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After the El Dorado Decade

Spain's Troubled Path in Managing Its Crisis

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Since the spring of 2012, the crisis in Europe has been shifting from the former epicenters of Greece, Portugal, and Ireland to Spain and Italy. In particular, the high level of unemployment in Spain has resulted in a choir of demands for increased public spending and a departure from austerity programs. The German government, and especially Chancellor Angela Merkel, is accused of being too stubborn in its demands for more fiscal prudence. American economist Paul Krugman, speculator-turned-philanthropist George Soros, and many others suggest that credit-financed spending would help Spain. In addition, dispatching aid to ailing Spanish banks is considered essential. However, the potential benefits of these policies are not convincing. Credit-financed stimulus programs would weaken the Spanish economy in the long run. On the other hand, large-scale rescue operations for Spanish banks would result in so much collateral damage that continuing on the current austerity path also appears unwise. But before the therapy, the patient's history ought to be examined: How did Spain – an economic poster child for over a decade – manage to slide into economic calamity?

In the first decade of the 21st century, many people considered Spain to be the new "El Dorado." In search of quick material fortunes, many people migrated to the Iberian Peninsula, boosting Spain's population dramatically. From 2003 to 2010, the population grew from 42 to 46 million, an increase of almost 10 percent, most of which was due to immigration. Not only the demand for housing, but also the supply of labor rose considerably. The conservative government of José Maria Aznar, Prime Minister from 1996 to 2004, created an unprecedented economic boom. The liberalization of building regulations and the toleration of illegal immigration fueled the Spanish economy, which until 2008 showed growth rates significantly above the eurozone average. From 2001 to 2007, Spain recorded average annual growth rates of 3.4 percent, whereas the eurozone average was 2.0 percent. But that alleged economic miracle was not sustainable.

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Table
Spain's economic development from 2001 to 2011

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*
Real GDP growth (%)	3.7	2.7	3.1	3.3	3.6	4.1	3.5	0.9	-3.7	-0.1	0.7
Share of government GDP expenditure (%)	38.7	38.9	38.4	38.9	38.4	38.4	39.2	41.5	46.3	45.6	43.6
Current account (% of GDP)	-3.9	-3.3	-3.5	-5.2	-7.4	-9.0	-10.0	-9.6	-4.8	-4.5	-3.5
House prices (nominal, annual change in %)	9.5	16.9	20.0	18.3	14.6	10.0	5.5	0.2	-7.6	-3.6	-6.1
Interest payments on government debt (% of GDP)	2.6	2.4	2.1	1.8	1.6	1.3	1.1	1.1	1.4	1.5	2.0

Source: OECD, *Economic Outlook Database*, Paris 2012, Tables 1, 25, 31, 51, 59.

The Spanish El Dorado attracted foreign capital

The building boom was fueled by foreign capital. Between 2005 and 2008, Spain attracted about 365 billion euros in capital inflows. However, crucial ingredients of the building boom were homemade. Rodrigo Rato, Minister for Economics in the Aznar government, enabled local communities to massively expand the amount of developable land, resulting in communities across the entire country developing new building zones. The positive sentiment in the Spanish economy, combined with rising real estate prices, contributed to rising private consumption, which resulted in high domestic demand.

The booming economy attracted both labor and capital. In the building boom, all hands were welcomed by the construction industry. In 2007, the last year before building activity slowed, about 2.7 million people were employed in the building sector. In the same year, the Germany building industry had 170,000 fewer people – in a country with almost twice the Spanish population. In 2011, employment within the building sector had shrunk to just 1.4 million employees, whereas employment in the German construction industry rose to 2.6 million.

The roaring escalation of real estate prices and the building activity fueled by these price rises were the most important factors behind the specious prosperity of the Spanish economy. Similar developments occurred elsewhere. The crises in Ireland, the United Kingdom, and the United States were also based on excesses in the real estate sector. In all these economies, price bubbles were financed by foreign capital.

When that bubble burst, the old weaknesses of the economy resurfaced. Although Spain is suffering from the hangover of the real estate bubble and from overdue reforms, government spending is certainly not insignificant. In contrast to what the public debate may suggest, Madrid is in fact spending much more than it was six years ago. Between 2006 and 2010, nominal total government spending rose by 28 percent. Whereas the Spanish government spent 38.4 percent of GDP in 2006, in 2010 that figure rose to 45.6 percent, which is slightly above the OECD average. Subsequent expenditures have dropped a little, but drastic austerity looks different. The causes of Spain's problems have very little to do with fiscal policy, let alone austerity dictated by foreigners.

