THE SPANISH CRISIS:
BACKGROUND AND POLICY CHALLENGES

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1. Introduction

- Strange paper, written in turbulent times, with a sense of urgency
- Patent dichotomies between inside and outside views
- Many opinions and pieces of information circulated around those days fed the worries
  - by exaggeration & lack of perspective or...
  - by lack of transparency & denial of underlying problems

- Economic policies did not look like an adequate response to the depth and complexity of the crisis:

  With structural roots, precipitated by financial crisis, easily convertible into a solvency crisis

  – It was time for much more decisive policy action, on the short-term and structural fronts

  – Skeptics thought:

    * The situation was too severe for other exit than bankruptcy

    * Policy-makers would not have courage, support or long-term view to undertake remedial action

Main goal:

Balanced (yet subjective&selective) assessment of the situation

- The non-catastrophist message can be stated in *medical* terms:
  - The patient was severely ill, but not yet dead
  - If properly treated, he could survive
  - Proper treatment requires paying a short-term cost: political will is essential to make the treatment viable
  - International pressure was good (rather than evil) to help us put the patient under treatment

  Finally, in a moralist (*regenerationist*?) tone:

  - Once the patient recovers, his life will have to be different, abandoning the excesses and dysfunctions of the past

- Style is mid way a report and an essay
  - No proofs or formal evidence, but collection of facts, interpretations, informal predictions and policy implications
  - Many interpretations based on existing formal work but no attempt to survey the literature
- View as of June 2010 with no attempt to update the assessment (historical testimony)
- Several things have happened since then $\rightarrow$ brief account in my conclusions

Overview

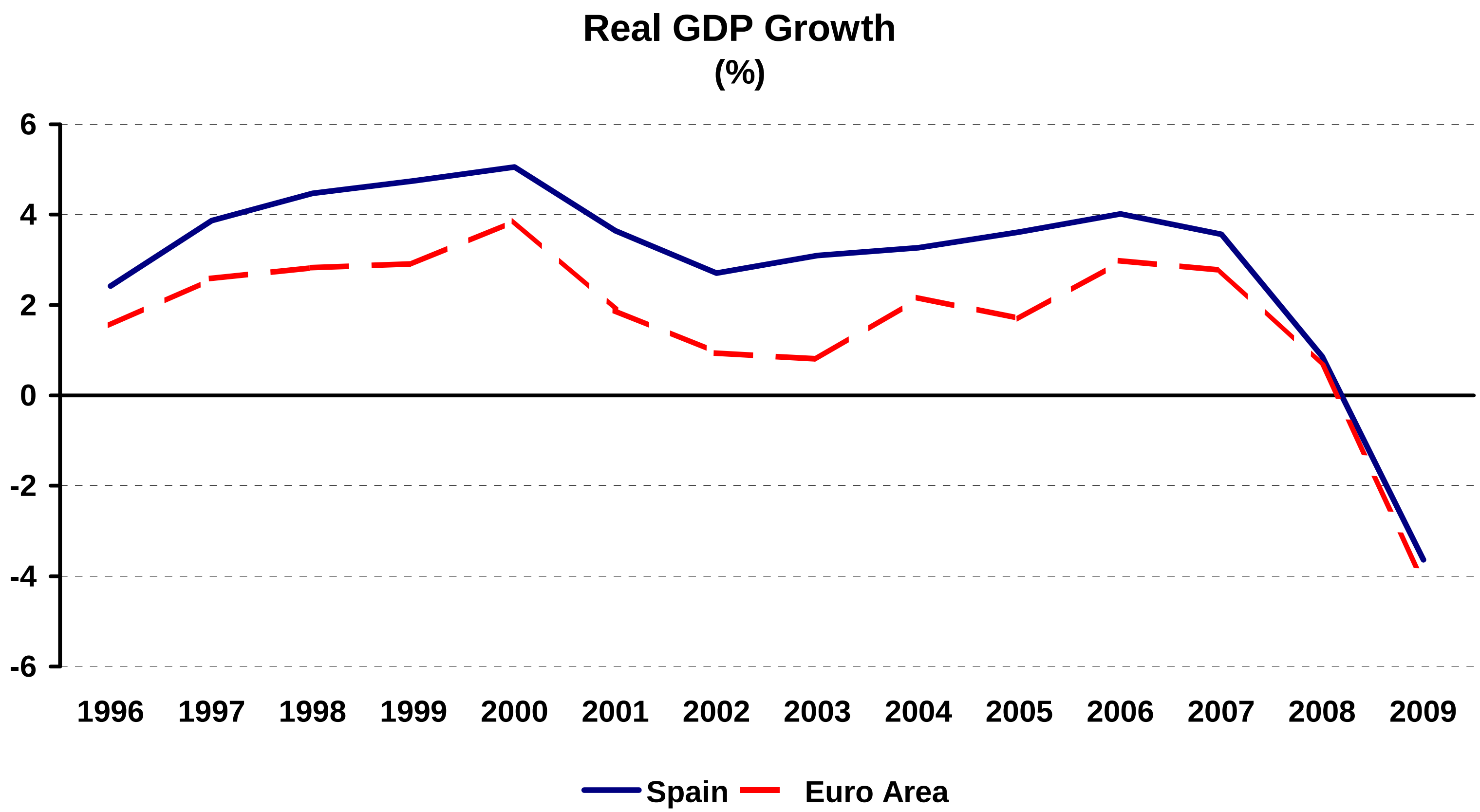
2. Abrupt end of a long growth cycle
3. Accumulated imbalances
4. The fiscal nightmare
5. Territorial dimension of the fiscal problems
6. Concerns on banks

7-11. Overcoming the crisis

12. Afterword

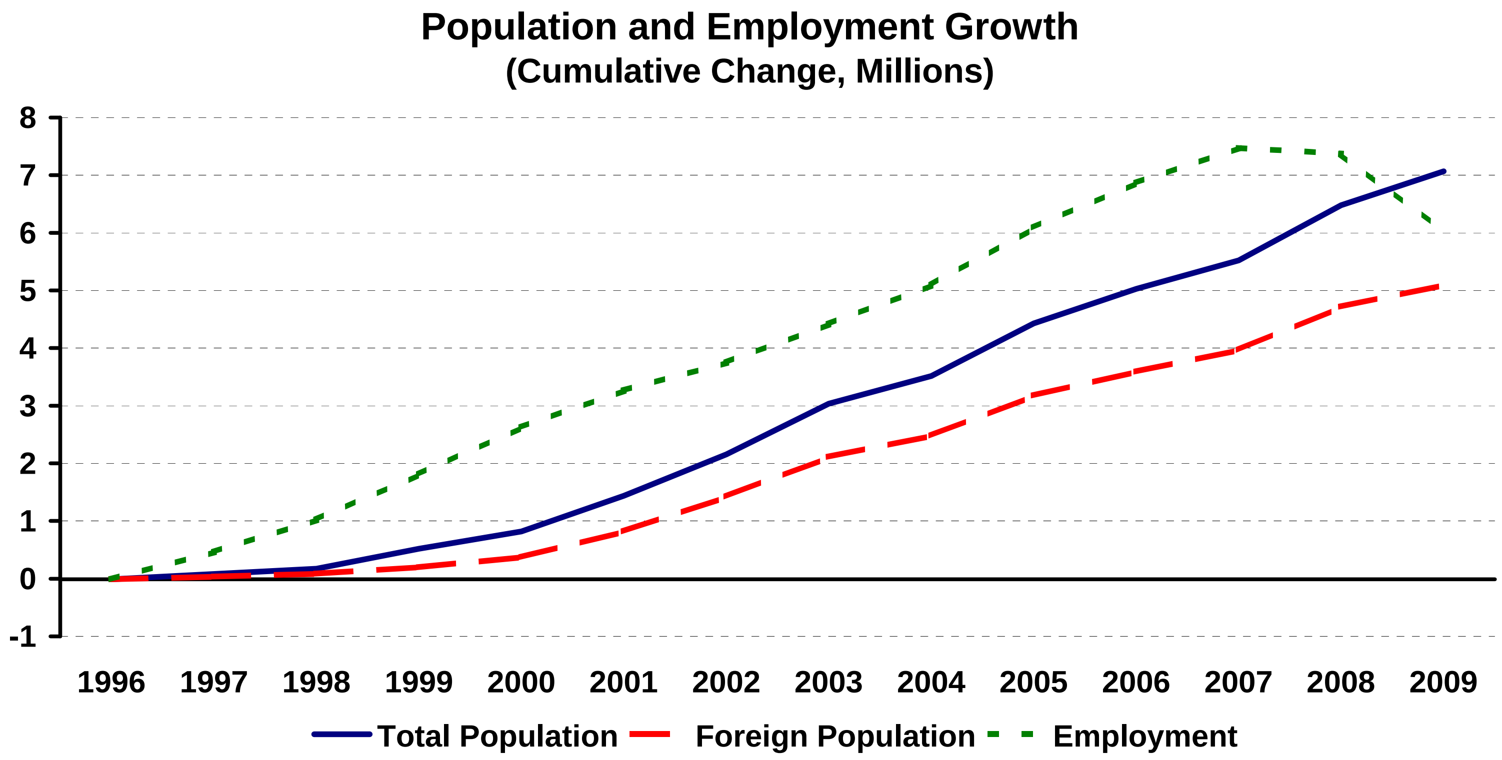
2. Abrupt end of a long growth cycle

- Abrupt end of a long high growth cycle started around 1996:



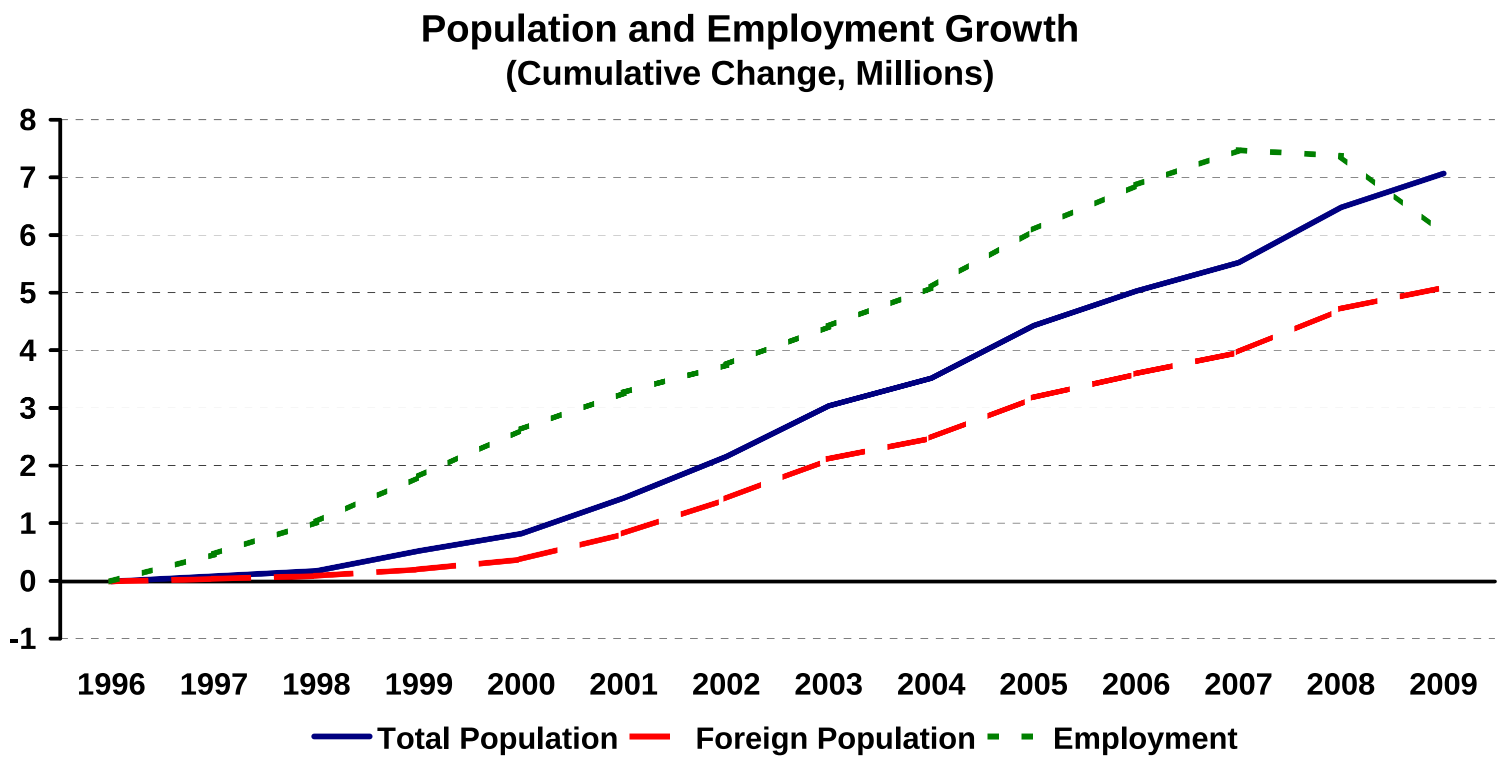
- Process involves several interrelated developments

