

After Austerity. Lessons from the Spanish Experience

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Introduction

The overall pattern of Spanish history has been described, crudely, as a graph shaped like an upside-down version of the letter ‘V’. That is, the graph rises—bumpily at times, through 600 years under the Romans, 700 years under or partly under the Moors, and a century of empire-building—to the peak of Spanish power in the sixteenth century. After that the history of the nation goes downhill until the 1970s. A vast empire was gradually lost, leaving Spain poor and powerless. And there was much political instability: Spain suffered forty-three *coup d'états* between 1814 and 1923, a horrendous civil war between 1936 and 1939, followed by thirty-six years of dictatorship under *Generalísimo* Franco.¹

After Franco's death in 1975, the graph turned upward again. King Juan Carlos, Franco's heir, oversaw the return of democracy to the country. A negotiated transition period, which has been labeled as a model for other countries, paved the way for the elaboration of a new Constitution, followed by the first free elections in almost forty years. These developments were followed by the progressive return of Spain to the international arena—where they have been relatively isolated during the dictatorship. The following decade also witnessed the Socialist party being elected to actual power in 1982, bringing a new aura of modernity to the country. The 1980s also witnessed Spain's integration into NATO (1982) and the European Community (1986). The following two and a half decades were a period of phenomenal growth and modernization.

Indeed, before the global crisis that hit Spain in the spring of 2008 the country had become one of Europe's most successful economies.² While other European countries had been stuck in the mud, Spain performed much better at reforming its welfare systems and labor markets, as well as improving flexibility and lowering unemployment. Over the decade and a half that

preceded the 2008 global financial crisis the Spanish economy has been able to break with the historical pattern of boom and bust, and the country's economic performance was nothing short of remarkable. Yet all this came to a halt when the global financial crisis hit Spain in 2008. As a result Spain is suffering one of the worst crises since the 1940s.

Following the transition to democracy and the country's European integration, Spain was, prior to the 2008 crisis, a model country. But then the dream was shattered and the country's economy imploded after 2008. How did this happen? Policy choices and the structure of decision making; the role of organized interest; the structure of the state; and institutional degeneration all played an important role in explaining the severity of the economic crisis in Spain; as did the country's membership under an incomplete monetary union. The country is currently (as of 2014) exiting a triple crisis: financial, fiscal and competitiveness. This paper seeks to provide an overview of the country's evolution since the transition to democracy, and to explain its economic collapse after 2008.

The first section of the paper outlines the main features of the Spanish growth model, and the challenges that it faced. Section two describes the scale of the shock it underwent from 2008 onward, and analyzes the triple crisis in financial, fiscal, and competitiveness performance. The paper concludes with lessons from the Spanish experience.

The Miraculous Decade³

European integration was instrumental in the modernization of the country. Indeed, before the global crisis that hit Spain in the spring of 2008 the country had become one of Europe's most successful economies (see Table 1). Propped up by low interest rates and immigration, Spain was (in 2008) in its fourteenth year of uninterrupted growth and it was benefiting from the longest

cycle of continuing expansion of the Spanish economy in modern history (only Ireland in the Euro zone has a better record), which contributed to the narrowing of per capita GDP with the EU. Indeed, in 20 years per capita income grew 20 points, one point per year, to reach close to 90 percent of the EU15 average. With the EU25 Spain already reached the average in 2008. The country grew on average 1.4 percentage points more than the EU since 1996.

Table 1: The Boom Years (2000–08)

SPAIN	Units		2000	2001	2002	2003	2004	2005	2006	2007	2008
	Scale										
GDP constant prices	National currency	Billions	546.9	566.8	582.2	600.2	619.8	642.2	668.0	691.8	697.7
GDP, constant prices	Annual percent change		5.1	3.7	2.7	3.1	3.3	3.6	4.0	3.6	0.9
GDP per capita, constant prices	National currency	Units	13,6	13,9	14,1	14,3	14,5	14,8	15,2	15,4	15,3
Output gap in percent of potential GDP	Percent of potential GDP		1.9	1.5	0.3	0.1	0.5	1.4	2.9	3.9	3.1
GDP based on purchasing-power-parity (PPP) share of world total	Percent		2.2	2.2	2.2	2.2	2.1	2.1	2.1	2.1	2.0
Inflation, average consumer prices	Annual percent change		3.5	2.8	3.6	3.1	3.1	3.4	3.6	2.8	4.1
Unemployment rate	Percent of total labor force		13.9	10.6	11.5	11.5	11.0	9.2	8.5	8.3	11.3
Employment	Persons	Millions	16.4	16.9	17.3	17.9	18.5	19.3	20.0	20.6	20.5
General government balance	National currency	Billions	-6.2	-4.4	-3.3	-1.6	-2.9	8.8	19.9	23.3	-41.9
General government balance	Percent of GDP		-1.0	-0.6	-0.5	-0.2	-0.3	1.0	2.0	2.2	-3.8
Current account balance	Percent of GDP		-4.0	-3.9	-3.3	-3.5	-5.3	-7.4	-9.0	-10.0	-9.6

Source: International Monetary Fund, *World Economic Outlook Database*, October 2009

Unemployment fell from 20 percent in the mid-1990s to 7.95 percent in the first half of 2007 (the lowest level since 1978), as Spain became the second country in the EU (after Germany with a much larger economy) creating the most jobs (an average of 600,000 per year over the last

decade). In 2006 the Spanish economy grew a spectacular 3.9 percent, and 3.8 percent in 2007. As we have seen, economic growth contributed to per capita income growth and employment. Indeed, the performance of the labor market was spectacular: between 1997 and 2007, 33 percent of all the total employment created in the EU-15 was created in Spain. In 2006 the active population increased by 3.5 percent, the highest in the EU (led by new immigrants and the incorporation of women in the labor market, which increased from 59 percent in 1995 to 72 percent in 2006); and 772,000 new jobs were created.

