After the fiesta: What can we learn from the economic crisis in Spain?

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The Impact of the Crisis

Subject Descriptor	2007	2008	2009	2010	2011	2012	2013	2014
GDP, constant prices	3.479	0.893	-3.742	-0.322	0.417	-1.419	-1.558	0.738
Output gap in % of potential GDP	3.768	2.313	-2.763	-3.389	-3.187	-4.5	-5.4	-4.2
Total investment	30.977	29.114	24.004	22.812	21.541	19.636	18.105	17.448
Gross national savings	20.982	19.491	19.181	18.334	17.799	18.564	19.208	19.616
Inflation, average consumer prices	2.844	4.13	-0.238	2.043	3.052	2.436	1.94	1.504
Unemployment rate	8.275	11.3	18	20.075	21.65	25	27	26.5
Government net lending/borrowing	1.922	-4.493	-11.177	-9.671	-9.442	-10.318	-6.606	-6.937
Government structural balance	-1.114	-5.348	-9.477	-8.043	-7.844	-5.699	-4.539	-5.085
Government net debt	26.7	30.801	42.491	49.805	57.485	71.931	79.133	84.664
Current account balance	-9.995	-9.623	-4.822	-4.477	-3.741	-1.072	1.103	2.168

International Monetary Fund, World Economic Outlook Database, April 2013

Estimates after 2012

Update (November 2013)

- The recession is over but the crisis continues
- **Positive**:
  - Small growth. Expected 1% in 2014
  - Fall of unitary labor costs and more flexibility
  - Surplus in the current account
  - Investment in equipment and machinery
- **Negative**:
  - Very slow recovery and very little employment growth
  - Debt increase: projected to reach 100% of GDP
- Perspective: a year ago the country was on the verge of a rescue, before the ECB intervention
- It will take years to recover from the crisis

Two Narratives: First one

- Countries with historic inability to manage their public finances were unwisely allowed into the EMU anchored by Germany, which has history of fiscal and monetary probity
- They took advantage of record-low interest rates. Bubbles
- They failed to address competitiveness challenges
- When reality caught up with them, they tried to undo the effects or decades of fiscal mismanagement by taking advantage of low interest loans from stronger countries
- They insisted in putting together a fiscal union and reforming the EMU institutional framework
- They want more money from the rich countries to maintain their ‘unjustified’ standards of living and continue retiring earlier.
- Debt relief as a way to rehabilitate and help countries

Second Narrative

- Countries in the periphery were encouraged to join a poorly designed EMU by the rich countries who designed and dominated it.
- The rich countries designed the fiscal rules and they were the first ones to break them and get away with it
- They encouraged their banks, who lacked good profitable opportunities in their stagnant domestic markets, to lend recklessly to the countries in the periphery.
- When these investments failed the governments bailed out the banks by lending funds to the debtors countries so they could pay back the banks
- They imposed draconian conditions on the debtor countries with unprecedented losses of sovereignty. Punishment.
- Germany in the 1920s: servicing a large debt in a context of austerity, no growth, and little demand for its exports failed.

Responsibility for the crisis

- "The responsibilities of this crisis are shared. Certainly the southern European countries were reckless, but for every reckless debtor there must be a reckless creditor and these reckless creditors are in the north of Europe. But they have sold this myth that they are virtuous and they must not depart from this policy."

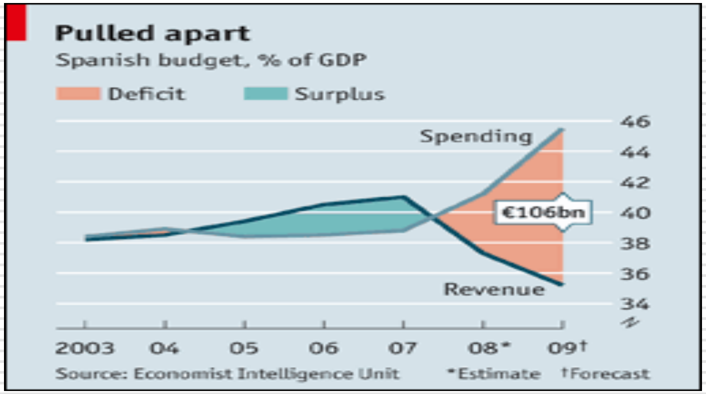
  (Paul De Grauwe. FT: 3/13/2013)

The anatomy of the fiscal crisis in Spain

- Low debt and deficit in Spain prior to the crisis
- Most of Spain's public debt held abroad
- High private-sector debt
- Property bubble
- From 2010 onwards: soaring deficit and debt in Spain because of regional state structure and banking rescuing operations

