

International economics - spain

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International Economics - Spain Somebody asked me the other day what happened with my country, Spain; why it is known by almost every young European person that it is so hard to find a job in Spain, and why is the Spanish economy so weak, with so much debt and with such high unemployment? Well, there are many reasons to explain the failure of the development of a stable and sustainable economic system of such an industrialised country, with so many resources and influences all over the world during the last 600 years, that it should appear as other rich and influential European countries, such as Germany, France or England; countries that are being world references in the exit of the crisis. The answer is so long that we couldn't explain all the mistakes and structural problems that the directing class had committed in Spain during the last 20 years, even if we wrote them by bullet points! The result of all these mistakes is hard reality... Spain and its economic boost from 2000 to 2006 were known between the world economic environments as the " Spanish miracle". Spain grew much faster than the other European top countries, its GDP grew between 3% and 4% each year, the unemployment decreased to even 6% - which for other countries may not be very strange, but for Spain, that historically has been very affected by unemployment, it was an unknown success - , and the consumption grew spectacularly, which lead to an economic launch where the majority of the Spanish that opened a business where achieving benefits. It is true that every developed economy that starts below the rest have usually higher rates of growth, just for a mathematical reason. But Spanish growth during these years was a surprise for everybody. The imports grew massively, Spanish banks where suddenly acquiring real

international relevance, investors from all over the world dreamed with having as much money much capital as possible invested on the " Spanish miracle"; in 6 years Spanish nearly was having the same GDP per capita as France and Italy, historically totally unachievable... And was this due to the great effort of the authorities that developed a perfectly sustainable economic system, creating logic labour that was necessary for fulfilling the so highly productive Spanish sectors (like Germany or Netherlands)? Or it was due to stable growth, launched by the high qualification of studies of the new young Spanish generations, launched at the same time by the precisely effective educational policy? Or it was due to the rise of productivity of the sectors that " moved" the Spanish economy, where the high investment on RR. DD increased the competitiveness of such sectors, allowing at last the Spanish economy being competitive in such fields? No. None of this is true. None of this logical ways of thinking how a developed economy like the Spanish can achieve top European levels is correct. Spain failed on its educational policy; the 3 political changes during the last 15 years — from the left to the right, and again to the left —, where the two main (and nearly unique), have so opposite thoughts that it has been impossible to keep a coordinated and agreed policy. The right wing (PP) of J. M Aznar and the left wing of Gonzalez and the former president Zapatero have varied so much the educational policies that the system created is right now possibly the worse of Europe in efficiency, scholarship failure and high qualified professional formation. The few incentives that students had to continue their studies, added to the high salaries that workers without formation of the construction were paid, provoked the Spanish begging of the fatal

imbalance; the economy based on the construction and the price floor. Many young people just left their studies and started working as simple bricklayers, which during these times where the "bubble" was inflating without stop, they were paid much more than many professional qualified workers. Spain also failed on creating a sustainable economy, where the only sectors where all the public efforts were focused were the construction and the tourism (service sector). These are two sectors that are not exposed to competitiveness and, this problem would later be the key mistake, because it meant that the prices were condemned to rise and rise as the investments and financing grew fast, leading to the unreal miracle and the later crash. There was no investment in research and development (RR. DD) by the public authorities, like it happens in the northern countries, Netherlands or Germany; places where this sort investments create the basis for a sustainable, competitive and dynamic growth of the economy and the society. And to finish this brief introduction of the country overview, where the political and socio — economic problems caused the multiplication of the effects of the global crisis on Spain, I must mention that all the government budgetary efforts such as, investments, licenses of exploitation of land or guarantees and support of great credits for supporting private operations have been almost strictly focused on the construction service. This meant that the other industries that are much more exposed to competitiveness and thus, become less based upon price rising, such as new technologies, car industry or many export business, were totally financially isolated. Later on, we will analyse these themes more precisely, but we have to consider that this industries where competitiveness ensures the constant innovation,

