Spain and the Euro Area Sovereign Debt Crisis

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Paper prepared for Resolving the European Debt Crisis, a conference hosted by the Peterson Institute for International Economics and Bruegel, Chantilly, France, September 13-14, 2011.

A Long Period of High Growth

Historical experience and empirical evidence show that deep financial crises tend to produce sovereign debt crises, given that bank bailouts, automatic stabilizers, and extra fiscal impulses produce an increase in the budget deficits and debt of the general government.

At the end of 2007, the year in which the financial crisis started, on August 9, the fiscal position of Spain was apparently excellent. According to Eurostat, it was better than in the other three largest euro area member states. Spain had a consolidated total government budget surplus of 1.9 percent of GDP, the third highest after Finland (5.2 percent) and Luxembourg (3.7 percent). Three other euro area member states were also in surplus, Germany (0.3 percent), Netherlands (0.2 percent), and Ireland (0.1 percent).

The rest were in deficit: Slovenia, which joined that year (–0.1 percent), Belgium (–0.3 percent), Austria (–0.9 percent), Italy (–1.5 percent), France (–2.7 percent), Portugal (–3.1 percent) and Greece (–6.4 percent). Cyprus (3.4 percent), which joined in 2008, also had a surplus as well as Estonia (2.5 percent), which joined in 2011, but Slovakia (–1.8 percent), which joined in 2009, and Malta (–2.4 percent), which joined in 2008, were in deficit. The average euro area deficit that year was 0.7 percent.

The total government debt to GDP position of Spain was also quite good and also much better than the other three largest member states of the euro area. Spain had a debt to GDP ratio of 36.1 percent compared with France of 63.9 percent, Germany of 64.9 percent, and Italy of 103 percent, all the three of which were above the 60 percent Stability and Growth Pact (SGP) ceiling. The best positions were that of Ireland (2.5 percent), Luxembourg (6.7 percent), Slovenia (23.1 percent), Finland (35.1 percent), and Netherlands (45.3 percent). By contrast, Austria (60.7 percent), Portugal (68.3 percent), and Belgium (84.2 percent) were well above the 60 percent ceiling. The member states that joined later were all below 60 percent (except Malta, which had 62 percent): Estonia (3.7 percent), Slovakia (29.6 percent), and Cyprus (58.3 percent). The average debt to GDP ratio of the euro area that year was 59 percent.

Spain had reached such an excellent fiscal position after growing at an average of 3.7 percent per year, for a period of 14 years (since 1994) while the euro area as a whole only grew at an average of 2.3 percent. This large boom was mainly due to two, once for all, factors. The first was the

Spanish entry into the Economic and Monetary Union (EMU), which produced a dramatic fall in the Spanish interest rates, once investors discounted the end of the exchange rate risk of the peseta (which had devalued several times before joining EMU). Average short and long term rates fell from 13.3 percent and 11.7 percent in 1992, to 3.0 percent and 2.2 percent in 1999 and to 2.2 percent and 3.4 percent in 2005. That produced a large expansion of credit, investment and growth.

The second factor arrived when, between 2000 and 2007, 3.6 million immigrants entered Spain, growing from 923,000 in 2000 to 4.5 million in 2007, mostly at working age. Immigration continued since, reaching the peak in 2010 with 5.7 million, 12.2 percent of the total population and 15 percent of the total labor force, which generated large contributions to social security. This huge inflow supported the boom by contributing to 80 percent of the population growth and giving a large push to the working age population contributing, on average, to a 36 percent of the GDP growth during that period. Immigrants were attracted by the housing and construction boom as well as from an expanding tourist sector.

Nevertheless it should be reminded that Spain has been growing at a high rate of growth and catching up very quickly, for much longer. In the last 50 years, since its first deep structural reform in 1959 (the Stabilization Plan), Spain has been the second member state of the euro area at 12 (after Ireland) with the fastest average growth as well as the sixth fastest growing country in the world, after Korea, Japan, Singapore, Hong-Kong and Ireland in the same period.

Between 1961 and 2010, the fastest growing euro area member state has been Ireland, at an average growth rate of 4.46 percent, followed by Spain (3.8 percent), Greece (3.7 percent), Portugal (3.56 percent), France (3.0 percent), Netherlands (2.98 percent), Austria (2.90 percent) the average euro area at 12 (2.86 percent), Belgium (2.76 percent), Italy (2.74 percent) and Germany (2.46 percent). Outside the euro area, Korea has been growing the fastest with an average rate of growth of 4.5 percent, followed by Japan (4.18 percent) by the US (3.16 percent), the EU 15 (3.12 percent) and the UK (2.30 percent).

