

SPAIN CAN AVOID A LOST DECADE: A WAY OUT OF THE CRISIS

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OUT OF THE CRISIS**

XAVIER VIVES

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Introduction

The financial crisis which started in the summer of 2007 has turned out to be an inflection point for the global economy. Financial systems have been put under extreme pressure and economies have suffered severely from the collapse of financial markets and credit and from the bust in different economic activities and sectors. Lessons have been learnt as traditional economic policies have been put under question. A global discussion on the future of capitalism, economic policies, and financial regulation and supervision is taking place. Deep reforms are being studied well beyond the financial sector and into the real economy. Human capital and innovation, banking regulation, reduced leverage, enhanced corporate governance, and consolidation in public finances are only some of the common themes.

Is Spain a special case? Many think it is an extreme case just as it was regarded as a “role model” in the good years. The country will probably have to undergo deep reforms in its labour market, its education system, the housing market, as well as re-regulating many other economic activities. The labour market has again proved to be the Achilles heel of the Spanish economy, destroying employment during the downturn just as fast as it created it during the boom years. A renewed economic model will need to arise in order to recover the growth path of the last decade and to create sustainable employment.

In the following papers, four prestigious and independent economists give their view on how to design and implement these reforms*. Starting with a diagnosis of the causes of the crisis and of the current situation, they provide different alternatives on how to approach the structural challenges faced by Spain's economy.

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* The opinions, estimates and recommendations included in these articles are those of the authors only and do not necessarily represent N+1's views.



SPAIN'S CHALLENGES TO GET OUT OF THE CRISIS

Xavier Vives*

The global financial crisis which started in 2007 with trouble with subprime mortgages has put an end to the extraordinary period of growth that Spain had enjoyed since 1996. Indeed, since then Spain has enjoyed a growth rate at least 0.7 points higher than EU-15 until 2007. This growth bonanza has been based on low interest rates, a large immigration inflow (foreigners were 2.2% of total population in 2000 while 10% in 2007), and wage moderation, and has been driven by a strong increase in internal demand accompanied by formidable employment creation. One out of three jobs created in EU-15 in the period 2000-2007 were accounted for Spain.

The pattern of growth has been based mostly on construction, real estate and tourism. By 2007 the weight of construction in employment was 13%, compared with a mean of around 8% in the EU.

Spain has caught up with the EU, although not in a smooth way since joining the common market in 1986, with crises after 1992 which were dealt with competitive devaluations between 1992 and 1994. Income per capita (in PPP terms) went from about 80% of the EU-15 level in the mid nineties to more than 90% by 2007. The joining of the euro in 1999 implied low interest rates, negative in real terms in the period 2002-2005, which contributed to a huge boom in construction and real estate accompanied with the expansion of financial intermediation. The pattern of growth has been based mostly on construction, real estate and tourism. By 2007 the weight of construction in employment was 13%, compared with a mean of around 8% in the EU.

Spain has typically had a more pronounced economic cycle than the EU average. Historical reasons were a sectoral composition with larger (albeit declining) weight of agriculture, low and medium technology industries, and tourism, and a more procyclical economic policy until 1994, when a

* In this article I draw in part from the results of the project Competitiveness in Catalonia co-directed with Pankaj Ghemawat at the Public-Private Research Center of IESE Business School (see www.iese.edu/competitiveness).

phase of orthodox macro-management was implemented. In the latest long boom it has been construction a main driver, with Spain managing to do better than the EU-15 even in periods of economic deceleration. This is set to reverse in the present recession.

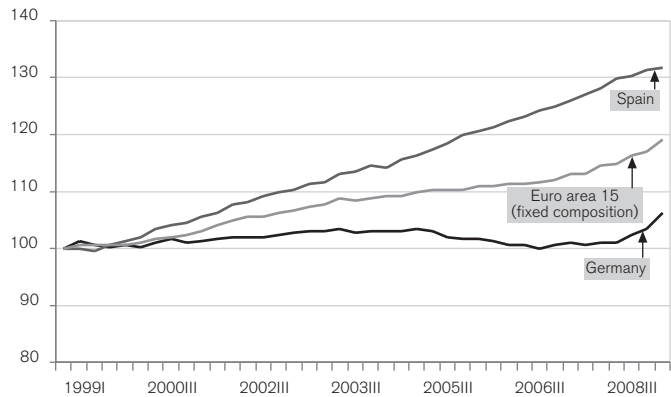
The Achilles' heel of Spanish growth has been productivity. Spain has had a consistent positive inflation differential with the Euro area, up to the recent recession. Spain has lost competitiveness with respect to EU-15 as measured by the evolution of unit labor costs. With respect to Germany and in terms of unit labor costs for about 30% since 1999 and since 1995 Spain has displayed a similar loss of competitiveness as Italy. This clearly points out at the unsustainability of the recent growth model.

Since the 1990's European labor productivity growth is lower than the growth of productivity in the United States, and Spain has been a laggard in the EU. In Spain labor productivity growth has been near zero between 1998 and 2000, with positive rates the next two years, turning negative later on up to 2006.

Total factor productivity (TFP) displays negative growth rates from 2001 until 2007 while increases in TFP have been consistently larger in the EMU area (although negative between 2001 and 2003).

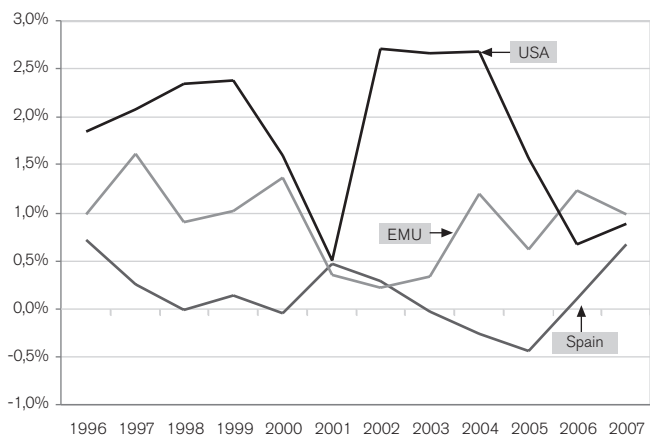
The Achilles' heel of Spanish growth has been productivity. Spain has lost competitiveness with respect to EU-15 as measured by the evolution of unit labor costs.

UNIT LABOR COSTS GROWTH



Index: 1999 = 100. Seasonally adjusted Source: Ghemawat and Vives (2009).

