BULLETIN

ECIPE Bulletin No. 02/2012

Please Make Spain Austere, But Not Just Yet!

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Spain is on the brink of another wave of profound market distrust. It is about to enter a depressionary cycle while serious doubts remain about it financial sector's ability to avoid defaults. There is no doubt that Spain will have to push through far-reaching cuts in public expenditures, but neither Spain nor its Eurozone partners should take an ideological view about how soon Spain should balance its budget. There are far greater risks for the Eurozone if Spain is forced to rapid fiscal stabilization than if it is allowed to honour the three-percent deficit rule "in the breach rather than observance" until at least 2015/16.

Spain is in the middle of a gigantic economic "correction". It has to address three core problems that were built up from the late 1990s to the start of the financial crisis in 2008. Such a correction process will take time. The experience from Finland's and Sweden's economic and financial crises in the early 1990s – which both went through corrections similar to what Spain now has to do – is that a country needs 7-8 years at least before it can exit the correction cycle. One important difference, however, is that these Nordic countries' recoveries were greatly assisted by considerable currency depreciations, which allowed for a quick rebalancing of the current account and restoration of economic growth after the initial drops in GDP. Nominal depreciation of the exchange rate is not an option for Spain – and this will prolong its correction cycle with at least a few years.

Three structural economic problems have conspired to push Spain to the brink. First, Spain's private sector (households and companies) has to substantially deleverage its debt level and the Spanish banks that were exposed to the real estate boom have to substantially improve their balance sheets to accommodate big and growing portfolios of non-performing loans. Yet deleveraging in Spain is moving slowly and there are still more stress to come in banks as house prices are likely to continue their decline. Some observers claim that real estate prices will have to go down with another 20 percentage points, compared with the prices recorded at the peak of the housing bubble in 2008. That is not an unrealistic scenario. Real estate prices in Spain have not fallen as much in the past four years as they have in other countries that suffered from a housing bubble, e.g. the United States and Ireland. Moreover, Spain had an extraordinarily fast rise in property prices and credit from 1999 up to 2008. Fuelled by the sharp drop in interest rates after the euro introduction, the Spanish real estate and construction sector grew four times as fast as it had done in the previous ten years.

Spanish households have lowered debt by approximately six percent since 2008, when measured as share of disposable income. Non-financial corporations have hardly deleveraged at all. In other words, much of the deleveraging in the private sector remains to be done. Combined with the fast rise in government lending, and also the increase in financial sector debt, the Spanish economy has expanded its debt since 2008.

The second structural problem is Spain's fiscal policy – or, more precisely, the structure of expenditure growth in the past ten years. Spain is now approaching worrying levels of public debt, but it did not have problems with deficits and debts up to 2008. In fact, its public debt shrunk to approximately 45-50 percent of GDP in 2007. But Spain's problem is that its high nominal growth rates during the Noughties was fuelled by an unsustainable real estate boom and that a significant portion of its growth was used to expand government consumption.

Between 2001 and 2007 government spending increased by almost 60 percent. That growth rate was manageable as long as nominal GDP growth remained high – at around 7 percent in average during that period. But it was not a sustainable expansion of government expenditure as general economic growth was too dependent on increased economic activity in the real estate and construction sector; economic output that to a significant extent would disappear once the bubble had burst.

The recent period of negative economic growth (which will be followed by a period of anaemic growth) has uncovered a structural problem in Spain's composition of expenditures. Its structural deficit is far higher than it should be and that forces the Spanish government to push through series of expenditure reforms. But appropriate expenditure reforms take time to have an effect. Slash-and-burn cuts in expenditures are typically ineffective: they may achieve real cuts in the short term but in the medium term they achieve little (e.g. radical cuts in health care expenditure tend to push up expenditures for social security).

Lasting expenditure reforms usually need 3-5 years before they improve fiscal budgets. Yet Spain is now pushed to quickly balance its budget, and some of its recent cuts will not bite while its tax increases (especially the increase in capital gains taxation) will depress new investments and growth. This is a dangerous policy. Forced austerity may be the last "wafer-thin chocolate mint", if you know the Monty Python sketch, that will push Spain into a depressionary cycle: rapid expenditure cuts and tax hikes depress growth, which forces the government to go for even more short-term austerity.

Third, Spain's competitiveness and potential growth are far too low to speed up overall recovery and private sector deleveraging. Finally the government has started to introduce new economic reforms, but much more is needed. Spain needs to go through another period of deregulations to get many of its ossified sectors to perform better. Those reforms are also essential for investments in the private sector to take off again. Its relative competitiveness vis-à-vis other countries also need to improve. If nominal exchanges cannot better reflect the country's competitiveness, it has achieve the same effect through the real exchange rate – that is, by increased productivity and/or declining labour costs. If Spain does not orbit into a higher growth trajectory in the next few years, private as well as public sector stabilization will be much harder – perhaps even impossible without financial sector and sovereign defaults.

Other Eurozone countries need to find a better approach to Spain than its current narrow approach, demanding rapid budget balancing. In effect, other countries have to make a choice between allowing Spain some fiscal flexibility or providing external finance through one of its bailout arms. That choice should be simple.