Feature 1: High population growth



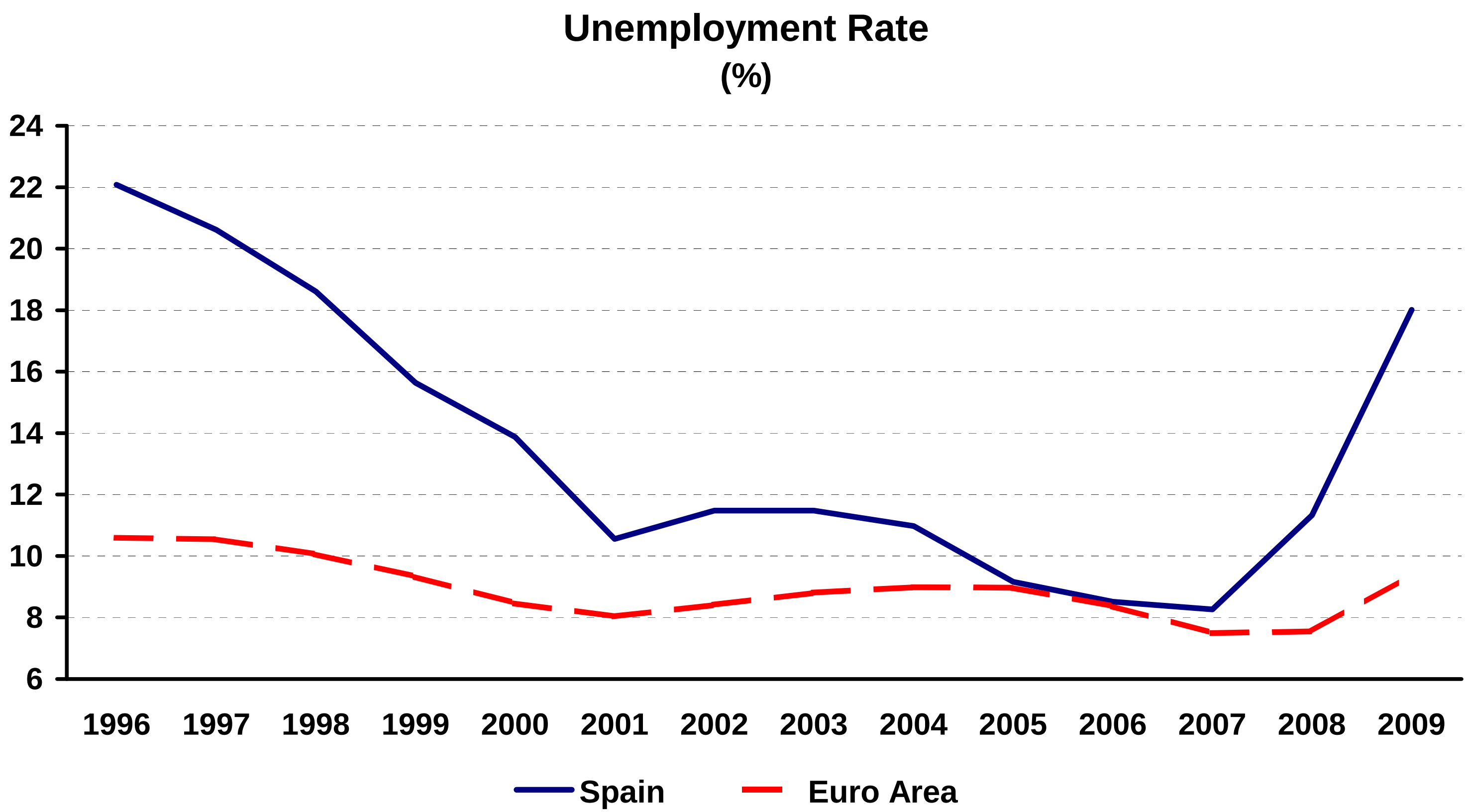
- Mostly due to immigration (40$\longrightarrow$47 mill)
  - Country of emigration $\longrightarrow$ return $\longrightarrow$ immigration ($>+$5mill)
  - Registered foreign population $<$2% $\longrightarrow$ $>$12% in 2009

Feature 2: High job creation (1/2)



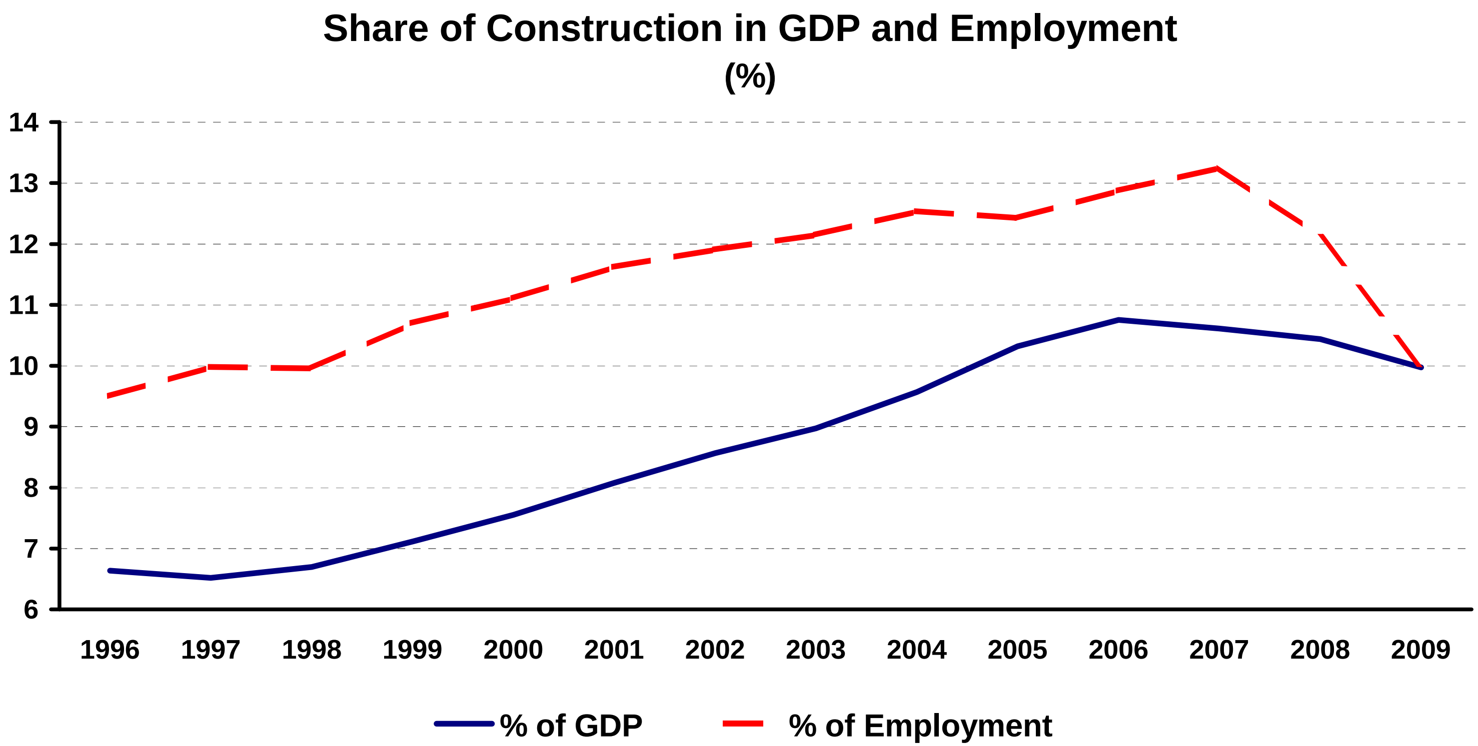
- People employed: 13 (96) $\longrightarrow$ 20 (07) $\longrightarrow$ 18.5 (10)
  - Both more active local population + immigrants found jobs
  - Immigrant workers popularly perceived as needed

Feature 2: High job creation (2/2)



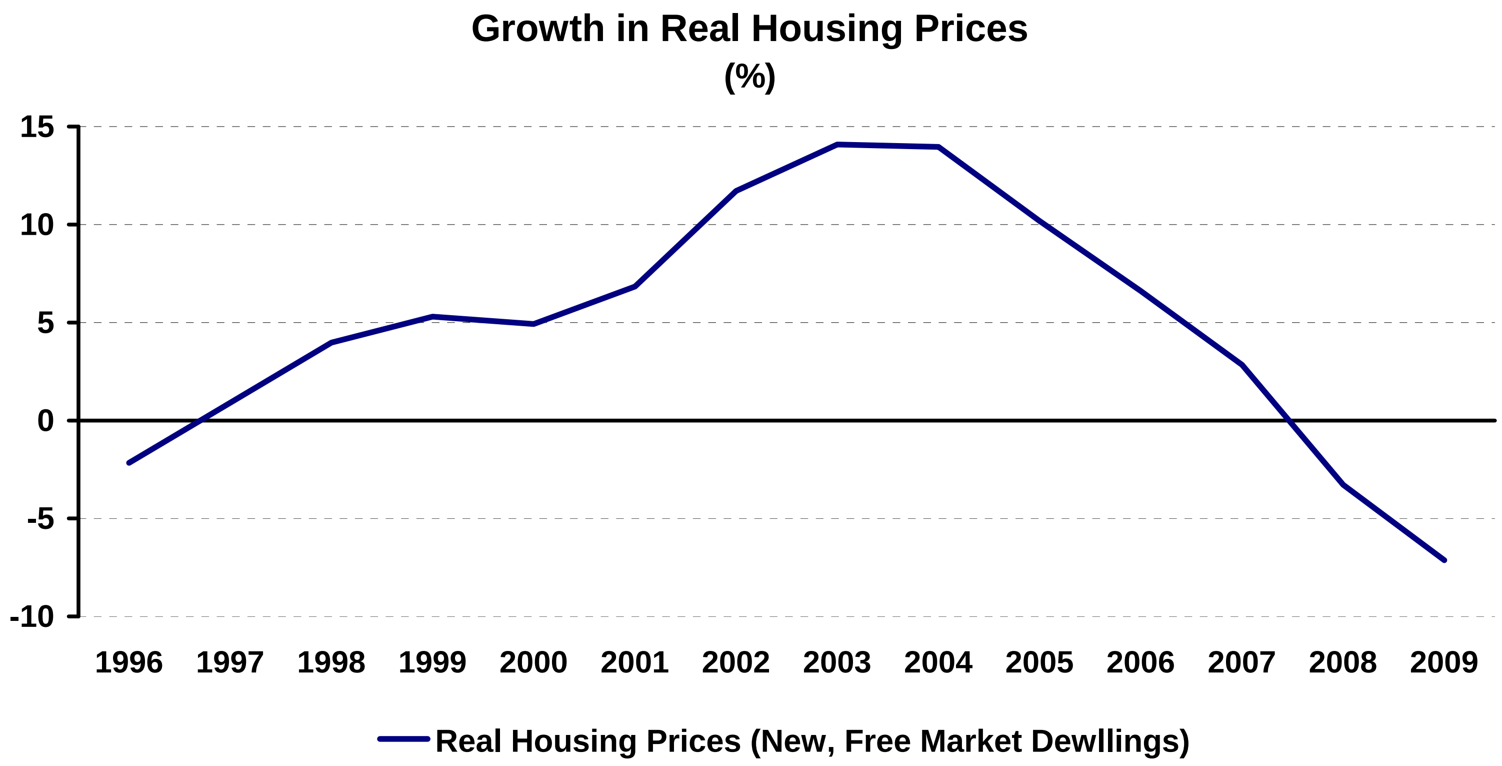
- Unemployment: 25 (93) $\longrightarrow$ 8 (07) $\longrightarrow$ 20 (10) %

Feature 3: Construction and real estate booms (1/2)