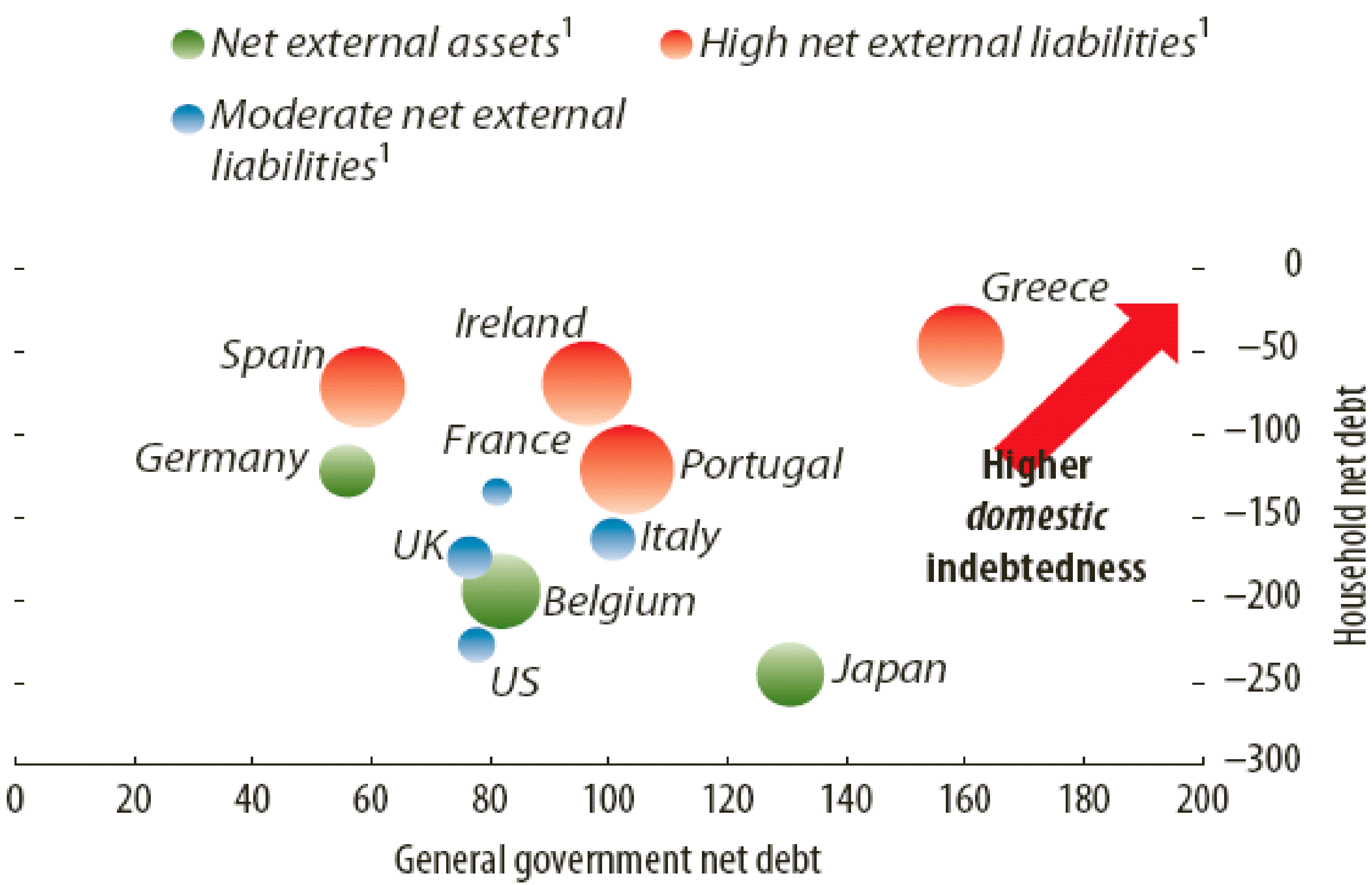
Not All Problems Were Fiscal

- In Spain the debt crisis did not originate with wildly mismanaged finances. The problem was the giant inflows of capital from the rest of Europe. The result was rapid growth and significant inflation.



- Public debt was 36% before the crisis, & budget surplus
- The deficit was a result, not a cause, of Spain's problems: Bubble burst, unemployment soared, & the budget went into deep deficit
  - On the contrary, a problem of ever-growing private sector debt, compounded by reckless banks investments and loans and aggravated by competitiveness and current account imbalances
    - Debt of private sector was 227.3% at the end of 2010.

Figure 1. Debt Burden in Selected Advanced Economies (Percent of GDP)



Is Austerity Enough?

- Can an expansionary fiscal contraction work?
  - Problem is feeble outlook for growth. OECD: economy expected to contract by 1.5% in 2013 (1.4% in 2012); high external indebtedness; and private sector debt.
  - Unemployment 2013: 26.02%; or almost 6m people.
    - Over 50% among young people; 850k jobs destroyed in 2012
  - Deep-seated structural weaknesses holding back growth and weighting on market assessment: overregulated product & labor markets, poor productivity, and education
  - Many investors have lost confidence in Spain’s ability to return to sustainable growth under its currents constraints.

Is Austerity Enough? (2)

- Sloppy lending and irresponsible private borrowing also key culprits
  - If fiscal profligacy was not the dominant cause for the collapse, fiscal discipline cannot be the cure
  - Piling austerity measures on top of one another will not work
    - Economy shrinking at a faster rate than forecasted for reasons outside the country's control
    - Ratio of Spain's general government debt was 36% before the crisis and 84% by 2012. Expected to reach 100% in 2014
    - Prior to the crisis Spain had a budget surplus. Deficit 8.5% in 2011, 6.9% in 2012 and expected close to 7% in 2013
    - Further adjustment of the deficit is undesirable and will exacerbate market tensions.