The economic success extended to Spanish companies, which expanded beyond their traditional frontiers (Guillén 2005). In 2006 they spent a total of €140 billion on domestic and overseas acquisitions, putting the country third behind the United Kingdom and France in the EU. Of this, €80 billion were to buy companies abroad (compared with the €65 billion spent by German companies). In 2006 Spanish FDI abroad increased 113 percent, reaching €71.5 billion (or the equivalent of 7.3 percent of GDP, compared with 3.7 percent in 2005).⁴ In 2006 *Iberdrola*, an electricity supplier purchased *Scottish Power* for \$22.5 billion to create Europe's third largest utility; *Banco Santander*, Spain's largest bank, purchased Britain's *Abbey National Bank* for \$24 billion, *Ferrovial*, a family construction group, concluded a takeover of the *British BAA* (which operates the three main airports of the United Kingdom) for £10 billion; and *Telefonica* bought *O2*, the U.K. mobile phone company. Indeed, 2006 was a banner year for Spanish firms: 72 percent of them increased their production and 75.1 percent their profits, 55.4 percent hired new employees, and 77.6 percent increased their investments.⁵

The country's transformation was not only economic but also social. The Spanish became more optimistic and self-confident (i.e., a Harris poll showed that Spaniards were more confident of their economic future than their European and American counterparts, and a poll by the

Center for Sociological Analysis showed that 80 percent are satisfied or very satisfied with their economic situation). Spain became 'different' again and according to public opinion polls it had become the most popular country to work for Europeans.⁶ Between 2000-2007, some 5 million immigrants (645,000 in 2004 and 500,000 in 2006) settled in Spain (8.7 percent of the population compared with 3.7 percent in the EU15), making the country the biggest recipient of immigrants in the EU (they represent 10 percent of the contributors to the Social Security system). This is a radical departure for a country that used to be a net exporter of people, and more so because it has been able to absorb these immigrants without falling prey (at least so far) to the social tensions that have plagued other European countries (although there have been isolated incidents of racial violence).⁷ These immigrants contributed significantly to the economic success of the country in that decade because they boosted the aggregate performance of the economy: They raised the supply of labor, increased demand as they spent money, moderated wages, and put downward pressure on inflation, boosted output, allowed the labor market to avoid labor shortages, contributed to consumption, and increased more flexibility in the economy with their mobility and willingness to take on low-paid jobs in sectors such as construction and agriculture, in which the Spanish were no longer interested.⁸

Indeed, an important factor in the per capita convergence surge after 2000 was the substantive revision of the Spanish GDP data as a result of changes in the National Accounts from 1995 to 2000. These changes represented an increase in GDP per capita of 4 percent in real terms (the equivalent of Slovakia's GDP). This dramatic change was the result of the significant growth of the Spanish population since 1998 as a result of the surge in immigration (for instance in 2003 population grew 2.1 percent). The key factor in this acceleration of convergence, given the negative behavior of productivity (if productivity had grown at the EU average Spain would

have surpassed in 2007 the EU per capita average by 3 points), was the important increase in the participation rate, which was the result of the reduction in unemployment, and the increase in the activity rate (the proportion of people of working age who have a job or are actively seeking one) that followed the incorporation of female workers into the labor market and immigration growth. Indeed between 2000 and 2004, the immigrant population has multiplied by threefold.

As a matter of fact most of the 772,000 new jobs created in Spain in 2006 went to immigrants (about 60 percent). Their motivation to work hard also opened the way for productivity improvements (which in 2006 experienced the largest increase since 1997, with a 0.8 percent hike). It is estimated that the contribution of immigrants to GDP has been of 0.8 percentage points in the four years to 2007.⁹ Immigration represented more than 50 percent of employment growth, and 78.6 percent of the demographic growth (as a result Spain has led the demographic growth of the European countries between 1995 and 2005 with a demographic advance of 10.7 percent compared with the EU15 average of 4.8 percent).¹⁰ They also contributed to the huge increase in employment, which has been one of the key reasons for the impressive economic expansion. Indeed, between 1988 and 2006, employment contributed 3 percentage points to the 3.5 percent annual rise in Spain's potential GDP (see Table 1).¹¹

The Basis for Success

What made this transformation possible? The modernization of the Spanish economy in the last two and half decades has been intimately connected to the country's integration in the European Union. Indeed, European integration was a catalyst for the final conversion of the Spanish economy into a modern Western-type economy. Yet, membership was not the only reason for this development. The economic liberalization, trade integration, and modernization of the

Spanish economy started in the 1950s and 1960s and Spain became increasingly prosperous over the two decades prior to EU accession. However, one of the key consequences of its entry into Europe has been that it consolidated and deepened that development processes, and it has accelerated the modernization of the country's economy. EU membership facilitated the micro- and macroeconomic reforms that successive Spanish governments undertook throughout the 1980s and 1990s. Spain has also benefited extensively from European funds: approximately 150bn Euros from agricultural, regional development, training, and cohesion programs.

Moreover, European Monetary Union (EMU) membership has also been very positive for the country: it has contributed to macroeconomic stability, it has imposed fiscal discipline and central bank independence, and it has lowered dramatically the cost of capital. One of the key benefits was the dramatic reduction in short-term and long-term nominal interest rates: from 13.3 per cent and 11.7 per cent in 1992, to 3.0 per cent and 4.7 per cent in 1999, and 2.2 per cent and 3.4 per cent in 2005. The lower costs of capital led to an important surge in investment from families (in housing and consumer goods) and businesses (in employment and capital goods). Indeed, EMU membership (and the Stability Pact) has provided the country with unprecedented stability because it has forced successive governments to consolidate responsible economic policies, which have led to greater credibility and the improvement of the ratings of Spain's public debt (and consequently to lower financing costs).

Another important factor to account for the country's economic success was the remarkable economic policy stability that followed the economic crisis of 1992-93. Indeed, there have been few economic policy shifts throughout the 1990s and early 2000s, and this despite changes in government. Between 1993 and 2009 there were only two Ministers of Finance, Pedro Solbes (from 1993-96, and from 2004-2009) and Rodrigo Rato (from 1996-2004); and the country only

had three Prime Ministers (Felipe González, José María Aznar, and José Luís Rodríguez Zapatero). This pattern was further reinforced by the ideological cohesiveness of the political parties in government and the strong control that party leaders exercise over the members of the cabinet and the parliament deputies.

