The sovereign debt crisis of Spain

- **The implications of private debt and unemployment in the context of membership of the EU and EMU**

Master's Thesis

Master of Science in Economics and Business Administration

Finance and Strategic Management

Academic Advisor: Finn Østrup

Authors: Anders Ladegaard-Pedersen

Daniel Galliano Dalgaard

13 November 2012

Copenhagen Business School

Characters (incl. spaces): 231.937

Number of standard pages: 117

Executive summary

Motivated by the current debt crisis in the European Union (EU)'s PIIGS countries (Portugal, Ireland, Italy, Greece and Spain), we have chosen to focus on Spain because it reveals significant differences from the other PIIGS countries, mainly because it suffers from high private debt rather than public debt. It will be highlighted how favorable macroeconomic factors coupled with lower interest rates (due to the integration of the Euro) and excessive lending by the banking industry, which was believed to be one of the most solid in the world, generated a property bubble which was doomed to burst. It kick-started the economic crisis in Spain, and magnified the private debt, as the banks were not as solid due to the "Dynamic Provisioning" accounting method, which made banks look healthy when they in fact were sick. The crisis has resulted in an explosion in unemployment and stagnation of GDP growth, which in turn increases the public debt and public deficit that were otherwise healthy, prior to the crisis. The crisis in many of the southern European countries, and in our case Spain, is the product of macroeconomic flaws triggered by the EMU, and thus the rules of the game for the Euro and future measures are crucial for the future economic stability of Spain. Through analysis of previous similar crises, we will show how Spain can draw lessons from solutions that have benefited the respective countries. We will mainly use Ireland and Iceland and, very briefly, Finland and the East Asian crisis as case studies coupled with the crisis management theory of the OECD which divides economic crises, and the crisis management thereof, into three different phases. With the similar crises in mind, we will be able to draft possible solutions for Spain in the context of the OECD theory. Namely in the phase of *resolution and deleveraging* Spain can use other previous crises as a benchmark. Firstly, Spain should consider both the pros and cons of a possible bail-out. In doing so, it should be weighed up against a bail-in, where the Swedish Model is mentioned by many experts as being most successful. Secondly, Spain can internally improve its situation through austerity coupled with new labor reforms and improved entrepreneurial and innovative measures. It is clear that Spain suffers under the macroeconomic flaws implied by the EMU, increasing cyclical instability and unemployment, and lacks the ability to correct the demand shocks by manipulating the currency and interest rates, since its currency was replaced by the Euro.

Introduction

In the aftermath of the global financial crisis, that stemmed from the collapse of the United States (US) investment bank Lehmann Brothers, a new crisis has arisen, namely the sovereign debt crisis of Europe. The crisis has shown the vast discrepancies between the different member countries of the European Union (EU) and Economic Monetary Union (EMU), leaving some of the weakest economies in ruin. One of the worst examples is of course Greece, which has been the center of concern for a long time, as well as Portugal and Ireland. All of the mentioned countries have received financial aid from the EU, and are struggling to consolidate their public finances. Recently however, there has been a shift of concern in Europe. The eyes are now set on Spain and Italy as problematic economies of the EU. The addition of these countries to the list of attention created the foundation for a new reference group of countries often mentioned as the PIIGS, describing Portugal, Ireland, Italy, Greece and Spain as the main concerns and problems of the Euro zone. While Italy is struggling somewhat, Spain is by far the biggest concern, and also the biggest economy among the PIIGS.

Spain, the Euro zone's fourth biggest economy, is caught in an increasingly desperate spiral of deepening recession, drowning banks and soaring borrowing costs[1]. Hence Spain poses the single most difficult problem in the Euro zone. Furthermore, Spain is a very interesting case in terms of PIIGS, because prior to the crisis it was well within the Euro zone's fiscal rules, and even now during the crisis, government debt at around 70 % of GDP, is lower than Germany's – the financial muscle of Europe.

This paper therefore intends to investigate the root causes of the current Spanish crisis. The two authors will go back in time and find the most significant causes that have led to the current crisis: A crisis that has been fueled by private debt and a property bubble, rather than public debt. This has further heightened the curiosity of Spain as an interesting country to analyze compared to many of the other PIIGS where public debt has been the major headache – one of them the most crucial example, Greece. When the causes of the Spanish crisis have been established, we will investigate the measures already taken by the EU, the European Central Bank (ECB) and the International Monetary Union (IMF) to prevent the crisis from prolonging. In addition, we will

[1] http://www.economist.com/node/21556238

investigate the crisis management of similar crises in other countries, and draw comparisons to Spain. We will comment on these and give our opinion on the anticipated effect and the actual influence. Later we will look deeper into possible future solutions for saving Spain.