But Producing Internal and External Imbalances

Spain's high average growth rate of 3.7 percent, between 1994 and 2007, has turned out to be 0.7 percentage points above its average potential growth rate, which was, over that period, around 3 percent, according to several estimates. As a result, its first imbalance has been that Spain's average annual rate of inflation during the same period has been 2.7 percent versus an average of 1.8 percent in the euro area, that is, 0.9 points higher every year. This differential rate of inflation has been even higher since the beginning of the euro 2.9 percent versus 1.8 percent, that is, 1.1 percentage points. This differential has produced a loss of competitiveness versus the euro area average.

It is also important to remind that the ECB inflation target is based on the harmonized index of consumer inflation HICP, weighted by the relative GDP of each member state in the total of the euro area. As, from the start of the euro, Germany, Italy and even France were growing at a relative low rate of growth and between the three were weighting 2/3 of the total euro area GDP, the ECB kept policy rates low. These rates came to be not low enough for Italy and Germany with low growth and inflation rates, and at the same time, not high enough for the faster growing member states such as Spain, Ireland and Greece, with higher rates on inflation. As a result, real interest rates for Spain were close to zero.

First, having Spanish households wages growing with the inflation rate and real interest were close to zero or even negative, they thought that it was the right time to take a mortgage and buy a home. Banks also thought that it was the perfect time to push the sale of mortgages. The housing boom was based not only on these extremely low real interest rates but also in the inflow of more than 4 million immigrants. As a result, nominal GDP was growing at 6.5 percent per year, while mortgages were growing at 32 percent almost five times more than nominal GPD, when past experience shows that they should grow, at the most, the double.

Second, the construction sector was booming, reaching 16 percent per cent of GD and generating close to 20 percent of the total employment in the economy. In both 2006 and 2007, 700,000 new homes were started, an even larger number than in the US, which was suffering another housing boom but with 7.5 times more population than Spain.

Third, total growth was achieved mainly through the accumulation of labor and, in a lower extent, of capital, while labor productivity growth was very low and total factor productivity growth was close to zero or negative depending on the year. For instance, the Spanish level of labor productivity per person employed, measured using PPP, fell from 110.6 in 1995 to 103.7 in 2007, being the EU=100 in both years and being 116.0 and 109.3 the averages of the euro area. Spanish labor productivity levels per hour worked, being the EU =100, came down from 110.7 in 1995 to 105.8 in 2007, similar fall to the average of the euro area which fell from 120.1 to 114.4 in both years.

Fourth, from 2007, structural and cohesion funds from the EU budget were starting to diminish at a quick rate, having been, since 1987, almost 1 per cent of total GDP per year. Finally, internal demand grew at an average of 4.7 percent during that period. Consumption grew at 4.2 percent per year, investment in equipment goods at 5.5 percent per year and investment in construction at 6.7 percent per year. Internal supply also grew during the same period but at a lower rate, 3.8 percent, based on employment creation through immigrants and also a much higher participation rate by women.

The end result was a very large external imbalance. Spain's current account deficit reached 10 percent of GDP in 2007, one of the world's largest in percentage of GDP and the second largest in total dollar volume, after that of the US. It must be said that the US current account deficit was produced by a large fall in its saving rate and a relatively constant investment rate, while in Spain the saving rate was almost constant around the 20 percent of GDP during that period while the investment rate went up to 30 percent of GDP, like if it was an emerging country. Moreover, in Spain, most, if not all, of the current account deficit was invested, by households buying homes and firms buying equipment goods, buying other companies and establishing themselves abroad, while in the US it was mostly consumed.

The main problem in Spain was that most of its current account deficit was financed with foreign savings, mostly in euro and from the euro area. Unfortunately, these foreign savings were mostly invested in "bricks and mortar", instead of in the production of tradable products which could be able to generate foreign revenue to pay for the debts.

The Financial Crisis Got Spain on the Wrong Foot

The financial crisis caught Spain in a highly vulnerable position: First, with a high private level of external debt owed both by firms and households which had not been compensated by a higher savings by the public sector, so that it had to be mostly financed with external savings. Second, it arrived when the real estate and the construction sectors were absorbing a high percentage of the total real resources available and a large part of wealth of households and firms.

