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**Spain at the crossroads: should it opt for a bailout?**

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Spain’s Prime Minister, Mariano Rajoy, is under pressure to formally request a bailout from the European Central Bank. AAP

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Up until fairly recently, Spain was a story of economic success. It was an example of how the periphery of Europe was quickly catching up with the core.

**Between 1995 and 2007, Spanish real GDP grew at an [average annual rate of 3.8%](http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx), 1.5 points more than the Eurozone average. At the same time, the unemployment rate fell from 23% (more than twice the Eurozone average) to 8.2% (just a few decimal points above the Eurozone average).**

The fiscal position wa s solid: the fiscal surplus hit 1.9% of GDP in 2007 and gross debt was at just 36% of GDP. Spain seemed to be ready to take the place of stagnant Italy as the third economic power of the Union.

**Storm after the sun**

Towards the end of 2007, the global financial crisis hit the world. Spain took a full blow in 2008. Output growth dropped to less than 1% before turning negative (-3.7%) in 2009. Unemployment quickly increased to 18% in 2009, from 8.2% in 2007.

The drop in fiscal revenues, coupled with the fiscal stimulus package, led to a 4.1% deficit in 2008, followed by a record 11% deficit in 2009. Inevitably, debt started accumulating and the debt-to-GDP ratio grew by 17 percentage points in two years.

Spain has not yet recovered. Output growth remained negative in 2010, turned barely positive in 2011, and it is now estimated to be -1.8% in 2012. Unemployment is back to 24% — exactly where it was in 1994. The debt to GDP ratio is twice what it was just four years ago.

And the short-term outlook is gloomy. In the midst of the Eurozone sovereign debt crisis, Spain has to raise 38 billion euros in 2013 just to service its outstanding debt. The yield on Spanish bonds has skyrocketed to close to 6% and the rating of its sovereign debt has dropped to just above the “junk” level.

As if all this was not enough, the country has been shaken by social and political tensions. Cataluña, the country’s largest regional economy of the country, is pushing hard to obtain independence.

In fact, separatist sentiments have always been strong around Barcelona (Cataluña’s capital). The region accounts for up to 20% of Spanish total economy and generates 30% of its exports. Cataluña transfers 12 billion euros a year in tax revenues to the rest of Spain, receiving significantly less in return from the central government.

The ongoing crisis contributes to the frustration of Catalans, who feel that the drainage of resources to finance the profligate central government has left them without enough funds for their own essential needs. Consequently, their demand for independence is today stronger than it has ever been in the last several decades.

Besides Cataluña, a second major source of tension is the growing welfare cost of the crisis. The combination of fiscal austerity, recession, and rising unemployment is putting a heavy burden on people’s shoulders. Many have become tired of sacrifices.

Mass protests and demonstrations have taken place in several Spanish cities since May 2011. In the past few days and weeks, the “indignados” have led a broad and heterogeneous popular movement demanding the end of the austerity measures and a shift in the policy focus of the government away from the conditions imposed by the ECB/EU/IMF troika.



Spain’s Indignados have led a wave of protests against austerity measures. AAP

**Something went badly wrong**

Why did the Spanish situation turn around so quickly and so badly?

Spain, of course, is not the only country in a crisis. Other “successful stories” (Ireland and Portugal, just to mention two) have had their share of troubles in the past few years. Still, the rise and fall of Spain has been quite spectacular.

Many would blame the European Union and the incomplete institutional architecture of the Eurozone. With a common currency, but no lender of last resort and no real coordination of fiscal policies beyond what arises from the imposition of deficit and debt targets, the economic institutions of the Eurozone might have hindered the ability of Spain to handle the crisis.

Moreover, the continuous — almost obsessive — focus on fiscal austerity prevailing in some EU circles is likely to have overshadowed economic growth and antagonised large segments of the population.

But it must also be acknowledged that a lot went wrong domestically. In the expansion of 1995-2007, Spain failed to realise that it already laid the roots of future economic vulnerabilities: a housing bubble and an overly exposed banking sector.

The economic expansion led to a fast increase in housing demand. The construction sector boomed and demand for labour increased. To a significant extent, this demand for labour was met by unskilled immigrant workers. Spanish resident population grew rapidly in the early 2000s, leading to even stronger demand for houses. While construction projects were started to increase housing supply, the peak in demand caused a fast increase in housing prices.