Following our conclusions on the possible solutions to the crisis in Spain, we will broaden our view and present a future outlook for the Euro as a whole.

As such, our problem statement for this paper is as follows.

Problem statement

What were the origins and root causes of the Spanish crisis? What were the macroeconomic effects of the impact of the crisis? What was the framework of the EU and the EMU, what changes have been made, and how does this affect Spain? How has crisis management been conducted in similar crises? Which solutions can be applied to Spain, to accommodate the crisis? What is the outlook for the Euro?

Limitations

As the European sovereign debt crisis is very broad and complex, we will focus our analysis on Spain, which is the most interesting economy to investigate at the moment. The last part of the paper will in short highlight the problems and future for Euro zone as a whole.

The current European economic climate is changing almost every day, while this paper is being written. This also makes writing it more fascinating, since we can follow the news and observe developments almost by the hour. However, it also complicates matters a little, since we can write something one day, and the day after it has changed. However we intend to use the process of writing as intensely as possible in order to keep up with changes in the news, and the solutions adopted by different institutions. We therefore aim for a proposed solution, which will come as close as the “real” solution. Another important dimension, in the light of the changing news, is the fact that Spain has not yet fully accepted the pledged bail-out. This is one of the fundamental factors that can change Spain’s destiny. Therefore the paper is being written and handed in prior to the implementation of this bail-out, and the assumptions and solutions hence also reflect this. However, we have established scenarios where we will discuss what consequences a bail-out of Spain will have.

Methodology

In the sense that the subject is very new, most of our information will come from newspaper articles and recent scientific papers. Our data will mainly be drawn from the OECD, IMF, ECB and Eurostat.

In addition to our empirical data, we will conduct an e-mail interview with Henrik Lumholdt from BBVA, to highlight some of our questions concerning the Spanish banking sector and the state of the Spanish economy.

The OECD theory will mainly contribute to the crisis management section and the solutions for Spain. The OECD divides crises and their handling into three different phases; initial containment, resolution and deleveraging and finally management of impaired assets. The analytical part of the paper is therefore very much geared to these three different phases.

The last part draws inspiration, as well as developing some theories on the establishment of monetary unions, mainly from Martin Feldstein and Robert Mundell.

Origins of the crisis

The current crisis in Spain is severe. It is the worst crisis the country has faced in the last fifty years. In short, the crisis began in the mist of the international financial turmoil with its deep roots in the US subprime crisis. However, domestic imbalance, developing in the booming years prior to the crisis, has strongly contributed to the fact that Spain today is in a recession[2]. The severity according to the OECD and the depth of the recession in terms of real GDP has been similar to other advanced OECD economies. However, this has led to a much larger increase in unemployment and a sharper deterioration in government finances[3].

The following section will highlight the origins of the current debt crisis Spain is now facing. It will be divided into different sections, which in detail will describe how certain factors have contributed to the current crisis. First, the two authors will lay ground to the origins of the crisis by describing how a huge property bubble fueled mainly by overconfidence, a favorable macroeconomic environment and the introduction of the Euro led many to invest in properties in Spain which eventually led to the build-up of a bubble that was doomed to burst. Secondly, one section will be devoted to the Spanish banks and the structure of the Spanish banking sector. Special emphasis will be placed on explaining various reasons why the Spanish banking sector was not geared to tackling the current crisis it is now facing. Unlike many of the other PIIGS, Spain does not suffer from public debt, but rather from private debt mainly generated by the banks and their dependence on the housing market. Lastly we will briefly explain why this crisis was not prevented.

