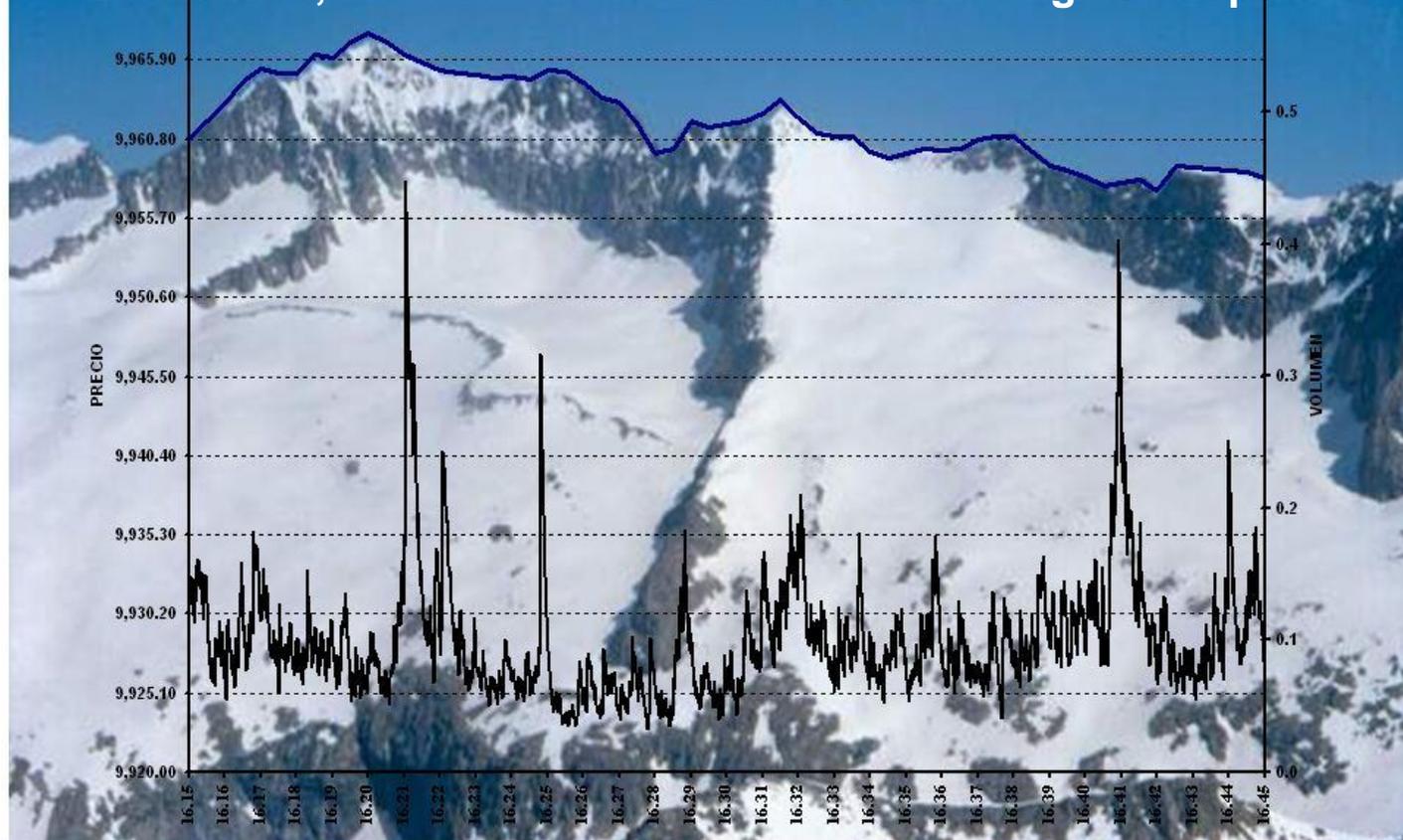


Economics, Finance and Mathematics from a high standpoint



Constraints and Alternatives for Employment and Output Growth. Spain during the Great Recession

Eladio Febrero
Universidad de Castilla-La Mancha

Jorge Uxó
Universidad de Castilla-La Mancha

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Autores:

Eladio Febrero

Jorge Uxó (Jorge.Uxo@uclm.es)

Edita:

Departamento de Análisis Económico y Finanzas de la UCLM

Teléfono: 34 967 599 200. Extensión 2143

<http://www.uclm.es/dep/daef/>

Depósito Legal: AB-351-2009

ISSN: 1989-4856

CONSTRAINTS AND ALTERNATIVES FOR EMPLOYMENT AND OUTPUT GROWTH.

SPAIN DURING THE GREAT RECESSION

Eladio Febrero and Jorge Uxo¹
University of Castilla-La Mancha, Spain

ABSTRACT.- The Great Recession of 2008 is having a devastating effect on unemployment and output in Spain. Hence, the first challenge for economic policy should be driving the economy back to pre-downturn figures. However, the prospect is rather gloomy since Spain faces several constraints which drag output, as a consequence of accumulated imbalances during the previous prosperity period, from 1997 to 2007. The aim of this article is to show the shortcomings of the current strategies of economic policy undertaken in Spain (fiscal austerity and some supply side reforms) to reach this goal, and to argue for an alternative strategy at a European level, consisting in increasing fiscal spending and, simultaneously, balancing trade surplus and deficit countries within the Euro Zone.

1. The challenge for economic policy in Spain: recovering employment and output growth.

Spain experienced a period of outstanding prosperity from 1997 to 2007. During this period of time, the rates of growth of GDP and employment were above those in the European Monetary Union (EMU onwards) and the US. However, the opposite holds since the beginning of the Great Recession, particularly on employment. In the second quarter of 2010, GDP was 4.6% lower than in the first quarter of 2008. The seasonally-adjusted rate of unemployment had reached 20.7% in October 2010, and about 2 million jobs had been mopped up in two and a half years (Table 1 and Figure 1).

