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Spain: Navigating the Storm

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1. Introduction

The history of the Spanish economy in the second half of the 20th century shows the advantages of internationalization in terms of wealth creation. First, membership in the European Union (EU) in 1986 and later in the European Monetary Union (EMU) in 1999 opened Spain´s economy and represented opportunities to modernize its institutions.

The journey to EMU was a long and winding road that could not come to exist without the unrelenting political commitment of EU leaders to make determined progress towards creating the euro with a single monetary policy. Membership of EMU demanded countries to meet nominal converge criteria, the so called Maastricht criteria.

The challenge was clear for Spain, whose real convergence with the EU had been uneven owing to inadequate macroeconomic discipline. The latter led to higher inflation rates than those of other euro area members and to the periodic devaluation of its national currency. As Rojo (2009) argues "EMU represented a reasonable institutional solution to the asymmetries in the way national monetary policy had tended to be handled in the 1980´s and early 1990´s." However, it was not by itself going to solve all the Spanish economy´s entrenched problems, many of which are still with us today.

The launching of the single currency (the euro) gave a significant thrust to financial integration by eliminating the last barrier to the free circulation of capital within the area. For Spain, it was necessary to convince markets that it was able to meet the challenge and comply with the convergence criteria. It became a self fulfilling prophecy and the virtuous circle materialized, pushing real interest rates progressively lower.

[1] The views expressed here represent those of the author and not necessarily those of Banco de España or the Eurosystem. Any errors are my own. Nieto (maria.nieto@bde), Banco de España, Alcalá 48, 2014 Madrid (Spain).

1.1 Imbalances and challenges ahead

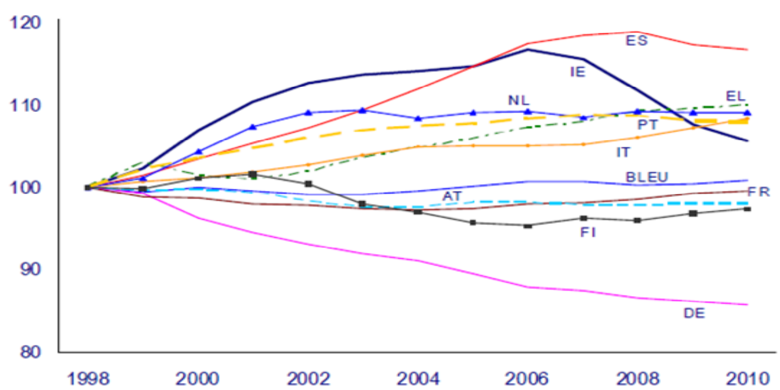
1.2 Imbalances

Three interrelated imbalances materialized during the period that Spain has been a member of EMU and experienced a long economic boom (Estrada, Jimeno and Malo de Molina, 2009):

- <u>Inflation differentials with its EMU trading partners</u>

  The continued positive inflation differential with the euro area countries that initially joined EMU (1% on average in terms of Harmonized Index of Consumer Prices over 1999-2007) can be explained by two factors: the increase of ULCs and profit margins above other EMU countries. Low productivity and high nominal (and real) wages explain the increase in ULCs (Fig. 1). And little market competition explains the increase in business profit margins. Both developments are consistent with the shift in activity towards the construction sector, which is less productive.

Figure 1. Unit Labor Costs

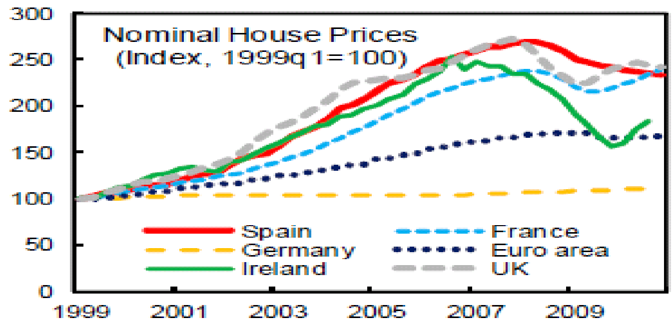


Source: European Commission - survey

- Property sector boom

The real estate boom explains to large extent the growth of Spanish economic growth since it joined the euro (Fig. 2). The weight of investment in housing as a percentage of GDP began to increase from mid-1990s and stood more than 1.5 pp higher than in the euro area by 2007. As a matter of fact, the low level of real interest rates and the increase in credit fuelled that boom (along with demographic fundamentals and the attractiveness of the location for non-residents´ second home). In turn, real estate was a suitable collateral asset to demand bank credit.

Figure 2: House Prices



Source: IMF (2011)

It was the imbalance that built up in the real estate sector that acted as the main trigger of the economic recession (IMF, 2011).

