
The Pain in Spain: Light at the End of the Tunnel?

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Over the past three or four decades, Spain had widely been seen as one of the great European success stories of the second half of the 20th century. In spite of their difficult, often violent political history, Spaniards surprised the world by undertaking a remarkably smooth transition to democracy in the wake of Franco's death in 1975. In turn, this allowed them to rejoin the European mainstream, leaving behind decades of isolation and irrelevance. Membership of the European Union as of 1986 acted as an incentive to undertake difficult, often unpopular structural economic reforms in the 1980s and early 90s, an effort which finally appeared to bear fruit during the years 1995-2007, in which Spain recorded a long period of strong growth. However, the global financial and economic crisis of 2008 has exposed serious structural weaknesses in the performance of the Spanish economy, and today the country is often perceived as the new 'sick man of Europe'. This article will argue that much of this doom and gloom is not always justified, and that, in spite of the very serious challenges currently facing decision-makers (in Frankfurt, Berlin and Brussels, as well as Madrid), there is light at the end of the tunnel.

The Spanish economy is currently undergoing a massive process of deleveraging after an unprecedented real estate bubble. As a member of the eurozone, it is dealing with this situation without monetary and exchange rate policies and with virtually no flexibility in its fiscal policy either. Moreover, the flaws in the design of the Euro have seriously damaged the functioning of the eurozone interbank system, making it difficult for Spanish institutions to refinance their debts. With sovereign risk at unsustainably high levels, social unrest on the rise and growing doubts about the banking system and regional government finances, it is not surprising that Spain's woes are attracting so much attention in Europe and beyond.

Despite this gloomy scenario, we would like to argue that the Spanish economy is undergoing its adjustment process faster than is commonly understood. Spending cuts and structural reforms are proceeding at a rapid pace, unit labor costs are falling significantly and productivity is rising. Most encouragingly, perhaps, despite the strength of the Euro, exports are booming. In our view, this means that provided Spain is given adequate access to external finance (either directly via the ESFS/ESM or indirectly through ECB debt purchases) and more flexibility to meet its fiscal targets, it should be able to return to a sustainable rate of growth in the near future. It is undoubtedly in the interest of both Spain and Europe that the Spanish economy should emerge from this crisis as soon as possible, since it is unlikely that the Euro would survive a Spanish exit.

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Where are we now?

The global financial and economic crisis has exposed serious weaknesses in the performance of the Spanish economy. The unwinding of these economic imbalances is weighing heavily on Spain's growth outlook. Private sector deleveraging implies subdued domestic demand in the medium term. Furthermore, sizeable external financing needs have increased the vulnerability of the Spanish economy. Finally, the challenges facing large segments of the banking sector continue to bear negatively on the economy as the credit flow remains constrained. As the linkages between the banking sector and the sovereign have increased, a negative feedback loop has emerged. Consequently, the restructuring the financial sector is key to mitigating these linkages, increasing confidence, and spurring economic growth.

The Spanish crisis entered a new, seemingly critical phase in July 2012, when ten-year government bond yields reached a Euro-era record 7.75%, prompting frenzied speculation of an EU bailout. Despite successive waves of fiscal adjustment and structural reforms, markets seemed to have lost confidence in the Spanish economy for good. Indeed the latter appeared to have entered a 'bad equilibrium', in which the risk of redenomination was scaring away international investors, who had started to withdraw funds from the country. However, in early September 2012 the ECB finally responded by announcing a new bond purchases programme, aimed at ensuring that the transmission mechanism of monetary policy operates correctly across the eurozone by eliminating the threat of a Euro break up. Nevertheless, for bond purchases to start, countries are first expected to apply for a precautionary credit line from the European rescue funds.

At the time of writing (early October 2012), it is still unclear if and when the Spanish government will request this bailout. Yields on Spanish government debt fell significantly after the ECB's announcement, and the Spanish authorities are in no hurry to submit an application. One reason for this is the widely-held view that it is virtually impossible for a government to survive a bailout, as the Greek, Irish and Portuguese experience suggests. To complicate matters further, early elections are now due on 21 October in the Basque Country and Galicia, and on 25 November in Catalonia, where the regional government is seeking to transform them into a *de facto* plebiscite on the right to national self-determination. Most importantly, perhaps, there is the fear that a bailout would entail additional austerity measures requiring painful budget cuts. Furthermore, Spain would probably prefer to apply for a bailout in tandem with Italy rather than go it alone so as to dilute the political fallout, but this would cause Mario Monti serious difficulties at home.