are always looking towards reducing the labour expense per unit: this means that the productivity of the industry is much higher than in less competitive ones, as it has to be reducing its costs constantly. To better understand the unbalanced development of the Spanish economy, we have to take a look on the recent history of the economic and social events that occurred in Spain during the last 40 years. While other European economies grew with much more productive industries, where innovation led usually to an increase of the exports, as these economies gain competitiveness, Spanish growth was always based mainly on less productive industries, such as tourism or construction. Spain during Franco's dictatorship was a very closed economy. Protectionism was the main characteristic during the autocratic years. Only with the 1959 "devaluation and stabilisation of the Peseta", designed by technocratic politicians, which were much more worried on the openness of Spain towards the European commerce; only then the Spanish economy started to reduce its level of protectionism. The devaluation of the currency permitted a much higher degree of openness, and the exportation timidly increased. The industrial network began to grow while the GDP converged gradually with the European countries. In 1975, at last, Francisco Franco died, and after his death Spanish economy was harshly affected by the institutional changes that the politicians of the transition to democracy implemented. The real problem was not the change of the political scene, but was the big world economic crisis that the economies all over the world suffered. The world commerce was shocked by the rise of the price of the petrol. The energetic crisis was even harder to cope with in Spain. There are the two reasons for this explanation: the industrialised countries where the

economies are totally dependent of the external petroleum because they do not have own production have much more sensitive economies to the energetic countries, such as Spain or Italy, adding the political instability of the transition provoked the divergence between the national GDP and the European average GDP during 1975 and 1985. Later on, between 1986 and 1999, there was a period of time of " macroeconomic stabilization", where the expansion or recession of the economy, as well as the macroeconomic unbalances, was much smoother, mainly due to the join to the European Union. After these periods where the Spanish economy tried to achieve similar industrial and productive results to the European ones, Spain's economy managed a rapid expansion of its GDP, which grew much quicker than the European average. It was the beginning of the so called " Spanish miracle". In the table below we can observe the differentials of growth between the European economies since 1960. [pic] [pic] To make a comparison between the situation that Spain registered during the years of the extraordinary higher growth rate, the so called Spanish miracle, and the situation that the Spanish economy is facing right now, we can analyse it with a very illustrative graphic. [pic] Spain registers its first budgetary surpluses since the begging of the democracy in 1975. And is in this point where the imbalances start increasing too; the inflation increases more than 4% of average each year, the commercial deficit rises to dangerous levels and the whole balance of payments suffers an important distortion. While the economy continued growing, this was not a huge problem because the international finance was easy to attract, as the credibility of Spain was bigger than the previous years. Spain was the envy of Europe's largest

economies, its GDP grew quicker, the unemployment rate (historically high) reached the 8% and the Spanish imports also grew rapidly, as the consumption registered each year constant rises. The Spanish banks gain international reputation, many investors were attracted by the profitability of the housing market and Spain received more than 5 million immigrants during this period of time, which came mainly from southern and Central America, migrated to work on the construction sector, where many cheap labour was needed. All this new conjuncture lead to a huge rise of the consumption, that at the same time helped the creation of employment, shifted an incensement of the inflation of the surpluses that we will analyse with attention to detail. All these macroeconomic imbalances led to a totally unsustainable situation of the Spanish economy. The bubble that was inflated by the building market, leading to high inflation and constant commercial deficit would have meant the Spanish economic disaster, even if the world crisis would not have landed: " the international financial crisis has been the detonator that provoked the adjustment of the Spanish economy, but this adjustment would have occurred anyway". [pic] The severe imbalances are the best thermostat of the Spanish economy by that time, and the best way of explaining and analysing why the crisis affected much deeply to the Spanish reign. We are going to identify the main imbalances that appeared during the " Spanish miracle" and after the crisis and then we will explain the main reasons and factors that acted as the catalyser of the imbalances, but firstly we are going to point out how and why such imbalances were provoked. The first imbalance that we can identify is the balance of payments deficit that was constantly creating conspicuous debts

