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Spain: From model country to crisis, a predictable decline

After having been presented as a model for other European countries because of its strong growth, decline in unemployment and budget surpluses, Spain is now presented as a country undergoing a major and long-lasting crisis because of the collapse of the construction industry which was central to the Spanish economy. However, this "decline" was predictable and should have been a source of lessons for the institutional organisation of the European Union.

Spain: First a model and then a country in crisis

For many years Spain was presented as an economic model: budget surpluses (2% of gross domestic product in 2007, Chart 1), strong growth (nearly 4% per year from 2004 to 2007 (Chart 2), very rapid growth in employment (also 4% per year, Chart 3) and a decline in unemployment, the ability to integrate 800,000 immigrants per year (Chart 4), and the very rapid convergence of living standards toward those of Northern European countries (from a relative standard of 40% in 1995 to nearly 80% in 2007 (Chart 5).

Today, however, Spain is undergoing a very serious crisis: negative growth of 3.7% in 2009, probably again a negative 1% in 2010; a 19% unemployment rate, and one of 40% for young people (Chart 6); fiscal deficits of more than 11.4% in 2009 and certainly more than 10% in 2010.

This trend raises two important questions: how did Spain go from being a model country to one in crisis, and why did observers not see that it was a false model? What lessons about the Spanish situation might be applied to Europe's institutional organisation and its economic conduct and how will the crisis end?

ECONOMIC RESEARCH
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Chart 1
Spain: Government debt and fiscal deficit (as % of GDP)

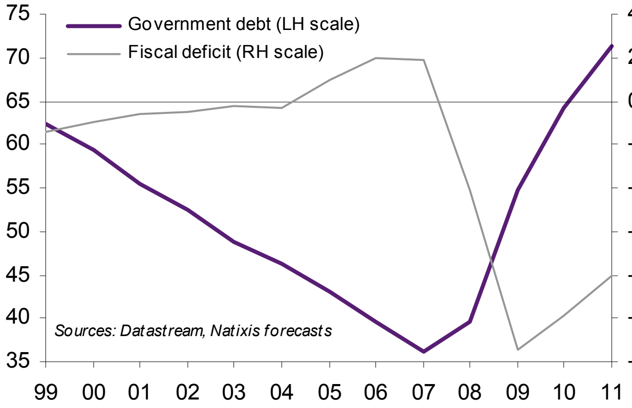


Chart 2
Real GDP growth (Y/Y as %)

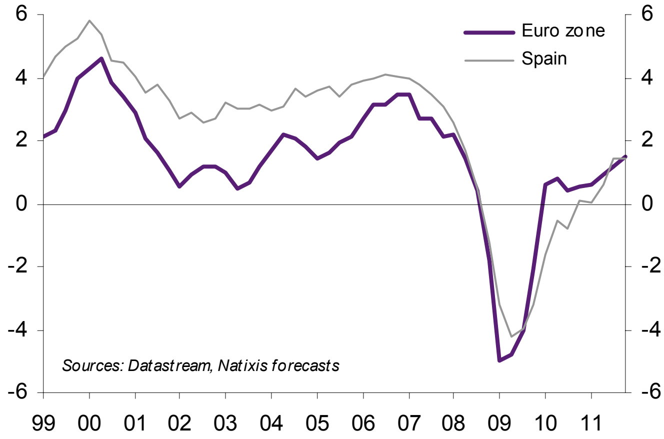


Chart 3
Spain: Total employment and unemployment rate

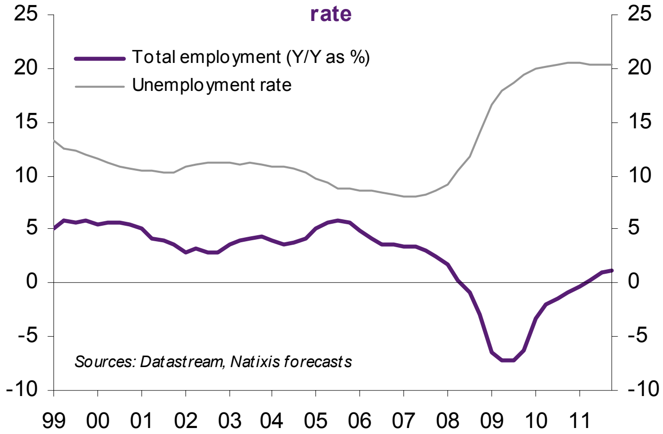


Chart 4
Spain: Immigration (as % of population)