Is Austerity Enough? (3)

- ***How do we balance austerity and growth?***
  - We need a program forcing the private sector to deleverage over 3-5 years; robust public sector deficits & structural reforms
  - Focus on public sector deficit should be after the private deleveraging is complete. This would accelerate the adjustment
  - Now stuck in a debt trap that may require a rescue

GDP EVOLUTION in the Eurozone

Eurostat. Quaterly variation in percentage

	2010 III	2010 IV	2011 I	2011 II	2011 III	2011 IV	2012 I	2012 II	2012 III	2012 IV
Francia	0,4	0,4	0,9	0,1	0,2	0,0	-0,1	-0,1	0,1	**-0,3**
Italia	0,4	0,2	0,1	0,3	-0,2	-0,7	-0,8	-0,7	-0,2	**-0,9**

Misdiagnosis of the crisis: Need to address current account deficits

- Below the public debt and financial crisis there is a balance of payment crisis caused by the misalignment of internal real exchange rates.
  - Spain had current account deficits over 10% of GDP prior to the crisis
- Loss of *competitiveness* since joining EMU. Explanations
  - Rigid labour market institutions and strong trade unions
  - Lack of structural reforms
  - Low productivity growth
  - Large uncompetitive public sector, inefficient bureaucracy
  - International division of labor (labor-intensive low-value-added productions)

Need to address current account deficits

- Southern European nations need to reduce their current account deficits, while Northern European nations reduce their surpluses:
  - Adjustment in the Eurozone should take place via shifts in competitiveness: the real exchange rates of Southern Europe decline, while those of Northern Europe increase
- Four options:
  - Aggressive monetary easing, weaker euro, stimulatory policies in the core, and austerity and reform in the periphery to restore growth and competitiveness
  - Deflationary adjustment and structural reforms to bring down nominal wages in the periphery
  - Financing by the core of an uncompetitive periphery
  - Debt restructuring and partial break-up of the Eurozone
- Right now mixture of the second and third options: austerity and financing. In long term, which one?

Address Unfinished Business

- While fiscal consolidation and structural reforms were key to Germany's recovery and current position of strength, they need to recognize that there cannot be exports without imports
- Germany's growth and trade surplus were possible because Southern Europe imported; and this was enabled by their borrowing.
- Southern Europe needs export markets for what they produce. They need demand from Europe, easier monetary policies, or deployment of funds from the EU or European Investment Bank
  - The crisis will be over if weaker countries regain competitiveness
  - One-sided deflation will fail

Conclusions: Address Institutional Degeneration

- **Institutional degeneration**: A fundamental reason for the crisis is rooted in the process of institutional degeneration that preceded the crisis. Mismanaged banks, excessive debts, bubbles in the real estate sector, or competitiveness losses are all symptoms of an institutional malaise that intensified in the years prior to the crisis.
  - We cannot understand the bubble without the corruption, and the corruption without the institutional degeneration. 800 cases and 2,000 detained in the last decade.
- **Institutional Divergence**. Institutional divergence in the rule of law.
  - The economic divergence in productivity and competitiveness between Spain and the EMU core that preceded the crisis were consequences of the institutional divergence in the rule of law between the core and Spain. Difficult to implement the reforms that EMU demands.
  - World Economic Forum's *Competitiveness Report*; International Financial Corporation's *Doing Business*; World Justice's *Rule of Law;* Transparency International's *Corruption Perception Index*
- In addition to Eurobonds, banking unions, and fiscal compact, we need an institutional reform compact.

Conclusions: Countries are Different

- The crisis was not only fiscal. Greece was first, but elsewhere different
- The underlying cause was also irresponsible lending
  - Both sides culpable: Stronger case for debt write-offs
- Focus on fiscal deficits (which were symptoms and not causes), instead of fixing the financial sector and reducing private debt.
- Misguided illusion that a fiscal contraction could be expansionary and exaggerated concerns about the impact of large debt
- US focus on financial sector, household deleveraging & monetary policy
- Still lower performance expectations but refusal to admit mistakes
- Crisis of governability and confidence
- How do we confront an age of austerity? Countries trapped in a sovereign debt trap. We need time, confidence, and liquidity
- History of financial crisis is a history of missed opportunities

Conclusions

- We need more integration, but EU-wide solutions will produce limited results unless politicians have the courage to carry out institutional and political reforms in their countries.
  - Clean up the domestic political culture of impunity
  - 96% of Spaniards believe that political corruption is "very high."
- Solutions are elusive. Austerity is not working but the fear of excessive debt is leading governments to cut spending, even in the face of stagnation.
- Citizens losing faith in national and European institutions
  - The European dream has been shattered: Before the EU was a way out of a situation of relative backwardness, isolation and authoritarianism. Now it is part of the problem
- Spain was perceived as a model for the benefits of integration. Now it is more a symbol of its shortcomings.
- Need a positive narrative to counter pessimism and cynicism