These facts lead us to contend that the chief challenge for economic policy in Spain is to drive its economy back to pre-downturn figures for both output and employment. This goal relies on a high GDP rate of growth. Table 2 shows the required rate of growth and the year when we should reach 8% unemployment.² Unfortunately, IMF (2010), the European Commission (2010a) or OECD (2010) forecast an economic growth for Spain ranging between 0.6% and 0.9% in 2011, and an average growth rate around 2% for the period 2012-2015. Given these predictions, the rate of unemployment in 2015 would amount to 15%.

As a consequence of the hysteria in financial markets, because of the sovereign debt crisis sending shock waves round the European periphery,³ Spain is cutting back on public spending, reforming its labour market and prompting banks to offer transparent information on their balances (particularly on how they are affected by the real estate burst).

The aim of this paper is to show the shortcomings of the current strategies of economic policy undertaken in Spain (grounded on fiscal austerity and some supply side reforms) to reach the afore-mentioned goals for economic policy, and to argue for an alternative strategy at a

¹ Correspondence email: Jorge.Uxo@uclm.es

² Under the assumption of a rate of labour activity amounting to 74% and a rate of growth of productivity of 1%. We take the population forecasts elaborated by the INE (the Spanish Statistics Agency).

³ When this was written (30 November 2010) Belgium and Italy appeared to be the next in the list of victims of the current financial turmoil.

European level, consisting in increasing fiscal spending and, simultaneously, balancing trade surplus and deficit countries within the Euro Zone.

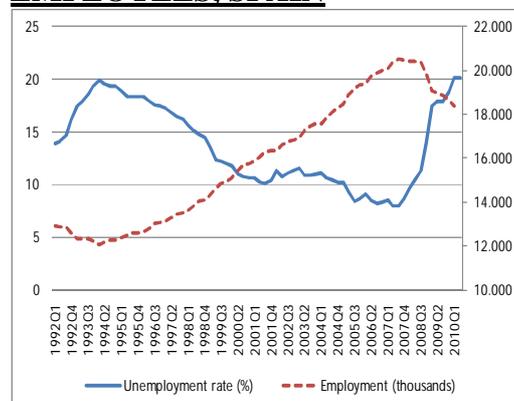
TABLE 1: GDP AND EMPLOYMENT (% GROWTH)

| Period | | US | EU | SPAIN |
|------------|-------------|---------|------|-------|
| GDP | 1997:1-07:2 | 3.2 | 2.5 | 3.8 |
| | 2009:04 | 0.2 | -2.2 | -3.0 |
| Employment | 1997:1-07:2 | 1.3(1) | 1.3 | 3.8 |
| | 2009:04 | -3.5(1) | -2,0 | -5.4 |

(1) Non-farm labour.

Source: INE, ECB and Bureau of Labour Statistics.

FIGURE 1: UNEMPLOYMENT RATE AND THOUSANDS OF EMPLOYEES, SPAIN



Source: Eurostat.

TABLE 2: REQUIRED GDP GROWTH TO REACH 8% UNEMPLOYMENT RATE IN SPAIN

| Year in which target 8% unemployment is reached | Average GDP growth since 2011 (included) |
|---|--|
| 2013 | 5,1% |
| 2014 | 4,0% |
| 2015 | 3,4% |
| 2016 | 2,9% |
| 2017 | 2,6% |
| 2018 | 2,4% |

Source: authors' calculations.

2. What are the constraints for a demand-led recovery?

A long lasting recovery should ultimately be driven by private demand. However, the prospect is rather gloomy since Spain faces several constraints which drag output, thus requiring further action.

2.1. Imbalances inherited from the boom (1997-2007).

The true cause of the Spanish recession is the accumulation of imbalances during the previous prosperity period, with international factors (e.g. the turmoil of US subprimes, or the sovereign debt crisis) aggravating an already existing crisis. Particularly relevant is the pile up of private debt as a consequence of soaring residential investment.

Between 1997 and 2007, the building of 6.25 million dwelling houses was initiated. And one out of five new jobs was created in the construction sector. Private and public

consumption also contributed to growing demand. Productive investment was high as well, as shown by the accelerator theory of investment. Yet, this demand actually had a lesser impact on GDP since a large fraction of this spending was matched with imports (48% in 1995, and almost 60% in 2000 and 2005, according to information reported in the symmetric input-output tables for the Spanish economy). In 2007, the weight of the building industry was much larger than in the EMU and its growth had been offset by a similar fall in the manufacturing sector.⁴

TABLE 3: DEMAND AND GDP (% GROWTH)

| | 1997:1 - 2007:2 | 2009:3 - 2010:2 |
|-----------------------------------|-----------------|-----------------|
| GDP | 3.85 | -2.08 |
| Consumption. Households and NPISH | 3.96 | -1.25 |
| Consumption. Government. | 4.54 | 0.78 |
| Gross Fixed Investment | 6.64 | -11.83 |
| GFI. Equipment goods | 6.42 | -8.93 |
| GFI. Vehicles | 10.09 | -11.38 |
| GFI. Dwellings | 7.53 | -22.55 |
| GFI. Other constructions | 5.23 | -2.55 |
| GFI. Other goods. | 6.85 | -15.93 |
| Exports | 6.47 | 1.55 |
| Imports | 9.47 | -4.08 |

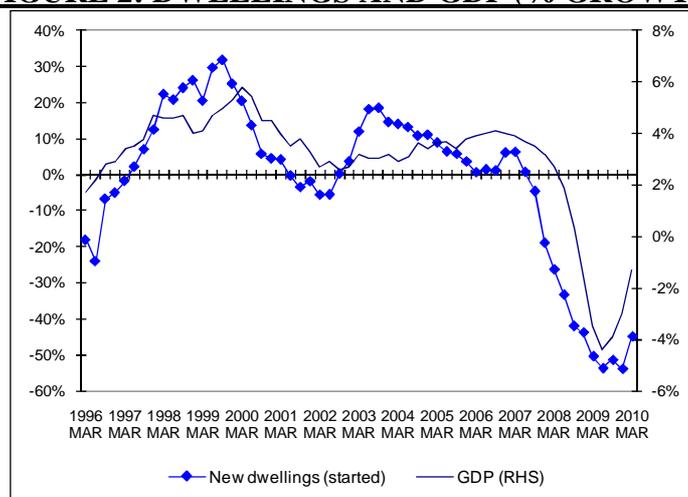
Source: INE.