In addition, this stability was reinforced by the shared (and rare) agreement among Conservative and Socialist leaders regarding fiscal consolidation (the balance budget objective was established by law by the Popular Party), as well as the need to hold firm in the application of restrictive fiscal policies and the achievement of budgetary surpluses: As a result a seven per cent budget deficit in 1993 became a 2.2 percent surplus in 2007; and public debt decreased from 68 percent of GDP in 1998 to 36.2 percent in 2007.

Finally, other factors that contributed to this success include the limited corruption and the fact that politics are fairly clean and relatively open; that Spain has a flexible economy; and the success of Spanish multinationals: There were eight firms in the *Financial Times* list of the world's largest Multinationals in 2000, and 14 in 2008.¹²

The Challenges

However, this economic success was marred by some glaring deficiencies that came to the fore in 2008 when the global financial crisis hit the country, because it was largely a “miracle” based on bricks and mortar.¹³ The foundations of economic growth were fragile because the country has low productivity growth (productivity contributed only 0.5 percentage points to potential GDP between 1998 and 2006) and deteriorating external competitiveness.¹⁴ Over the decade that preceded the 2008 crisis Spain did not address its fundamental challenge, its declining productivity, which only grew an average of 0.3 percent during that decade (0.7 percent in 2006),

one whole point below the EU average, placing Spain at the bottom of the EU and ahead of only Italy and Greece (the productivity of a Spanish worker is the equivalent of 75 percent of a U.S. one). The most productive activities (energy, industry, and financial services) contribute only 11 percent of GDP growth.¹⁵

Moreover, growth was largely based on low-intensity economic sectors, such as services and construction, which are not exposed to international competition. In 2006 most of the new jobs were created in low-productivity sectors such as construction (33 percent), services associated with housing such as sales and rentals (15 percent), and tourism and domestic service (30 percent). These sectors represented 75 percent of all the new jobs created in Spain in 2006 (new manufacturing jobs, in contrast, represented only 5 percent). The labor temporary rate reached 33.3 percent in 2007, and inflation was a recurrent problem (it closed 2006 with a 2.7 percent increase, but the average for that year was 3.6 percent), thus the inflation differential with the EU (almost 1 point) has not decreased, which reduces the competitiveness of Spanish products abroad (and consequently Spanish companies are losing market share abroad).¹⁶ May add a deep process of economic deindustrialization, low value added and complexity of exports, and low insertion in global value chains.

In addition, family indebtedness reached a record 115 percent of disposable income in 2006, and the construction and housing sectors accounted for 18.5 percent of GDP (twice the Eurozone average). House prices rose by 150 percent since 1998, and the average price of a square meter of residential property went up from 700 Euros in 1997 to 2,000 at the end of 2006, even though the housing stock had doubled. Many wondered whether this bubble was sustainable.¹⁷

The crisis that started in 2008 confirmed the worst fears, and the implosion of the housing bubble fuelled corruption and bad practices in the cajas sector of the financial system.

Between 40 and 60 percent of the benefits of the largest Spanish companies came from abroad. Yet, in the years prior to the crisis this figure has decreased by approximately 10 percentage points, and there has been a decline in direct foreign investment of all types in the country, falling from a peak of 38.3 bn Euros in 2000 to 16.6 bn Euros in 2005.¹⁸ The current account deficit reached 8.9 percent of GDP in 2006 and over 10 percent in 2007, which made Spain the country with the largest deficit in absolute terms (86,026 mn Euros), behind only the United States; imports are 25 percent higher than exports and Spanish companies are losing market share in the world. And the prospects are not very bright. The trade deficit reached 9.5 percent in 2008.¹⁹

While there is overall consensus that the country needed to improve its education system and invest in research and development to lift productivity, as well as modernize the public sector, and make the labor market more stable (i.e., reduce the temporary rate) and flexible, the government did not take the necessary actions to address these problems. Spain spends only half of what the Organization of European Co-operation and Development (OECD) countries spend on average on education; it lags most of Europe on investment in Research and Development (R&D); and it is ranked 29th by the UNCTAD as an attractive location for research and development. Finally, other observers note that Spain is failing to do more to integrate its immigrant population, and social divisions are beginning to emerge.²⁰

By the summer of 2008 the effects of the crisis were evident, and since then the country has suffered one of the worst recessions in history, with unemployment reaching over 27 percent in 2012, and more than 6 million people unemployed. This collapse was not wholly unexpected.

The global liquidity freeze and the surge in commodities, food, and energy prices brought to the fore the unbalances in the Spanish economy: the record current account deficit, persisting inflation, low productivity growth, dwindling competitiveness, increasing unitary labor costs, excess consumption, and low savings, had all set the ground for the current devastating economic crisis.²¹

After the Fiesta: The Global Crisis Hits Spain

The imbalances in the Spanish economy became obvious in 2007-08 when the real-estate market bubble burst and the international financial crisis hit Spain (see Table 2). In just a few months the ‘debt-fired dream of endless consumption’ turned into a nightmare. By the summer of 2013, Spain faced the worst economic recession in half a century. According to government statistics, 2009 was the worst year since there has been reliable data: GDP fell 3.7 percent, unemployment reached over four million people, and the public deficit reached a record 11.4 percent of GDP (up from 3.4 percent in 2008). Consumer confidence was shattered, the implosion of the housing sector reached historic proportions and threatened to extend for several years, and the manufacturing sector was also suffering.