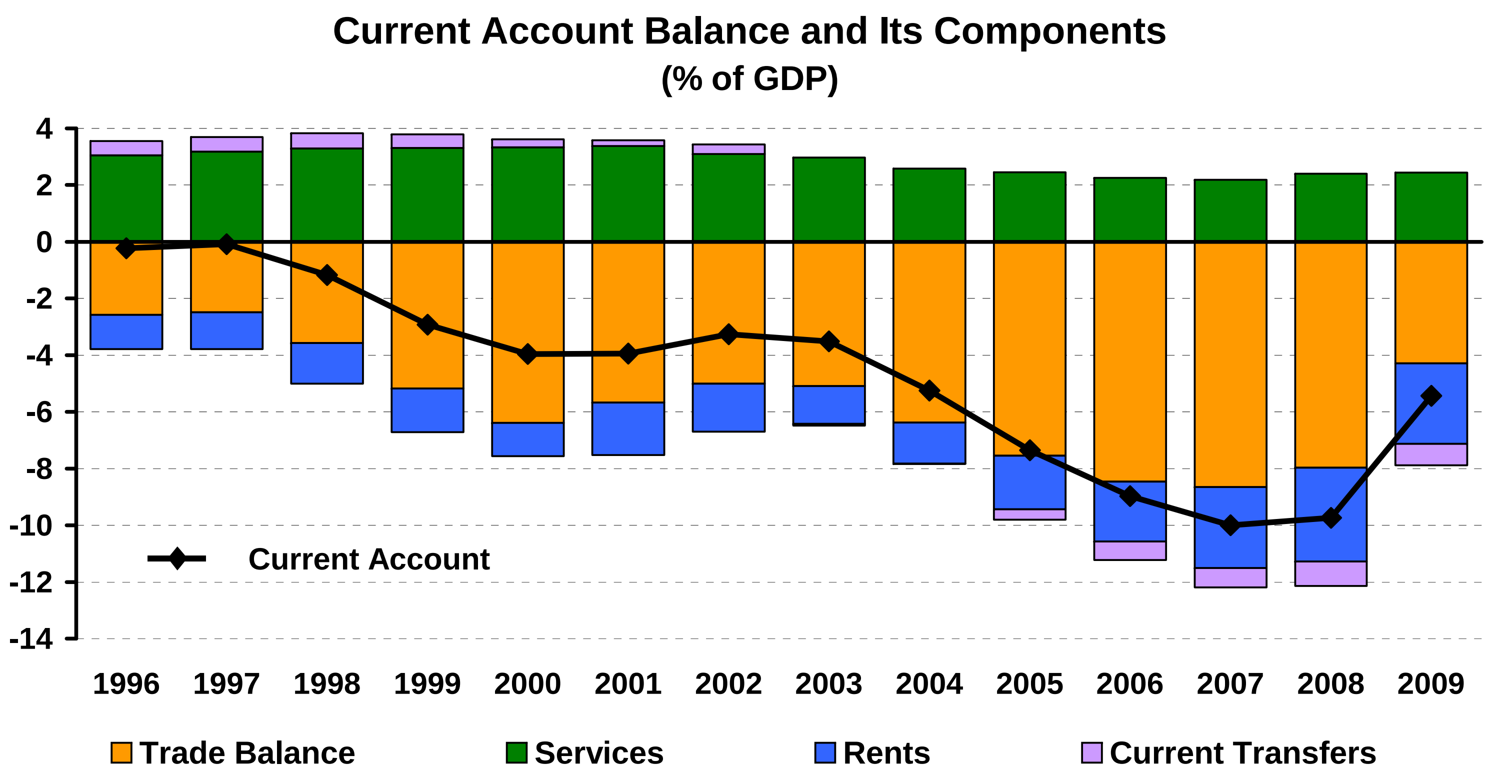
- Dwellings: 194,871 (96)$\longrightarrow$ 597,632 (2006) units (=rest of EU)
- Employment share: 9.5 $\longrightarrow$ 13 $\longrightarrow$ 10 %
- GDP share: 7 $\longrightarrow$ 11 $\longrightarrow$ 10 %

Feature 3: Construction and real estate booms (2/2)



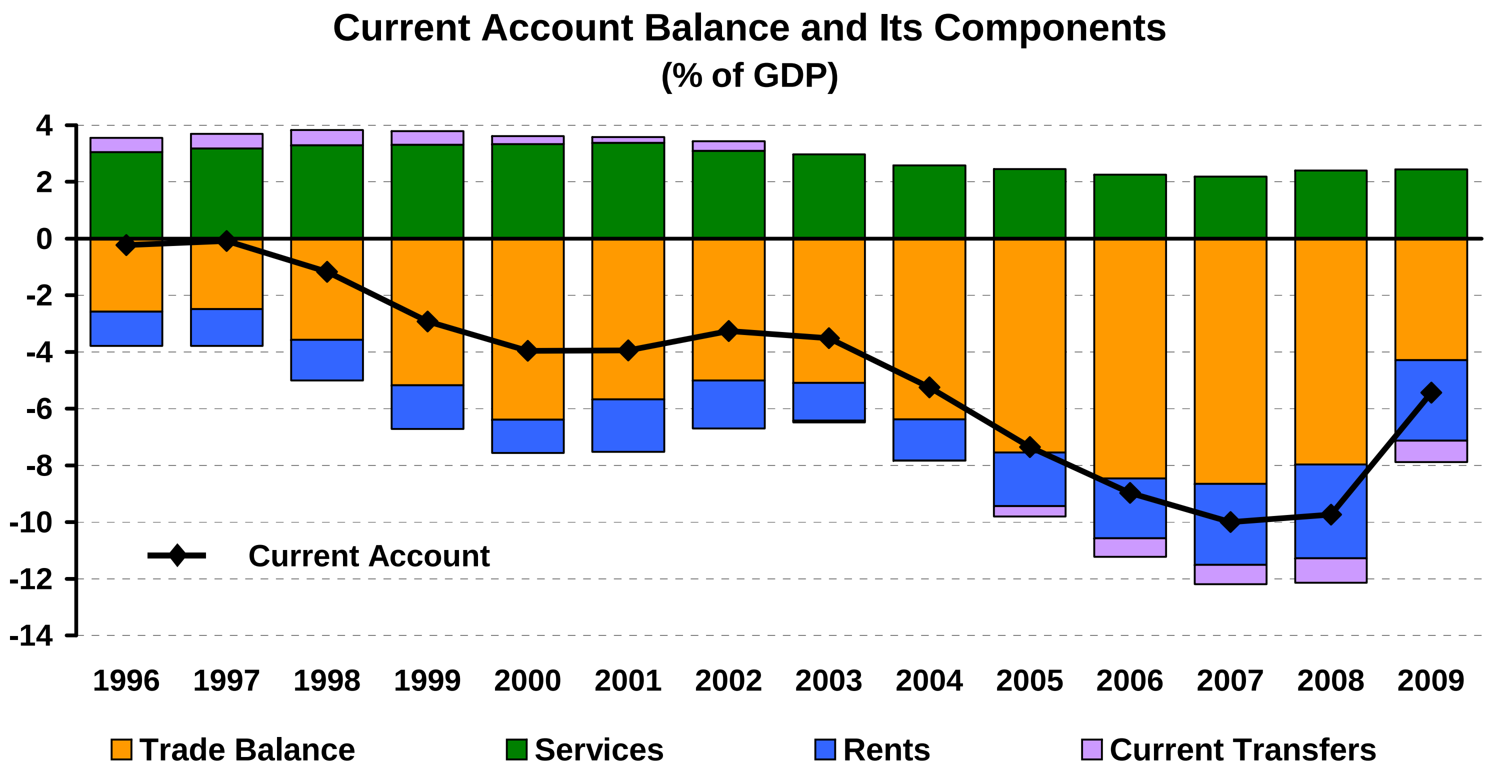
- Explosion in real housing prices: -2 $\longrightarrow$ 14 $\longrightarrow$ -7 %
- Bubble bursting?

Feature 4: High trade and current account deficits (1/2)



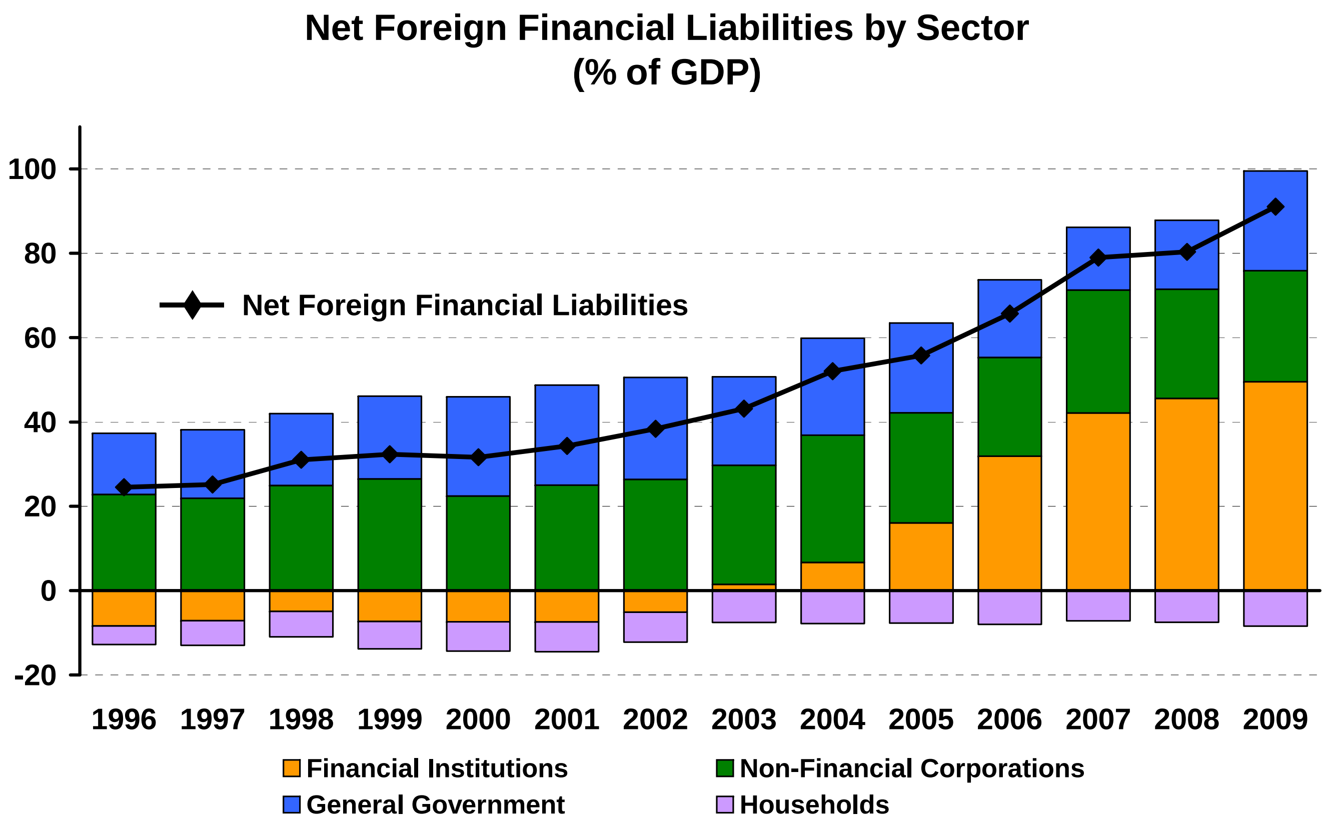
- Sustained trade deficit (structural feature), traditionally largely covered with net revenue from services
- Tourism remained single most important industry: 11% employment, 11% GDP, gross CA contribution of 4% of GDP

Feature 4: High trade and current account deficits (2/2)



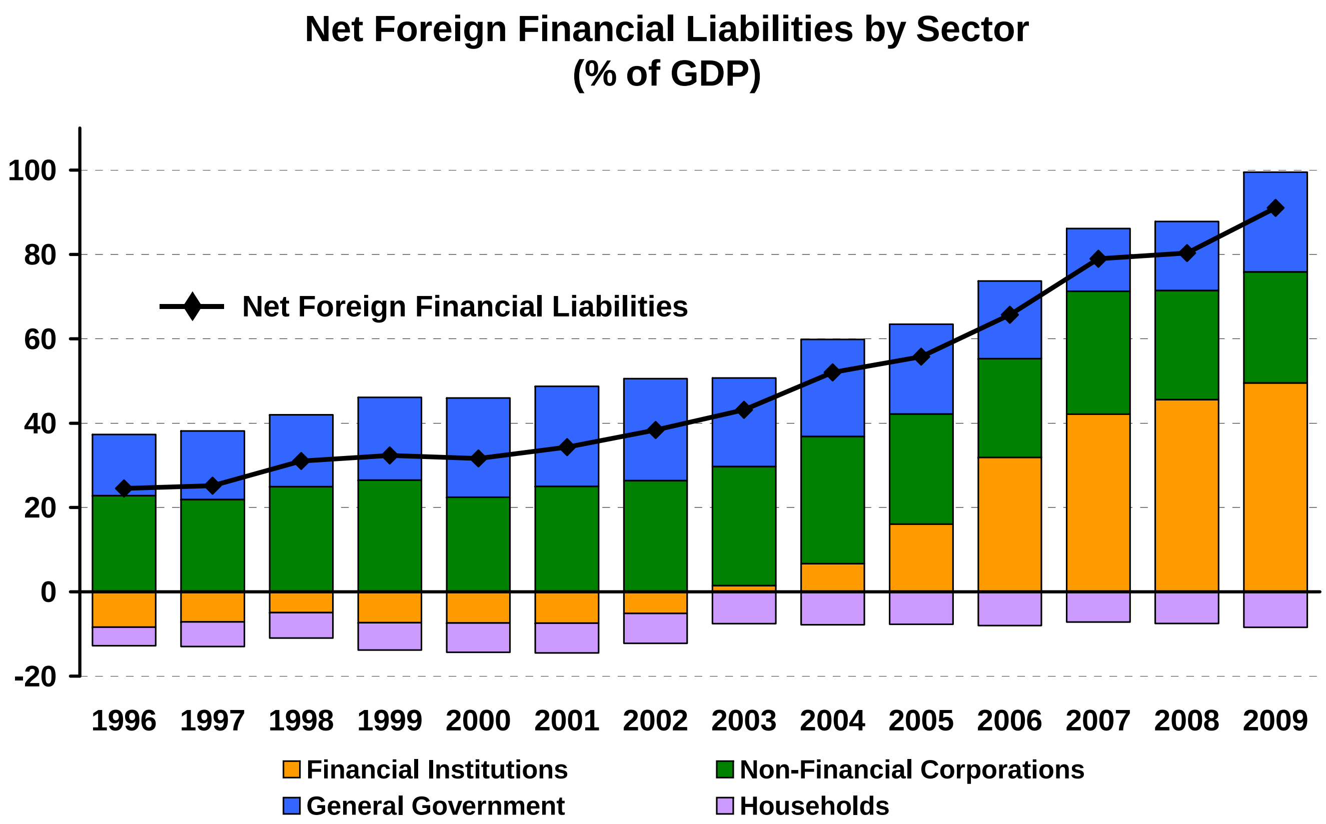
- But strong domestic demand → larger trade deficit (2.6→8.7%)
- Other factors: Spaniards tourism abroad, immigrant remittances, less transfers from EU
- Result: record CA deficit in 2007