TABLE 4: SUPPLY STRUCTURE (% GVA, PPS)

| Economic Sector | SPAIN | | EMU-11 | |
|--|-------|-------|--------|-------|
| | 1997 | 2007 | 1997 | 2007 |
| Primary Sector | 5.0% | 2.7% | 2.9% | 2.1% |
| Industry (exc. Construction) | 22.2% | 17.3% | 26.0% | 24.7% |
| Manufactures | 19.0% | 15.0% | 22.2% | 21.7% |
| Construction | 7.1% | 11.8% | 6.3% | 6.5% |
| Services | 65.7% | 68.1% | 78.7% | 85.4% |
| Trade, restaurants and hotels, transport | 26.4% | 24.5% | 23.1% | 23.8% |
| Financial Intermediation | 18.3% | 22.5% | 29.8% | 34.7% |
| Public and social services | 21.0% | 21.0% | 25.8% | 26.9% |

Source: INE.

FIGURE 2: DWELLINGS AND GDP (% GROWTH)



Source: Banco de España.

Household and non-financial corporations (NFC henceforth) net savings (say, savings minus investment) fell substantially giving rise to growing indebtedness. Household plus NFC bank debt shifted from 83% of GDP in 1997 to 218% in 2007 (see Table 5). Regarding households, 75% of their debt went to fund the purchase of a house. However, a large fraction of NFC debt was not used to fund productive investment but takeovers and speculative purchases (particularly in the real estate market, but also in financial markets). In spite of falling public debt (from 60% to 36% of GDP), indebtedness to the rest of the world rose from 27% to 110% of GDP.

⁴ A detailed account of the factors driving the growth in residential investment in Spain can be found in Dejuán and Febrero (2010).

TABLE 5: OUTSTANDING GROSS DEBT (% GDP)

| | 1997 | 2000 | 2003 | 2005 | 2007 | 2010:01 |
|------------------------------------|---------|---------|---------|---------|---------|---------|
| Households (1) | 35.46% | 44.5% | 58.71% | 59.95% | 84.73% | 85.92% |
| Non financial corporations (2) | 47.33% | 77.67% | 91.91% | 106.76% | 133.06% | 141.07% |
| Government (3) | 60.56% | 54.37% | 46.59% | 42.91% | 33.82% | 53.86% |
| Financial institutions (2) | 8.49% | 14.44% | 28.67% | 59.95% | 98.01% | 108.07% |
| Total Debt | 151.83% | 190.97% | 225.88% | 269.58% | 349.62% | 388.92% |
| Held by domestic agents | 125.15% | 147.48% | 167.49% | 183.97% | 239.69% | 274.6% |
| Held by the rest of the world | 26.68% | 43.49% | 58.39% | 85.61% | 109.93% | 114.32% |
| Spanish net assets held by the RoW | 28.41% | 31.63% | 43.16% | 56% | 77.29% | 89.39% |

(1) Total loans; (2) Total loans and securities other than shares; (3) Securities other than shares.

Source: Banco de España and authors' calculations.

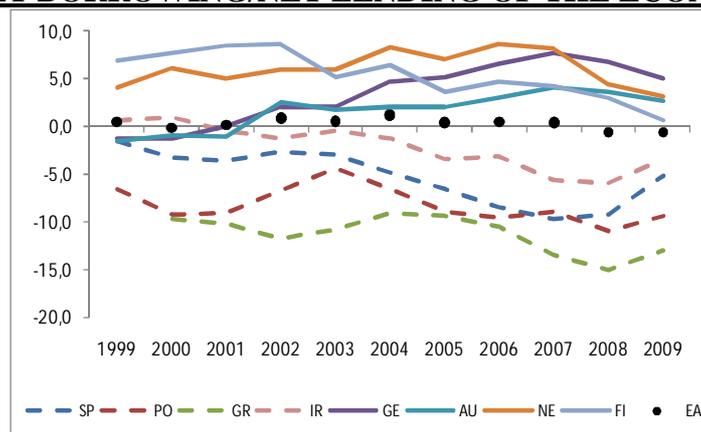
These two features of the Spanish pattern of growth (growing debt and an overdeveloped housing market) hinder the recovery:

- From the demand side, deleveraging requires increasing forced saving to deal with debt servicing, thus subtracting impetus for aggregate demand if an upturn grounded on consumption spending is required. Since 2008, residential investment has declined though saving required to service debt has increased. And uncertainty about the future has contributed to increasing gross saving. Actually, in 2009, the household saving rate rose to 18.9% of gross disposable income, from an average 10% during the boom period. However, the debt to household income ratio remains quite stable because savings (as a means to reduce debt) affect income –negatively. According to the European Commission (2010a), the contribution of domestic demand to growth will remain slightly negative in 2011 (-0.4%) before turning positive in 2012 (1.5%). Specifically, private consumption will grow by 0.9 percentage points in 2011 (less than in 2010: 1.1%) and will only accelerate moderately in 2012. Gross fixed capital formation is expected to continue falling in 2011, due to the ongoing shrinking capacity in the construction sector and significant cuts in public investment.
- On the supply side, the economic recovery cannot be grounded on the construction industry: the stock of unsold dwellings in 2009 amounts to 688.044 units, 2.7% of the total stock of existing dwellings (note that, in 2006, when the number of dwellings underway reached a historical maximum, the construction of 760.000 new dwellings started). Therefore, which industry is going to be the locomotive for the Spanish economy in the near future?

2.2. The trade balance constraint.

Needless to say, when investment outstrips savings, the trade balance goes into the red. In Spain, despite public savings having remained well above public investment (thus leading to a decline of public debt over GDP), private investment has surpassed private savings hugely, so that the trade deficit had been growing during the boom period, reaching 10% of GDP in the first quarter of 2008.