Table 2: The Economic Crisis: 2008-2013

<i>Subject Descriptor</i>	<i>Units</i>	<i>2007</i>	<i>2008</i>	<i>2009</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>	<i>2013*</i>
Gross domestic product, constant prices	% change	3.5	0.9	-3.8	-0.3	0.4	-1.4	-1.6
Output gap in percent of potential GDP	% potential GDP	3.8	2.3	-2.8	-3.4	-3.2	-4.5	-5.4
Total investment	% GDP	31.0	29.1	24.0	22.8	21.5	19.6	18.1
Inflation, average consumer prices	% change	2.8	4.1	-0.2	2.0	3.1	2.4	1.9
Unemployment rate	% total labor force	8.3	11.3	18	20.1	21.7	25	27
General government structural balance	% potential GDP	-1.1	-5.4	-9.5	-8.0	-7.8	-5.7	-4.5
General government net debt	% GDP	26.7	30.8	42.5	49.8	57.5	71.9	79.1
Current account balance	% GDP	-1.0	-9.6	-4.8	-4.5	-3.7	-1.1	1.1

*Estimates

Source: International Monetary Fund, *World Economic Outlook Database*, April 2013

Initially, the Zapatero government was reluctant to recognize the crisis, which was becoming evident as early as the summer of 2007, because of electoral considerations: the country had general elections in March 2008. And after the election, the Zapatero government was afraid to admit that it had not been entirely truthful during the campaign. While this pattern has been quite common in other European countries, in Spain the increasing evidence that the model based on construction was already showing symptoms of exhaustion in 2007 compounded it. Yet, the Spanish government not only refused to recognize that the international crisis was affecting the country, but also that in Spain the crises would be aggravated by the very high levels of private indebtedness. As late as 17 August 2007, Finance Minister Solbes predicted that ‘the crisis would have a relative small effect’ in the Spanish economy.

When it became impossible to deny what was evident, the government’s initial reluctance to recognize and address the crisis was replaced by frenetic activism. The Zapatero government introduced a succession of plans and measures to try to confront the economic crisis, and specifically to address the surge of unemployment.²²

The sharp deterioration of the labor market was caused by the economic crisis and the collapse of the real estate sector, and it was aggravated by a demographic growth pattern based on migratory inflows of labor: in 2007 there were 3.1 million immigrants in the country, of which 2.7 million were employed and 374,000 unemployed. In 2008 the number of immigrants increased by almost 400,000, to 3.5 million (representing 55 percent of the growth in the active population), but 580,000 of them were unemployed (and 2.9 million employed), an increase of 200,000. In the construction sector alone, unemployment increased 170 percent between the

summer of 2007 and 2008. Meanwhile, the manufacturing and service sectors (also battered by the global crisis, lower consumption, and lack of international competitiveness) proved unable to incorporate these workers.

The pace of deterioration caught policymakers by surprise. The Zapatero government prepared budgets for 2008 and 2009 that were utterly unrealistic in the face of rapidly changing economic circumstances (as did all other advanced countries which in the G-20 agreed on a plan for fiscal stimulus that will later prove ineffective and dangerous for Spain as it increased debt). As a result, things continued to worsen over the new four years. The most significant decline was in consumer confidence, which was hammered by the financial convulsions, the dramatic increase in unemployment, and the scarcity of credit. As a result, household consumption, which represents 56 percent of GDP, fell one percent in the last quarter of 2009 for the first time in the last 15 years. According to the Bank of Spain, this decline in household consumption was even more important in contributing to the recession than the deceleration of residential investment, which had fallen 20 percent, driven down by worsening financial conditions, uncertainties, and the drop in residential prices. So far the government actions have had limited effect stemming this hemorrhage, and their efficacy has been inadequate.

The impact of the global economic crisis has been felt well beyond the economic and financial realms. The crisis also had severe political consequences. Spain followed in the path of many other European countries (including Ireland, Portugal, Greece, and France) that saw their governments suffer the wrath of their voters and have been voted out of office.

The Socialist Party (PSOE) was re-elected in a general election on March 9, 2008. Soon thereafter, economic conditions deteriorated sharply and the government's popularity declined rapidly. Between March 2008 and March 2012, there were a number of electoral contests in

Spain at the local, regional, national, and European levels. At the national and European levels the one common pattern was the outcome: the defeat of the Socialist Party and the victory of the Popular Party (PP). And at the regional and local levels the Socialists suffered historical losses, losing control of regional government that they ruled for decades (notably, Castilla-La Mancha and Extremadura), and even losing the election for the first time in one of its historical strongholds, Andalusia (although they were able to reach a coalition with a smaller leftist party to stay in power).

Spain's economic crisis was mainly due to a mismanaged financial sector, which by over lending freely to property developers and mortgages contributed to a real estate property bubble. This bubble contributed to hide the fundamental structural problems of the Spanish economy outlined in the previous section, and had an effect in policy choices because no government was willing to burst the bubble and risk suffering the wrath of voters. Furthermore, cheap credit also had inflationary effects that contributed to competitiveness losses and record balance of payment deficits. Therefore, three dimensions of the crisis (financial, fiscal and competitiveness) are interlinked in their origins. The crisis exposed the underbelly of the financial sector and showed that many banks (particularly the *cajas*) were not just suffering liquidity problems but risked insolvency, which led to the EU financial bailout of June 2012. The bailout had onerous conditions attached and it limited national economic autonomy.²³ Finally, the financial and fiscal crisis were made worse by the incomplete institutional structure of EMU and by bad policy choices at the EU level (excess austerity and refusal to act as a lender of last resort for sovereigns by the ECB). Now we turn to the elements of domestic policy that underline the triple crisis in financial, fiscal and competitiveness performance.²⁴

The Triple Crisis

The fiscal crises

One of the most common misinterpretations regarding the crisis in Southern Europe is attributing it to mismanaged public finances. Many policymakers across Europe, especially in the creditor countries (crucially Germany), still insist that the crisis was caused by irresponsible public borrowing, and this, in turn, has led to misguided solutions. In fact, with very few exceptions, notably Greece, that interpretation is incorrect. In Spain, the current crisis did not originate with mismanaged public finances. On the contrary, as late as 2011, Spain's debt ratio was still well below the average for countries that adopted the euro as a common currency: while Spain stood at less than 60 percent of GDP, Greece stood at 160.8 percent, Italy at 120 percent, Portugal at 106.8 percent, Ireland at 105 percent, Belgium at 98.5 percent, and France at 86 percent.