Investments in housing caused a property bubble

Historically it has been popular to own a house in Spain. House ownership is above 80% of the entire population[4]. Furthermore Spanish citizens have, since the 1960s and 1970s, been encouraged by government to become house owners rather than tenants. One of the tactics, in this prioritization, has been to make house owners’ 15 % mortgage payments deductible from personal income taxes. In addition, the oldest apartments are

[2] OECD (2012)
[3] OECD (2010)
[4] OECD (2010)

covered by non inflation-adjusted rent control paired with a slow eviction process[5]. This again is a strong signal from the government that house ownership is preferred over renting. Also, rental opportunities were further weakened by inadequate legal protection for landlords that further limited the growth in the rental market, despite high demand and lower costs for rental of housing[6]. Overall Spain has therefore a culture for owning a house instead of renting. In fact, Spain is ranked 2nd in the world with an ownership rate of 85%[7]. Spain is surpassed only by a non-European country, Singapore, and is thus the country in Europe with the highest housing ownership rate. Two thirds of the housing units built in Europe between 1999 and 2007 were built in Spain[8]. In the following section we will highlight how this inherent culture, coupled with other factors, generated a building boom leading to a property bubble.

In recent times Spain can be characterized as having a building boom resulting from many factors – especially in the period between 1997 and 2007 there was a long cycle of housing expansion in Spain. The building boom in Spain is significant in many ways. Cruz points out, that the Spanish building boom was both extraordinarily large and of an exceptional duration – eleven years[9]. This building boom also had a massive effect on employment in Spain. As of late 2007, the construction sector accounted for almost 14 % of employment and 16 % of Spanish GDP. If we also add the output and employment dependent on the construction sector which was achieved in that same year, we reach 25 % of GDP and 23 % of the overall employment[10].

Many factors contributed to this massive demand in construction. First of all the macroeconomic environment and the worldwide economic attitude was conducive to such a boom. According to the Guardian, Spain *"suffered a bout of collective madness in the mid 1990s"*[11]. This madness can in part be put down to some of the impact the integration of the Euro had on the overall Spanish economy. With the previous currency, the peseta, the interest rate had been around 14%. In the next chapter (the

[5] OECD (2010)
[6] OECD (2010)
[7] http://wallstreetpit.com/47205-international-comparison-of-home-ownership-rates
[8] Éltetö (2011)
[9] Cruz (2011)
[10] Cruz (2011)

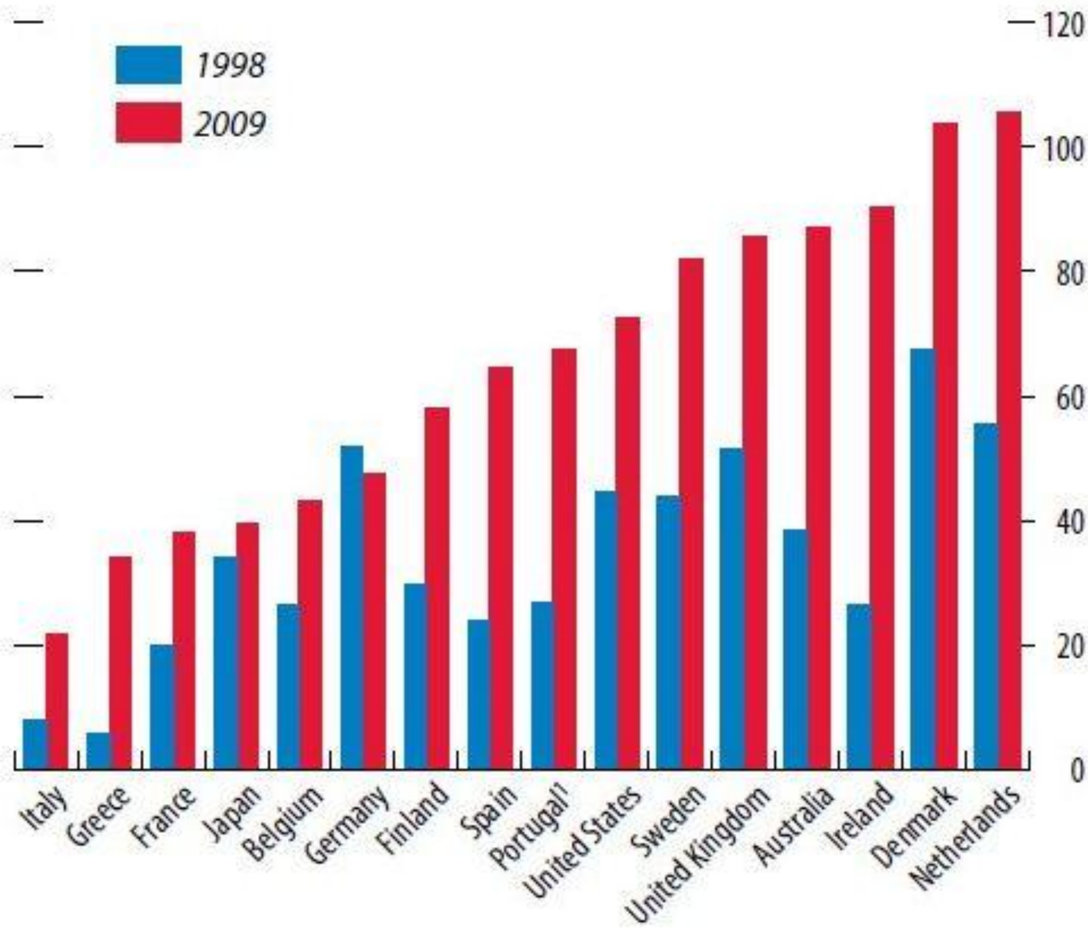
[11] http://www.guardian.co.uk/commentisfree/2012/jun/08/spain-90s-greed-banking-crisis