In essence, one-third of today's unemployed in Spain are former construction workers. This rise obviously has nothing to do with Spanish fiscal policy. However, the reaction of previous Spanish governments to illegal immigration is a factor that is contributing to the difficult situation today. The socialist government of José Luis Zapatero came into office in April 2004 and immediately started to prepare an amnesty program for illegal immigrants. From February 2005 onward, about one million illegal migrants were granted resident status. Many of these migrants worked in the construction industry, and these workers are unemployed today. German protests at the time, for instance by the Interior Minister Otto Schily, were ignored by the Spanish government. The German government complained about Madrid's unilateral actions and the resulting lack of coordination of migration policy. The comprehensive legalization of illegal migration is a classical case of the failure of good intentions. Like the boom in the construction industry, this measure was built on excessively positive assessments of the Spanish economy. Consecutive Spanish governments have suffered from delusions of grandeur, which is fine, of course, as long as the rest of the Europe is not asked to foot the bill for these miscalculations.

What we are observing in 2012 is the normalization of activity after a boom in housing. For too long, the Spanish government ignored the dramatic rises of house prices, which for years only knew one direction: up. The years in which price increases were at their highest, between 2001 and 2006, house prices grew by 11.2 percent – per year and inflation-adjusted. Warnings from other countries about the risks of high capital inflows – whether from the European Central Bank (ECB) Governing Council or during discussions in Brussels – were not considered and no action was taken to stop the bubble from inflating further.

The current crisis has little to do with the fiscal compact

The current correction is causing great difficulties for the affected citizens. But the adjustments – in particular the shrinking of the construction sector – have nothing to do with the fiscal compact, and they have very little to do with the eurozone. It is, however, true that the eurozone did not provide economies with instruments to cool off the boom that was fueled by an inflow of foreign capital. The development of instruments against unwanted capital inflows should be discussed in the context of the further development of the eurozone. But the Spanish labor market is not only in trouble because of the busted real estate bubble.

Similar to Italy, the country failed to make its labor market more flexible in times of economic growth. Until now, the Spanish labor market has been characterized by a high level of protection of workers with tenured contracts. This inflexibility results in a reluctance of companies to hire new employees, something that Spain is suffering from today. But the issue of inflexibility in the labor market has been on the agenda for quite a while. From 1997 to 2008, Spain occupied the inglorious top spot in the eurozone with regard to structural unemployment. Whereas the average in the eurozone was 8.7 percent, structural – that is, long-term – unemployment in Spain in that phase was as high as 12.8 percent. Even in the boom years, the economy was unable to bring the unemployed into new employment.

The structural deficiencies were somewhat hidden during the Spanish boom years, but they have resurfaced in the crisis. The weaknesses have to be addressed, and the government of Prime Minister Mariano Rajoy has already taken significant steps toward increasing the flexibility of the labor market. But in the middle of a severe economic crisis that has resulted in pessimistic expectations regarding future growth potential, those measures have had only limited effects. Companies are reluctant to hire new workers in the middle of a crisis. But within the next few years, the measures taken today will bear fruit.

On balance, the situation of the Spanish economy is certainly not hopeless. In contrast to Greece, for example, Spain has successful companies in manufacturing, finance, and retail. To name just two examples: The major Spanish bank Santander has a strong market position in several Latin American and European countries and has hardly been affected by the turbulence at home. The fashion label Zara, founded in 1975, is considered to be one of the most innovative garment houses in the world, has a commercial presence on five continents, and has half of its self-designed clothing manufactured in Spain.

Unit labor costs, which had risen significantly in the boom years and which had contributed to the deterioration of the competitive position of Spanish companies, have fallen recently. The current account of Spain shows a particularly positive trend. Whereas the deficit was as high as 10.0 percent of GDP in 2007, which is clearly unsustainable, the OECD has forecast a very moderate current account deficit of 0.9 percent in 2012 and a small surplus for next year. Whereas Spain was importing capital in the boom, it will be exporting capital in 2013. In all probability, the economy will still be in recession next year, but the decline will – at minus 0.8 percent – probably be moderate.

The interests of financial markets dominate the debate

Against this rather benign economic development, the lasting panic is somewhat surprising. Both in American and British newspapers, economists have suggested that Spain cannot help itself. Some calls for action from Spanish policymakers are not convincing and look unjustified. In recent months, members of the conservative government of Mariano Rajoy have complained that the Spanish government is cut off from financial markets. In June 2012, Finance Minister Cristóbal Montoro warned that “the doors of financial markets are not open for Spain.” This interpretation of rising interest rates at Spanish bond auctions is not convincing. In fact, not a single Spanish bond auction has ever failed. So what are the motives of a Spanish minister who makes markets more nervous than they already are?