Prior to 2007, Spain seemed to be in an enviable fiscal position, even when compared with Germany.²⁵ Spain ran a budget surplus in 2005, 2006, and 2007. It was only when the crisis hit the country and the real estate market collapsed that the fiscal position deteriorated markedly and the country experienced huge deficits.

The problem in Spain was the giant inflow of capital from the rest of Europe; the consequence was rapid growth and significant inflation. In fact, the fiscal deficit was a result, not a cause, of Spain's problems: when the global financial crisis hit Spain and the real estate bubble burst, unemployment soared, and the budget went into deep deficit, caused partly by depressed revenues and partly by emergency spending to limit human costs. The government responded to the crisis with a massive €8 billion public works stimulus. This decision, combined with a dramatic fall in revenue, blew a hole in government accounts resulting in a large deficit.

The conditions for the crisis in Spain were created by the excessive lending and borrowing of the private sector rather than the government. In other words, the problem was private debt and not public debt. Spain experienced a problem of ever-growing private sector indebtedness, which was compounded by the reckless investments and loans of banks (including the overleveraged ones), and aggravated by competitiveness and current account imbalances. In Spain, the debt of private sector (households and nonfinancial corporations) was 227.3 percent of GDP at the end of 2010; total debt increased from 337 percent of GDP in 2008 to 363 percent in mid-2011.

Though Spain entered the crisis in a relatively sound fiscal position, that position was not sound enough to withstand the effects of the crisis, especially being a member of a dysfunctional monetary union with no lender of last resort. The country's fiscal position deteriorated sharply—collapsing by more than 13 percent of GDP in just two years. Looking at the deficit figures with the benefit of hindsight, it could be argued that Spain's structural or cyclically adjusted deficit was much higher than its actual deficit. The fast pace of economic growth before the crisis inflated government revenues and lowered social expenditures in a way that masked the vulnerability hidden in Spanish fiscal accounts. The problem is that it is very difficult to know the structural position of a country. The only way in which Spain could have prevented the deficit disaster that followed would have been to run massive fiscal surpluses of 10 percent or higher during the years prior to the crisis in order to generate a positive net asset position of at least 20 percent of GDP.²⁶ This, for obvious reasons, would not have been politically feasible.

The Loss of Competitiveness

There is also another way to look at the problem. Many economists argue that the underlying problem in the euro area is the exchange rate system itself, namely, the fact that European

countries locked themselves into an initial exchange rate. This decision meant, in fact, that they believed that their economies would converge in productivity (which would mean that the Spaniards would, in effect, become more like the Germans). If convergence was not possible, the alternative would be for people to move to higher productivity countries, thereby increasing their productivity levels by working in factories and offices there (or to create a full fiscal union to provide for permanent transfers, as argued by OCA theory). Time has shown that both expectations were unrealistic and, in fact, the opposite happened. The gap between German and Spanish (including other peripheral country) productivity increased, rather than decreasing, over the past decade and, as a result, Germany developed a large surplus on its current account; Spain and the other periphery countries had large current account deficits that were financed by capital inflows.²⁷ In this regard, one could argue that the incentives introduced by EMU worked exactly in the wrong way. Capital inflows in the south made the structural reforms that would have been required to promote convergence less necessary, thus increasing divergence in productivity levels.

Adoption of the euro as a common currency fostered a false sense of security among private investors. During the years of euphoria following start of Europe's economic and monetary union and prior to the onset of the financial crisis, private capital flowed freely into Spain and, as a result, the country ran current account deficits of close to 10 percent of GDP. In turn, these deficits helped finance large excesses of spending over income in the private sector. The result did not have to be negative. These capital inflows could have helped Spain (and the other peripheral countries) invest, become more productive, and "catch up" with Germany. Unfortunately, in the case of Spain, they largely led to a massive bubble in the property market, consumption, and unsustainable levels of borrowing. The bursting of that bubble contracted the

country's real economy and it brought down the banks that gambled on loans to real estate developers and construction companies.

At the same time, the economic boom also generated large losses in external competitiveness that Spain failed to address. Successive Spanish governments also missed the opportunity to reform institutions in their labour and product markets. As a result, costs and prices increased, which in turn led to a loss of competitiveness and large trade deficits. This unsustainable situation came to the fore when the financial shocks that followed the collapse of Lehman Brothers in the fall of 2007 brought "sudden stops" in lending across the world, leading to a collapse in private borrowing and spending, and a wave of fiscal crisis.

The Financial Crises

A third problem has to do with the banks. This problem was slow to develop. Between 2008 and 2010 the Spanish financial system, despite all its problems, was still one of the least affected by the crisis in Europe. During that period, of the 40 financial institutions that received direct assistance from Brussels, none was from Spain. In December 2010 Moody's ranked the Spanish banking system as the third strongest of the Eurozone, only behind Finland and France, above the Netherlands and Germany, and well ahead of Portugal, Ireland, and Greece. Finally, Santander and BBVA had shown new strength with profits of €4.4 billion and €2.8 billion, respectively, during the first half of 2010. Spanish regulators had put in place regulatory and supervisory frameworks, which initially shielded the Spanish financial system from the direct effects of the global financial crisis. Indeed, the Bank of Spain had imposed a regulatory framework that required higher provisioning, which provided cushions to Spanish banks to

initially absorb the losses caused by the onset of the global financial crisis. And there were no toxic assets in bank's balance sheets.

Nevertheless, this success proved short lived. In the summer of 2012, Spanish financial institutions seemed to be on the brink of collapse and the crisis of the sector forced the European Union in June (2012) to devise an emergency €100 billion rescue plan for the Spanish banking sector. When the crisis intensified, the financial system was not able to escape its dramatic effects. By September 2012, the problem with toxic real estate assets forced the government to intervene and nationalize eight financial institutions. Altogether, by May 9, 2012, the reorganization of the banking sector involved €15 billion in public resources, including guarantees.