Feature 5: Increasing reliance on external financing (1/3)



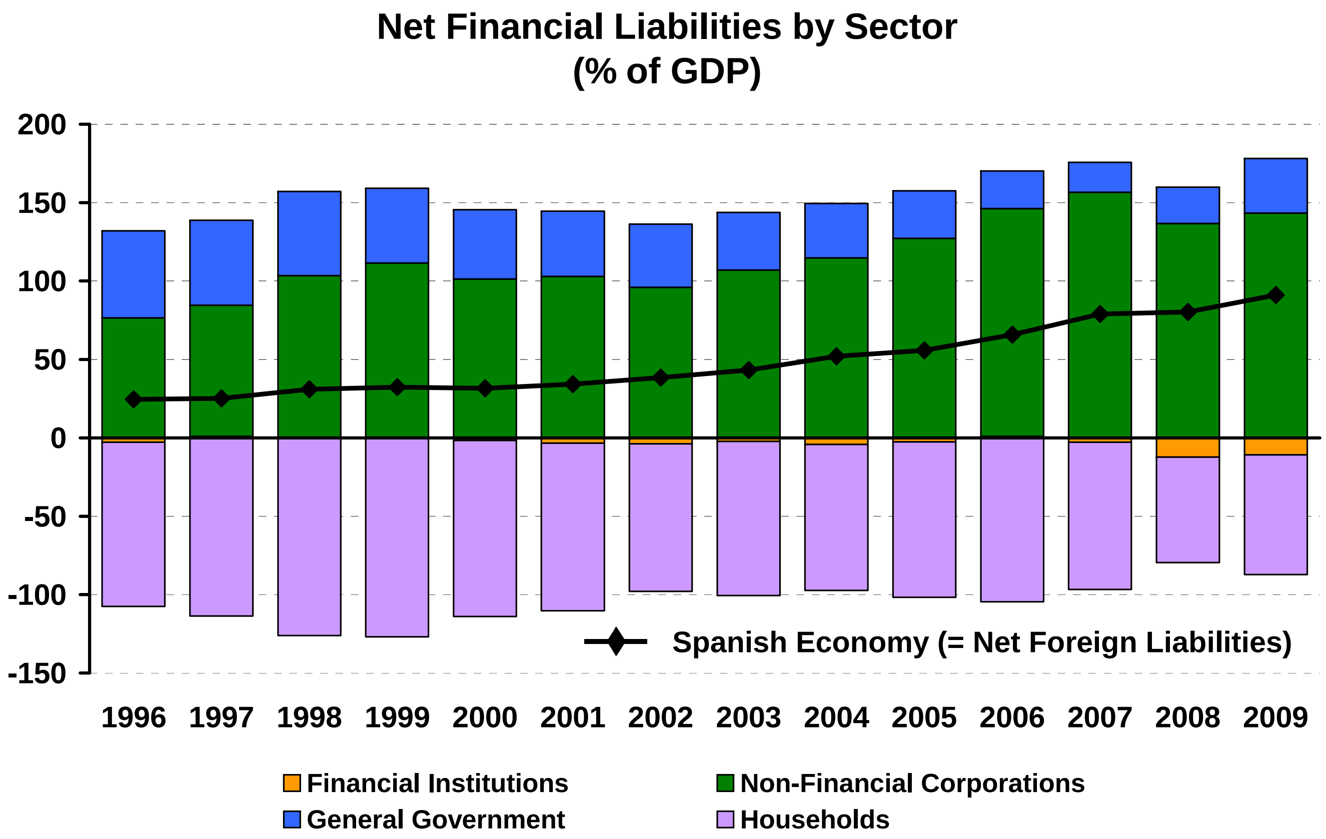
- Unavoidable counterpart of CA deficit: external *indebtedness*
  - In good years, a private sector phenomenon
  - Government deficit$<$GDP growth$\Rightarrow$ Debt 67% (96)$\rightarrow$36% (07)

Feature 5: Increasing reliance on external financing (2/3)



- Net needs of non-financial corporations (largely covered by banks)
- Weaker net financing capacity of households (↑mortgage debt)
- Largest negative position: banking sector (various instruments)

Feature 5: Increasing reliance on external financing (2/3)



- Final receivers of net financing: corporations and the government
- Yet households leveraging process is very obvious from 2000

Feature 6: Emergence of internationalized corporate sector

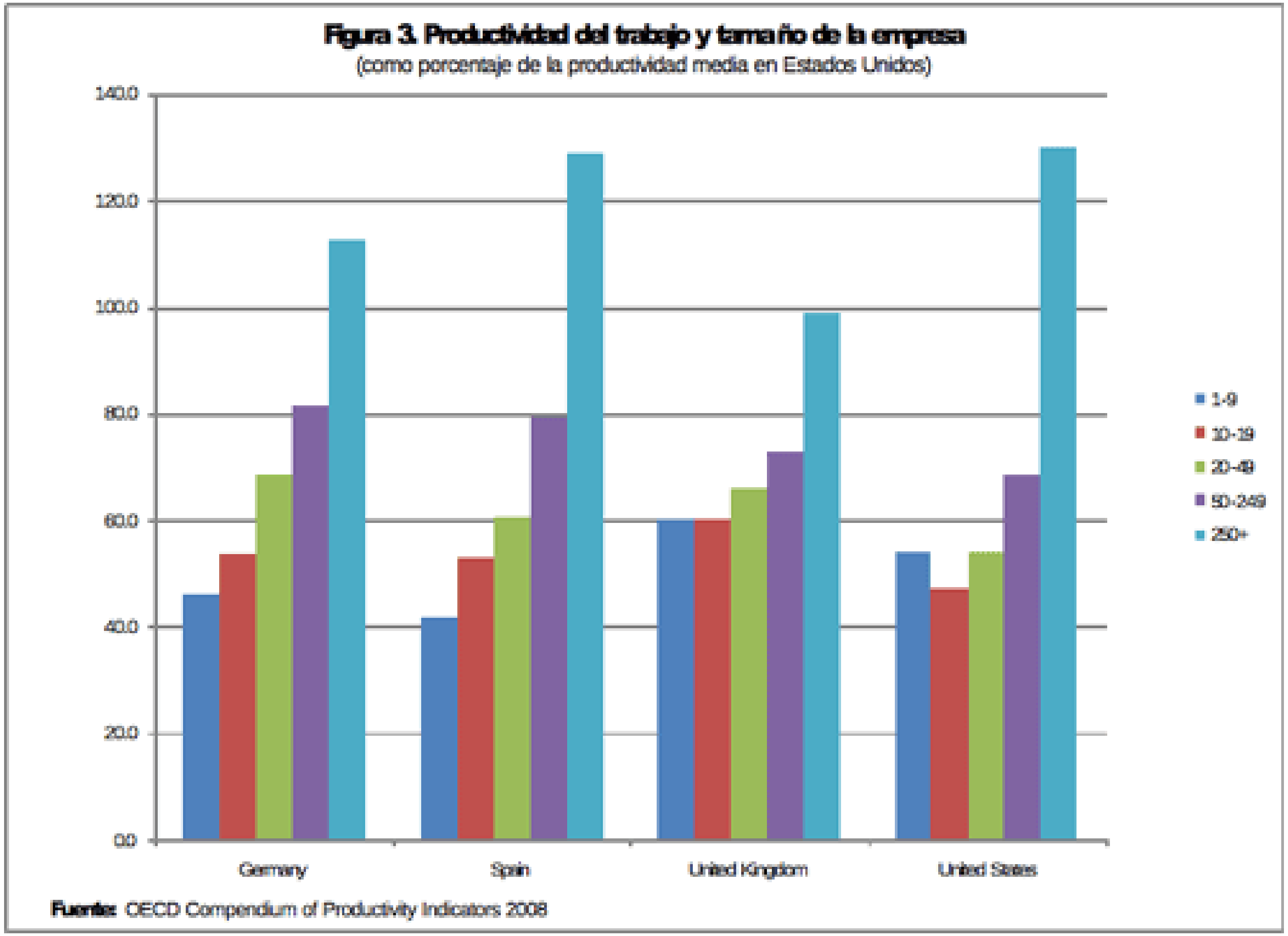
- Additional to population and housing developments...

  Changes in financial needs of the economy are also related to the success story of many financial and non-financial corporations

- Many turned into large international business groups:
  - BBVA, Santander; Repsol; ACS, Ferrovial; Indra; Telefonica; Inditex,...
  - Interesting "history chapter" to write

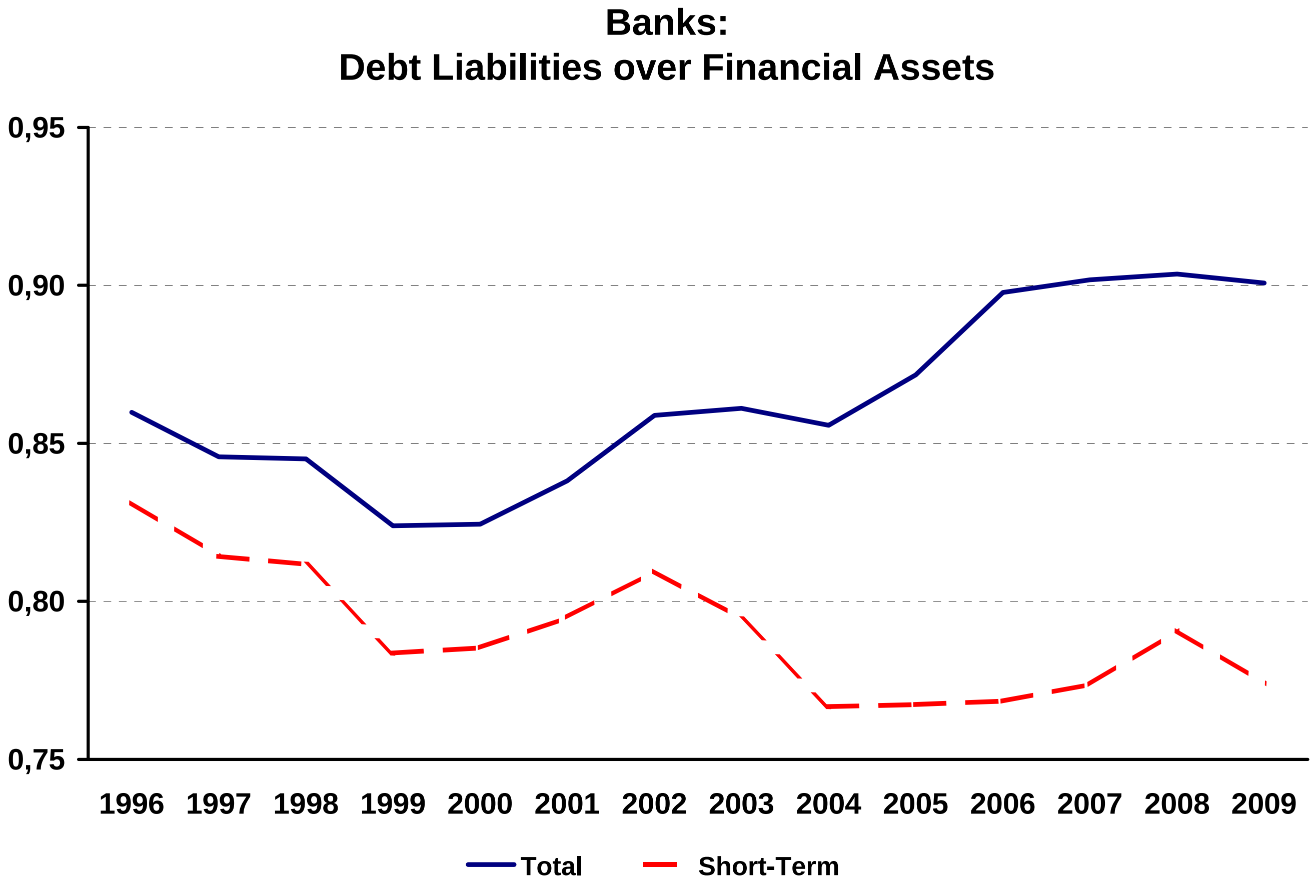
  ($\rightarrow$ accumulation of real and financial assets in Spain & abroad)