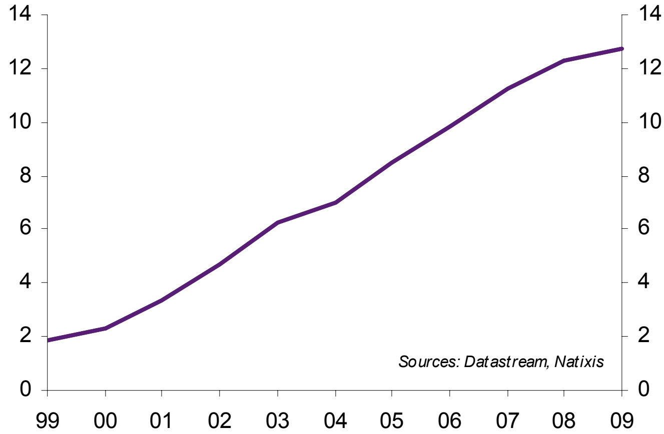


Chart 5
Unit wage cost (GDP/PPP GDP in USD)

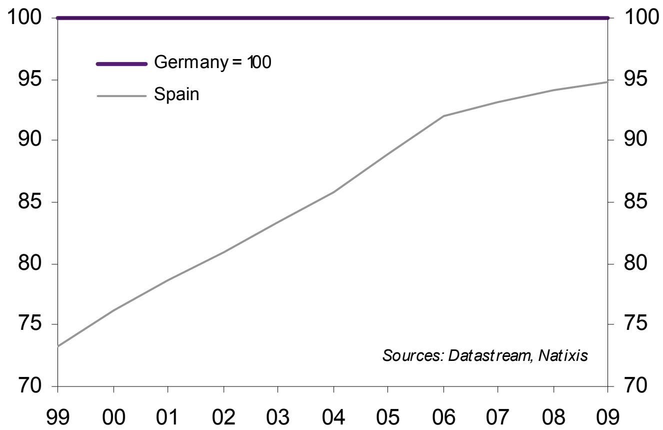
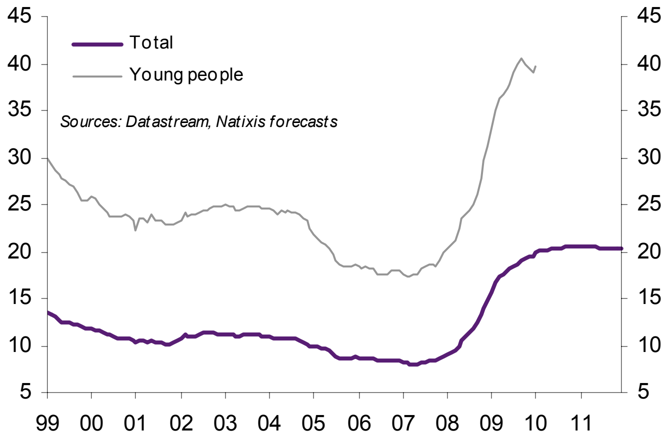


Chart 6
Spain: Unemployment rate



Spain: A false model, the perfect example of what not to do

Spain's situation was cited as an example prior to the crisis. And how! **Spain developed a "one-product" economy which as a result was extremely fragile and was based on an increase in indebtedness.**

If we add jobs in the construction industry to those involved in construction-related intermediate goods, real estate services and banking services linked to mortgage financing, we see that prior to the crisis 30% of Spain's working population worked directly or indirectly for the construction industry **(Chart 7)**. This was pure madness: The number of housing starts went from 1 million per year at the end of 2007 to 100,000 today, 10 times fewer **(Chart 8);** potentially 27% of Spaniards (90% of 30%) could thus lose their jobs.

