Regional Analysis Spain

The Spanish Productivity Puzzle

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The long-term prosperity of a society depends on its productivity growth, that is, its capacity to increase the quantity of goods and services produced per unit of labor input. GDP per working-age population can be decomposed into the product of the employment rate by the activity rate and productivity. Given that activity and employment rates cannot grow indefinitely, growth in GDP per working-age population is determined, in the long term, by the growth in productivity. Increases in wages, disposable income, private consumption, investment, and public revenues to fund the welfare state and leisure time, and the increased ability to devote resources to environmental sustainability, are ultimately dependent on productivity growth.

Regrettably, alongside unemployment, productivity growth has been one of the Spanish economy's chronic weaknesses. In fact, the lower level of Spain's GDP per working-age population compared to those of the United States and Europe's most advanced economies in recent decades can be attributed almost as much to Spain's lower productivity as it can to its unemployment rate. Moreover, given their similar demographic structures, this also explains the difference in per capita income between Spain and those countries.

What is behind this weakness of the Spanish economy? Rather than one single cause, there is a wide range of factors at play. The first of these is the intrinsic relationship between productivity and the size of the firms simultaneously interacting between them. On the one hand, more productive firms are more competitive and have greater capacity for growth. On the other, larger firms can benefit from economies of scale and scope that facilitate access to new markets, to new technologies and innovations, and to better human capital. Larger firms can thus be more productive if they are able to take advantage of such opportunities. Productivity per employee for medium and large firms in Spain is as high as it is in the most advanced European economies, and such firms are 2.3 times more productive than micro-enterprises. Spain's chronic productivity problem can, to a large extent, be attributed to its fragmented productive structure in which the proportion of employment represented by medium and large firms is lower than in other countries, including some smaller countries such as Ireland. For example, according to the data compiled by the OECD, in 2016 the average manufacturing, construction and non-financial services firm in Spain had 4.4 employees, compared to 11.8 in Germany. A 2015 study carried out by BBVA Research and the Círculo de Empresarios found that 73% of the productivity gap between Spain and Germany could be attributed to this difference in the average firm size, rather than to the sectoral structure. On an international level, the evidence suggests that the aggregate productivity of a country is closely related to its average firm size, which is also the case for the productivity differences between Spanish regions, but that this does not necessarily reduce competition and actually has the opposite effect.

The second characteristic is that productivity in Spain is markedly counter-cyclical due to a composition effect, meaning that it grows more in recessions than in expansions. Taking GDP per hour worked as the productivity measure, it increased by just 2 percentage points between the beginning of 1996 and the end of 2007 despite that period being one of expansion in which GDP grew by 55%. That stagnation in productivity that lasted over a decade was closely linked to the growth of the economy resulting from the allocation of productive resources to less efficient activities and firms. Thus, expansion was primarily driven by an excessive growth of demand, debt and prices that made those activities profitable. During the crisis we saw the opposite evidence, with a collapse in domestic demand (household consumption fell by 15%, and investment in capital goods and in construction fell by 28% and 51%, respectively) accompanied by an increase in GDP per hour worked of almost 11%. Unlike during the previous expansion, job losses primarily occurred in activities and firms with low productivity, something which can be largely attributed to the composition effect.

GDP per hour worked and unemployment rate Spain, 1Q1996-4Q2018

Source: BBVA Research based on INE. Productivity: moving average of 4 quarters.

The difference with this recovery was that the fall in the unemployment rate of over 10 points up to 1Q18 coincided with an increase in GDP per hour worked of almost 3 points. This is consistent with the fact that, during the recovery, supply-side factors predominated over demand-side shocks, with the contribution of exports to GDP increasing by almost 10 points and the structural unemployment rate falling. Unfortunately, since 2Q18, there have been signs that this process is coming to a halt and that the fall in the unemployment rate in recent quarters has been accompanied by a slight decrease in productivity and a deterioration of the current account balance. A continuation of this behavior over the coming quarters would confirm, once again, that economic growth depends more on demand-side factors than supply-side shocks, with no significant improvement in terms of aggregate productive capacity in the Spanish economy and no further reduction in the structural unemployment rate.

With the unemployment rate still above 14%, Spain needs many more quarters of continued growth. That growth must be driven by increased productivity so as to simultaneously enable job creation, and higher competitiveness and wages, thereby generating quality jobs that are sustainable over time. In the short term, this can be only be achieved by reallocating factors to the most efficient firms and sectors, thus removing any obstacles to permanent employment contracts. It is also necessary to continue making the most of the benefits presented by the Spanish economy's improved competitiveness abroad, not only in international value-creation chains but also in sectors that, traditionally, have not been particularly productive, such as tourism and construction.

There are no shortcuts in the long term. Productivity growth can only be achieved through improvements in firms' management and human capital, investment in R&D and technological capital, commitment to the digital revolution, the ease of doing business, larger internal markets, increased competition, better regulations and higher efficiency in the public sector, and the removal of regulatory, labor and fiscal barriers that hinder company growth. Fortunately, many of these measures are the same as those that reduce structural unemployment and inequality, and increase equality of opportunity, thus avoiding any conflict of objectives. That said, we need to resume, as soon as possible, the drive for reform that has been lost in recent years, and that has been replaced by measures aimed at stimulating aggregate demand and by uncertainty about the possible reversal of previous reforms. This is the only way to provide a solid foundation for the puzzle pieces to fit together stably, without collapsing like a house of cards when the next recession comes.

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