- Comparable in productivity to large US and German firms



[Source: post by Pol Antràs in NeG, 1/11/2010]

Feature 7: Financially dependent but reasonably capitalized



- *Financial liabilities* include debt and equity-like liabilities
- *Net debt liabilities/Total financial assets* ratios→more tranquilizing

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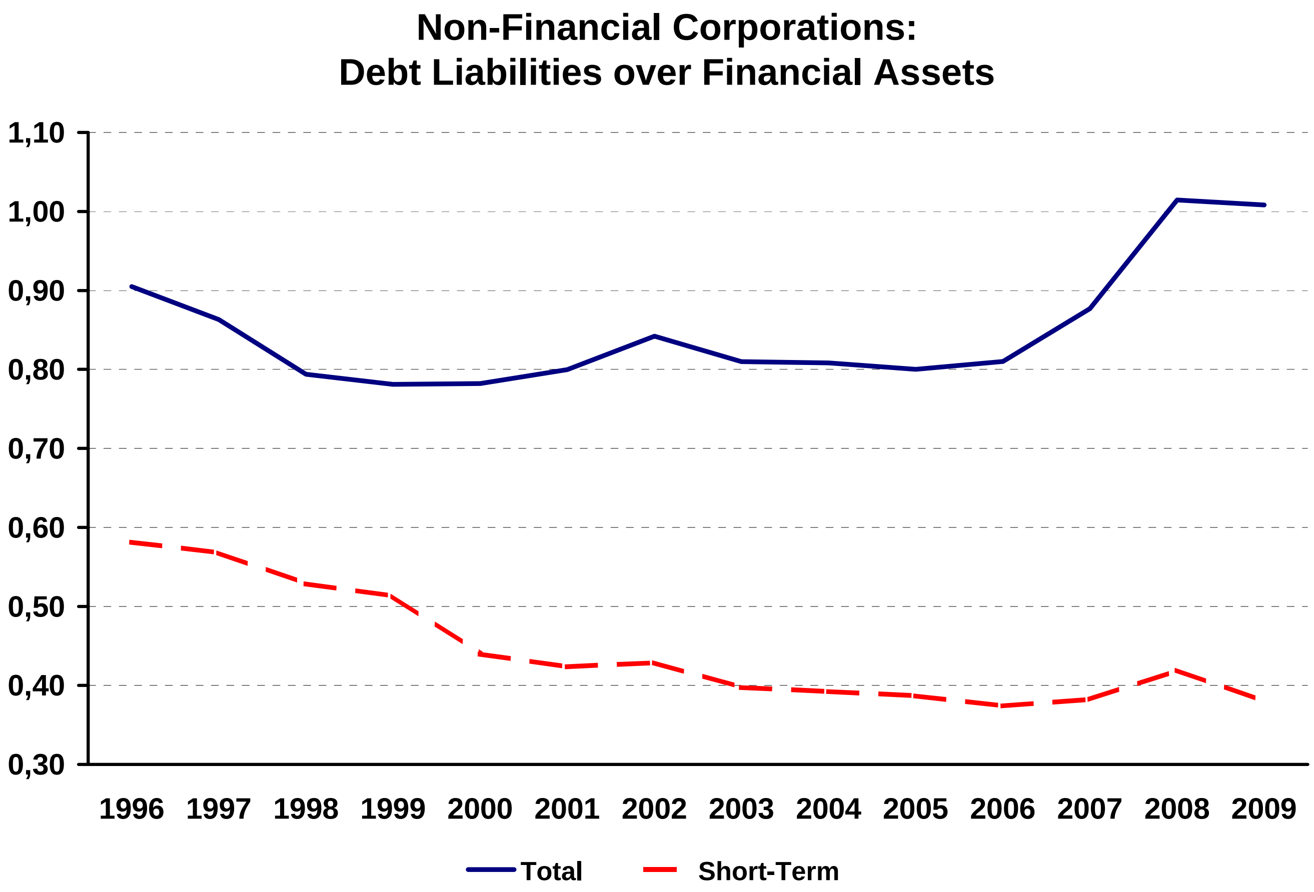


- *Financial liabilities* include debt and equity-like liabilities
- *Net debt liabilities/Total financial assets* ratios→more tranquilizing

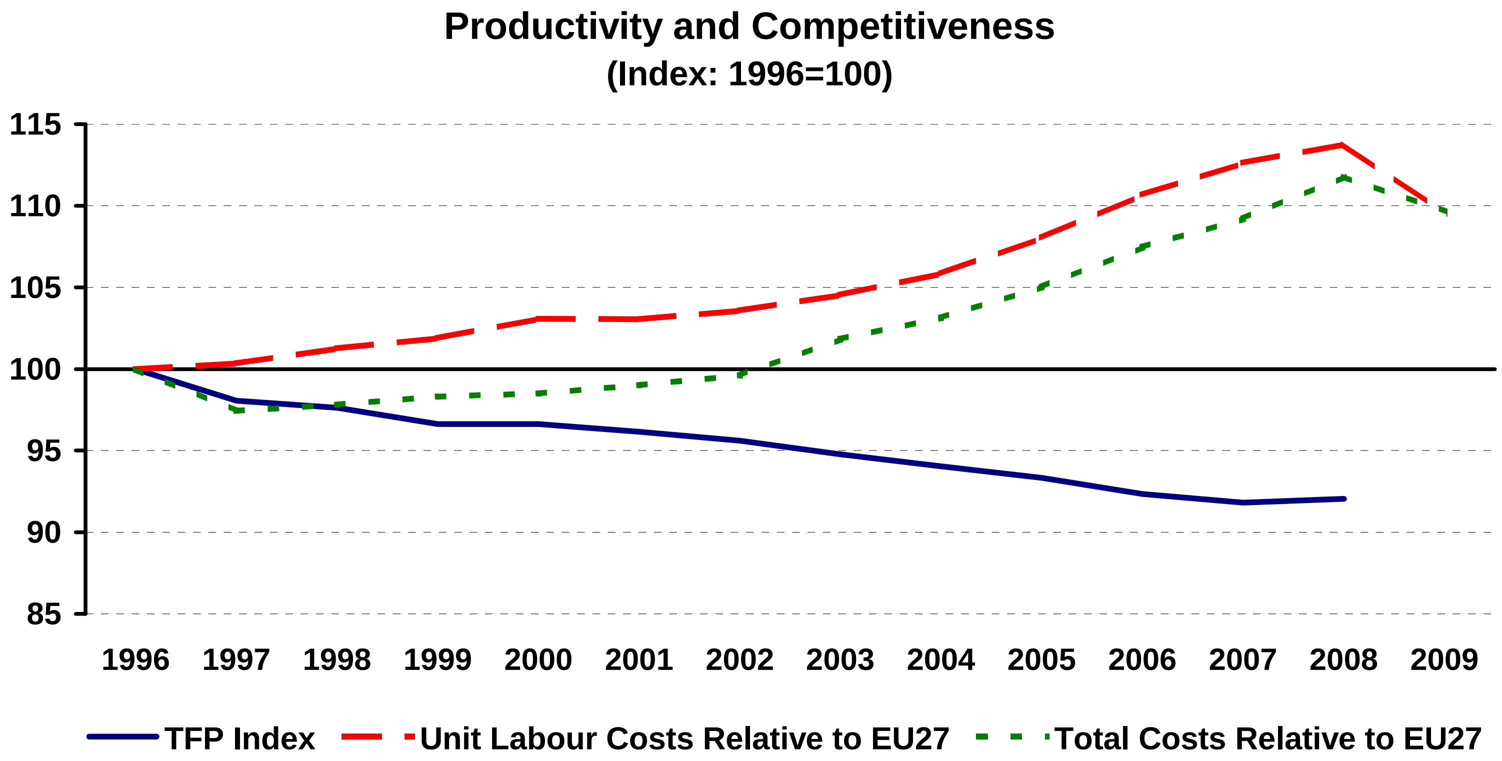
Feature 8: Apparent success story (circa 2004)

1. Improvements in public physical infrastructures
2. Rebalancing of demographics
3. General imprint of modernization (private&public equipments)
4. Solid social infrastructures, despite the many perceived pitfalls
5. Much more open economy
6. Internationally competitive financial system
7. Solid financial and non-financial firms (some multinationals)

3. Accumulated imbalances

Signs of a latent accumulation of imbalances (circa 2004):

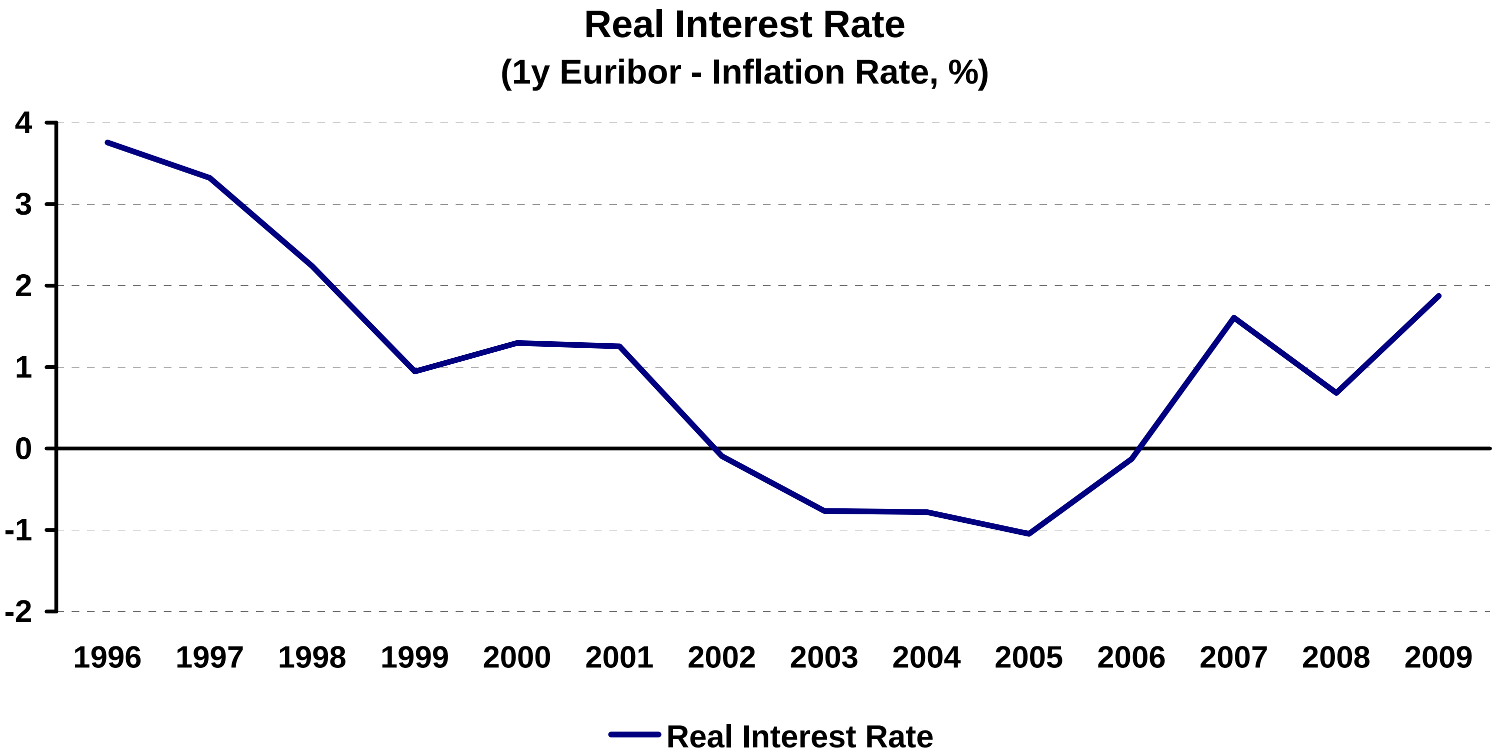
1. Over-specialization in residential construction [undisputed now, F4]
2. Disappointing performance of productivity [rather undisputed, F11]
3. Cumulative loss of competitiveness, according to standard metrics [disputed by some, F11]
4. Excessive “duality” in the labor market [undisputed]
5. Unsustainable growth in real housing prices [undisputed now, F5]