Chart 7
Spain: Employment by sector (as % of total)

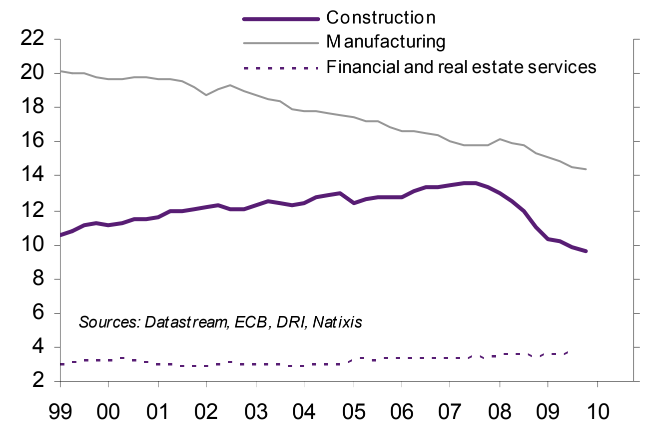
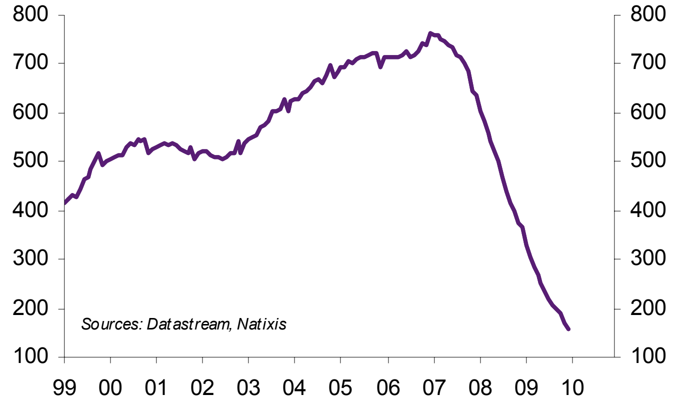


Chart 8
Spain: Housing starts (thousands per year)



The real estate boom was made possible by **a considerable increase in Spain's household indebtedness (Chart 9).** The "average" indebtedness of a household went from 70% of its annual income in 1999 to 140% in early 2008, with the last borrowers borrowing the entire amount of the houses they purchased (real estate prices increased by an average of 17% per year from 2001 to 2007, **Chart 10)** and having to spend more than 40% of their income to pay back the banks.

Chart 9
Spain: Household debt (as % of household GDI)

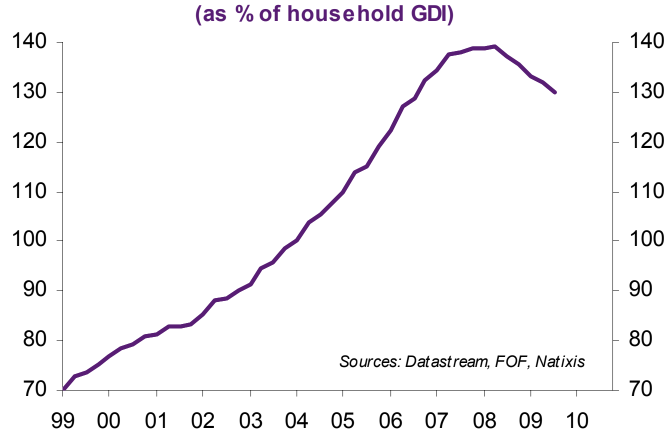
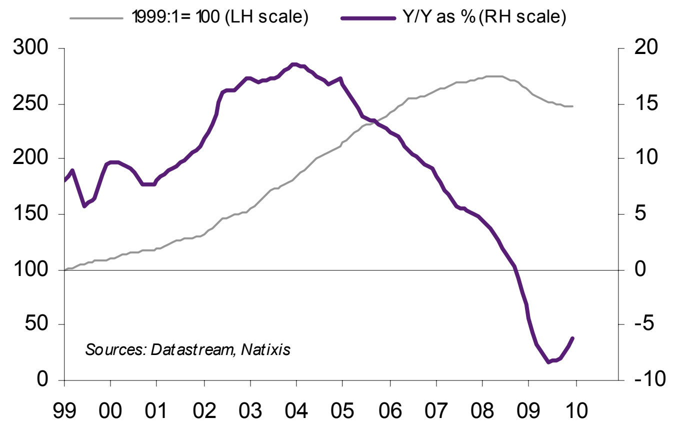