FIGURE 3: NET BORROWING/NET LENDING OF THE ECONOMY (% GDP)



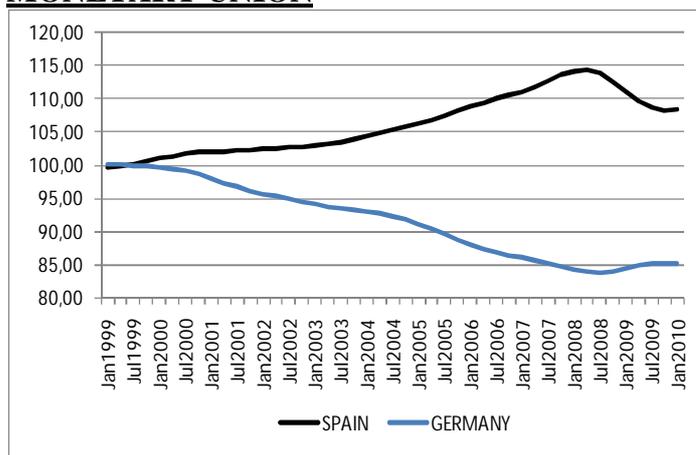
Source: Eurostat.

The trade imbalance has been caused by two factors: (i) Spanish GDP grew much faster than that of its EMU partners, and (ii) Spanish competitiveness declined:⁵ Nominal wages rose in Spain more than in the EMU (23 percentage points) and the effective real exchange rate, deflated with labour unit costs, rose 14 percentage points (see Figure 4).

This imbalance has got narrower during the bust (reaching 5.1% of GDP in 2009), caused by the fall in imports rather than a rise in exports.⁶

Thus the external constraint can be stated as follows: when the Spanish economy grows above the EMU, the trade deficit rises, but if it does not grow, unemployment increases. This vicious circle could be broken if GDP in EMU countries rises. Though, international institutions like the IMF forecast a trade deficit ranging between 4% and 5% of GDP for the next years.

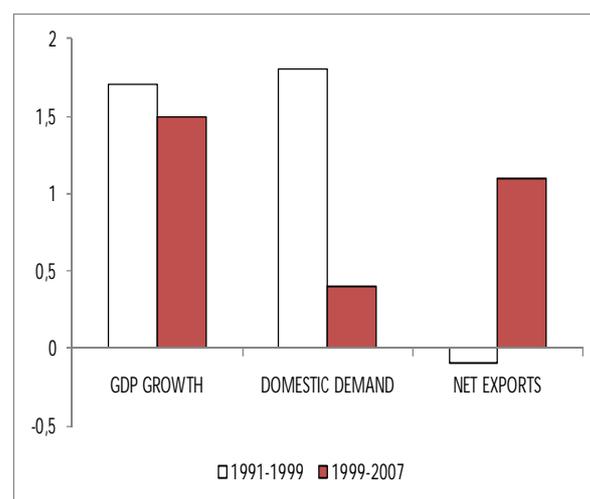
FIGURE 4: REAL EFFECTIVE EXCHANGE RATE VERSUS THE REST OF THE MONETARY UNION



Note: REER deflated with the ULC.

Source: Eurostat.

FIGURE 5: CONTRIBUTIONS TO GDP GROWTH, GERMANY



Source: Eurostat.

If we take into consideration what has happened with the trade balance at the EMU level, we see that it did not experience any substantial change during the period 1999-2007, with an

⁵ See European Commission (2010b).

⁶ European Commission (2010c)

average balance of 0.5% GDP (i.e. a small surplus). This means that surplus in countries like Germany, Austria, Finland or The Netherlands actually mirrors deficits in Spain, Portugal, and Greece.

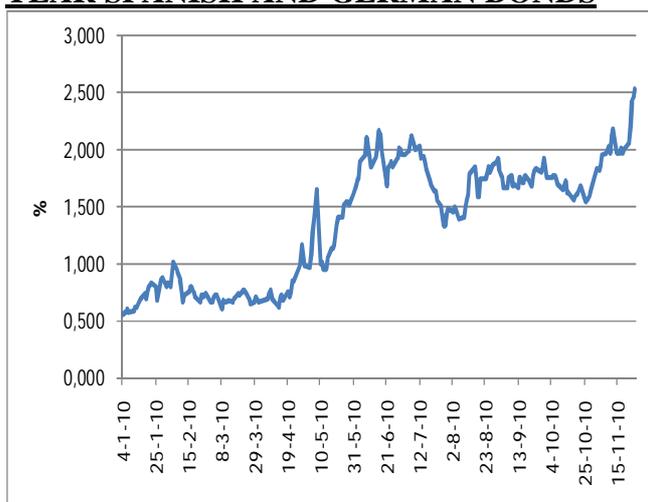
Regarding surplus countries, particularly Germany, the growth of exports has not been accompanied by a rise in internal demand, as Figure 5 shows. This is partly explained by a significant moderation of nominal wages with two main consequences: (i) slowly growing nominal wages lead to gains in competitiveness when productivity grows more, thus positively affecting the trade balance; (ii) relatively stable wages tend to give rise to a stable or moderately growing internal demand. Hence, GDP growth depends more on exports for these surplus countries.

The rising trade deficit in Spain is, thus, the consequence of two factors: falling competitiveness due to increasing nominal wages in Spain beyond productivity gains and, moderate wages in other countries within the EMU and weak internal demand in countries with moderate wages.⁷

2.3. Public debt and financial markets.

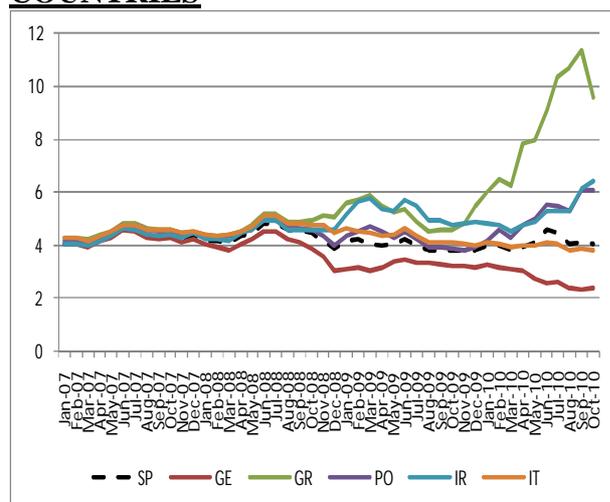
The Spanish economy faces another dilemma: on the one hand, private spending remains rather weak, thus requiring expansive fiscal policies in order to increase aggregate spending as a *conditio sine qua non* for the upturn. On the other hand, public spending means growing public deficit, piling up public debt. In 2009, the public deficit reached 11.1% of GDP; public debt over GDP increased 17 percentage points between 2007 and 2009. Part of this debt has to be sold in international financial markets. More debt without growth is seen as a growing default risk. And more perceived risk means having to pay higher interest rates to fund public spending, therefore increasing debt to service debt. Furthermore, this problem shifts to the private sector as private corporations get funds at rates linked to public debt.