Productivity and Competitiveness
(Index: 1996=100)
115
110
105
100
95
90
85
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
TFP Index
Unit Labour Costs Relative to EU27
Total Costs Relative to EU27

Relevant issues:

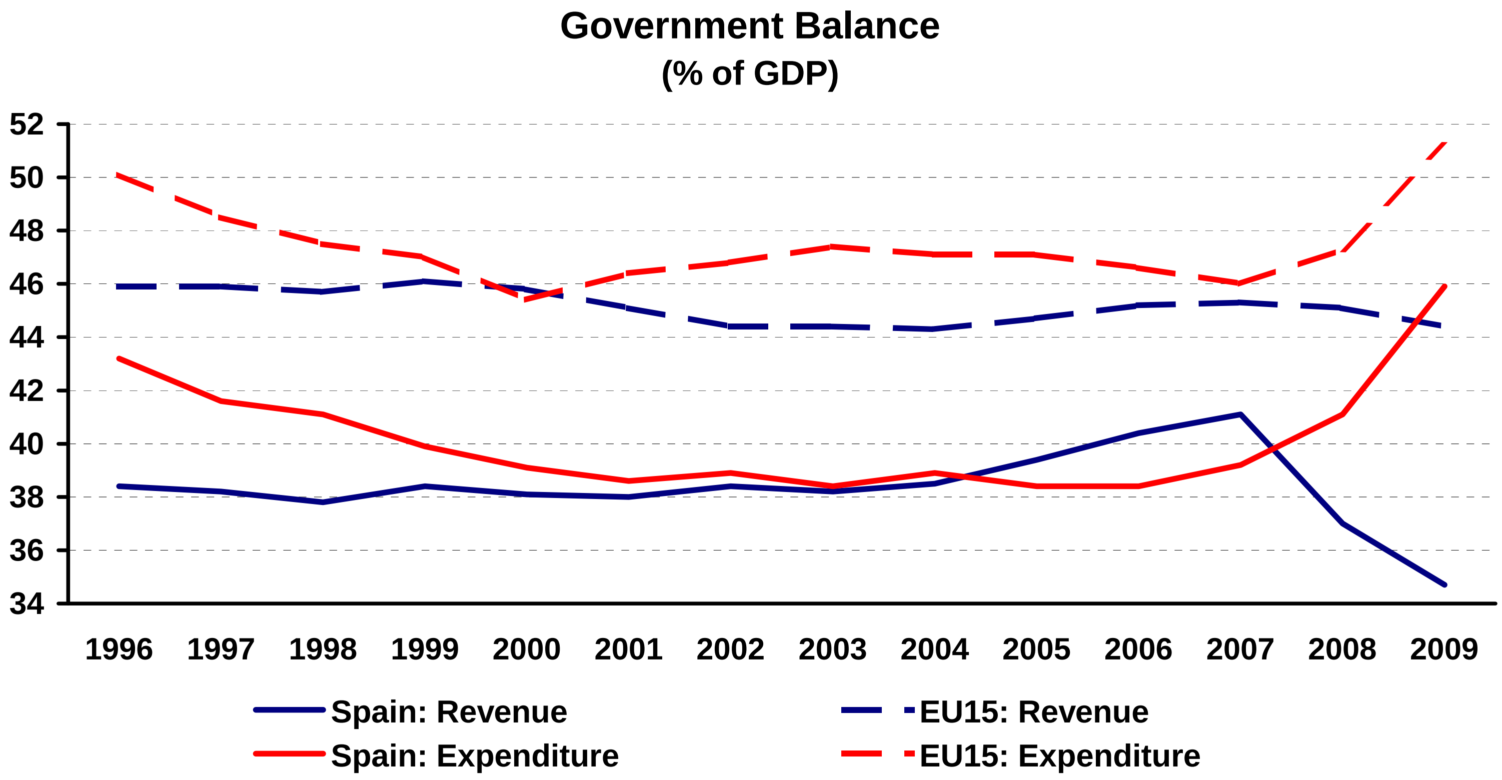
1. Awareness and policy inaction
    - Authorities should have been aware... but awareness led to little corrective action
    - Reforms commonly frustrated by incumbents' opposition
2. Bank provisioning rules
    - *Dynamic provisions* were only response to the credit side of housing & construction boom
    - Did not stop the boom but gave banks a buffer

3. Monetary policy



- Potential tool to fight the bubble was no longer under control
- EA asymmetric developments $\longrightarrow$ no clear case for tightening (e.g. credit growth: ES, IE & NE vs. FR, DE & IT)
- Negative interest rates in boom: not *macroprudentially* sound

4. Fiscal policy



- Obvious alternative tool in the presence of asymmetries
- But Spanish government finances looked in good shape
- Despite convergence to European *welfare state*, $\downarrow$deficit

4. The fiscal nightmare

- Fiscal numbers (even after conventional cyclical adjustment) possibly masked a structural deficit

- Fiscal implications of construction boom [% of GDP]:

  1. Taxes specifically or significantly related to construction & real estate:

     $$1.9\ (96) \rightarrow 3.5\ (06)$$

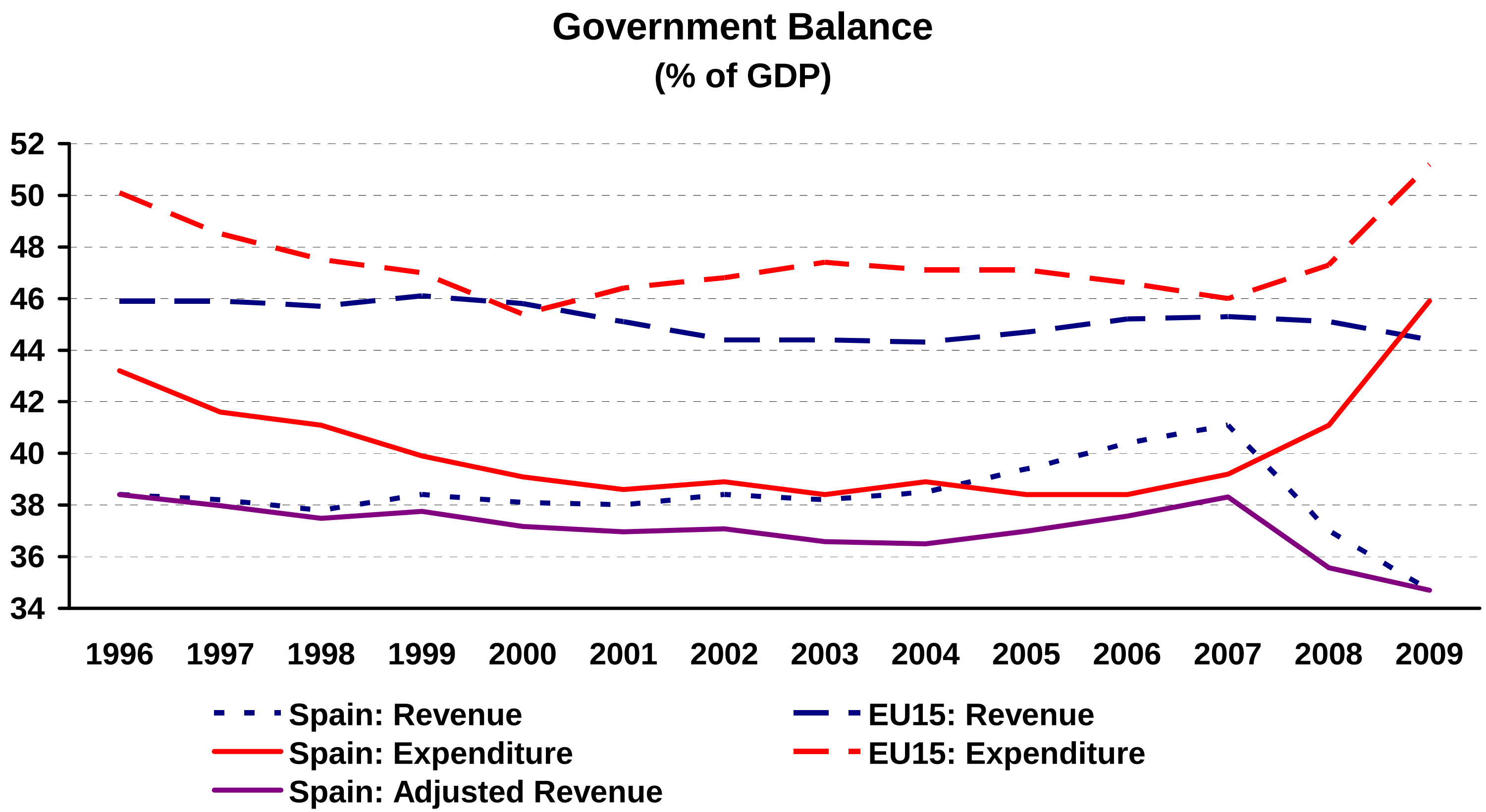
     [Construction permits; property taxes, general wealth tax; inheritance taxes, taxes on the acquisition of second-hand properties]

  2. Part of general taxes imputed to construction:

     $$2.6\ (96) \rightarrow 3.9\ (06)$$

     [VAT + personal taxes + corporate tax]

$\Rightarrow$TOTALS $4.5\ (96) \rightarrow 7.4\ (06) \qquad [= +2.9]$



Government Balance
(% of GDP)
52
50
48
46
44
42
40
38
36
34
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
Spain: Revenue
Spain: Expenditure
Spain: Adjusted Revenue
EU15: Revenue
EU15: Expenditure

- Only a lower bound:
  - Real state + banking boom not accounted for in 2nd part
  - Other indirect contributions of the bubble not accounted either

    [Job creation, low unemployment, rise in household wealth, consumption boom, immigration ($\rightarrow$SS balance)]

Relevant issues:

1. Not Greece?
   - Not systematic manipulation of government accounts
   - No intentional creation of hidden liabilities (exceptions?)
   - Apparent *discipline* pushed all government levels into ambitious expense plans (popularly perceived as "fair & worth paying")

2. Welfare state mentality

   - Culture of enjoying life & expecting outside support in bad times
   - Pro-redistributive political culture: more focus on outcomes equalization than equal opportunities

3. Subsidized incumbents

   - Many industries, professionals & organizations (inc. trade unions, employer org.) center their economic lives around concessions and subsidies
   - Does this explain TFP? employment rates? lost days of work? low mobility?

4. Unsustainable pension system

- Spaniards resist to believe current pension system is unsustainable
- Politicians have refused to acknowledge the truth

5. Not just Spain

- By objective standards, Spanish welfare state is smaller than in other Western European countries
  [E.g. state pensions of any class in 2007 (per 100 inhabitants):
  – Spain 21, UK 26, France 28, Germany 33
  – Demographics + late arrival & incomplete convergence]
- Welfare state under globalization & aging $\rightarrow$ challenge for Europe
- Spain should target new rather than old steady state

5. Territorial dimension of the fiscal problems

- Government decentralization continued during the good years
- Regional and local governments manage the bulk of expenses & policies using tons of regionally-segmented agencies

Relevant issues:

1. Limited fiscal federalism
    - Only a few taxes are fully decentralized
    - Sub-central authorities typically receive shares in large tax figures + grants from central government

2. Complex center-periphery game

   - Regional and local governments are "expense centers" in a political-economy game where the central government is the key "revenue raising" (or borrowing) center