Chart 10
Spain: Real estate prices



There are currently 1.2 million unsold housing units (enough to house 6 million Spaniards, **Table 1)** which are being carried on the balance sheets of real estate developers or Spanish banks, while their market value is virtually nil.

Table 1
Spain - stock of unsold housing units (number)

	Spain (cumulative since 2003)
2002	-
2003	37,738
2004	107,642
2005	198,709
2006	394,698
2007	694,853
2008	1,013,358
2009	1,189,958

Sources: INE, Colegio de Registradores, Natixis

Conversely, spending on research and development in Spain has been poor **(Table 2)** and productivity gains negative until the crisis (**Charts 11A** and **11B).** A one-product economy driven by an increase in indebtedness is obviously not a model to follow.

Table 2
Spain – Government forecasts of fiscal deficits and announced programme of fiscal consolidation

Announced programme of fiscal consolidation:	Tax hike (3.3% of GDP), spending cuts (0.7% of GDP), local investment fund (-0.3% of GDP) = 1.4% GDP adjustment

Government forecasts of fiscal deficits	2008	2009	2010	2011	2012
Spain (*)	- 3.8	- 11.4	-	-	- 3

(*)Spain's new 2009-2012 programme does not specify intermediate deficits. Therefore there are no figures for 2010-2011.

Table 2 – 1
Spain – Government forecasts of fiscal deficits and announced programme of fiscal consolidation

Country	2002	2003	2004	2005	2006	2007	2008
United States	2.66	2.66	2.59	2.62	2.66	2.68	2.80
Germany	2.49	2.52	2.49	2.49	2.54	2.53	2.60
France	2.23	2.17	2.15	2.10	2.10	2.08	2.10
Italy	1.13	1.11	1.10	1.09	1.14	1.15	1.16
Spain	0.99	1.05	1.06	1.12	1.20	1.21	1.21
Sweden	4.00	3.85	3.62	3.80	3.74	3.63	3.60
Japan	3.17	3.20	3.17	3.32	3.39	3.40	3.50

Tableau 2 – 2
Corporate R&D spending (as% of GDP)

Country	2002	2003	2004	2005	2006	2007	2008
United States	1.74	1.84	1.79	1.83	1.89	1.93	1.94
Germany	1.63	1.76	1.74	1.72	1.77	1.78	1.83
France	1.41	1.36	1.36	1.30	1.32	1.29	1.27
Italy	0.54	0.52	0.52	0.55	0.55	0.55	0.57
Spain	0.54	0.57	0.58	0.60	0.67	0.71	0.72
Sweden	-	2.86	2.67	2.62	2.79	2.66	2.78
Japan	2.35	2.40	2.38	2.54	2.63	2.68	2.69

Source: OCDE, Main Science and Technology Indicators

Chart 11A
Per capita productivity (Y/Y as %)