Third, with a large and sustained increase in internal demand, due, in part to price pressure, growing much faster than in the rest of the euro area, which appreciated the Spanish real exchange rate versus that of the euro area, absorbing almost 60 percent of its exports of goods and services.

Fourth, with a large increase in employment and disposable income, which generated a credit boom, both to buy houses and consumer durables, given a low risk premium and a low level of nominal and above all, real interest rates. According to the Bank of Spain, this private debt accumulation could be only justified if households and firms income would increase at above 2 percent per year during 10 years, that is, the double of their growth at that moment and even much higher than the present one.

In 1996, the Spanish economy did not need any foreign financing given that it had a surplus of 0.8 percent of GDP in its net foreign position with the rest of the world. But by 2007, its net foreign position had accumulated a deficit of 9.7 percent of GDP. This position consisted in a deficit of 11.1 percent of GDP by non financial firms, 2.7 percent deficit in households and a surplus of 2.2 percent of GDP by the public sector.

Real estate and construction were the two main drivers of debt accumulation, by both households buying houses and firms constructing them and other commercial real estate. The number of real estate transactions increased to almost 1 million in 2006 and 2007 and the total number of houses increased at a rate of 2.7 percent per year, increasing from 18.3 million to 25.1 million between 1996 and 2007 and by another million in 2008–2009 when many others were finished.

There was also a large speculative investment in houses as well by investors that were attracted by the expected upside value of houses while financial income was very low due to low interest rates. They were buying a house before it was built, making a down payment of 10 percent of the total price and selling it when it was finished tanking a huge return on the down payment of several hundred per cent.

Residential investment grew from 5 percent per year between 1990–1998 to 6.8 percent per year between 1999–2007, while in the US it only grew at 0.4 percent and in the euro area at 0.1 percent. House prices increased at an average of 10 percent per year between 1996 and 2007, so that house real appreciation achieved more than 30 percent during that period. Household real estate wealth increased by 18 percent in real terms between 2003 and 2006 and its weight in total wealth achieved 80 percent, when in Italy was 75 percent and in the US was 44 percent.

When the crisis started in 2007, the gross non consolidated stock of private debt, both internal and external, was 405 percent of GDP. Households had accumulated debt by 88 percent of GDP, non financial firms by 190 percent of GDP and financial institutions by 127 percent of GDP, but net foreign debt was only 90 percent of GDP. Credit achieved 170 percent of GDP, versus 120 percent of the euro area average. By contrast, total consolidated government debt was only 36 percent of GDP. One of the reasons for this low level of debt was that the real estate bubble had provided large tax revenue, mainly to the Spanish regional governments, but also the central government.

Unfortunately, the central government did not do anything to prevent the housing bubble, by increasing regulation on land use and urbanization. On the contrary, it maintained the very favorable interest payments deduction on personal income tax for household mortgages on their first home. The Bank of Spain, by contrast, invented "dynamic provisioning", now very popular among regulators, by which, banks had to provision every loan or credit at the time of giving it and not when it became non-performing. Banks were very upset, but they were able to build so called "generic provisions" of more than 40 billion euro, which were an important cushion when the financial crisis hit and non performing loans increased.

Moreover, banks had financed most of the debt of the private sector, both household mortgages and company loans. At the end of the bubble, both proved to have been given in extremely favorable good terms to households and firms. Banks then refinanced them in euro in foreign euro financial markets, by issuing covered bonds for the mortgages, other securitizations and placing senior debt. Unfortunately, when the crisis started, many investors stop buying any financial product related to mortgages because of the "subprime" meltdown.

The euro covered bond market was then re-nationalized and German investors were buying only "pfandbriefe" and French investors only "obligation foncières" but not the Spanish "cédulas hipotecarias." Later, after Lehman's default, the interbank market stopped, making it more difficult to tap foreign savings. Spanish banks engaged in a rush to buy deposits to finance their loans paying very high rates as well as appealing to the ESCB for liquidity through repos of government debt. In the end, there was a credit crunch that is still alive and well today.