LABOR PRODUCTIVITY ANNUAL GROWTH RATES



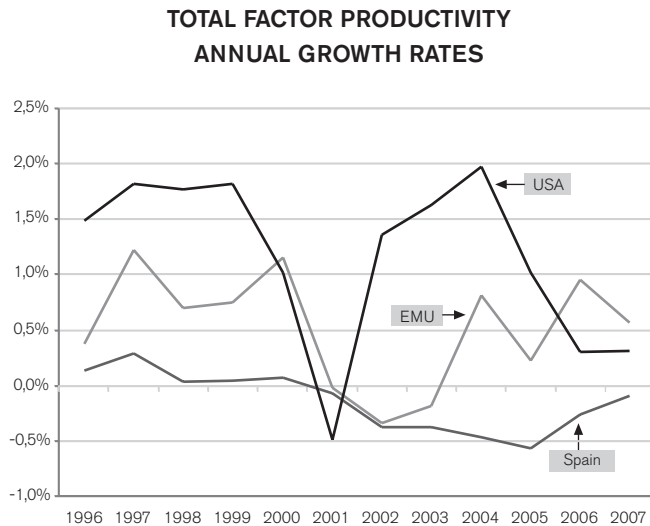
Source: Ghemawat and Vives (2009).

Behind the poor productivity performance of the Spanish economy lie several factors being an insufficient accumulation of human and technological capital central. The level of education of Spain in relation to the EU-27 is low and with a low proportion of high school and vocational training in the economically active population (23.6% in Spain versus 49.2% in EU-27 in 2007). Spain with a 31% also doubles the percentage of population between 18 and 24 in EU-27 (14.8%) that has not completed secondary education and is not

doing any other type of study or training (2005). Spain is in the bottom third in science and the bottom quartile in math; and only two countries do worse in reading in the PISA study. Correcting for the low education levels of Spanish parents, performance is somewhat above average in science and math, and approximately average in reading. However, Spain does relatively worse when we consider teenagers with college educated parents or parents with upper secondary school, than when we consider teenagers with parents that have a lower secondary education. The children of college educated parents are at or below the average in both science and math. This indicates that the Spanish PISA performance in science and math does not need automatically rise above average as parental education levels catch up to the European average. A particular failure of the system is the relatively low knowledge of the English language.

Somewhat surprisingly, Spain shows a higher proportion of University studies but it shows also a poor performance with a high rate of students quitting –between 30 and 50% depending on the

Behind the poor productivity performance of the Spanish economy lie several factors being an insufficient accumulation of human and technological capital central.



Source: Ghemawat and Vives (2009).

field - and with a high number of years required on average to obtain a degree (6.3 years for a 4/5-year degree). The University system has improved in its research capabilities but it is highly bureaucratic, universities lack autonomy and have severe problems of governance and financing. In relation to technological capital, R&D spending as part of GDP has shown an increasing tendency, but at 1.27% is still well below the EU-15 average at 1.91% (2007), not to mention the distance with countries such as the US, Japan or the Nordic countries within Europe. Furthermore, R&D policy has tended more to dispersion than to consolidate critical mass in key areas.

The rigidities in the Spanish industry are the outcome of (i) a rigid labor relations system, (ii) lack of competition in the service sector, (iii) constraints to mobility derived from the housing market, and (iv) the inefficiency of public administration and regulatory problems.

Spain has managed, partially out of the privatization process of state-owned firms, to consolidate outward looking utilities in the energy, transportation, and telecoms sectors, as well as in construction and banking. The latter displays two international banks that have come out strengthened from the crisis and at least one strong large savings bank with an ambitious international expansion plan. The competitiveness of Spanish banks, with expansion in Latin America, the EU, US, and starting in Asia, derives from the early liberalization process in Spain which increased competition and fostered efficiency in the sector. These large firms in regulated sectors are an asset for the Spanish economy. At the same time competitiveness of Spanish industry has lagged. Several factors explain this state of affairs. The size distribution of firms is tilted towards small firms with low productivity, there is a

lack of tradition of inter-firm cooperation, absence of locally rooted large multinationals and, most importantly, many rigidities in the process of entry and exit in industry, which may prove to be an obstacle to overcome the current crisis. The rigidities are the outcome of (i) a rigid labor relations system, (ii) lack of competition in the service sector, (iii) constraints to mobility derived from the housing market, and (iv) the inefficiency of public administration and regulatory problems. Indeed:

- (i) Spain has a very high index of protection of labor leading to a dual labor market (with a segment of protected jobs and another of temporary laborers), low levels of part time work and a welfare system that does not incentivate work. Collective bargaining is at an intermediate degree of centralization, very far from the decentralized extreme and not close to the centralized one (both with good properties). This system does not allow neither to fine tune salary conditions to the productivity at the firm level, nor to internalize general economic conditions when setting wages.
- (ii) Competition in services is weak and this discourages the use of information technology. Particularly severe competition issues arise in the energy and commercial retail sectors. In energy, on top, subsidies of technologies are pervasive distorting the efficient use of energy sources and a general policy on the appropriate technology generation mix is lacking.
- (iii) The rental housing market is very narrow because the property rights of owners are not firmly established.
- (iv) The administration of justice is slow and inefficiently organized, inflicting high costs on the operation of firms. Administrative procedures are cumbersome and the cost of doing business is high. Sectoral regulators still have a long way to attain the desired independence and technical capability.

Productivity is the name of the game to get out of the crisis. Renovation and productivity improvement at small and medium size enterprises may prove to be the key lever to get Spain out of the crisis.

The financial crisis has ended the period of growth based on the construction sector and will imply a major restructuring of industry and downsizing of the segments which are not internationally competitive. Productivity is the name of the game to get out of the crisis.

There are segments of internationally competitive firms (e.g. in Catalonia and the Basque Country, regions with a more diversified economic structure with less dependence on the construction sector). For example, Catalonia's export share in world markets has been steady at 0.46% from 1995 until 2008 despite the pressures of the globalization process. Those firms have made efforts to become more competitive in terms of reducing costs, investing in human capital, product differentiation and the adoption of new technologies. Innovation effort has lagged behind, mostly because of the constraints faced by small firms. Renovation and productivity improvement at small and medium size enterprises (SME) may prove to be the key lever to get Spain out of the crisis. A distinction must be made between those firms and segments which are at the world technological frontier, and for which the pressure to innovate is formidable and which need heavy R&D investment, and those which are well inside the frontier, for which a strategy of renovation and adaptation is in order to advance towards the frontier. The crisis may be an opportunity to get rid of the inefficient firms but for this to happen flexibility is necessary. In the short term adjustment will be painful since credit is not flowing to industry due to the financial crisis, and the predominant SME sector is very much dependent on bank credit. This may be a blessing in disguise and provide an impetus for the needed restructuring of the SME sector with renovation and innovation to increase productivity. This restructuring will be successful if no artificial impediments to transfers of resources from declining to emerging sectors are in place. The pressure of lower cost producers combined with the Darwinian selection that the crisis will subject the industrial fabric to should provide a crucial impetus for the needed productivity improvement. However, the protection with subsidies of sectors like automobiles may prove in the end to be a barrier to restructuring.