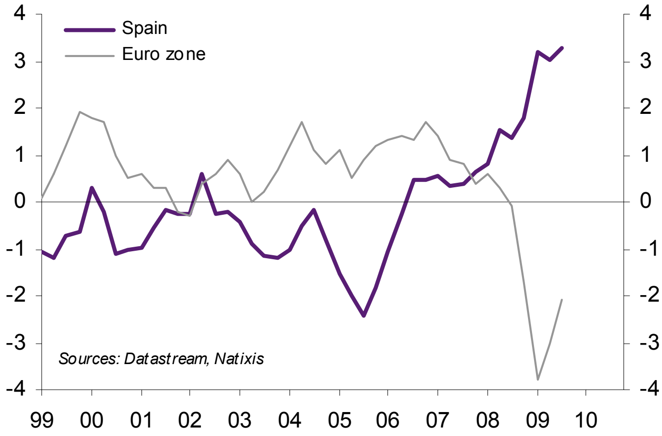
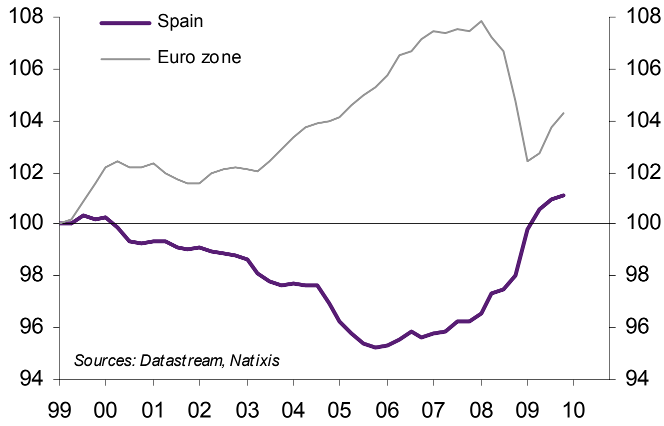


Chart 11B
Per capita productivity (1999:1 = 100)



The role of monetary policy

Spain's atypical situation (credit-driven growth, sharp rise in real estate prices) was stoked by Spain's membership in the euro zone. **In a currency area, countries whose growth rates are higher than interest rates (which corresponds to the average situation in the euro zone) find their economies violently stimulated by the fact that interest rates are low relative to income growth,** which is an incentive to increase indebtedness and pushes up asset prices **(Chart 12A).** The opposite holds true in countries with weak growth (such as Germany **Chart 12B).**

Chart 12A
Spain: GDP growth and interest rates

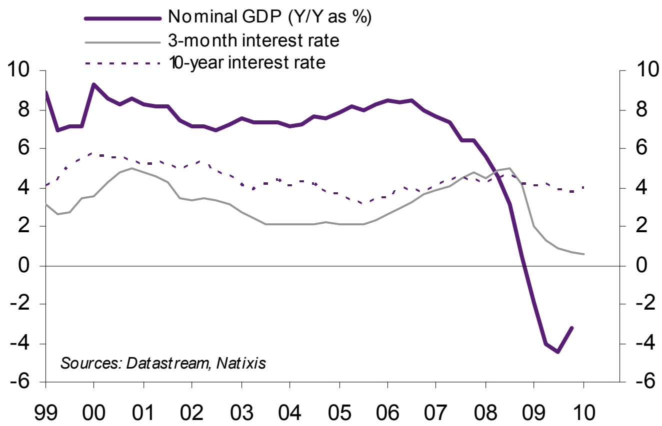
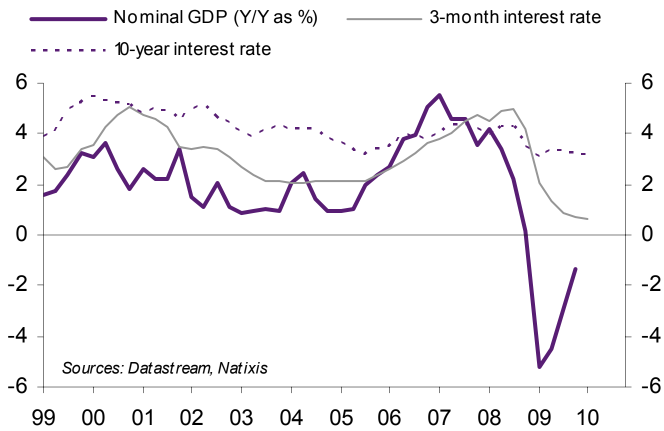