among the Spanish economy, although the tremendous incomes that the state was earning due to the continuous rise of the price of the land created a surplus that counter acted the imbalances that the unsustainable economic system was creating. If we speak about the massive rise of the imports that caused the commercial imbalance, we also have to relate this to the consumption activity and so, to the economic factor that helped the expansion of the consumption: the real interest rates. The Euribor, the index of reference of the banking market in Europe, which is the interest rates that the banks follow to lend money between them and thus, to the final private consumer, were situated between this years between 2.75% and 3.75%. At the same time, the inflation rates in Spain were increasing each year with more and more strength, shifted by the rise of the prices on the construction sector (land, flats, wages of workers) and in the tourism sector, which as I mentioned before, are less exposed to the competitiveness and thus, the labour cost per unit were constantly increasing. If the economy would not have been so much based on these less productive and competitive sectors, the inflation would not have rise so much, so the real interest rates maybe would not have been negative, and so the consumption would have be more moderate, thus the final huge level of debt that the families and the majority of the final sector acquired would have been less. This only reflects the spiral that the Spanish economy seemed to be trapped to for being so dependent to the non competitive sectors such as construction and tourism. At the same time registered few exports in comparison with the level of imports. This is because the national economy was not based on competitive sectors, which are more producers of competitive products that can be exported.

These countries are the ones that right now are facing the exit of the crisis and are no more under recession, while Spain's economic crisis seems to be much longer. Actually, in this moment the appropriate reform that Spain should execute would be a devaluation of the national currency, but since Spain entered the European Area, this possibility is no longer available. As Paul Krugman mentioned in his New York Times column: " If Spain still had a peseta, I'd say devalue it". But this type of spirals can and must be stopped by the politicians through a more strict fiscal policy or other legislative measures to try to contract such dangerous bubble of debt and consumption. But again, the lack of social consciousness that the Spanish politicians revealed was significant. Both parties at power, first the right wing during the first years of the bubble and later the socialists since 2004, preferred letting the economy grow in such selfish way because this meant that the votes and popularity held continuously rising. It is true that the monetary policy was impossible to vary for the governments because this is imposed, since Spain joined the euro region, by the European Union institutions, but legislative and fiscal policy are still sovereign to the national governments. The lack of responsibility of these politicians of my country was showed in the fact that it was really unpopular in short terms perspective to criticise the spectacular rising of the standards of life that Spain was experimenting, but in the long term it was surely the best idea, because now we are having 3 times the unemployment of European leading countries and no Spanish middle working class can afford buying a house. It is true that the housing market, like every other market, is based on the law of supply and demand, but there are many ways not incentivising the demand in such way that

distortion this basis so much. And at this point is where the politicians should have the social responsibility of taking care of these social matters, instead of looking only towards gaining votes or not losing power. So all this consumption — inflationist spiral lead to a massive distortion between the exports and the imports, because it dynamited the imports through the rise of the consumption and, as Spanish leading were not focused on the exports this created an important imbalance between imports and exports that made necessary the financing by the foreign countries of the national accounts. We show the 2007 balance of payments because it was during this year when the national economy reached its top.

IMPORTS — EXPORTS BALANCE 2007		
Imports	Exports	Balance
January 2007	21. 592, 08	13. 968, 54 -7. 623, 54
February 2007	21. 748, 80	14. 859, 7 -6. 889, 1
March 2007	24. 105, 88	16. 301, 84 -7. 804, 04
April 2007	22. 059 14. 399, 07	-7. 659, 93
May 2007	23, 942, 63	16. 018, 79 -7. 923, 84
June 2007	24. 425, 74	16. 109, 75 -8. 315, 99
July 2007	23. 982, 99	15. 321, 76 -8. 661, 23
August 2007	19. 945, 93	12. 125, 69 -7. 820, 24
Sept. 2007	26. 017, 06	14. 903, 1 -8. 410, 35
October 2007	24. 903, 10	16. 706, 64 -9. 310, 42
Nov. 2007	25. 266, 61	16. 568, 05 -8. 698, 56
Dec. 2007	24. 030, 38	14. 195, 62 -9. 834, 76
TOTAL		

COMMERCIAL BALANCE 280. 430, 55 181. 478, 54 -98. 952, 01 Nowadays, the inflation reflects the adjustment of prices of the main sectors of the economy, which together with the severe shrink of the consumption. The adjustment on the prices that Spain is suffering is much stronger than the European's. [pic] [pic] A very illustrative example of the thoughts of some of the most prestigious economists of Spain about the situation that Spain was suffering during the " Spanish miracle" was written by the Director of the