- Household and corporate debt boom

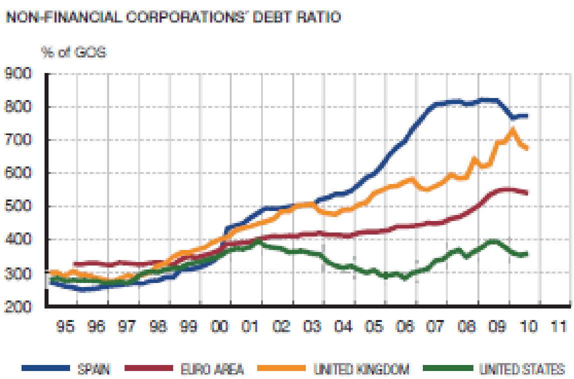
The real estate boom and the low real interest rates due to the inflation differential largely explain the strong increase in both household and corporate credit. Much of the growth of credit was used to purchase real estate assets. In turn, real estate assets were used as collateral for new credit. Household debt ratio over disposable income increased from 1995 and those increases were larger from 1999. In 2003, household's debt was well above the euro area average (Fig. 3).

Figure 3: Household Debt Ratio (%GDI)

Source: Bank of Spain (2011)

The rapid growth in corporate debt was associated with the strong growth of investment in capital goods and real estate both domestically and internationally. Corporate and household debt followed similar patterns. Corporate debt increases were above the euro area average in the past decade (Fig. 4).

Figure 4: Non-Financial Corporation Debt Ratio



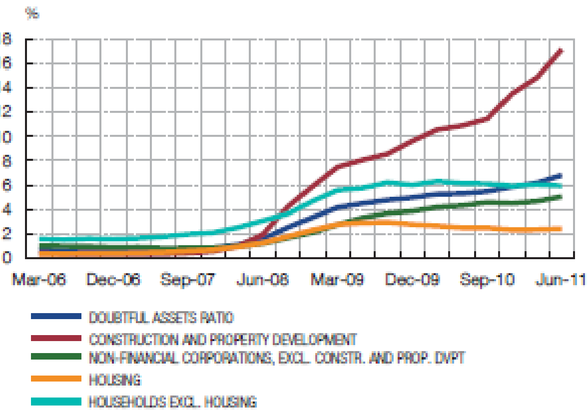
Source: Bank of Spain (2011)

The developments of household and corporate credit showed in the banks´ balance sheets that not only experienced a double digit credit growth but also a deterioration of credit quality (Fig. 5). Data relating to June 2011 indicate that the troubled real estate exposure (doubtful assets, foreclosures and standard loans under surveillance) amounts, for commercial banks and savings banks, to €176 bill.,2. This

[2] Only includes those institutions that participated in the European Banking Authority stress test

volume of troubled exposure represents 11.4% of the credit portfolio (credit to the resident private sector in business in Spain, including, for this purpose, foreclosed assets). Coverage by provisions (specific provisions associated solely with these assets and general provisions for business in Spain) amounts to 33% of the troubled exposure in June 2011. Troubled real estate exposure net of provisions is approximately 11.2 % of the 2009 Spanish GDP.

Figure 5: Spanish Banks: Doubtful Asset ratio



Source: Financial Stability Report (Nov 2011)

1.3 The challenges ahead

Spain needs to enhance market confidence and move to a new growth model. Unwinding the imbalances of the boom years and the legacy of the crisis will take years. A new economic growth model with more balance between tradable and non tradable sector is needed; both, and particularly the non tradable, need to spur productivity and contain costs.

As a mirror image, the banking sector (including S&Ls) is facing challenges that stem from the need of deleveraging in the context of increasing funding costs. The latter are also related to the euro area crisis and its institutional framework that, particularly at the inception of the crisis, showed a coordination failure, because countries only considered their own welfare. As argued by the IMF (2011), should Spain be affected by the euro area sovereign debt crisis, the ensuing shock to the other economies of the area would constitute a systemic event by its magnitude.

Last but not least, fiscal consolidation will be challenging in a slow growth environment but needed to control de increase in public debt that still remains comparatively low compared with other euro area countries.

2. Final reflection

The launching of the euro was the largest surrender of sovereignty that European policy makers have endeavored to accomplish in times of peace. The efforts to get to where we are now have been worthwhile, particularly for Spain, where economic agents have gradually adjusted to a macroeconomic framework of stability. However, the efforts have been incomplete and relied excessively on large capital flows.

Looking into the future, the agents need to adopt behavioral patterns more consistent with low-inflation environment coming to terms with the fact that national policy makers do have only two policy tools at hand: prudent fiscal policy and structural policies. The greatest risk of sovereign credit crisis comes from slow growth, when the rate of interest on debt far exceeds the nominal growth rate, making reducing debt to GDP ratio very challenging.

Last, the euro has relied on policy makers´ relentless commitment. The present crisis is an opportunity to strengthen that commitment.

3. References

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