Chart 12B
Germany: GDP growth and interest rates



When the situation is reversed and when, given economic difficulties, the interest rates (average for the euro zone) become higher than the growth rate, **the shock is extremely brutal:** suddenly there is the realisation that indebtedness is excessive (income growth no longer makes it possible to pay back debts), and asset prices (equities, real estate) fall (the returns demanded increase with interest rates).

This point is extremely important in a currency area; fast-growing countries have overly expansionary monetary policy (the area's interest rates are too low for them), while weakly-growing countries, symmetrically, have an overly restrictive monetary policy.

Institutional lessons

The Spanish example shows us (however, virtually all economists have long explained this point) **that euro zone countries can undergo very significant specific shocks. This is due,** as the Spanish situation shows, **to countries' economic specificities:** Spain's specialisation in construction (tourism) makes the country abnormally sensitive to shocks to credit, banks and asset prices.

If there were a serious crisis in the automotive industry, for example, other countries (Germany, Slovenia, Slovakia, etc.) would encounter problems. However, **the institutional logic of the euro zone,** in theory and according to its founding treaties, **is that between countries there is neither solidarity nor public transfers nor assistance in the event of difficulties** (this is the "no bail-out" clause). If it is applied, it means that countries with specific difficulties (currently Spain) should not expect help from others. They must therefore maintain very high unemployment and weak growth while the rest of the euro zone renews with growth.

This heterogeneity in a currency area is obviously unacceptable, both socially and politically. Regardless of public opinion (in Germany in particular), institutions must be reformed to establish solidarity (public transfers) in favour of countries in difficulty (as with the US states and the German Länder, etc.).

Economic surveillance of the European Union

The Greek and Spanish crises also prove **the inability of European institutions to supervise and analyse countries' economic situations.** There is mention of the "macroeconomic supervision" provided by the ECB, the European Commission, etc. However, are they able to do anything other than measure stupid ratios such as fiscal deficits, government debt and R&D spending as a percent of GDP? The IMF knows how to analyse in relative detail the complex situation of emerging countries while the proselytising European institutions understand nothing of the Spanish economy.

How will the Spanish crisis end? Two options that can be ruled out

Anglo-Saxon investors often believe that Spain (previously Greece) will either default on its government debt or withdraw from the euro zone in order to stimulate its economy through the depreciation in the exchange rate. Such speculation increases the risk premia on these countries' government debts **(Charts 13A** and **13B).** This will not happen.

Chart 13A
CDS (5-year, bp)

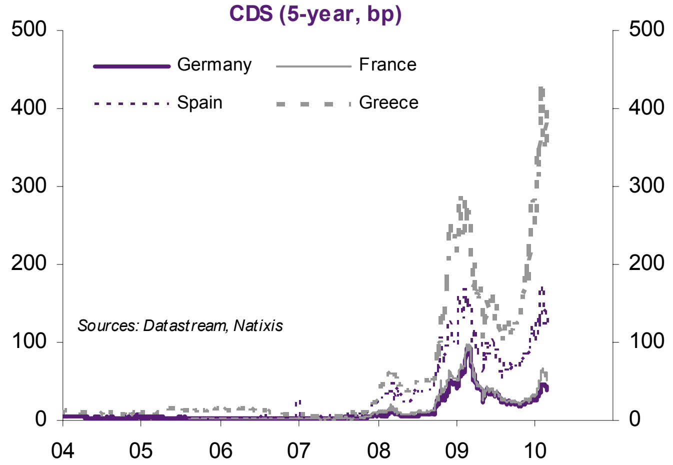
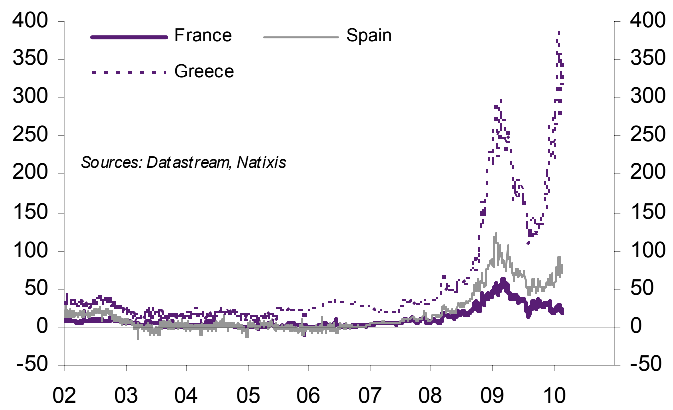