FIGURE 6: DIFERENTIAL BETWEEN 10-YEAR SPANISH AND GERMAN BONDS



Source: Banco de España.

FIGURE 7: 10-YEAR BOND YIELDS, EMU COUNTRIES



Source: Banco de España.

⁷ Busch (2010).

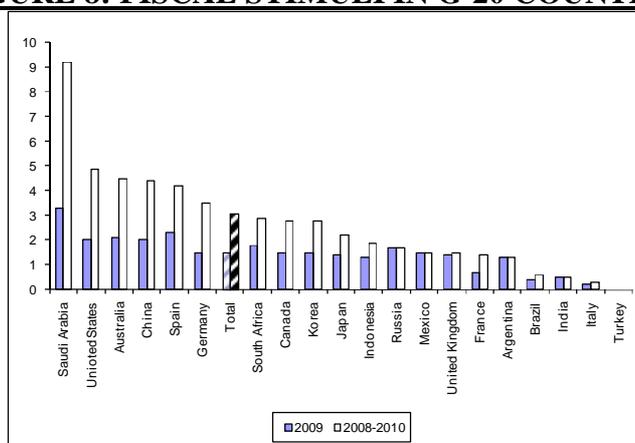
Figure 6 shows the differential of the 10-year Spanish bond with respect to the German bond during 2010. We see that the differential rises, and this is what drives the Spanish Government to implement fiscal austerity measures. Nevertheless, two statements should be taken into account:

- At least until the beginning of November, rising differentials do not mean that the effective cost of funding public deficit in Spain is increasing. Actually, the interest rate on the 10-year Spanish bond has remained quite stable. What we see, on the contrary, is that the interest on the German bond has declined as those investors selling Greek, Irish and Portuguese debt used their sale proceeds to purchase German debt (see Figure 7).
- This dilemma is the consequence of the missing support from the European Central Bank (ECB) to expansive fiscal policies at the European level. In the current situation, it should be convenient for the European economy if the ECB increases its purchase of public debt of all national treasuries, at least up to a certain minimum ratio, until markets calm down.
- As it will be argued below, and as the Irish experience shows, the attempt of the Spanish Government to avoid the increase in the differential by means of more fiscal tightening will likely be unsuccessful: the negative effects on GDP growth will reinforce, in turn, the doubts about the Spanish economy solvency.

3. What are the shortcomings of the austerity measures in Spain?

Economic growth during the decade 1997-2007 was driven by private indebtedness, particularly that of households, as has already been stated. The factors leading to increasing household indebtedness evaporated at the same time as the international financial turmoil caused by the US subprime mortgages entered the stage, making it harder for households and firms to fund their spending. Because of these two factors, the effects on aggregate spending from deleveraging outstripped those of new borrowing (to fund additional consumption and investment purchases). Therefore, aggregate demand began to decline and, as a result, GDP fell 3.6% in 2009.

FIGURE 8: FISCAL STIMULI IN G-20 COUNTRIES



Source: IMF (2009).

In November 2008, when it became clear that the crisis was here to stay, the Spanish government implemented an economic policy aimed at the recovery of domestic demand,

through a program of fiscal stimulus, with additional measures helping banks to give firms easier access to credit. These measures shared the aims of the proposals issued by the G-20, the European Plan for Economic Recovery or the IMF. Actually, the fiscal measures passed by the Spanish Parliament to deal with the crisis amounted to nearly 2.9% GDP in 2009.⁸

At the beginning of the downturn, Spain had a large fiscal room for manoeuvre (public surplus of 1.9% GDP and public debt near 36% GDP) and its package of fiscal stimulus was one of the most expansive throughout the world (see Figure 8). The outcome of this expansive policy was increasing fiscal deficit (-4.1% in 2008 and -11.1% in 2009), and soaring public debt (53.1% of GDP: 17 percentage points more in two years).

During 2010, the Spanish government has curbed public spending, due to the very real threat of being punished by investors in international debt markets and the pressure from other governments and the European Commission. The main strands of Spain's current policy of austerity are:

- Exports are expected to be the key component of aggregate demand to save the Spanish economy from this messy situation. Households and firms (responsible for consumption and investment spending) are heavily burdened by debt and the government has given up fiscal policy.
- Austerity from the demand side has been accompanied by structural reforms from the supply side, particularly affecting the labour market and the public budget. In essence, what these reforms are aiming at is to freeze or even reduce nominal wages and public pensions, and raise indirect taxes, in order to balance public accounts:
 - ✓ Wage increases are usually the outcome of collective bargaining but the government has the power to influence the results of negotiations. One of the ways to do so is by altering the wages of workers in the public sector, which works as a benchmark for wages in the private sector. Actually, in June, the government decided all on its own to reduce wages for workers in the public sector by 5% on average. In the private sector, wage increases agreed until September 2010 averaged 1.3% (Table 6) and businesses and trade unions have agreed to keep wages increases to below 2% until 2012.
 - ✓ With respect to the public deficit, the Spanish government has made it clear in its updated Stability Program (January 2010), that it is committed to bringing the deficit down to 3% in 2013, to avoid conflicts with the Stability and Growth Pact. Later on (in May 2010), and as a consequence of the pressure caused by the sovereign debt crisis in financial markets, the government also passed a bill aimed at reducing public spending an additional 15.000 million € between 2010 and 2011, to drive deficit down to 9.3% in 2010 and 6% in 2011 (see Figure 9). This goal was intended to be met by spending cuts (lower wages in the public sector, freezing pensions during 2011 and a 40% reduction in public investment), and increasing indirect taxes (2 percentage points more for VAT, on average).
- Regarding structural reforms, the government has passed a labour market reform, reducing costs for firing workers and making collective bargaining less relevant. It is now bringing to the fore proposed reforms on pensions, and putting caps on regional government spending.