At least four major areas need attention: human capital and innovation, labor market, competition and regulation, and fiscal consolidation.

Spain needs to foster human capital, formation, openness and internationalization. In education and R&D a change in organization and incentives in the bureaucratic structures is more important than increased public spending.

In short, without a series of reforms to improve productivity Spain will face a protracted period of low economic activity and high unemployment (which will reach soon 20%). No devaluation will save Spanish industry as in the early 1990s. At least four major areas need attention: human capital and innovation, labor market, competition and regulation, and fiscal consolidation.

Spain has to privilege brains and not bricks, human capital over construction and infrastructure. This means to foster human capital formation, openness, and internationalization. In education and R&D a change in organization and

The labor market must be reformed, ending its dual structure with the division between temporary and permanent contracts and adjusting severance payments to European standards. Unemployment subsidies should be redesigned so that they incentivate the search for a job, and mobility between firms and geographically.

incentives in the bureaucratic structures is more important than increased public spending. This is so both in secondary as well as advanced education. In both a culture of excellence should be promoted. Schools need more autonomy to compete for students and professors with more transparency on performance. English should be introduced as one of the working languages at school. In higher education, the universities should have autonomy to select professors and students with public financing according to results, charge fees closer to the real costs and develop a system of fellowships to foster equal opportunity. The University system should move from the bureaucratic mode to an excellence-oriented one. Investment in science and innovation needs to be kept in the crisis period with special care given to the segment of dynamic firms active in the international market.

The labor market must be reformed, ending its dual structure with the division between temporary and permanent contracts and adjusting severance payments to European standards. Part time work should be fostered and the protection of unemployment turned into the protection of work. The collective bargaining procedures should be revised also in order to be compatible with the needed improvement in firms' productivity. Unemployment subsidies should be redesigned so that they incentivate the search for a job, and mobility between firms and geographically. For this to happen, at the same time, a reform of the rental market is needed establishing clearly the property rights of the landlords. This is, fact, would represent also an important stimulus to the depressed real state market.

Competition should be fostered in services in particular (implementing the EU services directive) to lower costs and induce faster adoption of information technology. This may be particularly important in a sector such as commerce retail. In regulated sectors like energy an opportunity must be given to the market. At present the maze of subsidies and regulations induces an extremely high inefficiency and distorted use of energy sources. Sectoral regulators should be reformed.

Finally, the current crisis has important fiscal implications. Because of the construction boom the state was used to a public expenditure level which is not sustainable once the bubble has burst. This means that public finances have to be consolidated at some point. This includes a reform of the pension system in order to guarantee its viability. The short-term alternative is to raise taxes which, in the end, will be

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Public finances have to be consolidated at some point. This includes a reform of the pension system in order to guarantee its viability.

paid by dynamic segments of the middle class, lowering incentives to work and invest. In fact, one of the factors that potentially put Spain in the direction of the best performers in the EU, if the needed reforms are made, is that the relative weight of the public sector in the economy is more aligned with the UK level than with countries such as France, and that Spanish society is still more flexible and adaptable than the more entrenched middle Europe. An increase in the weight of the public sector in Spain may kill those prospects.

The way out of the crisis needs in the short term to restore the balance sheet of banks so that credit flows back to productive activities and families, and to allow the movement of resources from declining to upcoming sectors. At the same time the withdrawal of fiscal stimulus has to be timed carefully. Too early and we may end up like Japan with a long crisis. Too late and the burden of the public debt may become explosive. It is a difficult balancing act. What is clear is that Spain should put forward a package of reforms in education, labor market, competition and public administration to signal to international markets that it is a country where it is sound to invest both in the private and the public sectors. The more this package is delayed, hoping that the recovery of the world economy will get Spain out of the hole, the longer will be the period in which the economy will take to recover.



IS SPAIN REALLY SO DIFFERENT? WHEN LOW PRODUCTIVITY MEETS RESISTANCE TO REFORM

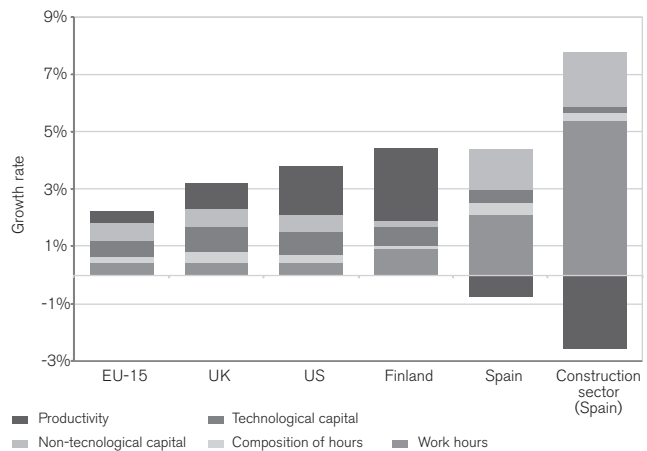
José García-Montalvo

“Yes, but Spain is different”. This is the excuse frequently used to justify the abnormalities of the economic structure of the Spanish economy. As it is well-known, Spain had a terrific record of economic growth during the years before the financial crisis of 2008. When you pointed out that an important share of that growth was based on the construction sector, especially residential investment, the answer was always the same: “Spain is different. All the retirees from countries in the North of Europe want to come to live in Spain so we have to build many, many houses”. But, could that growth pattern be sustainable in the long run? What would happen if housing prices go down? “That cannot happen in Spain”, was the unanimous answer. Not surprisingly many of the foreigners who bought houses were investors and many left the Spanish housing market before the debacle.

Therefore, at the end, Spain is not so different in the fundamental questions. Economists do not have many certainties. But if we know something for good is that a country with stagnant, or even decreasing, productivity has no long run future. And that was the case of Spain. The extraordinary growth rate of the “miracle decade” was just a mirage. And part of the problem was the excessive dependence on the housing sector.

Spain was growing faster than the EU, the UK and even the US. But the

**DECOMPOSITION OF GROWTH IN
MARKET PRODUCTION, 1996-2005**



Source: EU-KLEM and author's calculations

Spain was growing faster than the EU, the UK and even the US. But growth was not sustainable in the long run. The growth of Spain was sustained by putting lots of hours using low technology capital.

composition of growth was quite unhealthy. Therefore, growth was not sustainable in the long run. While other countries that grow slower than Spain presented a positive growth rate of total factor productivity, in Spain there was a negative (-0.8%) productivity growth. Finland was growing at a similar rate to Spain but more than half of the growth in market production was due to improvements in productivity. The growth of Spain was sustained by putting lots of hours using low technology capital. These two components have a very low weight in the composition of growth of the other areas. But, what was the basic source of such an unhealthy growth pattern? One basic reason is the enormous weight of construction in the sectoral

composition of the Spanish economy. The construction sector is the extreme case of an industry that uses lots of hours of work, low technology capital and shows strongly decreasing productivity.