Montoro had been Finance Minister in the Aznar government from 2000 to 2004. Thus, he is partly to blame for today’s painful economic situation, which has its origins in the credit-financed boom of the El Dorado decade. Rather than accepting that mistakes were made by a government to which he belonged – in fact, whose finance minister he was – he blames the markets for seemingly vicious behavior. But the markets are neither irrational nor nasty. They react to the failures of both the Spanish and the European rescue operations – and they do that very rationally. In fact, one could argue that the phase preceding the current crisis – when markets failed to differentiate between countries – was illustrative of market failure. But today, markets are working perfectly. They are correctly acknowledging that eurozone members can default. The Greek haircut of March 2012 has shown that lending to governments is not risk-free. Investors want to be compensated for that risk – as they should be.

But even more important is the failing strategy of the Spanish government with regard to its own financial sector. In essence, a government faced with a financial sector that has gambled too much and is burdened with debt can choose between two structurally different paths. The first is to take responsibility for the activities of private sector companies and bail them out. Capital injections are helping banks that would otherwise collapse. In one way or the other, a government then socializes the losses of private banks. This is the method being applied in Spain, and it is the very method that brought Ireland down. Several banks – above all the Bankia Group, which is the result of a merger of several Spanish savings banks – were partly nationalized. The capital injections gave the state majority shareholder status, but the shareholders were not completely expropriated. If the rescue operation is successful, the minority shareholders will benefit over time.

Of course, this is an approach that is alien to a market economy. Banks that do not understand their business should be permitted to leave the market – and should not be rescued. The approach taken in Spain protects the shareholders, not the depositors. In a market economy, first of all the shareholders of incompetent banks should lose their capital and the affected banks should – if closing them looks too risky – be fully nationalized. If the shareholders' capital is not sufficient to cover the losses, bondholders of the affected banks ought to make a contribution to the rescue operation. In most cases, a haircut for share- and bondholders will be sufficient. The Spanish and European taxpayers, who have not contributed to the economic failure, should not be required to accept responsibility.

This second approach – permitting banks to fail and primarily drawing on share- and bondholders to cover losses – is quite unpopular, both in Spain and the wider eurozone. But why is that the case? Why do more and more policymakers – from Mario Draghi to Cristóbal Montoro – and many journalists categorically rule out large-scale bank closures? A political economy analysis suggests that this reflects the increasing political influence of the financial sector on policymakers. Of course, banks always claim that they have to be rescued. In fact, in the past, many companies – their management as much as trade unions – have claimed that they ought to be rescued, but few have been as successful in that regard as European banks.

The successful campaign of the financial sector is also reflected in the increased use of the term "systemically relevant." While it is obvious that many banks claim that status for themselves, the fact that the ECB is using this term more often underlines the influence of the finance industry. ECB Vice-President Vítor Constâncio suggested in April 2012 that there are 36 systemically relevant banks in the eurozone. Of course, he also argued that mechanisms should be developed to stabilize, that is, rescue, these banks, should they lose money.

Interestingly, banks see themselves as being less relevant when regulators ask them. In the United States, the nine largest banks operating there – including Deutsche Bank, Union Bank of Switzerland (UBS), and Credit Suisse – had to provide their "testament" to the Federal Deposit Insurance Corporation (FDIC), the organization that ensures the safety of deposits in the United States. What would happen if one of these large banks failed? Would the financial system collapse? Are any of these big banks systemically relevant? The answer is no. Each of them could withdraw from the marketplace without having disruptive effects on financial stability.

There are two potential answers to this puzzle. Either the self-assessment of banks given to the American regulators is not correct, or there are hardly any systemically relevant banks in the United States or elsewhere. The term "systemically relevant" would then be no more than a rhetorical tool to generate taxpayers' support for any industry that is failing to tame itself.

Apparently, the Anglo-Saxon economies understand these mechanisms better than policymakers in the eurozone. A sobering example of this approach is the handling of the failed mortgage lender Northern Rock, which was nationalized by the British government on 21 February 2008. The shareholders of Northern Rock lost their capital, and subsequently the bank was split into a mortgage and savings bank (Northern Rock PLC) and a "bad bank" (Northern Rock Asset Management). While the British government continues to wind down the latter, Northern Rock PLC was sold to Richard Branson's Virgin Money in 2011. The British National Audit Office estimates that the entire rescue operation may cost the taxpayer up to two billion pounds – a modest sum compared to the costs accruing in the rescue operations in the eurozone.

