Spain's economy needs bold leadership to prevent the collapse of its banks and to reform its labour market

Despite growth and budget surpluses in the lead up to the financial crisis, Spain now faces falling GDP and high unemployment. **Manuel Muniz** *argues that Spain urgently needs to recapitalize its banks and to institute economic reforms to increase its competitiveness and bring back growth.*

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The scope and scale of the Eurozone crisis has led many to forget that different countries had very different economies when the crisis erupted. In an attempt to arrive at general conclusions about the malaise affecting the economies of the EU we have failed to understand the particularities of each case.

The most common of these generalisations is that high levels of public debt in the EU periphery are the overall cause of the its problems. Current debates about the economic situation in Spain, for example, are centred on the country's need to reduce its deficit to 5.3% of GDP, as agreed this year with European partners in Brussels. Just recently, the newly elected Spanish conservative government succeeded in gaining concessions from the EU and was allowed to exceed the original deficit target of 4.4% of GDP for 2012. The original 3% target for 2013 remains in place; more so after the Fiscal Compact which will allow for legal action to be taken against those in breach of its stipulations. However, public spending was not at the core of Spain's economic problems; nor was the Spanish complex and wasteful public administration. That the new government has decided to tackle a bloated and inefficient public sector is of course good news, but such actions alone will not solve the country's economic troubles.

Spain was in a truly enviable situation in 2007 and 2008 regarding public spending. It had run a budget surplus for years and its debt to GDP ratio was well below 60% in 2008 (compare that to Italy's 120%). Even today, after years of recession, stimulus packages and automatic stabilisers like unemployment benefits, that figure is below 70%. However, some worrying signs existed back in the late 1990′s and early 2000′s. Two were the most significant. The first was a massive trade deficit, led by long-running Spanish energy dependency, and above all, by a recurring loss of competitiveness. At its peak in 2008 that deficit was close to 10% of GDP, and today, after four years of economic slowdown, it remains at 6.5% (giving Spain's trade deficit figure the rare honour of being ranked 176 out of 210 countries listed in the CIA World Factbook). Not surprisingly Spain's current account balance threw a deficit of close to $61 Billion in 2011, making it, again, one of the largest in the world.

Spain's Economy Minister de Guindos is greeted by Luxembourg's Prime Minister and Eurogroup chairman Juncker at a Eurogroup meeting in Brussels

The second source of worry was an ever growing reliance on the construction sector. In 2007 construction represented around 16% of Spanish GDP and employed 12% of its work force. The real estate boom meant that at its peak more houses were being built in Spain than in the rest of the EU put together. This is despite Spain representing less than 10% of the Union's population and an equal amount its total territory. The boom in construction was made possible by low Euro interest rates and a rapid increase in private debt. By the year 2005 the average Spanish household had accumulated debt equivalent to 125% of the combined annual income of its members.

In 2007 things started to change. There were signs that the real estate bubble was about to burst. For the first time since 1998 household prices froze (they had risen on average around 150% since the late 90′s). It was not long before credit for further development or for the purchase of new homes fell. As Spain struggled with the collapse of one of the pillars of its economic success, the financial crisis broke out, first in the United States and shortly after everywhere else. Economies dependent on credit like that of Spain were hit hard by the rapid decline in liquidity. With further strains on credit, consumption collapsed and the real estate sector was all but brought to a halt. In 2009, Spain entered a recession for the first time in 16 years, when GDP fell by 3.9%. In January of this year the IMF announced its revised figures for the Spanish economy predicting an extension of the recession with a 1.7% fall of GDP in 2012 and of 0.3% in 2013 (previous estimates had shown GDP growing by 1.1% this year and 1.8% in 2013). All the while, unemployment rose rapidly from around 8% in 2008 to over 20% in 2010. Current government estimates place that figure over the 24% mark for the year 2012.

Development "Francisco Hernando" in Seseña, about 40 miles from Madrid. 13,000 homes were to be built. The population of Seseña was to rise from 6,000 in 2003 to 60,000 in 2011 due to this project. Today only a third of the development has been completed, flats have sold for less than 30% of the initial asking price and banks own close to half of all the properties

Digging out

So where does all this leave us? First of all it must enable us to understand that Spain's problems are very specific to its recent history and have a lot to do with its economic model. Indeed Spain has to deal with the collapse of the real estate sector, where a lot still needs to be done, and at the same time, rebuild its economy on a more solid footing.