Political commentators have repeatedly accused Mariano Rajoy and his government of allowing domestic political considerations to dictate their economic agenda. It would be churlish, however, to attribute his reluctance to apply for a bailout exclusively (or even primarily) to electoral concerns. It should be noted, in this regard, that Spanish banks have not yet been able to benefit from the €100 billion credit line approved by the EU in July, since this was conditional on an independent audit whose results were only made public in late September. (According to this new stress test, Spanish banks will require almost €40 billion in new capital). It is hardly surprising, therefore, that the government should want to wait for the first loan to become available before applying for a new one.

Disconcertingly, the current impasse may owe more to the fact that it is Angela Merkel who is actively discouraging the Spanish authorities from applying for a bailout. The German chancellor fears that her own Parliament, which would have to approve the

funds, might refuse to do so on the grounds that it would open the door to massive purchases of government debt by the ECB, a potentially inflationary policy that is adamantly opposed by the Bundesbank, as well as by much of the German electorate, which is clearly suffering from bailout fatigue. German reticence, which is shared by Finland and Holland, is causing growing concern in France and Italy, which would prefer Spain to apply for a bailout as soon as possible so as to protect them from a possible contagion.

Good news that is (easily) overlooked

From a Spanish perspective, what is truly surprising is that all the attention is focused on the bailout and none on how structural Spanish economic indicators are improving. This is not to suggest that Spain will emerge from recession anytime soon, or that it can do so without significant external help. However, we would like to bring to light some positive indicators of recent Spanish economic performance which suggest that internal devaluation and real estate adjustment are advancing steadily and that competitiveness is increasing. If the liquidity problem is solved and the EU gives Spain more time to consolidate its public finances, the country may well avoid a long depression and could even emerge as a powerful force in the subsequent reinvention of the euro.

The main concern of international investors seems to be the risk that Spanish public debt will become unsustainable, forcing a Greek-style hair cut that could trigger a collapse of the euro. Admittedly, it is virtually impossible to predict what will happen in the future because debt sustainability depends on a broad range of factors, such as growth, interest rates, inflation, and confidence. However, it should be noted that, despite the recent increase in financing costs, the average interest rate of Spain's outstanding debt is below 4.5%. Moreover, if the euro does not disappear, total debt is still at manageable levels, and, as a percentage of GDP, it is significantly lower than the debt of Italy, Japan, or the UK. This means that it is clearly premature to label it as unsustainable; as William Cline, a senior fellow at the Peterson Institute for International Economics, has argued in a recent paper, under reasonable assumptions both Spanish and Italian public debts are sustainable.¹

A second widely-held misunderstanding about the Spanish economy refers to the nature of its debt.² We are often reminded of that fact that Spain entered the crisis with healthy public accounts compared to most of its European neighbours (and the US), with debt to GDP standing at less than 60%, but with private sector debt above 200%. Admittedly, historically low interest rates –and cheap financing made available to Spanish banks by their European, mainly German, counterparts- provided families with a very powerful incentive to borrow and spend well beyond their means. However, during the past decade, the vast majority of this non-financial sector debt was used by Spanish companies to make investments in rapidly-growing markets around the world, particularly in Latin America, eastern Europe and Asia. The result is that the value of these foreign assets is significantly higher today than their outstanding debt, which leaves a net positive external balance for these companies.

¹ See Cline, W. (2012): *Sovereign Debt Sustainability in Italy and Spain: A Probabilistic Approach*. Peterson Institute for International Economics. Washington. Working Paper 12-12.

² José María Beneyto and Alexandre Pérez, *Beware the five common myths about the Spanish economy*, Financial Times, August 23, 2012.