There are a number of factors that help account for the deteriorating performance of the Spanish banks after 2009. The first is the direct effect of the economic crisis. The deterioration in economic conditions had a severe impact on the bank balance sheets. The deep recession and record-high unemployment triggering successive waves of loan losses in the Spanish mortgage market coupled with a rising share of non-performing loans. Like many other countries such as the United States, Spain had a huge property bubble that burst. Land prices increased 500 percent in Spain between 1997 and 2007, the largest increase among the OECD countries. As a result of the collapse of the real estate sector had a profound effect in banks: five years after the crisis started, the quality of Spanish banking assets continued to plummet. The Bank of Spain classified €80 billion euros as troubled assets at the end of 2011, and banks are sitting on €56 billion of mortgages of which 2.8 percent are classified as nonperforming.

A second factor is concern over the country's sovereign debt. As mentioned before the crisis in Spain did not originate with mismanaged public finances. The crisis has largely been a

problem of ever-growing private sector debt, compounded by reckless bank investments and loans, particularly from the cajas, as well as aggravated by competitiveness and current account imbalances. To place the problem in perspective, the gross debt of household increased dramatically in the decade prior to the crisis, and by 2009 it was 20 percentage points higher than the Eurozone average (86 percent of GDP versus 66 percent). And the austerity policies implemented since May 2010 have aggravated the fiscal position of the country. The ratio of Spain's debt to its economy was 36 percent before the crisis and is expected to reach 84 percent by 2013 (and this is even based on optimistic growth assumptions). In sum, Spain seems to have fallen into the "doom loop" that has already afflicted Greece or Portugal and led to their bailout. The sustainability of the Spanish government debt was affecting Spanish banks (including BBVA and Santander) because they have been some of the biggest buyers of government debt in the wake of the ECB long-term refinancing operation liquidity infusions (the percentage of government bond owned by domestic banks reached 30 percent in mid-2012). Again, the doom loop is a result of EMU weakness, namely the lack of a banking union with a centralized EU funded mechanism to bail out banks.

Spanish banks are also suffering the consequences of their dependence on wholesale funding for liquidity since the crisis started, and, in particular, their dependence on international wholesale financing, as 40 percent of their balance depends on funding from international markets, particularly from the ECB. Borrowing from the ECB reached €2 billion in 2012, and Spanish banks have increased their ECB borrowings by more than six times since June 2011, to the highest level in absolute terms among Euro area banking systems as of April 2012.

The crisis also exposed weaknesses in the policy and regulatory framework. The most evident sign of failure has been the fact that the country has already adopted five financial

reforms in three years, and it has implemented three rounds of bank mergers. The results of these reforms have been questionable at best. The fact that Spain has had five reforms in less than three years, instead of one that really fixed the problem, says it all. They have been largely perceived as “too little and too late,” and they failed to sway investors’ confidence in the Spanish financial sector.

Finally, the current financial crisis can also be blamed on the actions (and inactions) of the Bank of Spain. At the beginning of the crisis, the Bank of Spain’s policies were all praised and were taken as model by other countries. Time, however, has tempered that praise and the Bank of Spain is now criticized for its actions and decisions (or lack thereof) during the crisis. Spanish central bankers chose the path of least resistance: alerting about the risks but failing to act decisively.

Lessons from Spain’s Experience²⁸

It Is Essential to Prepare for EMU

The crisis has also shown that countries need to undertake the necessary structural reforms to fully adapt to the demands of a single market and a monetary union. Somehow there was an expectation that membership on its own would force structural reforms, and this (naturally) did not happen. On the contrary, the crisis has shown the limits (and also adverse incentives) of EU/EMU membership in imposing institutional reforms in other areas (e.g., the labor market, the financial sector, or competition policy) and to balance domestic and external economic objectives.

Nominal Convergence Takes Place Faster than Real Convergence

Spain's economic record for the past two decades shows that nominal convergence is faster, but that real economic convergence is a slow process. Spain still lags behind many of the EU's richest countries in terms of their GDP per capita

EMU Membership Carries Risks

The Spanish experience also provides an interesting insight into the pitfalls of integration into an incomplete monetary union (one not backed by a political union): lower interest rates and the loosening of credit will likely lead to a credit boom, driven by potentially overoptimistic expectations of future permanent income, which in turn may increase housing demand and household indebtedness, as well as lead to overestimations of potential output and expansionary fiscal policies. The boom will also lead to higher wage increases, caused by the tightening of the labor market, higher inflation, and losses in external competitiveness, together with a shift from the tradable to the nontradable sector of the economy, which would have a negative impact on productivity.

In order to avoid these risks, countries should develop stringent budgetary policies in the case of a boom in demand and/or strong credit expansion. At the same time, they should guard against potential overestimation of GDP, and measure carefully the weight of consumption on GDP, because they may inflate revenues in the short term and create an unrealistic perception of the budgetary accounts, as in the case of Spain. Furthermore, to avoid unsustainable external imbalances, countries should also carry out the necessary structural reforms to increase flexibility and productivity, as well as improve innovation in order to allow their productive sectors to respond to the increasing demand and to ensure that their economies can withstand the

pressures of increasing competition. They should also set wages based on Eurozone conditions to ensure wage moderation, instead of on unrealistic domestic expectations and/or domestic inflation (Abreu 2006, 5–6). Countries should also take the opportunity presented by the boom to move into higher value-added and faster growth sectors toward a more outward-oriented production structure. Finally, the current global crisis illustrated the need for strict financial supervision to avoid excessive lending and misallocation of resources.

Fiscal Discipline Matters, but It Is Not Enough

Prior to the crisis, Spain was perceived as one of the most fiscally disciplined countries in Europe. Initially, fiscal surpluses allowed the country to use fiscal policy to be used in a countercyclical way to address the global financial crisis. However, although Spain entered the crisis in 2008 in an apparent excellent fiscal position, the country's structurally or cyclically adjusted deficit turned out to be much higher than its actual deficit. As a result of the crisis, the country's fiscal performance collapsed by more than 13 percent of GDP in just two years. This shows that Spain's structurally or cyclically adjusted deficit was much higher than its actual deficit, and illustrates how difficult it is to know the structural position of a country.