But there are other reasons of this structural low productivity of the Spanish economy related with human capital formation, the working of markets, etc. In this brief note I want to discuss some of these factors without trying to be comprehensive.

We have to accept that Spain is different in some aspects. Two are particularly important for the purposes of this note. First of all, it is already clear that Spain will come out of this crisis later than most of the other developed countries. All the forecasts of the international economic organization (OECD, IMF, EU, etc.) point out in this direction. Second, the adjustments in the Spanish economy take place mostly on quantities instead of prices. In the labor market, while unemployment is increasing at an exponential rate, real wages continue to grow. In the housing market, while the number of housing starts has gone down dramatically (from 860.000 in 2006 to a forecast of less than 190.000 in 2009) the prices of housing have gone down from the peak only a mere 8,6%. For comparison purposes, in the US the price of housing has gone down a 33% from its peak, with a less severe reduction in housing starts. In fact the rapid adjustment of prices has helped the recent stabilization of the market. Therefore, Spain will come out of the crisis late. The traditional adjustment of the markets via quantities will retard further a sustainable recovery of the Spanish economy, which needs a substantial adjustment via prices to improve its competitiveness in a situation where exchange rates are not a policy instrument. Finally, the fact

The Spanish economy needs a substantial adjustment via prices to improve its competitiveness.

that most of the mortgages during the last decade were signed at an adjustable rate will also have important consequences in the dynamics of the exit of the Spanish economy from the crisis. When the large economies of the EU start growing the ECB will increase interest rates which will reduce after mortgage disposable income in Spanish families and retard the recovery of consumption.

The dangerous predominance of the construction sector in Spain was visible long time ago. Many indicators pointed out to plenty of abnormalities in the Spanish housing sector: residential construction reached 9% of GDP (total construction went over 18%); the rental sector represented only 11% of the available housing units; most of the resources to finance this large residential investment came from foreign countries (external deficit reached 10% of GDP); 95% of the new mortgages had an adjustable rate; etc. In 2004 the socialist party won the Congressional election and promise to “change the productive pattern of the Spanish economy” in clear reference to the excessive weight of residential construction. But it was unlikely, and it actually did not happen, that politicians would spoil the housing party when the construction sector provided 25% of the growth of the economy. Politicians are shortsighted due to the need to win the next election, and only in extreme circumstances go for structural reforms with long run benefits. Spain suffers particularly of this problem. Specifically, and despite the important problems of the Spanish economy, even now the government is opposing structural reforms in many issues (in fact the government does not even accept to talk about them like, for instance, reforms of the labor market).

Changing the “productive model” of the Spanish economy cannot be done just by approving laws of clean energies. It is necessary to eliminate the wrong incentives created by the subsidies and tax breaks for house purchases that the public sector maintains since the end of the 70's. Controlling the size of the construction sector requires: eliminating the elevated and indiscriminate tax breaks for buying houses; ending up with the large subsidies implied by selling social housing to the lucky individuals who win the social housing lottery; increasing the size of the rental market up to a reasonable level, say 30 o 40%; and, in the financial side, preventing new bubbles by linking the size of the mortgage to the official price (recorded by the notaries) of the houses and not to the appraisal estimation. One reason that explains the large housing bubble form in Spain is the spurious increases in the appraisals to suit the financial needs of families. If a buyer could not provide upfront the 80% of the price of the house, the appraisal company would increase their price estimation as much as needed to look as if that was the case. Why would the appraisal company play this game? Because almost 50% of the appraisal companies in Spain belong, or are participated, by credit institutions (banks or savings and loans). The link of notaries' prices to credits will avoid future credit bubbles and, therefore, would stabilize the sector in a reasonable share of annual production. The reduction in the weight of the construction sector will also produce a much needed increase in the aggregate productivity of the Spanish economy by redirecting resources to more productive industries. We should not forget that in 2007 the construction and housing industry accounted for 61% of all the credit of the Spanish economy, or as much as total GDP.

In addition, and given that there are more than one million new unsold dwellings it is unreasonable for the Spanish Government to construct 150,000 new social houses every year, as it is its intention. The public sector should produce fewer social houses than announced, and only if the objective is to rent them and no to sell them. In this case they could add to the needed increas-

The Spanish educational system is dual: there are lots of people with compulsory education, or less, and lots of young people with university degrees.

es in the Spanish rental market. The increase of the size of the rental market is vital to improve productivity. The weak rental market reduces the labor mobility of workers in a country with important problems of unemployment and occupational mismatch. It also keeps young people living with their parents for too long. In a recent document (Making the housing market work in Spain, <http://crisis09.es/vivienda/housing-proposal.pdf>) we have proposed (myself and other eighteen academic economists) a series of measure to improve the rental

market in Spain. Among them we consider critical to liberalize rental contracts, increase legal protection for owners, reduce obstacles for renters, abolish tax incentives for home purchases, and abolish owner-occupied social housing and reorient social protection towards the rental market.

There is another issue of critical importance to improve productivity in the Spanish economy: the accumulation of human capital and its quality. The Spanish educational system is dual: there are lots of people with compulsory education, or less, and lots of young people with university degrees. High school and vocational training graduates are relatively scarce. The return to education is going down in Spain and, even more important, the relative wage of university graduates versus secondary education graduates has gone down 40% since 1997 (the largest reduction of all the countries in the OECD). The education system is also quite dysfunctional: around one third of individuals do not get the compulsory education degree; the performance of the Spanish students in Program for International Students Assessment (PISA) is dismal: the average of Spanish students in reading, math and sciences is well below the average of the OECD; a large percentage of the population starts university studies (37% of the population in the age group between 18 and 24 years old, and 53% of the students who get the compulsory education degree) but 30% of them will not get the degree; and around 35% of the Spanish university graduates are overqualified for their jobs. This overqualification is not just a temporary phenomenon, related with low-qualification entrance jobs, but extends over time and successive jobs. We should also notice that 90% of the university students go to public universities. The subsidy for each student/year is around 6,000 euros.