It is also common for analysts to express concern that Spain will not be able to find alternative sources of growth. This overlooks the fact that the crisis has prompted an unprecedented surge in exports, which is helping to lower the trade deficit and contributing to a turnaround in the current account, which is expected to show a surplus by 2013 (thus reducing its external financial needs). Between 2009 and 2011 exports of goods rose by €54.6 billion to €214.5 billion, an improvement equivalent to 5.1% of GDP and a faster pace of growth than Germany, France and Italy, albeit from a smaller volume. The number of Spanish companies that exported in 2011 was a record 122.987, 14% more than in 2009. While the US, the UK, Germany, France and Italy have lost global exports market share to varying degrees over the last decade, mainly to China and other emerging countries, Spain's share has remained virtually unchanged at around 1.7%.³ Given the weakness of most markets in the EU, Spain's principal export destiny, this performance is remarkable and shows what companies can do in order to survive in times of difficulty.

Other analysts worry about the fact that Spain (like other southern eurozone countries) needs to go through a process of internal devaluation to regain competitiveness because it cannot devalue its nominal exchange rate. Pessimists such as Nouriel Roubini and Paul Krugman argue that this process, which will result in wage cuts and higher indirect taxes, will be so protracted and painful that it could become socially unsustainable, especially if Germany is unwilling to accept higher inflation to shoulder some of the burden of adjustment. However, thanks to a combination of wage restraint and improvements in productivity, in less than three years Spain, like Ireland, has already reversed almost 50% of the price-competitiveness loss experienced by its economy vis-à-vis Germany in the years 2000-2008. Finally, another factor to bear in mind is that a strong euro is less damaging for Spain than for some other economies because over 60% of its trade takes place within the eurozone and its economy is highly dependent on foreign oil, which is cheaper when the Euro is strong because it is invoiced in dollars.

The political and social consequences of the crisis should also be kept in mind in this context. In spite of growing disaffection, Spanish political institutions remain fundamentally sound, and the Rajoy government, which was elected as recently as November 2011 with 44% of the vote and a 71% turn-out, enjoys an absolute majority in both houses of Parliament. Concern is often voiced about the seemingly dysfunctional nature of Spain's federal system, and Madrid's difficulties in reining in spending by the 17 autonomous communities. However, regional debt amounts to only 13% of GDP and, with the sole exception of the Basque Country and Navarre, the central government has almost complete control over sums transferred to the regions. Admittedly, the crisis has fuelled centrifugal tensions that already existed within the system, most notably in Catalonia, but this does not represent a fundamental challenge to Spain's economic stability. Foreign observers who question the country's ability to undertake painful, far-reaching reforms would do well to remember that, due to the challenges imposed by democratization, European integration and single currency membership, Spain has lived in a state of almost constant upheaval during the past four decades, resulting in an unprecedented transformation of its social and economic structures.

³ Similarly, in 2010 Spain only lost 0.4% of its global share since its peak of 2.0% in 2004 compared with Germany's 0.7% since 2004, France's 1.6% and Italy's 1.1%.

Finally, it is also relevant to note the remarkable resilience and cohesion of Spanish society. As in other southern European countries, family ties and so-called intergenerational solidarity remain strong, providing a buffer against adversity. This partly explains why extremely high levels of unemployment –which currently stands at 25%– have not resulted in widespread social unrest. (It should be noted, in this regard, that when journalists state that 50% of youths aged 16 to 24 are unemployed, what they really mean is that only half of them are at work; a very substantial number are either studying or not actively seeking work). Given that Spain absorbed more immigrants than any country in the world except the United States during the boom years, it is truly remarkable that there have been no significant outbursts of xenophobia or political extremism in spite of these high levels of unemployment.

Conclusion

We have argued here that some positive signs in Spain's recent economic performance suggest that the adjustment may be quicker than expected. It is clear that Spain will need external help from its European partners, and also that it would be wise to give it more time and flexibility to achieve its fiscal targets. But it has a number of strengths that are too often overlooked in favor of rather more irrelevant debates about the timing of the bailout.

In the longer term, a determined effort at the European level, aimed at improving the incomplete governance structure of the Euro, will be essential to ensure that the reforms and adjustments implemented in Spain (and in other southern European countries) are effective. This effort should include a full banking union, a more dynamic European Central Bank (capable of acting consistently as a lender of last resort), and some form of limited debt mutualization. Spain has to do its homework, as do the Eurozone authorities. If either fails, the whole European integration project will be at risk