

A stylized world map composed of grey dots, with several dots highlighted in red, primarily in the Western Hemisphere.

# A Progressive Growth Strategy for Spain

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## The Most Important Economic Challenges

The Spanish economy is a good example of the vicious circle in which the economies on the periphery of the Eurozone have been immersed since the start of the crisis in the summer of 2007. This circle consists of three elements: an economy in recession, a vulnerable banking system and a public sector deficit and debt expanding in parallel with the other two elements. The fiscal consolidation policies implemented since May 2010 have contributed to the further deterioration of economic activity and this in turn damages the quality of bank assets.

Besides the commonalities with other economies in the Eurozone, Spain presents specific features that should not be overlooked. These have emerged from the situation that characterized the Spanish economy at the onset of the crisis. It may be useful to recall its main features at the end of 2007:

- With the onset of the financial crisis in the United States in the summer of 2007, a long period of growth and job creation ended in the Spanish economy. The average pace of economic growth during the decade previous to the crisis was above 3.5 per cent in annual terms, well above the EU average. In 2007, Spanish GDP growth was 3.6 per cent.
- At the end of 2007 the unemployment rate in Spain was equal to the European Union average of 8.5 per cent.
- In 2007, Spain did not register a public sector deficit. On the contrary, Spain enjoyed a surplus of just over 2 per cent of GDP, while public debt represented only 36 per cent of GDP.

However, alongside these positive indicators the Spanish economy exhibited some significant private-sector imbalances, in particular the very high concentration of economic and financial activity in residential construction and real estate, which accounted for more than 12 per cent of GDP and employment. The main players in this sector had very high levels of indebtedness, and so did households, which had made significant investments in housing.

One of the main reasons why the Spanish economy was growing at such a high rate, and with a large concentration in real estate, was the cost of financing – low in historical terms – since the inception of EMU. This factor was also the main reason behind the rise in private debt during the 2000s. That is now Spain's main problem, and one of the most important constraints on GDP growth. Spanish private debt as a percentage of GDP is one of the largest in the Eurozone and the pace of deleveraging is very slow. It is important to underline the private nature of the Spanish economy's problems when the crisis began. There is a strong correlation between growth in private debt and the fall in private consumption after the crisis. It is also a key factor in the lack of stability in the Spanish banking system.

The collapse of economic activity led by residential construction led quickly to a very high rate of unemployment and the weakening of domestic demand. Tax collection fell strongly and the fiscal deficit rose. The Spanish banking system began to show solvency problems arising from the erosion of the quality of its assets linked to the real estate sector.

Since May 2010, the implementation of fiscal austerity policies has compounded the weakness of domestic demand, accelerating the rise in unemployment and rapid

deterioration in the quality of bank assets. The situation in the banking sector was so severe that, in the summer of 2012, the Spanish government demanded the provision of a credit line from European institutions to recapitalize the weakest Spanish banks. The tensions in government bond markets have also contributed to the weakness of Spanish banks, traditionally major investors in Spanish government debt.

The most expressive and distinctive Spanish economic indicator is the unemployment rate, the highest in the Eurozone, particularly among young people. As a result, wages are decreasing, both in the private and in the public sector. This evolution helps us to understand the vicious circle: the weakening of private demand and the consequent deterioration of public revenues.

In this context, it is clear that the main challenge for the Spanish economy is to reduce unemployment. A significant stimulus to aggregate demand is needed and, given the restrictions imposed by fiscal austerity, this can come only from the European institutions.

If both internal and external demand could count on a more growth-oriented European context, it would be possible to reduce the vulnerability of the banking system and Spanish public finances would stabilize. However, since the onset of the crisis, external financing to the private sector of the Spanish economy has practically disappeared: with a few exceptions there was a sudden halt in the capacity to obtain foreign financing.

## Requirements for a Progressive Economic Policy

The main priority should be to re-establish the necessary conditions for job creation, above all, a return to growth of aggregate demand in the economy. Despite the dynamism of Spanish exports in recent years, its contribution to economic growth is insufficient to offset the still very weak domestic demand. Despite the easing in the pace of fiscal consolidation to be approved by the European Commission, it is absolutely necessary to receive some stimulus to aggregate demand from the European Union.

Assuming this orientation as a priority, the Spanish authorities should continue to implement reforms aimed at improving the supply side of the economy, promoting

a change in the growth pattern toward a less vulnerable and more competitive economy.