Despite this diagnostic, some Spanish analysts still claim that the lack of financial resources is the main cause of the inefficiencies of the education system. But the PISA dataset makes clear that there is no direct link between public expenditure in education over GDP and students performance. The experience of some developing regions should also be a good indicator of the scarce relationship between expenditure and educational outcomes. The countries in the MENA region (Middle East and North Africa) spend a large percentage of their GDP on education but they suffer a high level of unemployment, including university graduates, and very low rates of return of education.

Financial resources are not the main problem to improve the efficiency of the educational system in Spain. Any credible strategy to attack these inefficiencies should include several basic elements. First of all, there should be a reduction in the extension of the comprehensiveness of the system. Not all the students are able, or interested, in following the same educational paths. Second, vocational training should be a priority. During many years vocational training has been perceived by students and families as a way out for “losers” or bad students. But this is not the case at all. Labor market data show that vocational training graduates have low levels of unemployment and reasonably good salaries. They are quickly reducing the gap with university graduates. This information should be known by students and families. Third, universities should be more sensitive to the needs of firms and society. This approach does not imply transforming the university in another vocational training institution. But universities should not hide behind their autonomy to avoid fulfilling their social responsibility. Since public universities will not go this way without some help, the system of financing public universities should rest on indicators of outcomes (research outputs, graduation rates, etc.) and not of inputs (number of students). The reform of the governance and decision making processes will also help in improving the relationship between universities and the needs of the society. For instance, there should be more external members in the board. The rector should be recruited by the board. The “Claustro”, or academic congress of the university, should also change its composition. Currently it includes representatives of students, staff and professors. However, the interests of staff and current students are not always aligned with the objective of providing a high quality education. The staff is mostly worried about their labor conditions, which should be discussed in the context of the negotiation between trade unions and the public sector representatives but it should never contaminate the discussion in the academic parliament. Alumni should substitute current students in the academic congress of the universities. Alumni, in contrast with current students, have been already able of evaluating the relevance of the methods and content of their university studies in their professional career and personal life. Alumni have also fewer conflicts of interests than current students.

Financial resources are not the main problem to improve the efficiency of the educational system in Spain. Vocational training should be a priority.

Universities should be more sensitive to the needs of firms and society. It is also important to establish different levels or categories of universities.

Forth, it is also important to establish different levels or categories of universities. Just a few universities in Spanish would qualify as “research universities”. The rest are in fact “community colleges”. The recent program of “Campus de Excelencia” promoted by the Spanish Government is a very good step in this direction. Students should have a clear ranking of universities and departments before they choose where they want to study. This will imply a big change since up to

Grants for university students should increase drastically in number and size to finance mobility of students and to cover the opportunity cost of students coming from low income families.

now student just go to the university closer to their residence. It is important to stop the absurd process of creating a university in every corner of Spain for "local development" purposes. There are better instruments for local development than universities, and students need to move around when they are young in order to reduce the resistance of adult workers to relocate in order to find a job, or a job that is more appropriate to their qualifications.

Fifth, grants for university students should increase drastically in number and size to finance mobility of students and to cover the opportunity cost of students coming from low income families. But students coming from families with high level of income should be ready to pay a much higher share of the cost of their education.

Finally, there is the issue of entrepreneurship among university graduates. All the surveys show that between 50 and 60% of university students want to become a public servant. It is a clear waste of resources that the individuals with the highest level of education and the one better prepared to understand complex systems, the working of economics and society, etc. have lower propensity to start their own business than graduates from lower education levels. There are several reasons for this allergy to risk shown by university students. In many occasions their role models are their professors, most of them civil servants. But more important, many university professors still transmit the idea that entrepreneurs are individuals without ethical principles that only want to take advantage of workers and consumers. For these motives, and many others, it is reasonable to question the public servant status of staff and university professors. This is not an oddity. In fact, from January of 2010 the professors and staff of the universities of Finland will no longer be civil servants. In exchange for this universities will gain greater autonomy in terms of finances and overall management.

In this brief note I have decided to concentrate in a few issues that I consider strategic in order to improve the productivity of the Spanish economy and avoid the painful alternative: a sharp

It is reasonable to question the public servant status of staff and university professors.

reduction in real wages. There are obviously many other reforms that can help the Spanish economy to enhance its productivity. There is need to reform the labor market, the public sector, the regulation of financial institutions, the system of research and innovation, etc. But what we need is to stop dreaming in mirages and to get the job done.



THE GREAT RECESSION. DIAGNOSIS AND PROGNOSIS

Juan Urrutia

After several months of failing to recognise the crisis beginning at the end of the summer of 2007, and another few months of thinking that, after the fall of Lehman Brothers, we would end up with a depression as severe as the Depression of 1929, our language appears to have stabilised and we admit that most of the world economy is in what is being referred to as the Great Recession. The fact that our language and economic situation have mutually adjusted to each other shows that not only are we in a global economy, but that we are witnessing the first online recession, with all the contagion and volatility of expectations that this involves. These characteristics have made diagnosis difficult in the last few months and are now generating different prognoses which have turned, in a suicide movement, against Economics as a science, revealing some of the strange intellectual adventures of what is known as the dismal science. I therefore intend to present a few supposedly clarifying ideas concerning the connection between the Economy and the economic systems considered either as national systems or as constituting a global system.

The origin of the crisis can be found in international disequilibria related to savings and investment.

Two warnings before I come to the task. First, this short paper is like a follow-up of my more technical one "Una visión (Semi) heterodoxa de la crisis. Un simulacro de formalización parcial" published in Vol. 32, nº 88, enero-abril 2009, pp.13-41, of Cuadernos de Economía. The quotation below comes from this publication. Second, except at a point (Cajas de Ahorros) nothing specific is said about the Spanish economic system because, among other things, I do not have it as so different, at least at the level of abstraction I plan to let my thinking fly.

1. I will start with the diagnosis. It was not easy but few doubts remain. The origin of the crisis can be found in international disequilibria related to savings and investment, which led to apparently permanent disequilibria in trade balances, with enormous deficits in highly developed countries and sur-

It was soon realised that the problem was one of solvency and that it could not be quantified because the situation had been hidden or ignored by the regulator or supervisor.

reduction which would endanger their generation of value and, ultimately, confidence in the payment system. They were therefore forced to innovate in different ways which have been thoroughly examined and include the transformation of subprime mortgages by securitisation and division into different tranches, together with different manoeuvres, in order to take off the balance sheet most of the leverage they had incurred in order to effect their innovations. The banks were therefore in a difficult situation and it is not surprising to find that, when facing the first liquidity problems, it was soon realised that the problem was one of solvency and that it could not be quantified because the situation had been hidden or ignored by the regulator or supervisor. The financial crisis was served. Its transmission to so-called real sectors – as if the financial sector were imaginary – was incredibly fast because banks ceased to provide credit, as they were unwilling to enter the interbank market because of their suspicion that their colleagues were in as bad a state as they themselves were.