Chart 13B
10-year yield spreads against Germany (bp)



Spanish banks finance the country's fiscal deficit (Chart 14). They have abundant funding and very low interest rates thanks to the ECB's expansionary monetary policy **(Chart 15);** household and corporate demand for loans has fallen **(Chart 16),** and the banks naturally lend to the government, the only borrower, which currently significantly facilitates the financing of the fiscal deficit. **A government default would therefore lead to a failure of the banks,** which hold the government debt, thus obviously dissuading the government from defaulting.

Chart 14
Spain: Net purchases and bonds outstanding held by the banks (as % of GDP)

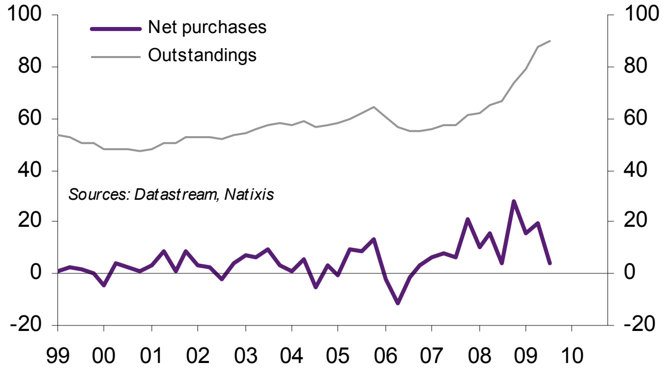


Chart 15
Euro zone: Repo rate and monetary base

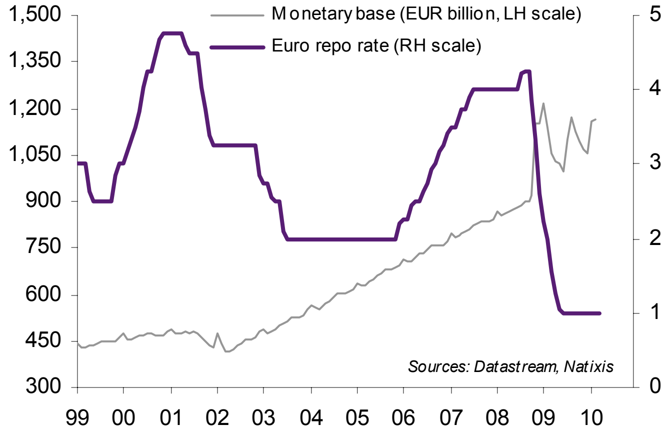
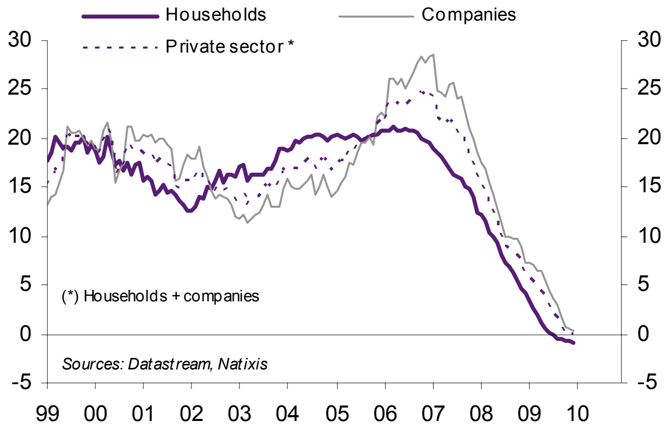
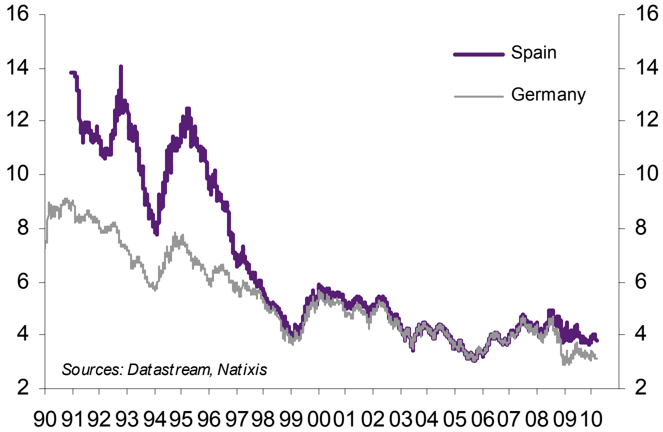


