EUROZONE ENLARGEMENT: SPAIN'S ECONOMY BEFORE AND AFTER THE EURO

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"Joining a single currency union like the eurozone comes with economic costs and benefits that each nation has to weigh up. Liam Brady explores these costs and benefits for the Spanish economy since joining the eurozone up until present day. The improvements in economic growth, employment, and fiscal responsibility that came from eurozone membership are balanced against the loss of monetary policy sovereignty which limited Spain's ability to deal with the global financial crisis. Brady goes on to show that this crisis, despite its devastating effect on the Spanish economy, created the pressure necessary to make the long-needed reforms to banking, fiscal policy, and labour markets that has helped integrate the Spanish economy into the European framework."

Introduction

Spain is one of the largest economies in the EU and saw substantial economic growth upon joining the Eurozone. Through membership, the Spanish economy doubled in size, unemployment fell, and prices rose. With the global financial crisis and subsequent fallout, Spain was forced to fundamentally reform its banking sector, fiscal policy, and labour market. Without the Eurozone, and the crash it entailed, Spain would not have the economy it does. In order to understand this process, this paper will look at Spain's journey through the Eurozone, from before joining to the modern day. Overall, Spain was able to grow in the Eurozone to a more competitive economy, although much work remains to be done.

Before the Euro

Before the Eurozone, the Spanish economy had fundamental issues. In recovery from

Francoism, Spain maintained many worker protections that increased business costs. For example, companies were expected to pay high severance to fired workers. Hiring new workers was also expensive, with red tape increasing the cost of legal employment. As such, Spain was characterized by high official unemployment, with many workers unable to get a job, or working in temporary or black-market employment. In the 1990's, official unemployment never fell below 15%, peaking in the mid-1990s at 24% (Spain Unemployment Rate, 2021). The reliance on temporary workers, and the high unit cost of labour, meant that the Spanish labour market was woefully inefficient.

Spanish banking was also severely flawed. Spanish regional governments controlled saving banks, called Caja de Ahorros, that were established to provide alternatives to commercial banks. Eventually, the 45 regional 'cajas' competed with normal commercial banks, providing all the same services. These cajas were poorly regulated and controlled by local politicians, making them considerably less fiscally responsible than commercial banks. Little oversight was given, and the system was rife with corruption and unsound decision making. Caja chairmen were usually local politicians, with little to no banking or financial experience.

Before entering the eurozone, the Spanish current account ran only a small deficit (Spain Current Account, 2021). Entering the Eurozone was expected to facilitate trade with the rest of the EU, as Spain had lower input costs and could seemingly develop quickly. Spain was an early Euro adopter, and expectations were high for the new union.

Entering the Eurozone

Upon entering the Eurozone, the Spanish economy was relatively underdeveloped. Spain had lower GDP per capita than larger economies and relatively high unemployment. With sedated economies like Germany becoming the focus of European monetary policy, Spain had low interest rates relative to the capital requirements for the economy. This encouraged the growth of capital hungry industries, and raised the price of domestic goods, especially assets.

The current account deficit burgeoned under the Euro as investments and goods came into Spain. Investment from around the Eurozone was easier than ever before, and higher returns could be expected from the quickly developing nation. By 2007 the current account deficit accounted for 9.6% of GDP (Spain Current Account to GDP, 2021). These investments helped to bring up Spanish GDP and standards of living over the period. GDP per capita rose from $14,713 in 2000 to $35,366 in 2008 (World Bank, 2019). Hidden within these numbers is high inflation in both goods and assets, with Spain having higher inflation than the Euro average for most of 2000-2009 (Euro Area Core Inflation Rate, 2021). This high demand for goods was also a cause of a high current account deficit.

This economic growth allowed the government to reign in its usual budget deficit. While Spain ran a deficit throughout the 1990's, the government was able to run a surplus from 2005 to 2007 (Spain Government Budget, 2021). This led to Spanish debt to GDP being considerably lower in Spain than the Euro area average. In 2007 Spain had a sovereign debt of 35.6% of GDP, compared to a Eurozone average of 62.2% (Spain Government Debt to GDP, 2019). Although a reduction from the 1990's, the real debt remained constant for most of the period, with the reduction in debt to GDP coming almost entirely from GDP growth.

