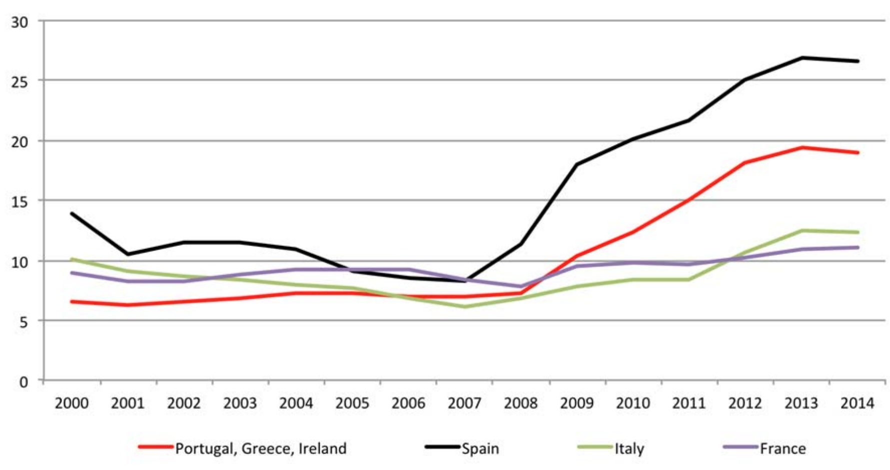
Figure 3 represents the general government debt and Figure 4 represents the unemployment rate, both according to the IMF and with estimates for data beyond 2012. Figure 5 represents the labour market participation rate according to Eurostat

Figure 3. General government net debt, as % of GDP (estimates beyond 2012)



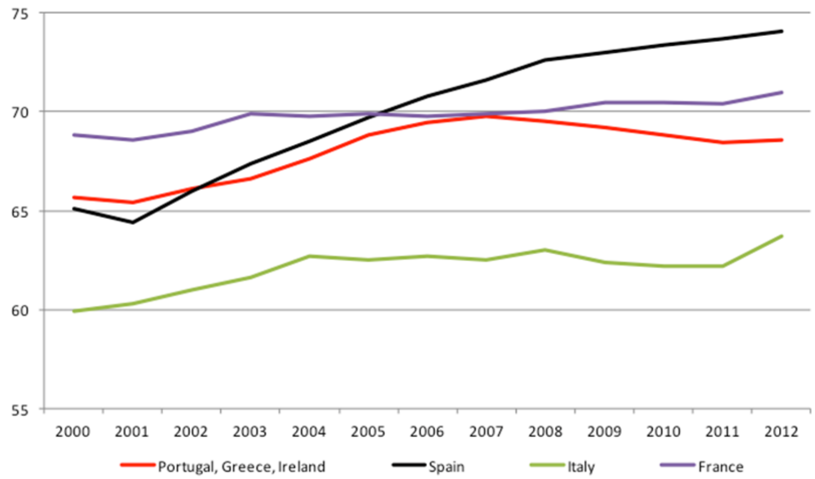
Source: IMF WEO

Figure 4. Unemployment Rate (estimates beyond 2012)



Source: IMF WEO

Figure 5. Labour Market Participation rate



Source: Eurostat

From figures 4 and 5 it is clear that it is in the EAP countries and Spain where these problems have been more acute. More specifically, in Spain, despite the policies aimed at expenditure cuts and revenue increases, the public deficit in relationship to the GDP has tripled during a period of just 7 years (between 2007 and 2013). And as it is well known, the unemployment rate in Spain pathologically remains above 25 % without any policy-based hope of major improvements in this figure in the near future. Concerning the Spanish labour market, which has attracted a great deal of attention in the recent times, it is noteworthy that it has the larger participation rate (nearly 75 %) of the countries under consideration.

This is a relevant fact which may be the consequence, in part, of the internal devaluation process mentioned above. As households see their income fall as result of some members earning lower wages or entering the unemployment, other members move from non-active to active workers. In the particular case of Spain, the incoming workers to the labour market are, by a large majority, women as the female activity rate in the country has moved from 52 % in 2000 to 68 % in 2012, featuring one of the largest increases in women incorporation into the labour market in the EU.

From a more general perspective the EAP countries and Spain, as a result of the effect of the automatic stabilizers, are very likely entering into a vicious circle. In this bad equilibrium, sustained employment keeps hurting public finances and the fiscal consolidation response further depresses the real economy. The way out to this vicious circle remains the top social and economic challenge in the EU periphery.