Chart 16
Spain: Private-sector loans * (Y/Y as %)



Withdrawal from the euro would lead to a massive and suicidal increase in the interest rates paid by Spain: what would be the current cost of a 10-year peseta-denominated bond? 20% as in the early 1990s **(Chart 17)?**

Chart 17
10-year interest rate



It must be kept in mind that belonging to the euro zone has enabled Southern European countries to enjoy very low interest rates, converging towards those of Germany and which they cannot renounce.

How will this situation end for Spain? There are two possibilities

One cannot rule out – far from it – **another speculative attack on the Southern countries within the euro zone:** Greece and this time Spain since the latter's economic and financial situation is too fragile for it to be ignored by speculators.

This speculative attack will probably be triggered **by the realisation by the financial markets of the impossibility of reducing fiscal deficits.** The Zapatero government has promised to reduce the fiscal deficit from 13% in 2009 to 3% of GDP in 2012 (Table 2); this will be impossible with no or negative growth.

Two scenarios are then possible**:**

Either a cooperative scenario; the other European countries give Spain the time to renew with growth thanks to favourable structural policies (innovation, attraction of direct investment); this implies that they accept continued high fiscal deficits and that they accept an increase in structural and regional funds paid to Spain **(Table 3).**

Tableau 3
European funds received (as% of GDP)

	France	Germany	Italy	Spain	Greece	Portugal	Ireland
1999	0.96	0.50	0.80	2.23	3.98	3.45	3.22
2000	0.86	0.50	0.91	1.71	4.20	2.63	2.50
2001	0.78	0.48	0.69	1.99	3.92	2.26	1.97
2002	0.78	0.54	0.63	2.09	2.97	2.85	2.00
2003	0.84	0.49	0.80	2.03	2.83	3.44	1.93
2004	0.78	0.53	0.75	1.94	3.14	3.06	1.89
2005	0.79	0.55	0.75	1.63	2.82	2.60	1.54
2006	0.75	0.53	0.74	1.31	3.19	2.40	1.39
2007	0.73	0.51	0.73	1.22	3.72	2.39	1.14
2008	0.70	0.45	0.66	1.11	3.56	2.47	1.13

Sources: European Commission, EU budget, 2008 Financial Report, Natixis

Or an uncooperative scenario; the other European countries adopt a rigid stance of no assistance, no solidarity. Spain's only solution faced with a speculative attack would then be to reduce its fiscal deficit very rapidly by raising taxes and cutting pensions which would result in a recession that would probably spread to other euro zone countries.