As part of the diagnosis, two specific points are of interest. They have an impact on my subsequent prognosis.

1.1. The first refers to the transformation of monetary policy into general financial policy which necessarily converts a Central Bank not only in a lender of last resort, but also in a creator of markets, as the latter were inoperative. Hence the innovations in the Fed, which started to accept practically anything as collateral for its loans, thus creating such a huge own balance that it is a clear evidence of what was happening and how serious it was. This is well known; but let's consider the second of the two points, one that requires a greater intellectual effort.

The transformation of monetary policy into general financial policy necessarily converts a Central Bank in a creator of markets.

pluses in some emerging countries. The latter were holding an enormous mass of reserves which, in a flight towards quality, were used to finance the debt of central countries, particularly the US. This movement created an excess demand for this debt which reduced long-term interest rates, a natural reduction which, together with the artificial reduction created by the Fed's lax monetary policy applied to prevent the financial crisis which have been recurring since 1987, necessarily led to a drop in the yield curve. Banks were forced to "sell" more to protect their financial margins and reach the bottom line of their accounts without a striking

1.2. The second specific point to be highlighted is the famous debate about the Economics capacity, in its macro-economic aspect, to anticipate or even understand what was happening and the danger involved. In the opinion of more than a few renowned economists, the effort to construct a computable dynamic general equilibrium model has macro-economists obsessed with their Herculean task of integrating not only the rationality of the representative individual

agent or instant market equilibrium, but also the hypothesis of rational expectations (REH) and that of efficient markets (EMH) in a manageable model, initially eliminating any sign of price inflexibility or gradual adaptation of expectations. It is like an artist's obsession for following the lines created by his intuition. And with this heroic attempt at field unification, we find an endless number of ideas to be considered in relation to what we could call, in a words playing exercise, the systemic failure of the macroeconomy.

2. Let's take a brief look at some of these ideas, duly divided into groups.

2.1. With regards to individual rationality, we can only hope that, gradually, acceptance will be forthcoming for some of the most promising ideas from Behavioural Economics, sustained by numerous lab experiments which show systematic behavioural biases that cannot be explained by the functional rationality considered in neoclassic economic theory. This includes the famous "animal spirits" and much more.

2.2. With regards to the use of a representative agent, it is certainly a highly convenient convention which facilitates mathematical modelling; but it does not withstand the mass of what is already old literature about the restrictive conditions involved (either all agents are the same from the beginning or we have to assume some ad-hoc hypotheses such as, for example, that there are no distributive effects) or the developing literature about heterogeneous agents who interact like elementary particles, jumping from one equilibrium position to another without prior warning.

2.3. The REH appears to be essential but is associated inexorably to the multiplicity of equilibria. So, a good model must have something enabling these equilibria to be distinguished from each other.

2.4. The EMH has been highly criticised in recent times, even though, on the one hand, the introduction of finance in macroeconomics seems essential and, on the other, it seems to have been widely confirmed. But we must admit that the paradox of searching for information in a context in which it appears to be entirely transmitted by the market has not been solved, and that different forms of asset aggregation generate different forecasts.

2.5. Finally, I cannot fail to mention that the very same idea of equilibrium will have to be enriched with old "Keynesian" ideas corresponding to what was once known as Disequilibrium Economics, which simply reminds us that there is no auctioneer who prohibits trade until the equilibrium price vector has been found, so allowing trade at "false" prices and consequently quantity fluctuations such as, for instance, unemployment, credit shortages and falls in housing construction.

3. These remarks form already part of the prognosis about the theory, but before I turn to the prognosis in general, allow me an interlude to mention some of the ideas I shall need to complete this discussion.

All Central Banks are “playing” with models including heterodox ideas which help to monitor economic systems even though they are not as pure as a theoretical mind could wish for.

3.1. The first of these bridging ideas is the possibility of constructing models combining Disequilibrium Economics with a neoclassic equilibrium model in the context of which not only can we discuss many significant issues, such as unemployment, but other less obvious but nonetheless important factors. One of them is the use of fiscal policy to solve a crisis which is no longer only financial and the form to be taken by this policy, weighing tax changes and public expenditure. Besides the discussion of the crowding effect, Ricardian equivalence and comparisons between the size of different multipliers, we can consider forgotten, but nonetheless significant, results.

3.2. The latter comment refers to the results available concerning the adjustment period. I will briefly summarise them to show their importance. Even assuming sufficient prudence in budgetary affairs, we can distinguish between “rich” and “poor” countries (in a sense that we do not need to go into here) and examine the adjustment period that they will use to reach, for instance, the same per capita consumption level. A “rich” country like the US would have a smaller adjustment period the larger its public sector and the lower its tax pressure. A “poor” country (say, Brazil) takes less time to recover the smaller its public sector and the larger its tax pressure. It is easily observed that these results, which can be obtained from an old growth model, have important implications which are nonetheless not systematically discussed, showing so that path-dependence is a sad intellectual fact.

3.3. The second bridging idea refers to the fact that, in spite of all the efforts for field unification, all Central Banks are “playing” with models including heterodox ideas which help to monitor economic systems even though they are not as pure as a theoretical mind could wish for.

4. I will now attempt to predict what will happen in areas of interest now that the recession, although deep enough, appears to be under control. I will just consider a few issues, as it would be impossible to mention all the factors which could be affected by the above mentioned comments. It is clear that the shock has been sufficient for there to be numerous ideas and more than a few institutions in need of a serious revision. Consider the different exit strategies, the very notion of money and financial wealth, the financial sector in general and, more specifically, the banking sector, and also, of course, the regulation of these crucial systems.

4.1. With regards to the exit strategies to be applied now that the recession appears to be under control, it is worth adding a critical remark to the current debate on when to abandon the public expenditure programmes in view of the public deficits being generated or the new monetary policy.

4.1.1. The latter will continue until the financial, and particularly the banking, world has achieved independent sustainability without the need for what is known as the quantity easing of some

Central Banks, and specifically the Fed, so that banks can start to grant credit to firms that need to renew their investment plans. The incentives, here, however, are not completely aligned. A bank can indeed borrow from the Central Bank at a practically zero rate but it can also use that financing to buy government bonds issued to cover the foreign deficit, thus obtaining a juicy differential at no risk. This should not be a surprise, as we have already said that one of the concomitant causes of this crisis that became a recession were disequilibria in the balance of trade. These have started to improve, but until they reach a sustainable equilibrium, banks, whose balance sheets continue to be somewhat precarious, will not easily go back to being instruments for granting the credit required for a smooth recovery.