In the United States, shareholders of banks have to show responsibility much faster than in Europe. Since 2008, the FDIC has closed 445 ailing banks. If a bank gets into trouble, the shareholders lose their investments and the FDIC either closes the bank completely or sells marketable parts of it. The FDIC protects the depositors for up to 250,000 dollars per customer. The closing of banks – including the then sixth largest US bank, Washington Mutual, in 2008 – has been a major factor in the disciplining of the US financial sector.

If governments and institutions like the ECB keep coming to the rescue of the financial sector, the players will become less – not more – prudent in the future. Rescue operations lead to what economists call moral hazard. The first bailout leads to bigger rescue operations in the future.

The irony is that, in Europe, the financial sector has successfully managed to link its own interests with those that favor European cooperation and integration. Even left-leaning parties are singing the siren song of the rescuers and have failed to acknowledge whose song they are singing. At the end of the day, the question is: How is it that some private sector companies have been successful in putting their economic interests above those of the taxpayers?

The high level of influence of the financial sector is, of course, not a phenomenon restricted to Europe. In 2009, the former Chief Economist of the International Monetary Fund, Simon Johnson, criticized the disproportionate influence of Wall Street on US economic and fiscal policy. Johnson even argued that the United States was exposed to a "quiet coup" and demanded breaking the power of the "financial oligarchy." If that did not happen, Johnson suggested, it would be very difficult for the American economy to return to a sustainable growth path. But the determined actions of the FDIC described above demonstrate that policymakers have been trying to address this issue.

Viewed this way, there is thus not a conflict between nations, but between interest groups within the eurozone. The main beneficiaries of the rescue operations have managed to put their commercial interests above the interests of taxpayers, which is a smart move on their part. Needless to say, a Europe that continues to serve privileged interest groups will not be a successful competitor in the 21st century.

Contradictions in the management of the European crisis are being critically observed, particularly in emerging economies. Disbelief in Asia stems primarily from the apparent unwillingness of European policymakers to apply well-established principles of a capitalist economy. How is it possible that Europeans have forgotten how market economies work and which incentives have to be given?

El Dorado is in crisis, but it is not a hopeless case

Like Italy and Portugal, Spain has delayed structural adjustments for too long and is implementing overdue reforms in the middle of a crisis. The measures taken by the government of Prime Minister Rajoy – in particular the liberalization of the labor market and the measures to reduce government spending – are showing their first positive effects, but many additional positive results will require a bit more time and patience.

In the meantime, markets are reacting and have been asking for a higher risk premium. But neither Spain nor Italy have anywhere near the levels of interest rate payments that they had to live with before the introduction of the euro. In 1995, the Spanish state had to pay 4.7 percent of GDP for interest payments on government debt. Of course, the reduction to 1.1 percent in 2008 was nicer for the Spanish Finance Minister than the subsequent rise, but even with the additional debt burden *and* the significantly higher interest payments, the OECD is forecasting interest rate payments of 2.9 percent of GDP in 2013. The same applies for Italy, of course. Italy's payments for government debt sank from 10.7 percent of GDP in 1996 to 4.3 percent in 2010 and will, according to the OECD, rise marginally to 5.0 percent in 2013. These levels of interest payments are clearly manageable. But there is no justification for taking away the incentive for prudent fiscal policy by shielding certain economies within the eurozone from (temporary) spikes in interest rates. The subsidization of interest payments for countries that temporarily suffer from these spikes is not appropriate. Over time, perhaps sooner than later, markets will honor reform programs in Spain (and Italy) in the same way they have been doing for Ireland and Portugal. Many other economies in Asia and Latin America have had this experience in the past. In a time which has seen the transition from "riskless return" to "returnless risk," investors will soon see the opportunities that a country like Spain has to offer.

The one area that will begin to show a new pattern is migration. Spain will most likely not be a country of net immigration in the coming years, but rather a country of emigration. Young people could (and should) look for employment elsewhere in the eurozone. In an integrating Europe, such temporary labor migration should not be considered a problem, but instead be seen as part and parcel of a functioning monetary union. In the United States, which is often seen as the benchmark for a functioning union, relocation from, for example, Detroit to Dallas is part of daily life for US citizens.

At this juncture, Spain does not need a stimulus program financed by additional borrowing, which would most probably delay necessary adjustments and increase the debt burden for future generations. Europe should refrain from rewarding imprudent bankers, who have successfully portrayed their interests as being the interests of all "good Europeans."

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