Spanish National Bank, Miguel Ángel Fernández Rodríguez: " During its expansion, the Spanish economy accumulated some imbalances interdependent between them, which can be condensed into two: the high level of debt of the private companies and the families, which, as it is not sufficiently compensated by higher savings of the public sector, this led to the need of the resort of the external savings; and to an excessive importance of the construction sector in terms of the concentration of the productive resources". Furthermore, we can add real data to this argument. Between 1999 and 2006 the Spanish suffered a strong shift of the demand: the internal demand grew at an annual rate of 4.7%, with increases on the consumption, the investments on equipment goods and the investments on construction of 4.2%, 5.5% and 6.7% respectively. The supply also grew but in a much slower rhythm; the production grew a 3.75% of average each year, helped by an intensive creation employment, due to the strong demand of workers during the construction bubble, especially immigrants, and due to the increase of the feminine active rate too. In the other hand, during this period only very few advances in productivity were achieved. " This imbalance between the growth rates of the expenditure and the production created, in the one hand, an increasing external debt and, in the other, a pressure over the prices that contributed to maintain a positive differential of inflation regarding the other countries of the euro area, and thus, an appreciation of the real exchange rate and a loss of competitiveness of the Spanish products" said Fernández Rodríguez too. This year, the balance of payments of our economy suffered a smaller difference between imports and exports. But this, unfortunately, was not registered because Spain gained

competitiveness and the economy started to export much more; it was due to the severe shrinkage of the consumption, which reduced the imports from 280. 000 millions to less than an expected amount of 200. 000 millions € (December has still not been calculated). Another channel that could have been used to stop the tremendous imbalance is the fiscal policy. This policy, as opposed to the monetary policy that is strictly imposed by the European Union, it is free for the national governments to manoeuvre as they want, as long as the deficit does not exceed 3%. During 1999 and 2007 this was not the case because there was a tiny deficit or, from 2005 to 2007 there was surplus registered in the national accounts. But the fiscal policy that really shifted and inflated the housing bubble was the tax exemption to the purchase of new houses that was introduced in Spain during the first years of the right wing government in the late 1990's. This exemption meant that every Spanish resident that bought a new house had to pay over 20% less for his or her new house. This measure provoked that the housing market was even more dynamic from that moment, incentivising the purchase of new houses instead of already built houses. This was one of the factors that led to a massive increase of the construction of new buildings in Spain. Although the tax exemption was created by Mr. Aznar government, after the arrival to power of the " supposed" left wing in Spain in 2004, this measure was not quitted, and the housing bubble continued growing until 2007. And this exemption is right now still being currently implemented, because probably if it was erased, it will shrink even more the housing purchases in Spain, as the consumption is almost a 40% less than before the crisis, and the purchase of new houses is only 50% of the rate that registered during

the bubble. The exemption is planned to be erased for 2011. The housing market in Spain is in fact the clue to understand the effects of the global crisis in my country. As an introduction to this bubble of the construction sector analysis, we can start giving some revealing data: the sum of the six main European countries (France, Italy, Great Britain, Poland, Germany and Spain) is 346 million people, for which Spain represents only the 13% of the total population. During the last 10 years, 11 million new houses were built in Europe; In Spain 5, 6 million new houses were built during this period. In other words: one out of three houses were built in Spain! This means that Spain produced 3. 09 times more than the European main countries; In 10 years Spain built the necessary houses for more than the next 30 years...

[pic] The housing sector by its own nature is particularly sensitive to the financial conditions. The constructions of new houses takes a large productive process, and usually it's done through housing promotions that include a huge number of units, and thus activity is very conditioned by the financial availability. On the other hand, the usually process of entering a new building as it is a long term good, that has a large impact on household budgets, is done by asking for a loan. These generates that the changes in the conditions of the access to credits affect directly to the supply (promotions , constructors) and to the demand (mainly families) of the housing market, producing considerable variations in the amount of transactions and the prices . Like this the majority of families´ debts that were focused on the purchase of new houses, in the same way that a significant part of the companies credits were destined to housing promotions. The amount of housing transactions grew exponentially (it