With low interest rates and large amounts of foreign capital entering the country, Spain quickly saw the expansion of their construction industry. Property values rose as low interest rates financed higher property values and speculators bought property up. Construction became a large employer in the economy, however the demand for housing could still not meet supply. Workers were seeing huge increases in nominal wages and were investing that into housing. Home ownership was some of the highest in Europe and the secondary home market was twice the European average (Romero, 2020). Property taxes allowed the government to tackle debt.

Property Market Crash

Until 2008, the Euro seemed to only help Spain. Unfortunately, the crash of the Spanish property market in 2008 uncovered the unsustainable systems behind the economy. In 2008 the Spanish property market was revealed to be a bubble, and it popped. The market had seen constant growth for a decade and homes were highly overvalued. Pushed by low interest rates and high employment, the property market was not reflective of the real value of real estate.

An important aspect of the crash were the cajas, who held 56% of all Spanish mortgages at the time of the crash. The cajas were rife with corruption and bad business practices. Generally, cajas had been run by politicians and their appointees, with little banking experience. Unsurprisingly, many of the mortgages issued by cajas were irresponsible. Politicians were incentivized to give their constituents loans, and often took large payouts for themselves, keeping reserves well below necessary (Tremlett, 2012). When the property market stalled, more than 5% of mortgages issued by cajas were underwater.

At the same time, the crash brought construction to a standstill. With the price of housing falling 30% over the period, no new housing was going to be built for several years (Karaian, 2013). The almost overnight destruction of the industry contributed to Spanish unemployment rising from 8% in Q4 2007 to 17.24% by Q1 2009 (Spain Unemployment Rate, 2021). These simultaneously gutted the government's ability to collect property and income taxes, contributing to a government deficit of 4.65% of GDP in 2008 and 11.3% of GDP in 2009.

If Spain was not in the Eurozone, it is possible some of these issues could have been resolved through a currency devaluation. By making their currency cheaper, Spain could increase foreign investment and boost their economy. As they were part of the Eurozone, this was impossible, and Spain had to deal with their economic situation without this monetary tool. As the Euro had built Spain up, it trapped the nation on the way down.

Naturally, the government increased spending in 2009 to encourage economic growth. Without monetary policy, it turned to the fiscal policy it could control. Importantly, the Spanish system for collecting taxes was carried out on a national level, but spending was mostly left up to local regions. By 2011, pressure was on Spain to institute austerity and balance its budget. Austerity measures were hard to manage politically, as reducing the funding to regions had to be negotiated with 45 different local governments (Badkar, 2012). This made austerity slower to enact in Spain, frustrating the EU and Spanish debt holders.

Furthermore, it became apparent by 2011 the cajas needed to be saved from their bad loans. Other lines of credit had dried up, and these savings banks were unable to back up their positions. This further contributed to the government deficit. At the same time, Spanish bonds were becoming difficult to sell. By 2012, the interest rates on 10-year Spanish bonds became prohibitively expensive. The government did not have enough money to bail out the banks and was unable to issue loans. It became clear the EU would need to get involved to handle the debt.

The EU bailed out the Spanish banks in 2012 for €100 Billion (Enrich and Forelle, 2012). However, the banks still needed help, especially prominent cajas. As such, the EU extended an offer for more credit contingent on Spain joining the European Stability Mechanism, the successor of the EFSF (ESM, 2021). The ESM was able to continue supporting Spain and keep them in the Euro. Spain needed fundamental reforms to grow without EU subsidies, many of which were not domestically popular. However, these changes were necessary to stay in the Euro.

Reforms to the Spanish Economy

Spain heavily reformed the caja system following its role in the financial crisis. Many of the regional banks were incorporated into local private banks, hurting domestic shareholders. Others, like La Caixa and Bankia consolidated and continued operation. These savings banks continued with new rules on governorship and conflict-of-interest. With proper oversight and less perverse incentives, the banks were expected to operate more responsibly into the future (International Monetary Fund, 2012). Private banks in Spain already had the reputation for being overly cautious with reserves, so the new regulations improved sector confidence. Without EU pressure, it is unlikely that Spain would have done this on their own.