   - The objectives pursued by central government in the game include

   (a) Guaranteeing minimal standards across the country

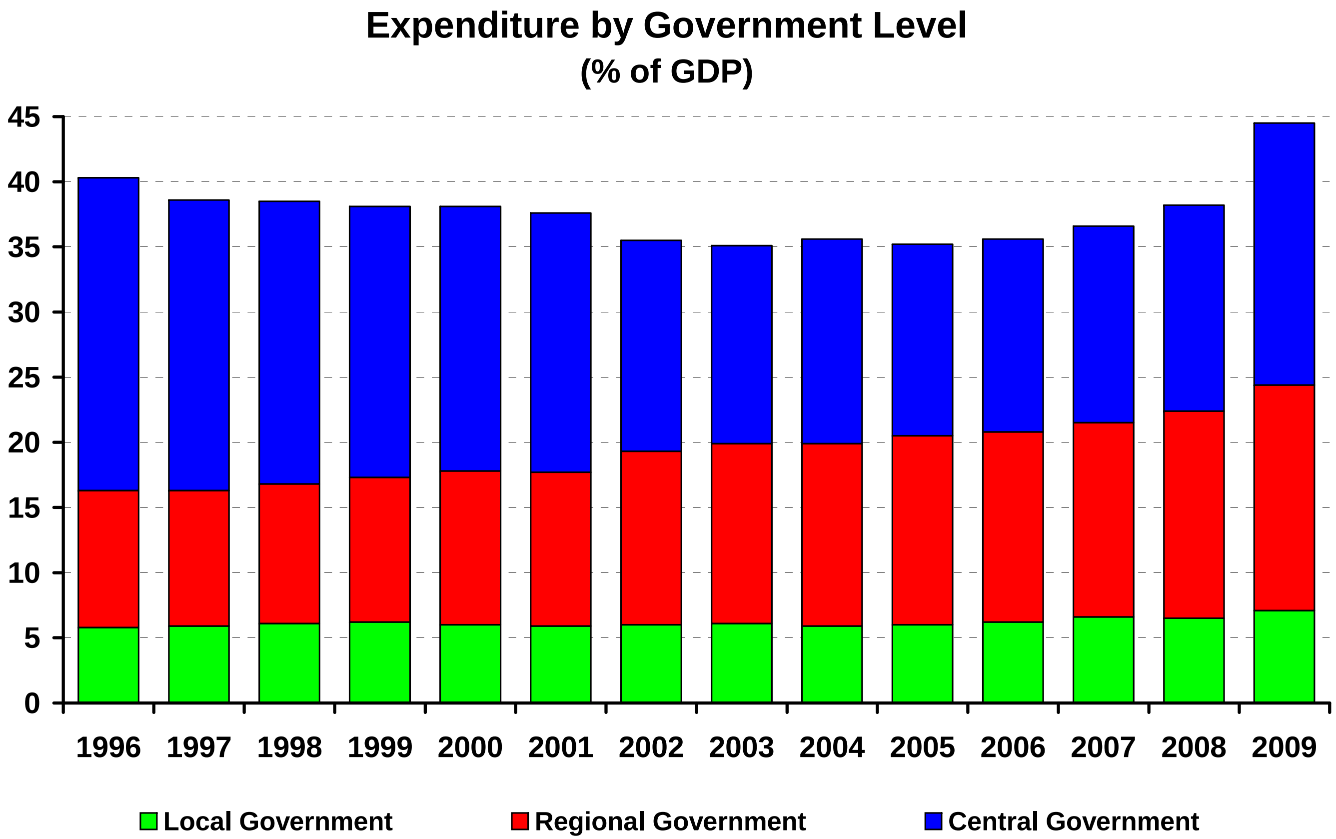
   (b) Preventing the accumulation of imbalances

   (c) Preserving sufficient political support in national parliament

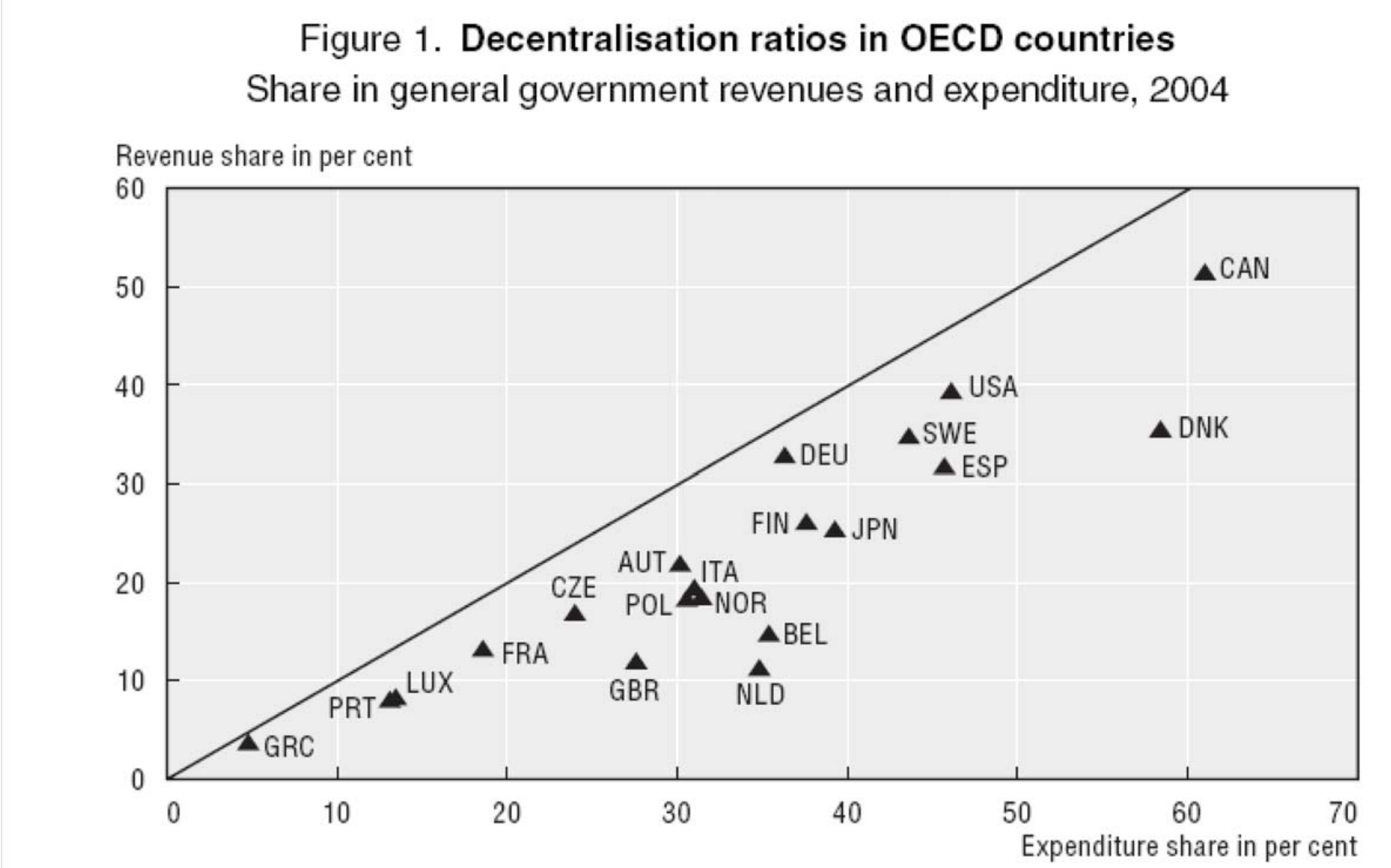
3. Result: a fiscally expansionary bias

   Specially, with big national parties winning general elections with absolute majority in few occasions

   [Concessions + recurrent topping up of committed expenses]



[Downward trend in central government share only reversed with the crisis (unemployment benefits + fiscal stimulus)]

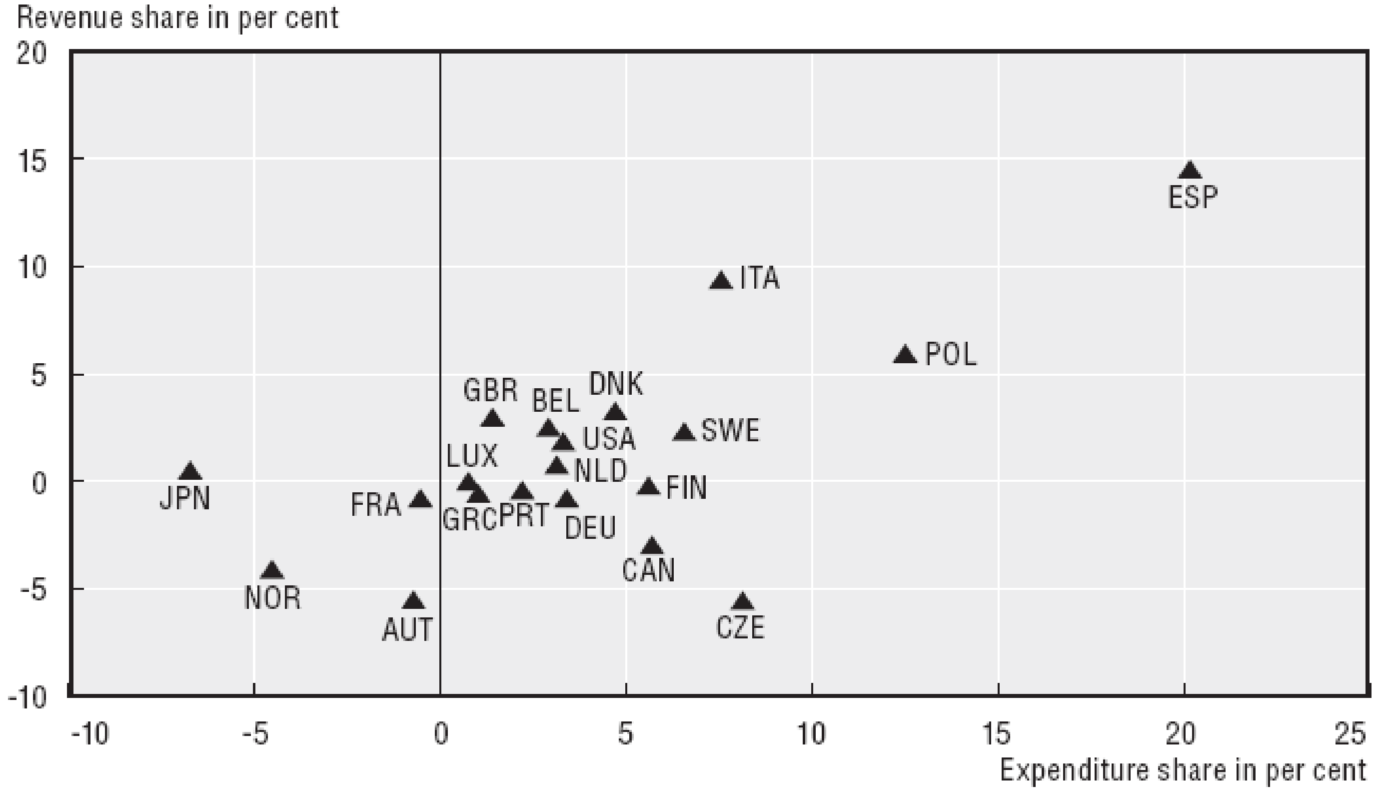


Source: National Accounts of OECD Countries, 2005.

[Source: Blöchlinger & King (2006, OECD)]

Figure 2. **Decentralisation ratios, evolution**

Changes expressed in percentage points, 1995-2004



Source: National Accounts of OECD countries, 2005.

[Source: Blöchlinger & King (2006, OECD)]

6. Concerns on banks

- Construction & real state boom$\rightarrow$ our own *subprime problem*?
  - Yes, but not quite
  - Beware undue extrapolations [debt in books, more equity&provisions, generally stricter standards of origination, recourse debt, etc.]

Relevant issues:

1. Impaired assets are growing but not all banks are equal
   - Main losses: Loans to land developers & mortgages (especially those granted last) + normal cyclical rise in delinquencies
   - Impaired assets/Total assets=5.5% (03/2010) [$<$ prior recessions]
   - Large cross-sectional differences, mostly due to regional/sectoral diversification [e.g. developers' impairment ratio =10% (03/2010)]

2. Dealing with asset losses

- Most banks have tried to smooth loss recognition
  E.g. acquiring real estate in cancellation of debts prior to default

- Banks are accumulating real assets for later (orderly?) sale

$\Rightarrow$ Negative externalities: delaying price adjustment & generalizing fear of *zombie banks*