In order to avoid such a situation countries should further tighten budgetary policies in the case of a boom in demand and/or strong credit expansion. It is also important that they use fiscal policies in a countercyclical way to be prepared for recessions; finally, higher revenues, as in Spain prior to the crisis, should not drive budget surpluses. On the contrary, governments need to address the structural reasons for the deficits and avoid one-off measures that simply delay reforms but do not address the long-term budgetary implications.

Address Deficiencies in the Policymaking Process and Challenge the Dominant Paradigm

Prior to and during the crisis, there was strong consensus in Spain among economic elites, as well as among Conservatives and Socialists leaders, regarding fiscal consolidation and the balance budget objective. Indeed, prior to the crisis, Spain presented itself as the model of a country applying the budget surplus policy mantra. This consensus may have worked well in the short term, contributed to the credibility of the government policies, and allowed the country to become a founding member of EMU, but a more accommodating policy would have positively contributed to upgrading the productive base of the country with investments in necessary infrastructure and human capital that may have contributed to a faster change in the model of economic growth, as well as reduced dependency on the construction sector.

Learn from Traditional Financial Crises

The financial crisis in Spain did not involve subprime mortgages, collateralized debt obligations, structured investment vehicles, or even investment banks. In many ways, the financial crisis in Spain has strong similarities with traditional banking crisis: banks should not lend excessively to property developers; governments and central bankers should be proactive in bursting the bubbles before it is too late; bankers should recognize that retail banking is not a low-risk activity, and should avoid overconcentration in property loans; and finally, governments and central bankers should avoid any complacency (as it happened in Spain), and instead need to be vigilant and proactive to avoid the mistakes of the past and to anticipate all possible scenarios, including the most negative ones. In Spain, the misplaced and excessive confidence on the

strength of the financial sector, and the almost unquestioned belief in the regulatory and oversight prowess of the BoS, led to hubris.

Financial Regulation Matters

Regarding the experience of the Spanish financial sector during the crisis, there are also several lessons (Royo 2013a). First, there is consensus that the stern regulations of the Bank of Spain played a key role in the initial positive performance of Spanish banks, because it forced banks to set aside during the good years “generic” bank provisions in addition to the general provisions for specific risks. In addition, it made it so expensive for them to establish off–balance sheet vehicles that Spanish banks stayed away from such toxic assets. Second, no model is perfect. Indeed, the experience of the Spanish financial sector shows that it is impossible for banks not to be affected from a collapsing bubble in real estate. Spain is still suffering a property-linked banking crisis exacerbated by financing obstacles from the international crisis. The Bank of Spain announced in 2012 that bad loans on the books of the nations’ commercial banks, mostly in the real estate sector, reached 7.4 percent of total lending.

Finally, the Spanish government (and the ECB) failed to cope with the asset bubble and its imbalances. Hence, the Spanish experience shows that financial stability cannot be divorced from economic policy and macroprudential supervision; while regulation matters, macroeconomic factors do too. And they had options: the government should have eliminated housing tax breaks and/or establish higher stamp duty on property sales, or higher capital gains tax on second properties.

It Is the Politics, Stupid

Throughout the crisis the focus has been largely on the economic dimension of the crisis, as well as on its economic causes and consequences. It would be a mistake, however, to underplay the political dimensions of the crisis, and not just at the Spanish national level, but also at the European and global ones. This has been as much a political crisis as an economic one, and as much a failure of the markets, as a failure of politics. Political decisions have marked the course of the crisis.

Need to Address Current Account Deficits and Competitiveness

While the focus during the Eurozone crisis largely centered on the fiscal challenges, it is essential to note that we are also dealing with a crisis of competitiveness. EMU membership fostered a false sense of security among private investors, which brought massive flows of capital to the periphery. As a result, costs and prices rose, which in turn led to a loss of competitiveness and large trade deficits. Indeed, below the public debt and financial crisis there was a balance of payment crisis caused by the misalignment of internal real exchange rates. The crisis will largely be over when Spain regains its competitiveness.

Between 2000 and 2010 the loss of competitiveness vis-à-vis the Eurozone deteriorated: 4.3 percent if we take into account export prices and 12.4 percent if we take into account unitary labor costs in the manufacturing sector. The experience of Spain within EMU also shows that there have been lasting performance differences across countries prior to the crisis. These differences can be explained at least in part by a lack of responsiveness of prices and wages, which have not adjusted smoothly across sectors, and which, in the case of Spain, have led to

accumulated competitiveness losses and large external imbalances. While Germany (and other EMU countries) implemented supply-side reforms to bring labor costs down, through wage restraint, payroll tax cuts, and productivity increases, making it the most competitive economy with labor costs 13 percent below the Eurozone average, Spain continued with the tradition of indexing wage increases to domestic inflation rather than the European Central Bank target, and it became one of the most expensive ones with labor costs going up to 16 percent above average (Portugal leads with 23.5 percent, Greece with 14 percent, and Italy with 5 percent).²⁹ A lesson for EMU members has been that it is critical to set wages based on Eurozone conditions, and not on unrealistic domestic expectations, to ensure wage moderation (Abreu 2006, 5–6).

A crucial problem for Spain has been the dramatic erosion of its comparative advantage. The emergence of major new players in world trade, like India and China, as well as the eastern enlargements of the European Union were somewhat damaging to the some European economies because those countries have lower labor costs and compete with some of our traditional exports (as exporters of relatively unsophisticated labor-intensive products), leading to losses in export market shares (aggravated by the appreciation of the euro and the increase of unit labor costs relative to those in its trading competitors). Yet while this was particularly true for Portugal, Italy and France, in Spain the problem has been that too few companies export, and that those that export have differentiated products because they are the large multinationals. That explains why the market share of Spanish products in world trade did not fall in the last 15 years. At the same time, Spain's attempt to specialize in medium- and higher-technology products was also hindered by the accession of the Eastern European countries into the EU, which were already moving into those sectors specializing in these products.