⁸ A more detailed view can be found in Uxó *et al.* (2010).

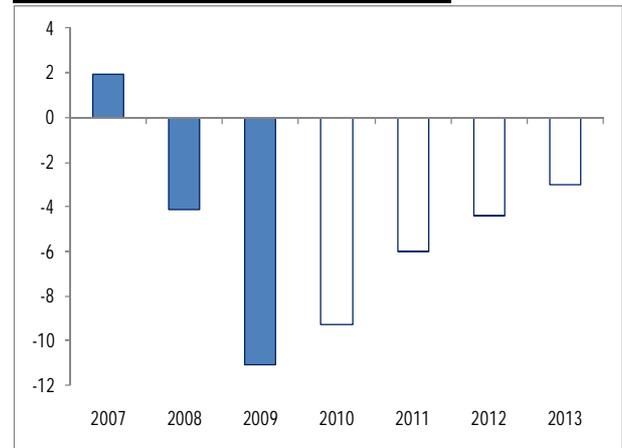
TABLE 6: WAGE GROWTH IN SPAIN (COLLECTIVE AGREEMENTS)

| Year | Wage growth |
|------|-------------|
| 2006 | 3.6% |
| 2007 | 4.2% |
| 2008 | 3.5% |
| 2009 | 2.3% |
| 2010 | 1.3% |

NOTES: Years 2006 to 2009 include the application of the wage revision clause when the inflation rate is higher than expected. Year 2010, until September.

Source: Ministerio de Trabajo e Inmigración.

FIGURE 9: PUBLIC NET LENDING / NET BORROWING (SPAIN, % GDP)



2010-2013, forecasts.

Source: Spanish Government.

With this set of measures, the government is looking for a change in the structure of the productive capacity of the Spanish economy, making it less dependent on brick-laying and more intensive in new technologies. In our more realistic view, this strategy will have high social costs and the prospect for success is nearly nil. Here come our arguments.

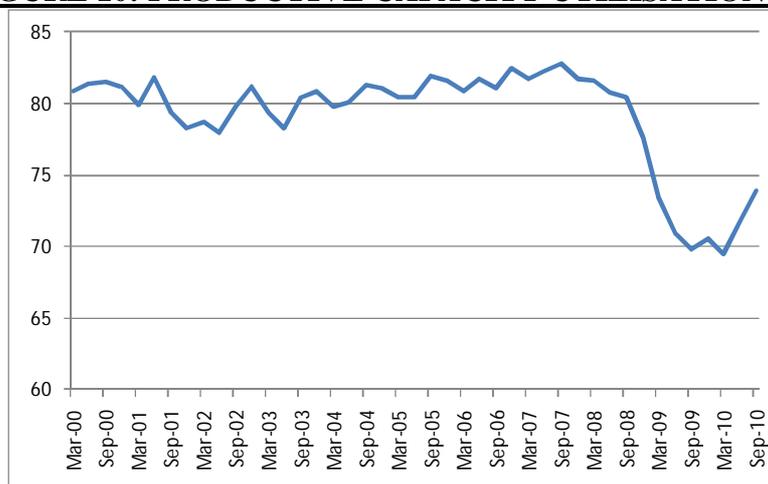
3.1. Wage cuts will have restrictive effects.

Renowned economists, such as Krugman (2010), Blanchard (Cotizalia, 2010), Rodrick (2010a,b) and Gros (2010) have hinted at falling nominal wages in Spain, in order to get a real exchange depreciation, which might increase exports, offsetting the weakness in other components of aggregate demand. However, the expansive effects of this measure might be cancelled out by other restrictive consequences:

- As the nominal official rate is set by the ECB for the whole of the EMU, if the inflation rate falls in Spain, real interest rates rise.
- Debt servicing is a nominal burden. So, if nominal wages fall, the real weight of debt settlements rises, leaving less space for consumption.
- Falling wages might make it harder to deal with debt servicing at due dates. If defaults rise, banks might tighten credit conditions.
- In a deflationary environment, firms sales proceeds would fall. This might reduce operating surplus after debt servicing, and this would probably reduce productive investment as well.
- Falling wages might improve firms profitability (because of a distributional shift). Though, this might not happen if the fall in wages does not lead to a proportional fall in prices but, in this case, the afore- mentioned competitive devaluation might not occur. Additionally, a distributional shift in favour of profits might weaken aggregate demand. And furthermore, if demand is weak, it is difficult to believe that these profits will be ploughed back into investment, especially when the degree of utilization of productive capacity remains quite low (as Figure 10 below shows).

- Lastly, falling nominal distributive categories might lead to a fall in public revenue, without a similar fall in the interest payments burden. This might make it harder for the government to deal with debt servicing, and it would have to cut public spending even more to achieve the desired reduction in deficit.

FIGURE 10: PRODUCTIVE CAPACITY UTILISATION (%)



Source: Banco de España

3.2. Other countries could also apply wage cuts.

To be successful, the moderation of the nominal wage growth should be translated into a lower inflation rate than in the rest of the countries belonging to the EMU. What is relevant is the change in its relative position, not in its absolute value. However, since all of our neighbours are adopting deflationary measures simultaneously, it is not clear whether the end result of this “race to the bottom” will lead to an improvement in competitiveness. Moreover, if these wage policies provoke a generalized reduction in aggregate demand, the winner will obtain a higher participation of a smaller total income. The potential advantage of less than average inflation would be compensated by a reduction in the total income of the rest of the EMU.

3.3. Fiscal austerity will deepen the lack of aggregate demand and will delay recovery.

The Spanish economy will still register a negative growth rate in 2010 (-0.3%) and fiscal policy is the only lever available to increase the lack of aggregate demand in the short term. However, a restrictive fiscal policy will deepen this problem. After the announcement of the cuts, the Spanish government increased its own forecast for the rate of unemployment for 2010 and 2011 (from 19% in 2010 and 18.4% in 2011, to 19.4% and 19.3%) and reduced the expected GDP growth for 2011 (from 1.8% to 1.3%).