The Buildup of the Sovereign Debt Crisis

Today, it is clear that the building up of the euro area sovereign debt crisis has been mainly due to, on the one hand, financial markets finally realizing the design failures of the euro area as a true monetary union and, on the other hand, governments being first in denial and later reacting too late with too little, while dragging their feet and being always behind the curve.

When writing this short paper, the sovereign debt crisis has deteriorated even more and the chances of a European monetary union failure continue increasing while euro governments continue moving slowly and reacting too little and too late. This is most probably the story of the worst government crisis management since the Great Depression and I have no doubt that it will be a teaching subject for a long time, independently of its final outcome, in most schools of government, political science and economics.

It is very clear that bad management by the euro leaders has played a major role in the crisis, but it is also clear that some member states had gone into a larger spending boom than others. This was for instance the case of Spain, which was used to so many years of economic, financial and fiscal revenue booms that most people in government, but also in the society at large, wrongly thought that it could last forever. The Spanish reaction to the recession which followed the financial crisis was a very large fiscal stimulus at the same time that fiscal revenue was falling.

Spain went, in a very short period of time, from a General Government budget surplus of 1.9 percent of GDP in 2007 to a budget deficit of 11.1 percent of GDP in 2009, 13 percentage points of GDP change in only two years. Part of it was due to a large fiscal stimulus, part to the working of the built-in automatic stabilizers and part to a large fall in fiscal revenue, due to the recession and to the puncture of housing bubble.

It was then, when it was felt the lack of a true market labor reform for many years, which produced again a rate of unemployment that reached 21 percent of the labor force. The yearly cost of such a high rate of unemployment has been more than 3 percent of GDP, mainly in unemployment subsidies both contributive and non contributive.

The fall in government fiscal revenue has been very high because part of it was due to the recession and another part to the real estate and construction bubble burst, which had been generating large fiscal receipts for many years, mostly for the regional governments but also for the central government. In sum, there was an issue of inefficient investment by the private sector and another of inefficient stimuli by the government. In principle, this situation was going to be manageable because there was not much to worry about Spanish finances when its debt to GDP ratio was still below 60 percent of GDP.

Nevertheless, the mismanagement of the Greek crisis was a huge mistake. The crisis could have been managed from the start by the IMF alone and, later, the IMF would have managed to restructure Greek debt without any large market reaction or contagion effect. The euro area leaders thought that the IMF involvement in the euro area member state was a "stigma" for the euro area and unfortunately did not let the IMF do its job.

The euro area leaders did not know or remember that the IMF intervened in the UK in 1976, in Italy in 1978 and in Spain in 1979. Moreover, they took such a decision without having any knowledge of how to manage debt crises and, what is even worse, any funds to inject to Greece in exchange of a conditionality program. Since then, every decision taken by the European Council not only has not created confidence in the markets but it has produced more uncertainty, less confidence and a greater contagion effect on to other member states until finally reaching some member states of the core of the euro area.

Spain Has Taken Serious Steps to Avoid Contagion; Strong Fiscal Contraction in the Short and Medium Terms

Between 2009 and 2011, the general government budget deficit has been reduced from 11.1 percent of GDP to 6.0 percent of GDP, that is, 5.1 percentage points of GDP in two years. There is a strong commitment is to achieve 3 percent of GDP in 2013, another 3 percentage points of GDP more in two years. Today, 60 percent of the fiscal contraction needed to cut the budget deficit to 3 percent of GDP in 2013 has already been achieved and most of the contraction is affecting expenditure.

In 2009, the general government budget balance was –11.1 percent of GDP. Within this, the central government represented -9.3 percent of GDP, the autonomous regional governments –2 percent of GDP and the local governments –0.6 percent of GDP. Social security was in surplus 0.8 percent.

In 2010, the general government deficit was reduced to –9.2 percent of GDP. The central government deficit was reduced to –5.0 percent of GDP, the autonomous regional governments deficit was increased to –2.8 percent, the local governments kept at –0.6 percent and social security went into a deficit of –0.2 percent of GDP.

In 2011, the general government deficit is being reduced to –6.0 percent of GDP, the central government deficit to –2.3 percent, the autonomous regional governments deficit increased to –3.3 percent, the local governments deficit reduced to –0.5 percent and the social security will be again in surplus 0.4 percent.