reached 955. 000 in 2006) and the growth of housing rate was 2, 7 % between 1995-2007". The laxity of the financial conditions provoked also an excess of productive resources on the housing market ' ', said Ángel Laborda not long ago in the best economic newspaper in Spain. Some of the conditions we already mentioned before: the negative real interest rates, where inflation was higher than the interest rates imposed by the ECB (European Central Bank). Again for this specific matter, the lack of freedom that the EU members have to choose their monetary was probably quite harmful for the Spanish economy, because maybe higher interest rates would have slow down the expansion of the credit for the house loans. But it is true that the banks in Spain adopted many times an " American subprime position", as it granted many credits to people that were suspicious of not paying, as they didn't have stable job or their salaries were very low. But probably the main financial condition that encouraged almost everyone to ask for a credit to purchase a new house was the simple increase on the housing market. The simple bubble that inflated the prices of the floor in Spain made that a Spanish flat, land or house was surely one of the most profitable assets in the whole global financial market. Also the banking competence has been a lax factor that helped the expansion of the credit loans. Spain banking market grew to become a really relevant banking market, with strong investments in South America and Europe. This created an environment of banking competence, where the banks each time were relaxing more and more the conditions for the granting of loans. If a Spanish person went to the bank, asked for a credit, where he had to pay between 5% and 7% of interests; bought a house, and each year the house grew an

average of 10%, the business then in much more profitable than any financial product in the market. It is registered that between 1995 and 2007, the houses in Spain grew an average of 10% each year. Some years, the housing inflation reached 18%, while the salaries grew only a 2% each year; this has generated that after the high unemployment that was produced by the bursting of the housing market bubble (adjustment of the house prices), nowadays the lower and mid-low Spanish working class was becoming more and more poor, and for these people buying a house, is right now totally impossible for a big percentage of the Spaniards. "The Economist", a very prestigious economic newspaper stated that the Spanish housing bubble has been "bigger than those countries where there is no doubt that there was a housing bubble during the last year, such as United States, where the price of the floor rose a 85% , or Great Britain with an increase of 168%." But this sector of the economy has little exposition to the competitiveness so, as we pointed in the first chart, while the other European economies were growing much slower than Spain, its productivity was way higher than Spanish; Spain grew between 3% and 4% (much higher rate than Europe), but its productivity only increased a 0.7%. This is because of the importance of the two main Spanish sectors, if you consider the weight they have in the GDP: construction and tourism. Why the authorities didn't try so strongly to contain the bubble? Well, a part from the obvious fact that the economy was growing and the standards of living were the best that Spain registered in its modern history — only real convergence with the top European countries — and that a withdrawal of the "supposed successful" policy, would have very unpopular for any government, there were advantages that made the

withdrawal of this approach a very delicate decision. In first place, because the construction is a very intensive sector on work force, and this is very important for a country with a historical high structural unemployment. In the second place, because an increase in the housing prices favoured the middle class voters, although only the people that sold their houses in the right moment, took profit of this, which is only a few percentage of this middle class. And finally, because the housing market generates a huge income to the national, local and regional public authorities. For example, in my city, Valencia, in 2004 it meant the 60% of the whole regional income, while in Madrid the 50%. The tourism has the same problem of competitiveness than the construction. Historically tourism has been one of the " engines" of the Spanish economy, as it is the most touristic country of the world (in proportion to the population). But the labour cost unit was continuously rising during the prosperity years, due to the fact that sector the new technologies or the investment on research and development do not play an important role in the sector, and thus, the productivity of the touristic sector also grew much slower than the majority of the other sections of the economy; now at last improved its productivity last summer, although it was just a consequence of the huge unemployment suffered in the sector due to the withdrawal of the touristic consumption. During these years, the inflation on tourism increased nearly 5% every year; this means that this rate grew quicker than the total national inflation. The salaries were constantly rising, as well as the touristic products: hotel accommodation, bars, restaurants, organised trips, etc. The salaries also rose quicker than the salaries of the other sectors of the national economy. As a result of this,

nowadays, most of the touristic sites in Spain are under a severe price adjustment or, as it happens in Canary Islands or Mallorca, under deflation. The tourism sector activity last year suffered a decrease of almost 25% in the whole Spain, and it is right now is also being very threatened by new touristic destinies that offer much cheaper accommodation prices, such as eastern Europe or the North of Africa. But the massive unemployment suffered in the two main sectors, construction and tourism was not only because of the retreat of the Spanish and the global family consumption, but also due to the inappropriate employment contract policy. Spain has had since the years of prosperity a " duality" in the flexibility of its labour market: this means that, one the hand it has fixed - term contracts which have a high protection, as it includes a very high dismissal severance pay. Such big compensation makes the dismissal very unattractive for the owners of the companies. On the other hand, we have the temporary contract (especially in the touristic sector also called seasonal contracts), which has no compensation for dismissal and has very flexible terms. These are called " rubbish contracts too", and where signed by many workers of the construction sector (many immigrants, non — qualified Spanish workers) but also many young Spanish workers, no matter the level of professional qualification. And after the bursting of the economic bubble, this situation generates this data: the total unemployment in Spain reached the 19. 4% 4 months ago; but the immigrant population rate is of 30%, and the young unemployment reached 42. 9%, the highest of all Europe, even higher that Lithuania, Estonia or Bulgaria, and nearly the double of European's average. A very illustrative example of this was written by Paul krugman in the New