4.1.2. This would seem to be important in relation to the withdrawal of public aids which necessarily affect the budget and, whatever the tax policy, always generate an enormous budgetary deficit. Given the precarious nature of the slow recovery process and current unemployment levels, it would appear that they cannot be immediately withdrawn. But the longer they are in place, the larger the deficit and the burden of debt and the less incentives banks will have to perform their function of providing credit. In my opinion, in spite of the hard conditions that this involves for future generations and the idea of Ricardian equivalence that questions their effectiveness (given the knowledge that the deficit will have to be paid for in the future with higher taxes) these public expenditure items should be maintained until we reach a growth rate enabling the creation of net employment. And, as a simple reminder, we should not forget that a country could be tempted to withdraw the aid soon, thus attempting to benefit, through international trade, from the expenditure incurred by another country that maintains its programmes.

4.2. However, in spite of the possible problems derived from these strategies, more important seems the reaction, not only expected for some time but now detected, against the apparent artificiality of financial wealth which appears to have vanished off the face of the earth. Allow me to quote myself at this point since, in fact, it is not easy to explain. The floating debt that banks created in their attempts to sell more in view of price cuts, is Inside Money. Well, now "a financial derivative is only a bet between two people; when one of them wins, the other loses. It would appear, then, that the global amount of such bets is irrelevant. But each of the people who have run a risk by betting on a financial derivative can insure himself against an unfavourable outcome with one or two or...N "third parties" who also bet in the same way... *ad infinitum*. So, is the total amount of wealth involved still irrelevant? If this chain closes at a point in time and the first betters are insuring by the last, there is an immense floating cloud of social debts which, since they cancel each other out, are worth zero. We would see a redistribution of resources, but not net creation of wealth in the usual sense in which the word is used in macroeconomics, although we would see new opportunities and better distribution of risk, and both these factors should be seen as forming part of wealth. Refreshing now some notions of monetary theory, we could say that this "floating cloud" is Inside Money that "only" facilitates trade, makes credit flow and leaves net gains for some and

These public expenditure items should be maintained until we reach a growth rate enabling the creation of net employment.

Saving banks would probably be healthier if they became listed public companies subject to the Bank of Spain's supervision. My recommendation would be an adjustment of the "Ley de Sociedades Anónimas" to force firms in the financial sector to have a dual board, with executive members in the first board and a second board formed by stakeholder representatives.

which, in spite of all the criticism, redistribute risk and facilitate an economy's global investment by enabling a global acceptance of risk which, without new products and their respective markets, would not be possible. The bonuses paid to some bankers, however, have generated a lack of confidence in banks greater than that derived from their shareholders being concerned about a moral hazard which would end up creating dangerous short-termism. In as much as many banks have had to be bailed out or supported with public money, tax payers feel that they are being unfairly punished for the mistakes of ambitious bankers. There have even been debates about dividing banks into two different institutions: banks proper, which would operate with 100% reserves and end up being mere utilities, and other different institutions which would deal with more or less sophisticated financing and create markets for new financial instruments providing insurance for individuals and organisations.

4.3.2. These bitter reactions are understandable, especially when some of the banks that have returned the aid received appear to have gone back to their old tricks. I, however, fail to see either the convenience of or need for such changes. What would be convenient, however, is for banks to start to be concerned for the interests of their stakeholders. At this point, it is worth mentioning that the saving banks (Cajas) in the Spanish financial system are no longer the best example of this concern. They may have been in the past, but the Spanish financial system would probably be healthier if they became listed public companies subject to the Bank of Spain's supervision. The financial system would be broadened, the Spanish stock market would grow and this would put an end to the abuse of some regional authorities. My recommendation would be to change the Ley de Cajas in this way, together with an adjustment of the Ley de Sociedades Anónimas to force firms in the financial sector to have a dual board, with executive members in the first board and a second board

net losses for others. The quantity is not irrelevant... What if the chain does not close? There could then be creation of net wealth in the traditional sense, together with a risk which is larger the longer the chain, regardless of new opportunities and better distribution of risk. This was precisely the initial situation of the world economy before the onset of the crisis, and a situation like that needs to strike a compromise between wealth and risk, something that certainly did not happen on this occasion".

4.3. Let's now consider the banking sector

4.3.1. Banks perform a crucial function in a modern market economy. Not only do they provide coverage for the payment system and lend money to firms and households, but, especially since regulation became less strict in the 1980s, they have become creators of markets

formed by stakeholder representatives. The objective of this latter board would be to ensure that managers and shareholders have their incentives correctly aligned.

4.4. That does not seem to be the way things are going, however. A new look is being taken at regulation and supervision. There are certainly enough experts to explore both possibilities, improving Basel II and perfecting the recommendations found in the Larrosière report. At this point I dare to say something irreverent: if one of the central problems revealed by this recession is the lack of mutual knowledge among banks, so the mistrust between them was inevitable, we should focus regulatory or supervisory efforts on the public domain nature of risk calculation models or their basic platform. This would avoid mistrust and enable the Central Bank or the regulator to acquire sufficient knowledge about the applications of the platform of different banks which, consequently, would not be able to hide their balance sheets for long. Along these same lines a special effort should be made in order to know clearly and distinctly the structure and main characteristics of the network formed by banks since it should be understood that the more links there are among them the lesser the danger of implosion.

5. To close let me say that we can be sure that nothing will be the same after this Great Recession. The market system will survive, but some of its characteristics will undergo more or less serious changes. I will only comment on geopolitics, the labour market, the environment and the possible reconfiguration of corporations. These will have to pay more attention to their financial problems and needs, therefore spending less resources on technological innovation. Such innovation appeared to remove hierarchies, but this tendency may change direction now leaving us wondering about the

I expect a triad, with the US innovating, China manufacturing and Europe preserving a cultural heritage of increasing value.

new directions trade unions may take and about the nature of other institutions, legal or judiciary, conditioning the workings of the labour markets. The corporations, in their transnational activities will have to adjust to a new international division of labour. What I expect is a triad, with the US innovating, China manufacturing and Europe preserving a cultural heritage of increasing value. In a context like this, environmental protection will arise as the focal point of a global economic system. Not an easy one though.

We should focus regulatory or supervisory efforts on the public domain nature of risk calculation models or their basic platform.



HOW TO EMERGE FROM THE CRISIS

Juan E. Iranzo

The Spanish economy is reeling from the effects of the prevailing financial crisis following a protracted period of economic growth. A growing loss of competitiveness, the housing sector bust and the slump in consumption have hurled our economy into a recession that has been aggravated and accelerated by the fallout from the international financial crisis. The construction and manufacturing industries, which had been the major pillars upon which the heady growth of the past decade had been predicated, are suffering an unprecedented correction in terms of scale and speed.