The main issue today has to do with the budget deficits of the regional governments. These are committed to get a maximum budget deficit of 1.3 percent of GDP in 2011 and at then of the first quarter they had reached 1.2 percent on average only 0.1 percent below the target. Unfortunately, most of these regional governments underwent regional elections and spent much more in the second quarter, so at the end of June, 7 of the 17 regional governments had already exceeded in June the target for the year of 1.3 percent, another 5 have reached the half of the year target deficit of 0.75 percent compatible with the 1.3 percent at the end of the year and another 4 are below 0.75 percent and 1 is in surplus.

The central government has warned those that they may exceed the target that they still need to reach their target at the end of the year and it has introduced three different stages of authorization controls over new debt issuance. Regional governments require authorization for debt issuance depending on their compliance with their budget rebalancing plan of the previous year. Every region needs to present a rebalancing plan if its budget deficit is above 0.75 percent of its regional GDP. Regions without a rebalancing plan will have to achieve a balanced budget from 2012 to 2014. Finally, the central government has already introduced its maximum expenditure ceiling for 2012, which is a drop of 3.8 percent versus the 2011 budget.

Higher Fiscal Sustainability in the Long Term

The first step has been the **pension reform**. Its main guidelines are: First, gradually increasing the statutory retirement age from 65 to 67 years and allowing retirement at 65 only for long-contributing careers. Second, tightening the conditions for early retirement and making partial retirement more expensive.

Third, the relationship between contributions and benefits is reinforced. On the one hand, the pension is now computed as a function of the last 25 years of career, with an increase of 15 years from the previous system. On the other hand, the number of working years needed to achieve a full pension entitlement is increased to 37 years.

Finally, to increase its long term sustainability, the parameters of the current new system will be automatically adjusted to the changes in life expectancy every 5 years from 2027 onwards. The expected yearly social security system costs reduction after 2030 will be of 1.4 percent of GDP. (21-07-2011)

The second step has been the approval by both houses of Parliament, by more than two thirds of the total votes, to introduce a *constitutional fiscal rule* of budget stability, limiting the structural deficit and debt. It limits the maximum growth of general government expenditure to the reference growth of the Spanish economy, using the simple average of the last five years annual growth rates of real GDP and the next four, plus an unchanged rate of inflation at 1.75 percent. Eligible expenditure does not include interest payments and non-discretionary unemployment benefits.

The exact limits are left to an organic law to be approved before June 2012, which also needs two thirds of the total votes, in order not to introduce into an article of the constitution so many the details. In principle, the proposed limit to the structural deficit (over the cycle) will be 0.4 percent of GDP (0.26 percent for the central government, 0.14 percent for the regional governments and 0.0 percent for the municipal governments). The date to be fully enforceable will be 2020, but limits to deficits will be established in the period 2015 to 2018. The maximum debt limit will be set at 60 percent as determined in the EU Treaty. (07-09-2011)

The Spanish present and expected debt path is the following: In 2010 it reached 60.1 percent of GDP, in 2011 will reach 67.3 percent of GDP, in 2012 68.5 percent of GDP, in 2013 69.3 percent and in 2014 will go down to 68.9 percent of GDP.

Faster Adjustment in the Housing Sector

Residential investment, which in 1995 accounted for 4.4 percent of GDP, increased up to 9.3 percent of GDP in 2006. At the end of the second quarter of 2011 was already below the percentage of GDP of 1995. Its year on year growth has been -16.8 percent in 2010 and -5 percent in 2011, which have reduced GDP growth by 1.0 and 0.2 percentage points in both years.

Average real price housing adjustment up to 2011 Q1 was 27.6 percent going from 20 percent to 35 percent in different regions and the stock of unoccupied housing is on average 2.7 percent oscillating between less than 1 percent up to 5 percent in different regions. The average yearly demand for housing is around 350,000 units but the stock of finished and unsold houses doubles the yearly demand. The fall in real estate prices is reducing household leverage given that the home ownership rate in Spain is 84 percent of total households one of the highest in the world. The same happens to real estate firms which were also highly leveraged because leverage has been mainly concentrated in real estate and construction.

Several Important Structural Reforms

Labor reform tries to achieve the following targets: First, to foster hiring by improving an existing labor contract with an improved definition of the causes of fair dismissal and by lowering severance costs for employers. Second, to incentivize working day reductions, to avoid provoking dismissals or suspensions, by introducing the "German model" for a reduced work schedule Third, to enhance internal flexibility by facilitating the opting out from higher-level collective agreements when companies are under stress. Fourth, to give incentives for the hiring of young workers through the introduction of a training contract and also by forbidding, for the next two years, any limitation to roll over temporary contracts.(19-09-2010)

Collective bargaining reform gives incentives to increase the development of firm level collective bargaining by allowing firms under certain circumstances to opt out of their collective agreements and also by giving incentives for renegotiating new collective agreements before the expiration of the previous one.