The banking sector invested heavily in real estate, which fuelled the bubble. A crucial role was played by the regional saving and loan banks (“cajas”). The cajas were (and to some extent still are) substantially unregulated and largely under the control of local politicians, who used them as a source of political patronage. As a result, their exposure towards risky clients expanded considerably in the years of the real estate boom.

By 2009, cajas owned almost 60% of country’s mortgages and loan payments from property developers accounted for 25% of their total assets.

As the first wave of the crisis hit the economy in 2008, demand for houses started to decline. But because of the time it takes to complete construction projects, supply continued to increase — at least for a while — leading to a sharp decline in housing prices.

With the end of the housing bubble, the share of non-performing loans held by the banking sector grew significantly above what the financial institutions could handle. The cajas, being more exposed, were also the first to require a bailout.

The first bailouts of cajas in 2009 were taken by depositors as a signal that the entire banking system was in distress. Clients started to line-up to withdraw their deposits and this was the beginning of the banking crisis.

Today, the Spanish banking system is still quite fragile. A severe stress test — the results of which were [released late last week](http://www.ft.com/intl/cms/s/0/2a145c3e-0b1f-11e2-afb8-00144feabdc0.html) — showed that seven major banks out of 14 tested are still vulnerable and need 59 billion euros in new capital.

The EU has already made available a package of 100 billion euros to rescue the Spanish banking system, even though the Spanish government states that only 40 billion euros will be needed from the European partners.

**What next?**

A week ago, the Spanish government presented [a new budget for 2013](http://www.abc.net.au/lateline/content/2012/s3599562.htm), which included a set of additional fiscal austerity measures. The budget proposal was met with mass demonstrations and much opposition. But paradoxically, it might not even be enough to stabilise the country’s beleaguered economic situation.

Firstly, ending the crisis in Spain requires a return to strong GDP growth and the consolidation of the financial system. To what extent more fiscal austerity can help achieve these two conditions is unclear.

For sure, lax fiscal policy hurts growth prospects. But growth is primarily a matter of economic reforms — the labour market in particular, in the case of Spain — and harsh austerity measures can discourage investment and consumption, which in turn are the drivers of economic recovery.

Also, the rescue of the banking system might require spending in addition to what the government has planned in its new budget. A strict enforcement of the austerity plans might then clash with the need to recapitalise banks.

Secondly, and perhaps more importantly, the amount of financial resources that Spain needs to mobilise to honour its sovereign debt is massive, and the cost of borrowing is already high. Rating agencies are considering a further downgrade of Spanish bonds. This would make it virtually impossible for Spain to raise any significant finance at an affordable cost.

For this reason, many observers expect Spain to formally request a sovereign bailout. Just last month, the European Central Bank (ECB) announced that it was prepared to buy unlimited quantities of sovereign bonds of countries in financial turmoil. This ECB facility would therefore be a suitable mechanism to carry out the Spanish bailout.

However, the ECB also made it clear that any intervention will be subject to countries meeting a set of conditions concerning their economic and financial policies. If the ECB were not satisfied with the new Spanish budget for 2013, then it could require Spain to take further fiscal austerity measures, which may be neither affordable nor desirable.

The ECB does not seem to be willing to provide details on specific conditions before Spain has formally applied for a bailout, and Spain does not seem to be willing to formally apply before it has clearer indications on the type of conditions the ECB/EU might impose.

Perhaps it is because of this stalemate that the Spanish Prime Minister, Mariano Rajoy, declared on Wednesday that [Spain has no intention](http://www.guardian.co.uk/business/2012/oct/02/spain-pm-mariano-rajoy-bailout-not-imminent) — for now — to request any financial help.

One should hope that the ECB and EU realise that their help is welcome, but that it should come with conditions that do not divert the attention of the government away from crucial reforms.

On balance, lowering yields on debt is of critical importance at this stage of the crisis. Easier access to finance would relief pressure on the Spanish budget and free resources to strengthen social welfare and recapitalise the banking system. But even more important is the implementation of a plan of structural reforms of the labour market, the product and service markets, and the business environment. It is only with these reforms that Spain can return to growth and exit the tunnel.