York Times: " Like hundreds of thousands of other young people, Jesus Pesquero Peñas dropped out of school to go to work when the Spanish economy was booming. But since he was laid off from his construction job two years ago, he has been living on unemployment benefits. Now Mr. Peñas finds himself part of a lost generation in Spain: " I went to work because the money was good, the lifestyle was good and I really wanted to get out of school, " Mr. Peñas, 25, said as he waited on a long line snaking down the block from an employment office in suburban Madrid". But the solution to the totally inefficient labour market in Spain has a difficult solution, because the socialists are still in power, and they don't to reform this duality for two simple reasons: firstly, because the reform of the fixed — terms contracts into more flexible contracts it would mean that the dismissals become cheaper, which is not very popular for the socialist ideology. Furthermore, Zapatero's government is ruling with the close support of the syndicalism force, and this would not permit the appearance of a cheaper dismissal with this so negative economic conjuncture. The other reason is again the popularity that these reforms may have toward the voters. These middle class workers that are now 20 or more years working are the voters that Zapatero needs to win again the elections, so this necessary employment contract reform is becoming very delicate. Few months ago, 100 of the most prestigious economists in Spain proposed through a web page, the new terms that the reform should have, as well as asking with urgency to the government for the immediate employment reform. They asked in this letter again to create a new economic model, more based in dynamic sectors that need investment on human capital and

in research and development. But the most important was the labour market reform; they asked the President to change the two different contracts, temporary and fixed — term, into one single undefined contract, with a cheaper dismissal but with equal protection, and with a collective negotiation between syndicates and employers much more intensive. They quoted that “neither the reforms on fiscal stimulus nor employ formation will be efficient if the real problem that generate an inefficient labour market are analysed. ”

Finally we have to mention that the period of time when the Spanish accounts were having surpluses that were financing the commercial deficit that the distortion between imports and exports was creating is over. Now the public deficit is reaching the 10%. This means that the public debt is also growing at a very high rate, making the international finance of Spain more and more difficult. One month ago, one of the most important rating agencies (agencies that measure the quality of the credits), “ Moody’s”, rated Spain with A*, while the main European countries are being qualified with A***. This can have very bad consequences for the financing of the public debt, because it means that this finance is going to get more expensive if the Spanish economy continues showing the same weakness.

One of the last resources that the government has left is the collection of taxes. In few months, the Spanish IVA, the indirect tax that every one pays when buying any type of product, is going to rise from the 16% to 18%. Some economists in Spain think that this tax reform is going to have even more negative for the economy and for the collection, as it will affect even worse to the already burst internal consumption. As a conclusion, we can say that the Spanish seems to have a very difficult exit of this global crisis.

Surely, this crisis arrived in the worse possible moment for the national economy, as this was adjusting the tremendous over value that many assets, especially those related to the housing market, were starting to suffer. The most important change for the Spanish economy has to come through an institutional reform. Another economic model is needed with urgency. " This new model should not include fiscal incentives", appointed Michele Bordin, Professor of the Washington University. This means that in the next years, no political, legislative or fiscal reforms should orientate the population to a certain economic activity, as it happened during the housing bubble. The new economic model should include the elimination of structural obstacles and the creation of an economic environment that favours the creation and arrival to Spain of work force with a high rate on human capital. During the previous years, the labour force was based mostly in capital, because the construction needs much more the money (capital) investment than qualified work force. And this becomes, as we have perfectly understood after the crisis, totally unsustainable, and leads to a situation where many workers find themselves without any qualification to work in other professional sectors. Politicians, society and the Spanish mentality and idiosyncrasy of becoming rich through the easiest way must radically change so that the Spanish economy recovers and can compete again with top world countries.