These measures try to reduce the traditional high responsiveness of employment to negative activity shocks. These measures are already facilitating adjustment in the labor market different from firing, such as short time working contracts and wage flexibility within the firms. (26-08-2011)

Active labor market policies have also been deployed. The unemployment rate is still too high (20.9 percent) mainly due to the difficulty of reallocating 4 percent of the total labor force that has lost their job in the construction sector after the housing boom went bust and are not fit to do other jobs. These policies include: Incentives for hiring young people on a part-time basis by reducing social security contributions by the hiring firms. Personalize career advice for young unemployed, older long-term unemployed and unemployed from the construction industry. An unemployment assistance grant, conditional upon training courses once unemployment benefit has expired and finally the creation of private employment agencies (11-02-2011)

Product market reforms on SMEs: reducing their corporate rate tax to between 20 percent and 30 percent; reducing the maximum time to incorporate them to 5 days; accelerating payments in arrears by municipalities; exempting capital gains tax for entrepreneurial projects by business angels; improving the viability of companies undergoing difficulties through agreements with creditors and a free amortization scheme for new investments. (03-12-2010 and 07-07-2011).

Privatizations: Airports: Separation of airport operation and traffic control (15-02-2011). Madrid and Barcelona airports are given on concession to private operators (Nov 2011). 49 percent of the National Airport System is privatized (first quarter of 2012) Expected revenue: 3 to 4 billion euro. Lotteries: New gambling law, separation of regulation and operation and regulation of on-line gambling (May 2011). Privatization of 30 percent of the National Lottery (November 2011) Expected revenue: 7 to 9 billion euro. Telecommunications: Introduction of technological neutrality in the usage of spectrum, reallocation of the TDT extra-spectrum to telephone services and spectrum auction (July 2011) Expected revenues 1.8-2.0 billion euro.

Saving bank system restructuring: Saving banks, which in their over 200 year's existence suffered very few casualties because they were sticking to their territory in which they knew every one of their clients well so their non-performing loan ratio was very low. At the same time, as they were not quoted and did not have shareholders, they were only making a payout of around 25 percent of their profits in the form of a "social dividend" that was invested in the region and it was very appreciated by their citizens, while quoted banks' dividend payout was 50 percent on average.

As they were so much liked by their customers, they were able to pay less for deposits and to charge more for loans than the banks. Therefore, they had good profits and low payout so that they never had a shortage of capital problem. Their main problem was that of governance, since their boards were mainly formed by local and regional politicians, which, in some cases redirected loans to projects that end up in disarray.

This nice picture changed when, in the 14-year boom period, they decided to lend more in their own region, with higher economic and political risk, to cover many other regions or the whole of Spain with branches and even to get foreign presence, notably in Latin America. This fast increase in their activity made them to be a larger group than the rest of the Spanish banks both in deposits and loans, but also to increase their risk more than what they expected, mainly in real estate and housing sectors because they had always been the leaders in mortgages.

Unfortunately, in the middle of this expansion they were caught by the financial crisis and the burst of the housing bubble. Something similar happened to small and medium size banks which decided to grow faster during the housing and growth boom period.

The first step by the Central Government and the Bank of Spain was to create the FROB a government fund with 36 billion euro (that could be increased to 99 billion) in order to liquidate nonviable entities and to support the restructuring process of the viable ones. The support was conditional to cutting 25 percent of branches and 18 percent of employment.

Of the 45 saving banks, only three, of similar size, have become insolvent and taken by the FROB. Two of them have been restructured and sold in an auction to other saving banks and a third one is in the process now to be auctioned. In other cases, the FROB has injected capital temporarily in the savings banks in order to get out during the expected IPO.

The second step was to reform the regulation of the saving banks in the sense that all had to consolidate as much as possible and to become, in a period of one year, quoted banks by doing an IPO with at least 40 percent of it coming from institutional investors and a maximum of 60 percent from retail investors.