Labour markets also needed reform. While hiring and firing workers was expensive before the crash, reforms in 2010 and 2012 made the labour market more flexible. Unions were given less control over national wages and industry wide contracts (Eurofound, 2012). The new laws made it much easier to hire new workers, and as such the unemployment rate began to fall in 2014 (Llantada, 2014). This was down from the peak unemployment of 27% with young people hit even worse. Still, issues remained in the Spanish economy around unemployment and underemployment. Temporary jobs and work off books hides a lot of underemployment in the economy, and the unemployment rate does not reflect that.

To receive a bailout and remain in the Euro, the Spanish government had to reduce its deficit by instituting austerity. A significant issue was that the collection of taxes was done unilaterally, while spending was decided locally. This created overspending and under-collection of taxes, requiring complex negotiations to bring in austerity. This was resolved in 2011 through a change to the Spanish constitution that required a balanced budget by regional and federal exchequers by 2020 (Badkar, 2012). The budget deficit was highest in 2009, at 11.3% of GDP, but remained high until 2013, when it reduced to 7%. The deficit shrunk annually until 2020, with a 2019 deficit 2.8% of GDP. During this time, government debt reduced as a percentage of GDP from a peak in 2014 of 100.4% to 95.5% by 2019 (Spain Government Debt to GDP, 2019). Although it is far above the 2006 35.6%, the government was on track before the Covid-19 Pandemic.

Since the reform period, the Spanish current account has returned to pre-Euro levels, with Spain exporting as much as it imports. This shows that the Spanish market is capable of meeting domestic demand. As Spain continues to grow out of the recession, the Eurozone will facilitate capital flows between Spain and other nations. Spain trades with many nations outside the Eurozone, however membership of a large currency aids these trades (World's Top Exports, 2021).

Current Challenges

Unlike the property crash of 2008, the Coronavirus pandemic was an unprecedented and unavoidable economic shock. Spain's tourist industry, which represents a large sector of their economy, was badly hit. By being an EU member, Spain can avail of collective relief and vaccine distribution efforts. Although not a fix-all, the Eurozone membership will also go far to stabilize banks and financial markets. Little to no discussion was held on the possibility of Spain being forced out of the Euro, or if the union was untenable. These point to economic progress and Spain's newfound security in the union.

Challenges remain with unemployment, however. With the pandemic, unemployment rose to 16.1%, one of the worst rates in the EU, before falling to 13.3% by January 2022 (Spain Unemployment Rate, 2021). Youth unemployment rose to 40% by the start of 2021, before returning to 30% by November 2021 (Spain Youth Unemployment Rate, 2021). Youth unemployment is a major issue Spain must tackle in the coming years. Since emigration is easy many young people, especially the best educated, choose to leave Spain for other nations when they cannot find jobs. Being in the Eurozone only compounds this, as the wage information and ease of remittances reduces moving costs. As such, Spain will need to strengthen its youth employment going forward.

Similarly, Spanish business is currently fickle and uncompetitive. Although the business sector has developed considerably since joining the Eurozone, Spain is lacking in competitiveness where it counts. Young people are generally not willing to start a new business, with the concerns around expenses and volatility being very important (Alemany et al., 2011). Spain ranks 30th in ease of business by the World Bank (2021). Since the crash in Spain, banks have been particularly wary of investing and lending. As such, entrepreneurial business loans are not accessible for many potential businesses. The EU and Eurozone can aid these processes through more business focused measures. The openness of the Spanish economy today can be credited largely to EU markets. Spain must also make entrepreneurship easier, through internal reforms of the bureaucracy.

Conclusion

In the end, the Euro has been a double-edged sword for Spain. In many ways, the Euro has increased the quality of living and competitiveness of the economy. However, it also exposed the deep flaws in the Spanish system and forced them to be corrected. Spain still has problems with its labour market; however, the Eurozone pressed for more open and flexible labour. The caja system, which would eventually lead to a recession, was finally scrapped and replaced with a modern banking system. Spain saw its public debt skyrocket, but now has instruments to address its spending and taxation in a uniform manner. If Spain stayed out of the Euro, it is unlikely it would have suffered the worst of the global financial crisis. However, Spain today would be much more like the Spain of the 1990's, underdeveloped and in need of fundamental reforms. The Eurozone forced Spain to fit its economic decisions into a European framework. While this transition has enacted a toll on Spain, the economy has grown larger and more robust because of it.

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