Besides improving labour market reform, now in force for one year, it is necessary to prioritize the following:

- Reform of public administration towards greater efficiency. Without diminishing the constitutional powers of regional and local administrations, this would require a review of administrative procedures. It is also necessary to review all the measures involved in the joint provision of common services for smaller municipalities.
- Reform of the public pension system, in order to ensure its sustainability in the medium and long term. The extension of the retirement age and the increase in contribution periods are also necessary. Because the previous policy measures would have higher costs for people with low incomes and wealth, it would be necessary to secure social cohesion by adopting programmes to mitigate the negative effects of fiscal adjustment in essential welfare services and equality, especially with regard to education and health care. These two areas, together with public investment, have been the biggest losers in the process of fiscal consolidation which has been taking place in the Spanish economy since May 2010.
- Reform of the energy sector in order to achieve more internationally competitive prices. The high cost of electricity hinders business competitiveness. This is influenced by the so-called ›tariff deficit‹. A credible plan is needed to eliminate this financial imbalance to bring about the necessary convergence of electricity prices with those in more competitive economies in Europe.
- Reforms designed to facilitate the creation of enterprises. Removal of bureaucratic barriers to business creation and support for the creation of specific mechanisms of non-bank financing for new businesses.

## Is There an International – or European – Dimension?

The recession in the Eurozone provides the clearest proof of the failure of the policies adopted to overcome a crisis that was not genuinely European, but that in the Eurozone has generated the most severe damage: in the real economy (with lower growth and high unemployment

rates), in the financial economy (hindering the transmission of monetary policy and producing a severe sovereign debt crisis) and the erosion of the quality of common institutions.

The Spanish economy has a significant share – with others in the Eurozone – of the problems, especially those countries considered peripheral. The most prominent is the absence of growth, but also the lack of acceptable results from the implementation of policies aimed solely at fiscal consolidation imposed by the European institutions. The implementation of fiscal austerity has provided enough evidence: the recession has become stronger and the imbalances in public finances have not been addressed sufficiently. Some of the structural reforms implemented in recent months have not provided for a re-start of growth, but rather the opposite.

This is the case with regard to labour market reform: providing greater flexibility to companies has significantly facilitated the dismissal of workers, driving unemployment to historically high levels. More than 57 per cent of young people in Spain are unemployed. Nearly 2 million families have all their members unemployed. Among the employed, the temporary rate is close to 30 per cent.

It is time, therefore, to implement measures aimed specifically at offsetting the depressing effects of the policies applied so far. These should be defined by the European institutions. Indeed, in the absence of measures to boost growth – through stimulus implemented by the European institutions, the Spanish economy will be unable to achieve any meaningful recovery. Moreover, continuation of the current recession will significantly erode potential economic growth.

## Urgent decisions

The EU faces depression in some Eurozone economies, thereby increasing the threat of fragmentation. To stimulate economic growth, curbing the rise in unemployment is the most urgent task. To do this, the EU has the following options, all of them complementary:

- A more flexible approach to fiscal consolidation. The consolidation of public finances is important, but as the IMF said »it is not a sprint but a long distance race«. In any case, it has to be reconciled with the appropriate ex-

pansionary measures to offset the contractionary effects of extreme austerity.

- Pan-European investment programmes aimed at reducing unemployment, particularly among young people, as well as measures aimed at strengthening the European single market.

- Support for the ECB to carry out specific financing programmes to small and medium-sized enterprises in order to alleviate the obvious problems of monetary policy transmission in the peripheral economies. In Spain, SMEs are responsible for almost 70 per cent of employment. Strengthening programmes of aggregated loans to SMEs by the ECB or direct funding must be possible courses of action to be explored by the ECB. These decisions are necessary to avoid additional financial fragmentation in the Eurozone.

- Expansionary policies, mainly through income policies applied in those economies in the Eurozone with lower unemployment, higher rates of labour productivity and less severe scrutiny by bond markets.

- It is necessary to develop and present a detailed timetable leading to banking union, at least in the Eurozone.

- The requirements and steps to fiscal union must be defined, at least in the Eurozone.

## A New Formula for Pro-growth Policies

The duration and severity of this crisis is endangering the political, economic and social integration of Europe.

At present, progressive policies must prioritize the rapid overcoming of the recession in the Eurozone, stimulus of economic growth and a return to employment growth. By doing so, they would also neutralize the risks of fragmentation of the Eurozone and the growing disaffection of European citizens towards its institutions, particularly those belonging to the Eurozone.

The four sets of policies highlighted in the previous section are necessary conditions for any policy of progress. Next to them, strengthening Community institutions and their democratic legitimacy should be part of any pro-



gressive agenda. The role of the European Parliament is particularly important.

Beyond the necessary institutional strengthening of the EU, any progressive orientation should take into consideration the unprecedented inequality that is taking place in the distribution of income, both at the EU level and within the Member States. Inequality is expanding as a result of the crisis. The situation is particularly bad in peripheral economies.

Fiscal consolidation decisions proposed by the European institutions should take into account the effectiveness of taxation to ensure compliance with tax obligations by all economic agents and to reduce fraud. This is one of the preconditions of social cohesion in the European Union. To this end, EU structural funds should be increased and used more efficiently.

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