Free market leads to economic growth and provides higher levels of well-being than when the public sector provides all goods and services to the private sector.

This crisis has sparked economic debate on the role that should be played by the state in the markets. Evidence has proven that the free market, functioning under efficiency criteria, leads to economic growth and provides higher levels of well-being than when the public sector provides all goods and services to the private sector. That being said, market mechanisms can fail if the state does not provide a stable regulatory environment that guarantees protection of property rights. On

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occasion, market flaws such as asymmetric information emerge, in which event intervention employing the right instruments is justified, as these serve as a second best solution. For these reasons market liberalisation must stay as an economic priority if boosting economic growth remains the ultimate goal.

To this end certain structural economic reforms are necessary. The need for these reforms has become vital and pres-

Labour market reforms are the most pressing. The introduction of measures designed to stimulate geographic mobility represents an important tool for rebalancing the job market.

During the current crisis as the Spanish economy is now not only growing significantly below its potential, also the pace of job destruction is expected to continue to accelerate to leave unemployment well above current levels.

Labour market reforms are the most pressing, as this is one of the economy's most vulnerable markets. Its contraction has dire consequences not only from an economic standpoint but also from the social angle. Specifically, the introduction into labour market regulation of measures designed to stimulate geographic mobility represents

an important tool for rebalancing the job market given disparate regional unemployment rates and the proliferation of redundancy programs in certain sectors. In Spain, workers are somewhat reticent to relocate for job reasons as a result of cultural inertia, uniform salary levels, scant corporate incentives encouraging regional mobility and a lack of intermediating mechanisms to bring together information on job availability on a nationwide and international basis.

The rigidity that continues to characterise hiring and firing decisions in Spain constitutes an additional barrier to the reallocation of labour resources. The tremendous safety blankets enjoyed by workers under permanent contracts are fostering precarious employment contracts for highly qualified young workers as well as surplus capacity, forcing management to opt to restructure, which can sometimes cost more than filing for bankruptcy. Rendering the labour market more flexible requires reducing hefty redundancy payment obligations and the introduction of clauses that allow companies to lay workers off for economic reasons in environments as challenging as this, in order to bring their workforces in line with real production needs.

There is an urgent need to cut social benefit payments, particularly those borne by employers, and corporate income tax, both of which are above the European average. The distortions created by contributions to the social security system bear down on prices, by pushing up corporate costs, with greater ramifications in labour intensive sectors, in turn rendering the nation's productive assets less competitive. Corporate income tax meanwhile eats into companies' ability to save as they are forced to earmark a higher proportion of earnings to service their tax burden, money which otherwise would be freed up for investments and job creation. Accordingly, reducing companies' tax burdens is one of the more effective ways to revitalise the labour market, raise productivity and boost foreign trade. The most controversial aspect of this proposal is how to finance the social security net if

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employer contributions are reduced. However, if the reforms cannot be financed from cuts to public spending, lower social security contributions may be offset by the increase in VAT receipts. This is not only more equitable, as VAT is borne by the entire population, a higher VAT contribution makes the tax system more neutral. Indirect taxation generates a lower excess burden relative to direct taxation while boosting international competitive-

ness as VAT on exports is deductible. In essence, from a macroeconomic standpoint, it would be equivalent to a devaluation of the real exchange rate.

In addition, the elimination of the wealth tax should be extended to inheritance tax as this is the tax generating the highest excess burden or deadweight loss in relation to tax receipt levels. At the very least, even if not suppressed across the board, the regional governments should be allowed to decide whether or not to eliminate it.

It would be mistaken not to undertake these reforms in short order as the ensuing modifications would have a catalysing effect on production and job creation. Although implementation of these measures would have an effect on tax takings short term, this shortfall would be offset medium term by gains in corporate competitiveness, as demonstrated by analysis of European nations with higher income and lower tax rates whose receipts from this tax are higher than in Spain.

Low productivity in Spain, where it is well below the European average and a far cry from US levels, is the main drag on the Spanish economy's growth prospects. Economic theory supports the thesis that the free market is the most efficient when it comes to resource allocation. Progress has been made in Spain on application of measures targeted at deregulating certain sectors, although many significant challenges lie ahead in this area, primarily in relation to two key aspects: (i) greater regulator independence and (ii) the elimination of obstacles to free trade.

Deregulation of retail opening hours is sorely needed. The free hand in applying legislation on retail opening hours at the regional government level has underpinned market fragmentation. Given that the scale of a market conditions its potential efficiency (with the largest markets capable of greater specialisation, with the corresponding increase in well-being), the administration should consider the implementation of a common nationwide regulatory framework in order to establish a market that operates under the same 'playing rules', guaranteeing a uniform market. In addition, opening hour restrictions undermine sector efficiency as retailers are prevented from responding to shifting customer preferences. Consumers' need to balance work and home life in response to the constraints imposed by everyday life is resulting in growing demand for longer opening hours. It is also advisable to eliminate red tape such as store permits in order to reduce entry barriers and thereby facilitate access by new competitors which would intensify competition across the sector. In sum, opening hour deregulation benefits customers and efficient retailers who can leverage the opening hour angle to increase specialisation and, by extension, turn it into a competitive advantage. Also pressing is the need to restore market unity in Spain. If some regions unilaterally recognise the disparate regulations prevailing across the various regions governing the production of goods and services, the remaining regions will be forced to accept this reality; to the contrary, local investment will be displaced to other regions.

Significant challenges lie ahead in the area of deregulating certain sectors: (i) greater regulator independence and (ii) the elimination of obstacles to free trade.

What is required is a reduction in direct taxation which would stimulate household savings and investment in a nation faced with heavy external financing requirements.

As if the situation was not complicated enough, it is now compounded by the planned tax hike, which comes at precisely the wrong time, as the only thing it can possibly achieve is to seriously distort economic agents' decision-making. The consequences will be evident forthwith as the planned tax increase will delay recovery from this recession.

The general state budget calls for the elimination of the 400 individual tax break from 2010. Another controversial issue is the hike in indirect taxes as the standard VAT rate will go up by 2 points while reduced-rate VAT will be raised by one point. However, at this point in time what is required is a reduction in direct taxation which would stimulate household savings and investment in a nation faced with heavy external financing requirements. As a result, in conjunction with the planned VAT increase to take effect on 1 July 2010, the government should consider, as outlined above, a reduction in social security contributions and corporate income tax, and not only for SMEs, in a bid to restructure the economic system and favour job creation. Judging by current anaemic consumption, the VAT hike will hit corporate profits first and foremost rather than getting passed on in prices, which are ultimately the more important driver of corporate results.

Lastly, we would underscore our belief that these measures are vital to raising Spain's growth potential and to unlocking economic growth down the line with which to create new jobs.

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