macroeconomic effects of the crisis) we will more thoroughly examine how the introduction of the Euro affected Spain. In a matter of weeks after the Euro was introduced as a currency the interest rate fell to 4%. Such a drastic fall in the interest rate attracted many foreign investments to the country. In particular, construction was of special interest to foreign investors. They saw an opportunity to build new apartment complexes and holiday homes and to buy second homes. All these factors contributed to higher prices as demand grew higher. Furthermore, demand was also stimulated by demographic factors. Among other things, in the period between 2000 and 2006, Spain created five million new jobs that attracted many new immigrants to Spain, who in turn also needed housing. The number of immigrants increased five times during the booming years from the mid nineties until 2007. Ultimately 5.7 million foreigners were living in Spain in 2010, which was approximately 12.3 percent of the total population[12]. The labor market was, as explained above, stimulated by the massive boom in construction and could thus easily absorb the new workers. Foreigners took almost half of the jobs created during this period. They found jobs in services, tourism, agriculture, households and above all in the construction industry. Also, an increased rate of divorces and separations increased the demand as more Spanish people became single[13].

Overall, the above mentioned factors generated a substantial demand for credit – in other words Spain and especially its booming property market were very popular. Banks became more competitive as their services became more and more popular. This resulted in an astonishing demand for credit. As illustrated by the graph below, the mortgage-debt-to-GDP ratio increased significantly during the boom. The interesting aspect is to look at the large jump in mortgages from 1998 to 2009. This is where Spain has one of the largest rises, together with Ireland, which also will be highlighted later in the crisis management section.

[12] Éltetö (2011)
[13] http://www.theage.com.au/news/World/Spanish-divorce-rate-soars-to-EU-highest/2007/05/23/1179601495413.html

Residential Mortgage-Debt-to-GDP Ratio



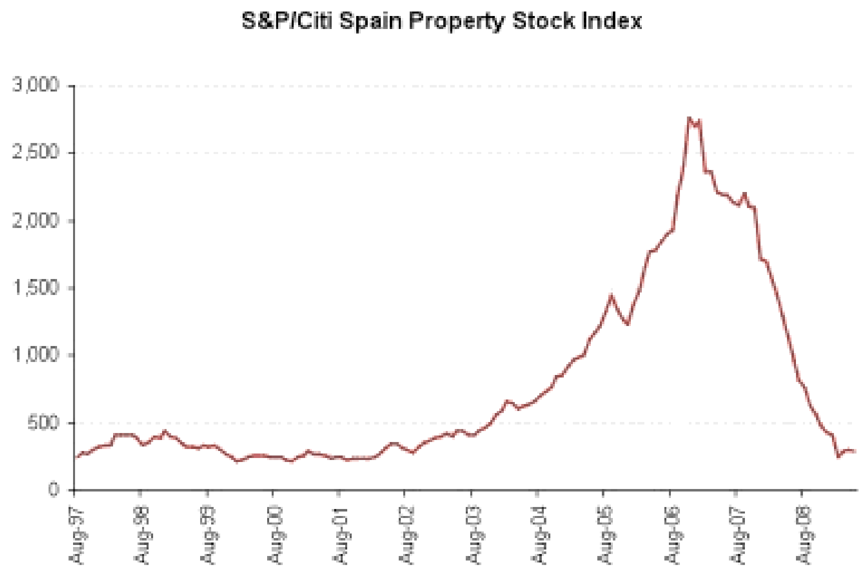
Source: IMF World Economic and Financial Surveys, April 2011

This chart shows the development in residential mortgage-debt-to-GDP ratio between 1998 and 2009 for the advanced economies.