Finally, in order to avoid unsustainable external imbalances, countries should also carry out the necessary structural reforms to increase flexibility (particularly internal flexibility which may be even more important for companies to allow them to deeply effectively their human capital, than the external one, despite the traditional fixation on dismissal costs) and improve productivity. This would be the most effective way to allow their productive sectors to respond to the increasing demand and to ensure that their economies can withstand the pressures of membership to a single market. Finally, countries should also take the opportunity presented by the boom to move into higher value-added and faster growth sectors, toward a more outward-oriented production structure.

Address EMU Institutional Constraints

The crisis has shown that the EMU is a flawed construction. Mario Draghi, president of the ECB acknowledged as much when he noted that it was like a “bumblebee” and declared “it was mystery of nature because it shouldn’t fly but instead it does. So the euro was a bumblebee that flew well for several years.” Lately it has not been flying well, and according to him, the solution should be “to graduate to a real bee.”³⁰

The crisis in Spain has illustrated the EMU’s institutional shortcomings: Spain had a huge bubble that crashed with the crisis. The “bumblebee” flew for a while and convinced investors that they could invest (and lend) massively within the country, thus money poured into Spain. However, when the crisis hit, the country could not count on the EU to guarantee the solvency of its banks, or to provide automatic emergency support. And when unemployment soared and revenues plunged, the deficits ballooned. As a result, investors’ flight followed and drove up borrowing costs. The government’s austerity measures and structural reforms so far only

contributed to deepen the country's slump. The country needs relief with its borrowing costs and hopes that the ECB plan will help (but resists the conditionality attached to it). It also needs support with its exports. Europe has so far largely come short on both accounts. This crisis has shown the fragility of an institutional framework that tried to balance fiscal sovereignty with a monetary union. This model failed to combine flexibility, discipline, and solidarity. Fear is what is keeping it all together. But is fear enough to hold it together? If anything, the crisis exposed the shortcoming of EMU institutions. This is replication of the mistakes of the gold standard (Ahamed, 2009).

Discipline and Austerity Are Not Enough

Can an expansionary fiscal contraction work? The problem for Spain is the feeble outlook for growth: the Spanish economy contracted by 1.7 in 2013; the country has high external indebtedness; and it has a tremendous private sector debt. As a result, Spain's sovereign debt was repeatedly downgraded throughout the crisis. Unemployment has also reached record levels at over 24 percent (and the unemployment problem is particularly acute among young people at over 50 percent). Furthermore, deep-seated structural weaknesses are still holding back growth and weighting on market assessment: overregulated product and labor markets, poor productivity, and low education achievement in international tests. And the effects of austerity are affecting not only Spain: by the end of the 2014 summer the risk of deflation in the Eurozone were acute.

In this regard, the contrast with the United States is striking. Since 2007, the US Congress passed the equivalent of three stimulus bills:

- a. A bipartisan \$158 billion package of tax cuts signed by President George W. Bush in early 2008

- b. A \$787 billion bill pushed by President Obama as he took office in 2009 in the wake of the financial system's collapse
- c. A tax cut and unemployment fund extension agreement reached by President Obama and Congressional Republicans in December 2010.

Many studies show that these measures are a key reason why the unemployment rate is not in double digits now in the United States.

Conclusion

The crisis has largely been a problem of ever-growing private sector debt, compounded by reckless bank investments and loans, particularly from the *cajas*, as well as aggravated by competitiveness and current account imbalances. In the end, the crisis has exposed the weaknesses of the country's economic model. Indeed, despite the previous two decades' significant progress and achievements, the Spanish economy still faces serious competitive and fiscal challenges. Unfortunately, the economic success the country prior to the crisis fostered a sense of complacency, which allowed for a delay in the adoption of the necessary structural reforms. And this was not a surprise; some economists had noted that the Spanish economy was living on borrowed time. Indeed, despite all the significant progress Spain still had considerable ground to cover to catch up with the richer EU countries and to improve the competitiveness of its economy. Given the existing income and productivity differentials with the richer EU countries Spain will have to continue and deepen the reform process.

The sudden collapse of the Spanish economy came as a shock. In retrospect, however, it should not have been such a surprise. The policies choices taken during the previous decade led to an unsustainable bubble in private sector borrowing that was bound to burst. Moreover, the institutional degeneration that led to systemic corruption and contributed to the implosion of parts of the financial sector made the crisis almost unavoidable.

Much of Spain growth during the 2000s was based on the domestic sector and particularly on an unsustainable reliance on construction. Tax incentives favored developers, property owners, and bankers. In addition, the particular regulation of the *cajas* proved fatally flawed, and led to a form of crony capitalism Spanish style, in which they invested massively in the construction sector in search of rapid growth and larger market share. These decisions proved fatal once the

real estate bubble burst, and they led to the nationalization of several cajas, including *Bankia*, and the financial bailout from the European Union.

Membership in the European single currency was not the panacea that everyone expected to be. Adoption of the euro led to a sharp reduction in real interest rates that contributed to the credit boom and the real estate bubble. However, it also altered economic governance decisions. Successive Spanish governments largely ignored the implications of EMU membership, and failed to implement the necessary structural reforms to ensure the sustainability of fiscal policies and to control unitary labor costs. These decisions led to a continuing erosion of competitiveness (and a record current account deficit); and a huge fiscal deficit when the country was hit by the global financial crisis.

Indeed, the experience of the country shows that EU and EMU membership have not led to the implementation of the structural reforms necessary to address these challenges. On the contrary, EMU contributed to the economic boom, thus facilitating the postponement of necessary economic reforms. This challenge however is not a problem of European institutions, but of national policies. Indeed, the process of economic reforms has to be a domestic process led by domestic actors willing to carry them out.

The Spanish case serves as an important reminder that in the context of a monetary union, countries only control fiscal policies and relative labor costs. Spain proved to be weak at both. It failed to develop an appropriate adjustment strategy to succeed within the single currency, and it ignored the imperative that domestic policy choices have to be consistent with the international constraints imposed by euro membership. On the contrary, in Spain domestic policies and the imperatives of participating in a multinational currency union stood in uneasy relationship to one

another. The crisis was the tipping point that brought this inconsistency to the fore, which led to the worst economic crisis in Spanish modern history.

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