Spain: Spiraling Downward in Greek Fashion?

The current approach to managing the sovereign debt crisis is so absurd that it will wind up destroying the European Monetary Union—perhaps even faster than anyone dares to imagine today. With the economy in free-fall since mid-spring, pressing ahead with fiscal adjustment programs means exposing Europe's crisis-ridden countries to major risks.

Spain's creditors initially greeted the new austerity plan unveiled by the Rajoy administration with a sigh of relief. Immediately after the prime minister's announcement, long-term interest rates fell by a substantial 20 bps to 6.60 percent. The pledges offered by the Spanish government in exchange for greater flexibility in meeting the deficit reduction targets set by Brussels seem to have convinced observers. What probably made the biggest impression were the promises to overhaul public administration, with the number of local government councilors to be cut by 30 percent, and at the same time to raise the value-added tax rate by three percentage points.

Yet there are serious grounds for concern about whether Spain can overcome the crisis in this way. The new package, which amounts to €65 billion for the period from 2012 to 2014, or 6.5 percent of current gross domestic product, is exceedingly restrictive, especially for an economy that is already in recession. **There is a very real danger that all these efforts will ultimately prove futile, because they cost too many points of growth. And the related danger that Spain may already have entered a Greek-style downward spiral should not be underestimated.**

A Devastating Austerity Plan for Households Already on Shaky Ground

Austerity programs typically start to look less and less effective as economic growth becomes harder to achieve. Particularly disturbing is the tendency of governments to step up implementation of their structural reform agendas at such times, because they run the risk of creating a debt-recession spiral that soon spins out of control.

Spain's new austerity plan saddles the country's households with a very heavy burden indeed:

- **The VAT rate hike**—3 points on the normal rate (from 18 percent to 21 percent, after a 2-point increase in July 2010) and 2 points on the reduced rate (from 8 percent to 10 percent, after increasing from 6 percent to 8 percent in 2010)—could raise the general price level by between 1.2 percent and 1.5 percent. And because the government plans to introduce it as of August (during vacation time), it will take an even larger bite out of purchasing power.

- **The cut in unemployment benefits,** from 60 percent to 50 percent of the worker's last salary as of the sixth month without work, will strongly affect Spain's rapidly expanding jobless population, which has already exceeded 25 percent of the workforce and 50 percent of the under-25 age bracket.
- **Elimination of the Christmas bonus for public sector employees** (equal to a "fourteenth month" of pay) and drastic downsizing of the local government workforce will have a major impact on the country's three million public sector employees (18 percent of all wage and salary earners).

Given that household purchasing power was already trending downward at an annual clip of 4 percent in the first quarter of 2012, in line with the job destruction rate, the additional decline to be expected from this new package is bound to be devastating.

To make matters worse, very little is being done to cushion the blow.
While the program for privatizing a number of public sector entities has the advantage of raising revenue that can go directly to paying down the national debt, in the short term it will probably bring further layoffs. That leaves the reduction in payroll tax (covering social security benefits), by one point in 2012 and another point in 2013. In the current environment, it seems unlikely that it will have more than a token effect.

Inevitable Deepening of the Recession in 2013

When all these issues are factored in, a much deeper recession in Spain than previously forecast becomes a very realistic scenario. So far, consumer spending has held up well despite dwindling purchasing power, but the Spaniards cannot go on indefinitely taking money out of their savings. Our first estimates suggest that purchasing power will shed another 2 to 4 points, which should translate into an annual contraction in real household disposable income of anywhere between 6 percent and 8 percent, depending on how fast the new measures are introduced. At best—that is, assuming a further decrease in net savings—household spending will fall off by between 4 percent and 6 percent next year. In Spain as in the rest of the region, consumer spending accounts for nearly 60 percent of GDP, so a shock of this kind will do major damage. For example, the export support programs that added up to 2.6 points to annual growth last year are already a thing of the past. And while the Spanish economy has made important strides these past two years on the road to competitiveness, the gains achieved will be of little use now that global demand is plummeting.

Quite plainly, this is a disquieting picture. Spain's leading economic indicators already suggest a substantial fall in gross domestic product: according to our estimates, by 0.8 percent in the second quarter and by 1.2 percent in the third quarter (assuming no additional fiscal tightening!). In this scenario, the latest austerity measures cannot fail to put a large dent in economic activity, and therefore in the country's public accounts, because even in a period of fiscal consolidation, a recession costs the government money. No one doubts at this stage that real GDP will contract by between 2 percent and 2.5 percent this year. But the forecasts for 2013 are even more alarming. They suggest that far from tapering off, the recession will get much worse, with real GDP likely to shrink by over 3 percent! How can Spain possibly be expected, under these circumstances, to

meet even the revised target of bringing its deficit down to 6.8 percent of GDP this year and then to 4.5 percent next year?

There is therefore a very real danger that Spain will enter a Greek-style debt-recession spiral. If it does, the relevant question is by what means the country can pull out of a crisis that looks so strikingly like the one in which Greece is currently trapped.

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