The end result is that of the 45 initial saving banks the present number is only 15 and may be less than that in half a year time. In 4 of the 15 final groups after consolidation, the FROB did not need to give financial support, in another the quantity was minimal, and in total the FROB financial support up to now has been around 10 billion euro, which is a very low figure compared to most other euro area member states. As a reminder, there are around 7,000 banking institutions in the EU, of which, Germany has the largest number with around 2,400, of which, around 1,400 are owned by the state governments or the public sector.

The third step has been to increase the minimum capital requirements of all the saving banks converted into banks and the rest of banks up to 8 percent of total weighted assets and to 10 percent for banks that depend more than 20 percent on wholesale funding or that have more than 20 percent participation of third parties in their equity. Capital requirements to reach these thresholds in 13 large banks reached 17 billion euro. The FROB may intervene as a backstop in the form of instruments convertible into common equity before December 2014.

Finally, the Spanish banking stress test, conducted in 2011 under the supervision of EBA, the new European Banking Authority, has been one the most comprehensive, with 25 banks, covering 28 percent of all the sample of European banks subjected to the test, and 93 percent of the all the Spanish financial sector assets. The 25 Spanish banks passed the test when considering key mitigating instruments, generic provisions and convertible debt, under very harsh assumptions such as a fall in GDP of 2.1 percent in 2011 and 2012, a fall in house prices of 21.9 percent and in commercial real estate of 46.7 percent in the two year period

Competitiveness

One of the most important issues raised by the Euro Pact Plus is competitiveness based on unit labor costs (ULC). But in this pact, as with everything else, the benchmark is Germany, as if there was a correlation between competitiveness and bond spreads. Of course, if the benchmark is Germany, then every member state is apparently not competitive because Germany is the only member state that enter the euro area voluntarily with a high exchange rate and later did a real devaluation by reducing its wages in order to grow, given that its internal demand was flat or negative during many years and needed exports to grow faster.

Nevertheless, real data show that there is very little relation between ULC and exports and export market shares. Spain is one of the member states which have lost more competitiveness in the euro area according different measures of relative prices, but strangely its export performance within the euro area and worldwide has been quite good.

According to the WTO, the Spanish market share of total world merchandise trade has been the following: between 2000 and 2010, Spain has lost 0.4 percentage points of market share, from its peak in 2004, that is, from 2 percent of the total in 2004 to 1.6 percent of the total in 2010. In terms of ranking of the top world exporters of merchandise, Spain has lost three positions, from 15th to 18th.

But other euro area members have also lost market share, mainly because of the eruption of China and other emerging exporters. Germany has lost market share from its peak of 9.9 percent of the world total in 2004 to 8.3 percent of the world total in 2010, that is, 1.6 percentage points and, in terms of ranking, it has lost also 2 positions, from 1st in 2004, to 3rd in 2010, after China and the US.

France has lost 1.6 percentage points of market share, from its peak of 5.0 percent of the total in 2004, to 3.4 percent of the total in 2010. In terms of ranking, it has lost 1 position, from 5th to 7th. Italy, has lost 1.1 percentage points of market share from its peak of 4 percent of the total to 2.9 percent in 2010 but is has maintained the 8th position.

In world total exports of commercial services, Spain has lost 0.6 percentage points of world market share from its peak in 2004, that is, from 3.9 percent in 2004 to 3.3 percent in 2010, but is has kept its world ranking position in number 7th. Germany has lost only 0.2 percentage points of world market share since its peak in 2004, from 6.5 percent of the total, to 6.3 percent of the total in 2010 and it has gained 1 position to number 2nd. France has lost 1.9 percentage points from its peak in 2000, from 5.7 percent of the world total to 3.8 and it has lost 2 positions from 3rd to 5th. Italy has lost 1.4 percentage points, from 4.0 percent to 2.6 percent and has lost 6 positions from number 6th to number 12th.

Within the euro area, I only have data overall up to 2009. From 2000 to 2009, the Spanish market share of total merchandise exports in the euro area has been maintained in 3.5 percent. In the same period, Germany has increased 0.2 percentage points its market share from 13 percent to 13.2 percent. France has lost 1.3 percentage points from 8 percent to 6.7 percent of the total and Italy has lost 0.6 percentage points, from 5.5 percent to 4.9 percent of the total. According to the balance of payments calculations by the Bank of Spain, the Spanish goods export quota in 2010 to the euro area has increased to 3.9 percent, 0.4 percentage points in one year!