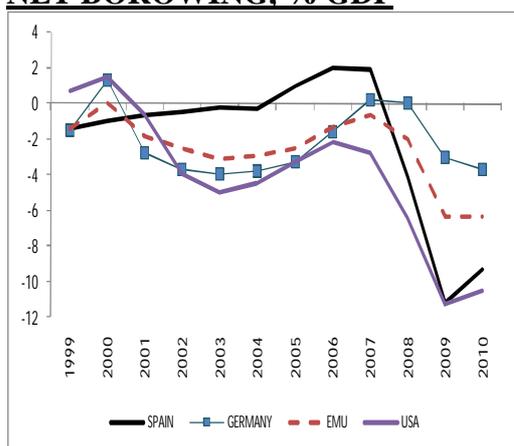
As Palley (2009) states, negative effects will come not only from the traditional multiplier effect, but also because cuts in public spending will reduce household disposable income, making it more difficult to reach the desired pace of deleveraging and forcing a higher saving rate. And the IMF (2010) has confirmed that, according to empirical evidence, the restrictive effects of fiscal restraint are more important than the supposed “no keynesian effects” derived from an improvement in confidence and investors’ expectations. Finally, these contractive

effects will be multiplied because almost all European countries are cutting back on public spending simultaneously.

3.4. The current public deficit is not the cause, but the consequence of the recession. To reduce the deficit, Spain needs to fight the recession, rather than the other way round).

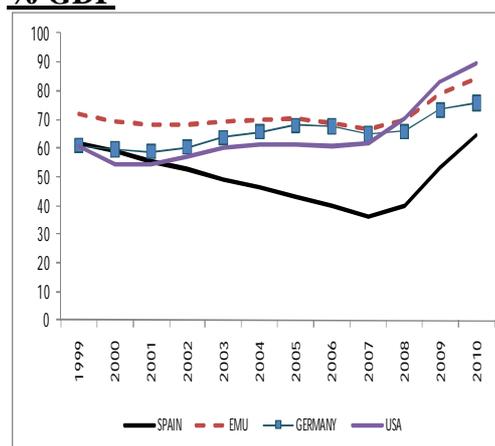
The Spanish public sector cannot be accused of profligacy (see Figures 11 and 12). Since the Stability and Growth Pact was agreed, and up till now, Spain had never run a deficit beyond 3% GDP, and the average budgetary balance during those years was practically zero, with a maximum deficit of -1.4%. The Spanish public sector is not that large. On average, public sector proceeds for countries within the EMU-12 were 45.7% of GDP during the period 1995-2007, whilst for Spain it amounted to 38.7%. Regarding outlays, figures were 48% and 40% respectively. Finally, despite the high growth rate of public debt during the last two years, from 36% to 53%, Spain still has a low level of public debt, 26 percentage points below the average for EMU-12.

FIGURE 11: PUBLIC NET LENDING / NET BORROWING, % GDP



Source: Eurostat and OECD.

FIGURE 12: GROSS PUBLIC DEBT, % GDP



Source: Eurostat and OECD.

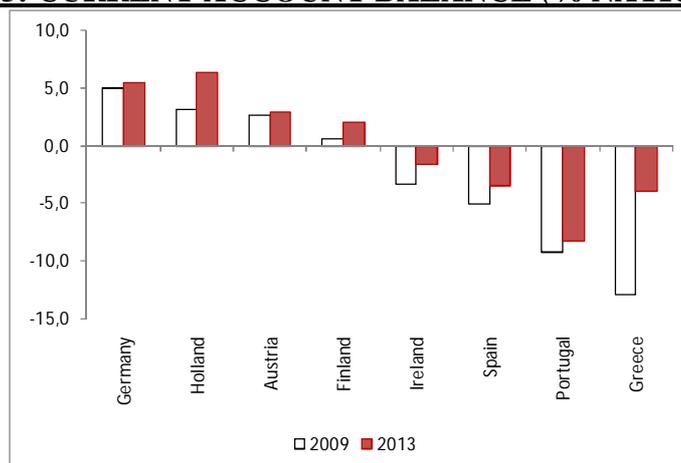
4. A European crisis requires a European solution.-

Spain, and Europe in general, not only face the problem of a lack in aggregate demand, but also has to deal with the impossibility of sustaining permanent current account deficits and surpluses within the Euro zone. Because of this, a new economic policy strategy, coordinated at a European level, is required to increase effective demand and, at the same time, to provide a global solution to these imbalances.

The updated Stability Programs for the period 2010-2013, however, do not give any real grounds for optimism. Not only do deficit countries hope that an improvement in their external sector will drive an increase in their aggregate demand and solve their imbalances, but the surplus countries also intend to increase their net exports thus prolonging a growth model focused on exports and not driven by domestic demand (Figure 13).⁹

⁹ See Brecht et al. (2010) for a more in depth analysis of this subject.

FIGURE 13: CURRENT ACCOUNT BALANCE (% NATIONAL GDP)



2013, forecast included in each Stability Program.
Source: European Commission.

The main components of an alternative economic policy strategy to the Austerity Strategy would be the following:

- 4.1. Europe needs to increase its effective demand and this requires maintaining an expansive fiscal policy. Official interest rates should be maintained at a low level.

The forecast for Euro Zone growth for the coming years is low. In this context, dramatic fiscal cuts in nearly all countries will be procyclical, and will have a very negative impact on employment and curbing unemployment rates.

Current account surplus countries which also have higher than average fiscal room for manoeuvre (Table 7) should lead the economic recovery by increasing domestic demand. With regard to the other countries, the removal of fiscal stimuli should be graduated according to their fiscal situation and the speed and strength of their recovery, while prioritizing this economic objective before meeting the deadlines imposed by the Stability and Growth Pact.

TABLE 7: PUBLIC FINANCES IN CURRENT ACCOUNT SURPLUS COUNTRIES

| | 2010, % GDP | |
|---------|-------------------|-------------|
| | Budgetary Balance | Public Debt |
| GERMANY | -3,7 | 75,7 |
| AUSTRIA | -4,3 | 70,4 |
| HOLLAND | -5,8 | 64,8 |
| FINLAND | -3,1 | 49,0 |

Source: European Commission.