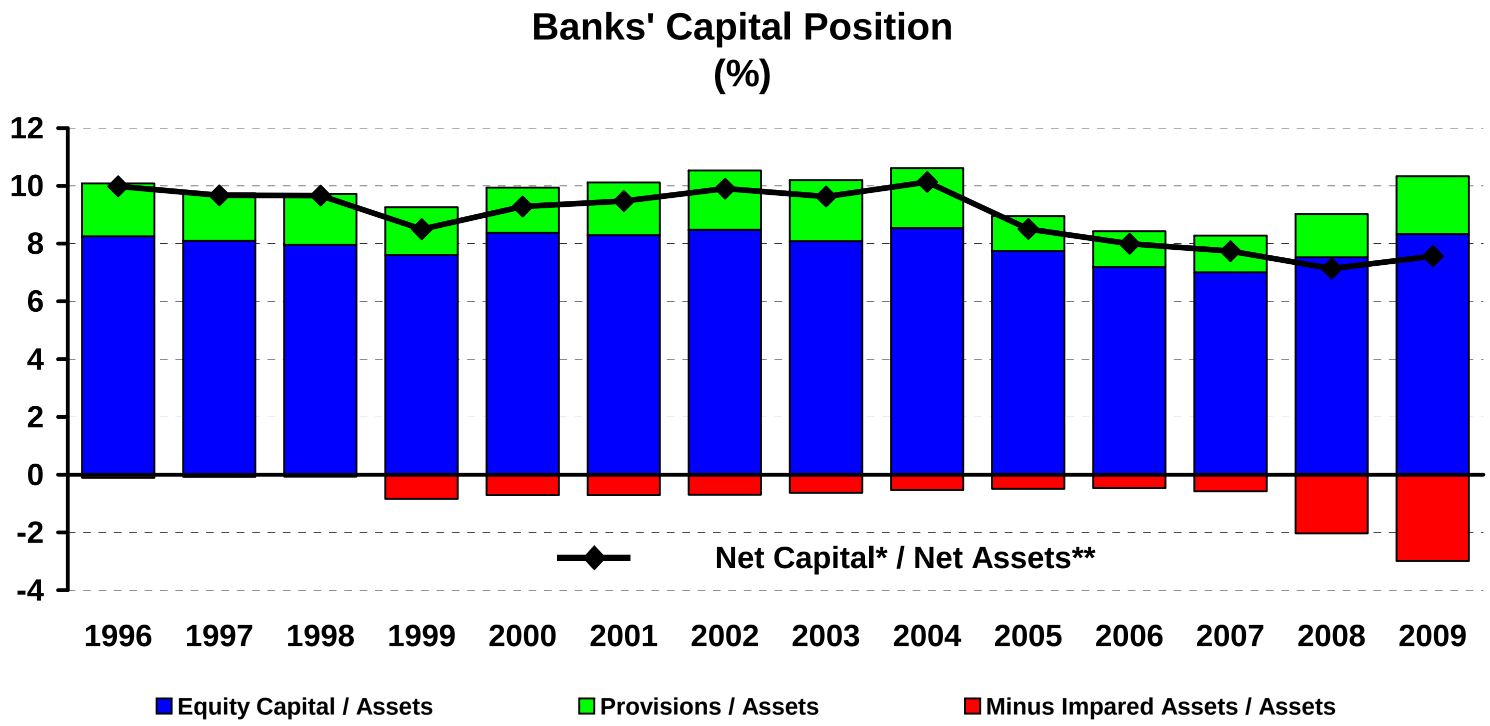
3. Solvency concerns

- Bank of Spain entered the crisis with good reputation
  [strict accounting rules & intervention practices + pre-provisioning + no shadow banking]

- So far two minor interventions

- Other interventions delayed/avoided with publicly-supported & long-to-orchestrate merges (under FROB I)

- Stress test calculations suggest satisfactory loss absorption capacity for two years
- But LT survival requires general recovery after that horizon



* Net Capital = Equity Capital + Provisions - Impaired Assets, ** Net Assets = Assets - Impaired Assets

4. Recapitalizing viable institutions

   - Consolidation synergies & lower capacity help but are no magic
   - The *magic* comes from: capital sharing, ability to raise *equity* & to transform *cajas* into *bancos*

5. Liquidity problems

   Main ST/MT problem (by 06/2010) was satisfying refinancing needs

   - Given skepticism about access to wholesale markets (or subsidiary ECB lending) banks are fiercely competing for retail deposits
   - But attempt to tap funding with local sources is unfeasible in the aggregate
   - Wholesale funding or CB facilities → essential for years

6. Lending capacity problems

- Banks are trying to improve their capital positions
- The net impact of the various strategies is a tightening in credit standards & a credit crunch [or is it all demand?]

$\Rightarrow$ Will bank capital be enough to finance the recovery?

7. Spaniards' economic prospects in the boom

- Miraculous differential growth was unduly extrapolated by most
- Fed the strength of private consumption and job creation

Relevant issues:

1. Another source of duality:
   - Investment in real state + prospects of revaluation / inheritance promised an easy life for many
   - Meanwhile, younger workers complained about being *mileuristas* (outrageous cost of housing + long stay on fixed-term contracts)

   [Yet national dream=permanent job+owned flat+paid retirement]

2. Supporters of the status quo (until the crisis)

   - Either on factual or expectational basis, many felt reasonably satisfied in status quo, supporting its endurance
   - Crisis extended perception that largest beneficiaries were rent seekers (real estate owners, developers, corrupt politicians)

   [Sad truth: boom provided easy life not based on talent, training, diligence or hard work]

8. Overcoming the crisis

- Crisis forced traumatic acknowledgement that
  - Part of past progress was only apparent
  - Growth process could have been more solid (more based on productivity, creativity, talent, technology & human capital)

- Implications of the crisis (by 06/2010):
  - Quantity-based adjustment
  - Frustrated expectations
  - Massive job destruction + little job creation → unemployment
  - Freeze of bank credit to the private sector

- Jump in household savings
- Fall in private investment
- Sudden drop in government revenue
- Unsustainable increase in government expenditure

- In sum...
  - excessive unused resources
  - excessive private debts
  - excessive redistribution + budget deficit
    (unless strong growth resumes $\rightarrow$ fiscal suffering)

- Alternatives:
  - Economists' old friends: Internal devaluation + Structural reforms
  - Non-exhaustive list of possible reforms $\rightarrow$ a *decalogue*

The Decalogue of Reforms

- Education system

    1. Reward educational attainment & search of excellence at all levels
    2. Improve contents & quality of secondary education

- Labor market

    3. Eliminate duality
    4. Improve the collective bargaining process (flexibility of wage & non-wage working conditions)

- Pension system

    5. Adapt the system to demographic challenges (obvious alternatives: postponing retirement + revising entitlement formulas)

- Public sector
  6. Rationalize the government sector and, specifically, its territorial decentralization (expansion incentives, redundancies, and threats to single internal market)
  7. Revise public programs / public prices / tax benefits (in all areas) (to improve incentive compatibility and cost-effectiveness)
- Housing sector
  8. Remove distortions that favor home ownership, damage rental market &discourage mobility; prevent creation of new bubbles; prevent collusion of local authorities, corruptible officials, land developers &banks
- Banking sector
  9. Remove doubts on bank solvency; restore the efficacy of financial intermediation; reform the savings banks sector

- Work *ethics*

10. Impulse a new economic culture in which all the dimensions of *merit* (i.e. effort, talent, entrepreneurship, professionalism, competence, diligence,...) are encouraged and better rewarded

9. Views after the trauma

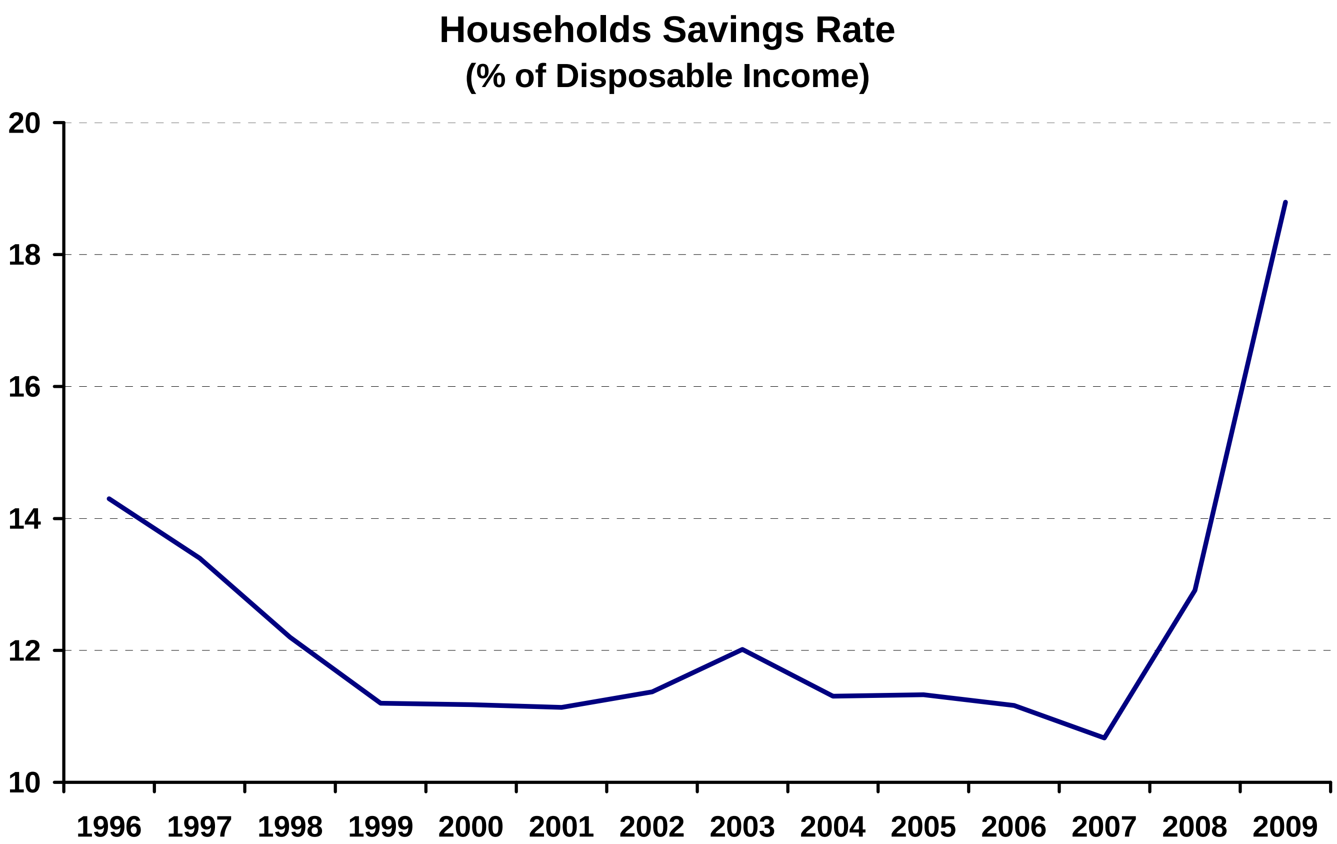
- By May 2010, the crisis had left the Spanish population and its leaders under state of shock

- All phases of *trauma* were experienced: incredulity $\longrightarrow$ rebellion $\longrightarrow$ assimilation or depression

  1. The citizens

     Complex reaction

     – upward jump in savings, lower risk-taking
     – changes in household composition
     – changes in electoral preferences


Households Savings Rate
(% of Disposable Income)
20
18
16
14
12
10
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009

2. The government
   - Crisis initially diagnosed as imported & temporary
   - Later: specific problems (e.g. overspecialization in construction) were recognized
   - But fiscal stimulus & commitment to generous "social policies" were maintained until mid 2010

   Basic strategy was to wait for the rest of the world to recover

   $\Rightarrow$ Events in May 2010 (gladly) motivated a reconsideration

3. The external analysts
   - Most external analysts were skeptical since much earlier
   - Some foresaw possibility of a slow, fragile & fiscally explosive recovery [even a Japanese-style *Lost Decade*]

   $\Rightarrow$ Consensus moved to fiscal consolidation+structural reforms

4. The international investors

– International investors woke up with Iceland and Greece

– Became aware of the problems of Spain in a panicking environment

$\Rightarrow$ Possibly, over-reacted

[Perhaps succumbing to self-fulfilling *disaster prophecies*]

10. A European problem

- Guaranteeing sustainability of EMU forced European leaders to
  - improvise support to sovereign debts subject to speculation
  - recommend rapid fiscal consolidation. . .
- ST response to a deeper weakness:
  - Lack of single fiscal policy or credible arrangements to prevent accumulation of cross-country imbalances
  - Solving this is a major *constitutional* challenge...
- Meanwhile, Spain is committed to EMU
  - Remaining a well-behaved European partner carries strong value
  - Possibly willing to accept sacrifices (if asked for them)
  - In fact, many countries in Europe need similar reforms

11. An opportunity for Spain

- Given the usual political resistance to structural reforms...
  - financial market turbulence
  - coordinated fiscal consolidation
  - focus of international investors on Spain

  provide an opportunity to advance in the right direction

- Current process requires political leadership & technical guidance
  - The deep fundamentals of the Spanish economy are robust
  - But rigidities and frictions impose heavy burden on recovery & growth prospects
  - Prospects of higher tax burdens and/or social unrest do not help

- Fortunately, the list of pending structural reforms is well defined

12. Afterword

- Several things have happened since June 2010:

  Spain

  – Cut in government sector wages + freeze on pensions
  – Timid labor market reform + general strike
  – Other reforms announced + not yet executed
  – Publication of stress tests + certain sense of financial calm
  – FROB phase I completed + progress unclear since them
  – Spanish football team won the world cup
  – Central government tries fiscal discipline but territorial dimension is unclear
  – ST prospects: no miracle recovery + no major disaster
  – Political impasse in wait for elections (most likely in 2012)

World

- German recovery surprisingly strong + US recovery at risk
- G20 process slows down + dissenting views become apparent (battle on exchange rates, not fully coordinated financial reform)
- Europe tries new financial authorities while redefining fiscal rules

[In sum, uncertainty and potential vulnerabilities]

- The key message given in June 2010 remains valid:
  - Need to eradicate idea that we can all live an easy life (based on a new bubble, an effortless miracle or some State help)
  - Sad trade-offs about the future of the welfare state have to be spelled out (insurance vs. incentives, generosity vs. sustainability)
  - Reform and adjustment impulse should not be relaxed!