During that period the real effective exchange rate of Spain has appreciated versus the euro area average by 9.7 percent measured by the relative CPI, by 4.6 percent measured by the relative export prices and by 12.6 percent measured by the relative unit labor costs in manufacturing. How is it then possible that with such a loss of real competitiveness, can Spain maintain its market export share in the euro area and even improve it in 2010 by 0.4 percentage points, which is its most important market for goods and manufactures, absorbing 57.3 percent of its total exports? There could be several explanations:

The first is that competitiveness within the euro area seems to be more strictly correlated with internal demand than with productivity and ULC. The argument is the following: if labor productivity growth is considered permanent, it produces a permanent increase in workers income, so there will be an increase in internal demand both in consumption and investment. Labor may became scarce and wages will go up reducing competitiveness.

Nevertheless, the Spanish internal demand has been growing much faster during these 10 years than any of the other three largest member states of the euro area. Therefore, it does not work as an explanation for Spain because it is maintaining its export market share in the euro area. Conversely, the external demand within the euro area grew faster for Germany and Italy than for France and for Spain. Being external demand index 100 in 2000, the index in 2009 for Italy was 115, for Germany 113, for Spain 110 and for France 109.

The second is that Spanish goods may have been improving in terms of quality and therefore in terms of value enough to compensate for its loss in price and costs competitiveness. This can only be known when hedonic prices will be computed within the euro area.

The third relates to the relative composition of exports. There is a recent and very interesting research done by Goldman Sachs on the euro area relative export performance that constructs a measure of "revealed price elasticity index" of each exported product by each member of the euro area showing that member countries with price sensitive exports such as Greece and Portugal, suffer substantially more than member countries with price-insensitive exports such as Spain. If, on average, countries run a quantity trade surplus in a low unit value good, then, it is revealed that the market for that good is price dominated. If, on the other hand, countries run a surplus in a high unit value good, the implication is a quality-dominated market through vertical differentiation.

The most quality-dominated products are chemical products, rubber, plastics, motor vehicles and pharmaceuticals. Germany is the most relatively skewed towards capital goods but also chemicals and motor vehicles, Spain scores well in all these kinds of goods. Moreover, Spain is the member country with the highest price insensitiveness index, followed by Germany, Belgium and Sweden. Being 100 the most inelastic, Spain scores 59.9, followed by Germany (58), Belgium (57.5), Sweden (57), Austria (56), Ireland (55), France (54.5) and Italy (52.2). Greece and Portugal are below 50.

The Balassa indicators of the OECD, based on the sectoral technological intensity of exports, tend to confirm these results. Spain is specialized in intermediate products, of medium to high technology where there is less competition, or are off-shored so that the subsidiary manufactures it for the parent company without competition. It is also specialized in other products of medium to low technology, such as agricultural products (fruit and vegetables) fish products, wine and tobacco, textiles, leather and shoes, but with a known trademark.

Finally, Spain has very important multinational companies established in Europe and in the US as well as in emerging countries, notably in Latin America. Its main sectors are banking and insurance, telecommunication, travel and tourism, construction and infrastructure management ,telecommunications and technology and energy. Its FDI reached 44.2 percent of Spanish GDP in 2009.

Conclusions

Spain has generated during its membership in the monetary union and in the euro area, very large fiscal, credit and current account imbalances that need to be corrected as soon as possible, but it is making progress to reduce them except in growth and unemployment.

From the fiscal point of view Spain has been the second fastest growing member state of the euro area, after Ireland, during the last 50 years and it should regain a normal rate of growth in the next four to five years. It is also one of the member states with the lower debt to GDP ratio but its general government deficit needs to be brought to 3 percent of GDP as soon as possible. It is also one of the few with the higher age of retirement and one of the very few with a balance budget and a top level of debt clauses in its constitution.

From the competitiveness point of view, it has now one of the most concentrated and efficient banking systems in the euro area as proved by the stress test. Its external competitiveness is quite high, according to its market shares of exports within the euro area and worldwide. By contrast, its internal competitiveness is still low and needs quick progress to enhance it.

Finally, it is one of the member states which are trying to implement more structural reforms, not all with enough level of success, to improve growth potential. In spite of all that, nevertheless, it is also one of the member states which are paying higher spreads when placing its debt.