Clearly, we cannot avoid the problem of rising public debt and the possibility that this could provoke a new crisis in the financial markets. But it is also true that this default risk is related to the ECB's unwillingness to cooperate by providing liquidity to fund public spending.

Even those supporting the Austerity Strategy must recognize that financial markets are currently highly influenced by expectations, which can quickly change direction, and which reinforce themselves. If it is believed –whether this is true or not– that the public debt of a

country is risky, investors will start to sell bonds, and interest rates will increase. Consequently, the rising differential will be understood as objective proof of the weakness of public finances, and this, instead of closing the gap between supply and demand, will increase it, because of the flight of new investors. A fiscal readjustment will become unavoidable, but its negative consequences for GDP growth will reduce solvency and doubts about the country in question will reappear.

Under these circumstances, with the present high uncertainty regarding the situation of the financial systems and the strength of economic recovery, European governments should not allow their fiscal policy decisions to rest on unstable financial markets given the risk of continuous changes in direction. Therefore, in order to develop a fiscal policy truly focused on output and employment growth, the following decisions should be taken:

- To eliminate the pressure that the risk of a debt crisis implies for the fiscal policy choices of national governments, the ECB should be clearly committed to purchasing as much public debt as necessary, to avoid speculation against any country. Actually, the arguments against monetizing public spending are irrelevant. Currently, there is no risk of inflation, but of deflation. In any case, a little inflation might indeed be good for indebted agents, and would reduce the real interest rate, which in turn would reduce the required fiscal deficit from reaching the same level of effective demand. In fact, the ECB is monetizing public debt, although in an indirect and insufficient way, through quantitative easing. Finally, the Fed is cooperating with the US Treasury through quantitative easing and we see that the price of US public debt is not plummeting, and its public deficit is at the same level as the Spanish one, with public debt 30 percentage points above.
- A European fiscal authority should be implemented, with the ability to issue debt on behalf of European countries, at least up to a particular level. This would also require real cooperation on fiscal policy making sure that, the full effect on aggregate demand would be the appropriate one.¹⁰
- Falling taxes and not increasing spending has led to fiscal deficits in most European countries. These policies are regressive and put the Welfare State at risk. So, national fiscal authorities should raise taxes, particularly on financial capital and the wealthy, and should harmonize taxes instead of practising “fiscal competence”.

¹⁰ A good example of the limitations of the current framework is the European Economy Recovery Plan, which was agreed to by the European Council in December 2008. The main part of the fiscal expansion was to be applied by national governments, but no specific commitments relative to quantities or dates were established.

4.2. The solution of current account imbalances requires a realignment of levels of competitiveness, but this should be achieved jointly.

Generalized wage and public spending cuts are not the right way to improve competitiveness if this goal is to be reached at the expense of higher unemployment. However, this improvement should actually be a central objective of economic policy in countries like Spain, not only because this would mean an increase in aggregate demand, through more net exports, but because they would also prevent the high output growth required to reduce the current 20 per cent unemployment rate from producing new current account deficits. If Spain (and Portugal, Greece or Ireland) does not address this problem, it will suffer low growth rates and persistent high unemployment rates. But this (non) solution to the problem of current account deficits would not be good for those countries with a surplus: first, because their exports would also be reduced, and, consequently, their output growth; and second, in the event of a deflationary spiral, the repayment of debts could be highly problematic.

Blanchard, Dell'Ariccia y Mauro (2010) have suggested that central banks should raise their targeted inflation to 4% in order to prevent the zero bound of nominal interest rates. This change is even more pertinent in the case of a monetary union, because it would allow readjustments in relative unit labour costs without having to cut nominal wages. At the same time, it would reduce the real value of the debt and the burden of interest payments, instead of increasing them.

Taking these two points into account, we propose the following:

- An increase in the inflation target set by the ECB for the monetary union. Also, deficit countries should have lower than average inflation for some time, thus making it possible to realign real exchange rates.
- To avoid a war of competitive devaluations through wage cuts, it would be advisable to implement a coordinated wage policy, targeting wage increases in accordance with productivity gains plus the national inflation target. Once losses accumulated in competitiveness, since the beginning of the monetary union, were eliminated, this wage policy would be neutral for competitiveness inside the Euro Zone, thus avoiding the recurrence of current problems (see Stockhammer (2008), and Glassner and Watt (2010)).

5. Concluding remarks.

The Spanish economy faces a serious economic policy dilemma. It needs to implement expansionary fiscal policies in order to address the problem of the lack in effective demand, which is the outcome of a period of economic growth with rising (private and external) indebtedness. But, at the same time, it has to fund public debt in international financial markets, and interest rates are rising as a consequence of sovereign debt crisis in peripheral countries within the EMU and because of speculation.

In this situation, the priority should be to raise employment and GDP, not to cut public deficit. This last is actually the consequence of declining economic activity, not the cause, and what is required to tackle the sovereign debt crisis is more effective intervention by the ECB, by purchasing the public debt of national states. However, European governments and the ECB have chosen austerity, and this strategy will lead to high economic and social damage.

Unemployment will remain high for a long time and this will have long-lasting effects on the potential growth rate and on the structural long-term unemployment rate.

It should not be forgotten that the rising imbalances between current account deficit countries and surplus countries within the Euro Zone are at the core of the current crisis. But surplus countries (and supranational institutions like the ECB or the IMF) are wrong when they impose austerity on deficit countries to solve this problem. This economic policy is short sighted in terms of a full European perspective: not all countries can have a trade surplus, and grounding recovery on exports requires a country playing the role of "locomotive" for the rest of the countries.

An alternative economic policy strategy should imply more coordination and a radical change in the very conception of the way a monetary union works and of its institutional framework: the creation of a true "European economic government", a complete revision of the Stability and Growth Pact, more cooperation between the ECB and European fiscal authorities, and employment as the primary target of economic policy. Any resistance to these changes will seriously threaten the very existence of the Euro.

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