2 Economic Policy Reforms

Economic policy reforms in EU countries are an increasingly coordinated effort in which the input of the European Commission is every time more relevant. In this respect, the Annual Growth Strategy (AGS) is the keystone document of the process. The AGS contains four policy dimensions: public finances, financial sector, growth and competitiveness and employment and social policies. This section reviews the 2014 AGS for Spain, Italy, France, Ireland, Portugal and Greece along these four policy dimensions. The annex provides more details on the individual developments for the AGS for each country.

Public finances

Following a period of large and swift increases since 2008, the Spanish deficit is expected to be fully corrected by 2016 according to the Commission. In addition, some bold reforms in the public pensions, including a new sustainability factor that will act as key reference in governing the system, have been introduced. Spain has also notably improved its public finance management with a new Law and by creating an Independent Fiscal Authority.

In comparative terms, the fiscal adjustment effort in Spain ranks among the largest for the countries under examination, both in quantitative terms and in terms of institutional reforms. In contrast to the Spain, the cases of France (running a non-corrected excessive deficit) and Italy (where public debt is major issue) are cases of concern quoted by the European Commission. The case of Greece appears to be more delicate and less clear as some important policy decisions related to the sustainability of public finances apparently are still pending.

Financial sector

In terms of the reforms in the financial sector, the situation in the five countries for which the Commission reports information (there is no information about France) is relatively similar. Ireland, Portugal and Greece have been under respective EAPs while Spain has been subject to a specific intervention focused in the financial sector, the Financial Sector Programme. The European Commission view is that apparently all interventions have been relatively successful and the national financial sectors are very much on track to improve their solvency and liquidity.

Growth and competitiveness

The European Commission points out at Spain as one of the countries where a larger share of effort still needs to be made to improve the competitiveness of the economy. Indeed, according to the Commission, Spain has certain idiosyncratic challenges to face like the segmentation of the domestic market. At the same time, Spain is praised for undertaking a reform of the public administration.

Having said that, most of countries under examination, including Spain, share common competitiveness bottlenecks, like entry barriers into certain industries and professional services, as well as improvement in the regulation of network industries. In addition, easing of administrative burdens and licensing procedures remains a top priority for Portugal as improving the infrastructures is so for Italy.

Employment and social policies

In terms of labour market reforms, the European Commission acknowledges that the 2012 Spanish reform has been a true crossover. In addition, according to the Commission, the agreement between the social partners on wage moderation has played an important role in stabilizing the Spanish labour market. In terms of to-do tasks, the priority seems to design smarter activation policies, even if this requires some sort of redefinition of the legal active labour market legal competences between the central and the regional governments.

More broadly, the labour markets of the countries under examination tend to share, despite the progress achieved by the reforms in the past years, certain common features like rigidity and segmentation, those being specially an issue for the case of Italy. Likewise, the Commission recommends improving the framework for public employment in France and Greece.

3 Conclusions

There is no doubt that Spain, as well as the other most-troubled EU economies (Greece, Ireland and Portugal) have made significant progress in correcting its economic imbalances, both in the external (current account deficits) and domestic (public deficit) fronts. This adjustment process may very well leave these economies in a better position than France by 2014 according to the IMF.

There is a good case for associating this progress with real competitiveness improvements in Spain and the other three economies under Economic Adjustment Programmes. In these countries it is clear that there has been an internal devaluation since 2008 while the opposite has happened in Italy, whose products are appreciating, in real terms and with respect to the rest of Euro Area economies, since 2000. The French economy has remained somehow neutral across time in terms of competitiveness gains or losses.

However, the troubled economies have a distinctly heavy burden for the future: the public debt and the unemployment have risen in these countries much more quickly than in Italy and France. Given the economic policy agenda the EU has adopted so far, it is not at all clear how the vicious circle that feeds back unemployment and public deficit will be dismantled.