The European Central Bank's 3-year longer term financing operation (LTRO) announced in December of 2011 has, according to a growing number of analysts, brought the Eurozone crisis to an end (see below for a depiction of this sophisticated monetary policy).

European private lenders accessed the ECB's cheap loans and used them to purchase Eurozone sovereign debt drastically bringing down treasury yields. Spanish banks alone used around 25% of the 1€ Trillion made available by the ECB. The Spanish government, in turn, profited greatly from the initiative and saw its 10-year bond yields fall from 6.7% in the winter of 2011 to below 5% in early 2012. Somewhat hidden from view is the fact that the LTRO is also a program to capitalise the banks given that they pay around 1% to the ECB and are buying sovereign debt at close to 5%. However, it is precisely the health of its banking sector that makes Spain a worrying exception. If the worsening of the national economy was to continue Spanish banks could be in dire need of recapitalisation in order to provision for heavy losses on real estate related debt.

Freshly baked Euros at the European Central Bank. Printing money can get you so far. Now it is time for deep reforms.

It is estimated that in 2011 property related loans in Spain amounted to 1€ trillion, which would be very close to Spain's annual GDP. Out of that around 140€ billion have already gone bad. Overall real estate related debt is around one quarter of the Spanish domestic financial market. Housing prices have fallen since 2007 by an average of 22% (compared to over 40% in Ireland) although a clear acceleration in the drop has been felt in late 2011. It is expected that prices will continue to fall, and with unemployment rising it is only reasonable to expect further trouble for Spanish financial institutions holding large amounts of real estate debt.

Anticipating this scenario, in February, the new Spanish government announced new bank regulations that will see national banks increase their capital by around 50€ billion. The European Commission, meanwhile, is reported to be moving slowly towards the idea that further capitalisation will be needed, expected to be an additional 50€ billion. Such a figure is significantly more than the 35€ billion budget reduction that the Spanish government is attempting to achieve in 2012. If another round of aggressive recapitalisation is needed it would not be extraordinary to see Spain having to bail out some of the smaller and more exposed regional banks (particularly the politically influenced Cajas which have historically lent to high risk real estate developers and home buyers). Further pressure on the budget can only lead to a bailout from the EU with strict economic oversight.

This leads us to the second big problem that Spain faces: The dire need for overarching economic reforms that increase its competitiveness and bring back growth. This is, of course, easier said than done. It is however evident by now that the main problem in Spain's economy is its labour market. Collective bargaining arrangements, which sanctioned the imposition of what was agreed by very few on entire sectors of the economy, as well as the high cost of firing employees produced terrible imbalances in the market, and an overall rigid and unproductive economy. It is truly unsurprising that youth unemployment in Spain is close to 50% and that a two tier labour market has emerged with highly paid and highly protected work being an oddity, and poorly paid temporary work being the norm. The recent reform of the labour market is probably not as profound as it should have been and has led to a general strike, taking place as this article is being written. The lack of productivity is also an issue. According to World Bank data, Spanish labour productivity fell by about 0.5% from 2002 to 2008 when it was expected to rise by over 4%. In 2002 average annual labour productivity in Spain was around $42,000, compared to $61,000 in Germany or $83,000 in the United States. Unit labour costs in Spain are unsurprisingly well above those of other Eurozone members.

Logo of the 29th of March general strike

If Spain is to overcome the current crisis it is to tackle, first and foremost, the problems indicated above. It has to come to grips with the lingering real estate crisis and protect its banks from the excessive risk they exposed themselves to during the boom years. This will mean recapitalising banks well beyond the $50 billion announced, in anticipation of a further decline in real estate value. The time for this has now arrived. However, what is truly needed is a new economic model based on a productive and competitive labour market capable of creating exportable goods and services. That will take a generation and will require large-scale reforms in the failing Spanish educational system, reducing business regulations and a commitment to innovation.

Keeping the budget deficit in line should be a key objective of the Spanish government. However the true problems of Spain's economy have been high levels of private debt, which fed a truly enormous real estate bubble, and an uncompetitive labour market. These issues were worryingly present during the years of growth and are present now, very much driving the recession. The future of Spain will therefore depend not so much on fiscal discipline as on how decidedly and effectively those underlying problems are tackled.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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