Annex- Overview from the 2014 Annual Growth Strategy by the European Commission

	Public finances	**Financial Sector**	**Growth and competitiveness**	**Employment and social policies**
FRANCE	France did not correct its excessive deficit by 2013. Whether the planned decentralisation reform will bring significant savings remains unclear. The 2013 pension reform also covers only the general scheme and falls short of fully addressing the revision of special schemes.	N.A.	Only limited measures have been taken to increase the competition in regulated sectors. In network industries, the NOME regulation will reduce barriers to entry in the energy sector and a reform which seeks to increase the efficiency of the railway system is underway.	The law of June 2013 on securing jobs is a step to improve the functioning of the labour market. A reform of the public employment service was also undertaken in 2012/13. Labour market segmentation was partially addressed. Further structural reforms are needed to reduce the cost of labour.
ITALY	The public debt remains a major burden. Close monitoring of budgetary developments to ensure strict compliance with the Stability and Growth Pact is therefore warranted. The reform of the tax system remains piecemeal. Taxation on labour and capital remains high in Italy.	To strengthen the Italian banking sector, the Bank of Italy conducted a targeted asset quality review, which is a positive step despite the limited sample of banks involved.	Some reforms to foster competition in the services markets were introduced but implementation risks exist, notably with regard to professional services. Regarding network industries, energy prices remain very high and the upgrading of infrastructures across the country remains a challenge.	Rigidity and segmentation have been structural features of the Italian labour market. To address these challenges, a reform was adopted in 2012. However, implementation is slow. Challenges linked to education also remain high and therefore urgent improvements are needed.
SPAIN	Spain is committed to correct its public deficit by 2016 and advances in reforming its pension system. Public finance management has been strengthened and Independent Fiscal Institution has been created. Since 2012 tax burden has shifted towards consumption	The financial sector programme was conducted smoothly and successfully finished in January 2014. Compliance with the horizontal policy requirement is nearly complete and the governance, regulatory and supervisory framework has been strengthened.	There remain weaknesses in the business environment such as segmentation of the domestic market and entry barriers in several industries and services. The legal framework for corporate insolvency has been improved. Further efforts are needed to	The more comprehensive 2012 labour market reform, together with the social partners' agreement, has created the conditions for increased labour market resilience. The coordination between the center and the regions concerning active labour market policies still poses a risk to

	and environmental taxes.		address shortcomings in the regulation of the electricity and transport sector. Spain is taking steps to reform its public administration.	effective delivery.
IRELAND	Ireland has strictly adhered to the fiscal headline targets throughout the Economic Adjustment Programme period. Budgetary framework reform has been kept in pace with the advances at the EU level, but expenditure framework and data reporting and transparency need to be further improved.	The deleveraging and restructuring of domestic banks has progressed well. Recent efforts have focused on defining and achieving targets for the sustainable resolution of mortgage arrears, addressing other non-performing loans and improving the legal and regulatory framework, including the personal insolvency.	Private consumption remains weak. Some key pharmaceutical products manufactured in Ireland are coming off patent this year and this has led to a slow-down in export and import growth. Price pressures are expected to remain low, considering the high degree of spare capacity in the economy.	Recent reforms under the programme have focused on strengthening activation mechanisms, providing deeper and wider support to jobseekers, improving the relevance and delivery of further education and training programmes to foster re-skilling and up-skilling. Work on rolling out these services is not complete yet.
PORTUGAL	The general government deficit is expected to be 5.95% of GDP in 2013 according to the Commission 2013 autumn forecast. The government has confirmed its deficit target of 4% of GDP in 2014. Public sector reforms continue to strengthen public financial management, fight tax evasion, restructure state enterprises, and reduce costs of public-private partnerships.	Portuguese banks have significantly improved capital ratios from the beginning of the Economic Adjustment Programme and they are in a good position to weather short periods of uncertainty and cope with a potential further deterioration in asset quality. Measures to ensure adequate funding for viable small and medium-sized companies are being implemented, including initiatives to encourage the diversification of financing sources.	The Economic Adjustment Programme's agenda of structural reforms is well advanced. Progress is being made, although with some delays, in the reduction of barriers to doing business via easing of administrative burdens and licensing procedures. Further progress is still necessary to make the transport sector more sustainable and open to competition, especially in ports	While the labour market situation has recently improved, unemployment remains high, particularly among the young. As part of the long-term strategy for job creation the following reforms were implemented: more flexible collective bargaining rules, a reduction in severance payments, a reduction of unemployment, changes in working time arrangements and reforms in ALMPs and VET.
GREECE	Greece continues to make progress under the Second Economic Adjustment	A determined and effective implementation of the privatisation programme is	While declining unit labour costs, supported by successful labour market reforms, are	Fighting unemployment continues to be a top priority. it is now vital to advance on four

	Programme albeit some important actions being delayed, including the reform of an ineffective revenue administration.	necessary. The recapitalisation of the four core banks has been completed.	improving cost competitiveness, the on-going product markets reforms need to be accelerated and reinforced.	pillars: public works programme; internships for the young: reform of the Public Employment Service; and strengthening vocational education and apprenticeships.

Source: Extracted and adapted from "Overview of Progress in Implementing Country-Specific Recommendations by Member State". Commission Staff Working Paper accompanying the 2014 Annual Growth Survey