Banks became, with the popularity of their services, less conservative in their lending. This is also reflected in the private debt, which Spain accumulated in the booming years. Private debt thus rose from 52.7% of disposable income in 1997 to a maximum of 132.1% in 2007[14]. With prices of real estate continuously rising, expectations of future prices were high. This was, according to Cruz, another factor that further fueled demand and eventually higher prices[15]. The prices therefore did not follow the basic fundamental factors of supply and demand, but were bloated, mainly stimulated by

[14] Cruz (2011)
[15] Cruz (2011)

overconfidence and conservative lending policies. This situation can best be illustrated by the figure below.



Source: S&P/Citi

This graph shows the development in the property stock index in Spain from 1997-2008

As illustrated by the graph, the price starts taking off from 2003-2004 onwards. To give an example, Spanish house prices rose by 17.4% in 2004 – only emergent countries like Hong Kong and South Africa experienced higher growth in house prices that year. From 1998-2005 prices rose by nearly 150 % compared to salary growth of 32.7%. Spain possessed at the time one of the highest “home price to wage” ratios in Europe and the EU. In the time during the boom and increases of prices economists believed that the market was overvalued by 20%. In other words there was potential for a build-up of an economic property bubble. Overall, the entire economy of Spain was overheating. Later we will show how this overheating also resulted in higher wages compared to productivity growth.

Stiglitz provides a general definition of the creation of an economic bubble. He argues that:

"If the reason that the price is high today is only because investors believe that the selling price is high tomorrow – when "fundamental" factors do not seem to provide such a price – then a bubble exists"[16].

Clearly a property bubble was established, and by the end of 2007 it collapsed. The path of the economic bubble in Spain is similar to many other economic crises around the world. It started with affection for real estate and with low interest rates and overconfidence. Thus, the existence of a bubble was born. In a later chapter of this paper, we will hold the Spanish crisis up against the Irish, Icelandic and others around the world, in order to illustrate their crisis management efforts. As one can see, the origins of these different crises are very much like in Spain, with overvalued assets, mainly in the real estate industry, which caused a bubble to build up.

As can be seen from the previous graph, prices were artificially high. Basic fundamental factors were not the value basis for the assets, and thus prices needed to find their natural equilibrium – in other words the bubble burst. The decreases in prices began in late 2007. According to the Ministry of Public Works, the fall in prices between the maximum of 2007 (the peak of the above figure) and the first quarter of 2011 was 15% in nominal terms and 20% in real terms[17]. Tinsa, the main real estate company in Spain, estimates that the adjustment in prices was even greater. In nominal terms the cumulative fall in prices, between the maximum in 2007 and July 2011 was slightly above 22%.

Another important dimension of the fall in prices and causes of the property bubble is the supply side. There were simply too many houses and apartments left unwanted. Therefore, the supply of housing was increasing as demand was decreasing, causing prices to fall. This can also be reflected in how many dwellings were built in Spain in the pre-crisis years compared to the post-crisis years. According to Rodríguez, prior to the crisis in 2006 the number of dwellings started exceeded 850 000. However during the crisis only one third of this number were actually started, and in 2010 only 90 000 dwellings were started. The crisis had a major impact on unwanted housing, which left the country full of empty houses. In 2010 almost 1 000 000 completed unsold houses

[16] Himmerberg, Mayer & Todd (2005)
[17] Cruz (2011)

were registered[18]. It was therefore safe to say that a fake supply of housing was built based on a poorly estimated demand. Evidence of this can also be found in the analysis by David Martínez, Tomás Riestra, and Ignacio San Martín. In a paper from 2006, a year before the crisis, they estimated that during the pre-crisis years an average of 500 000 dwellings a year were started. Nevertheless, according to the demographic structure only 350 000 new dwellings a year were needed[19].

This fact gives a good illustration of the massive oversupply which was artificially created. After the burst of the bubble, the supply was somewhat more ruled by market fundamentals, and therefore slowly decreased. In articles from the time right after the burst of the bubble, many property developers criticize the artificially produced oversupply. One of them states that:

"This is a crisis of oversupply, made worse by the credit crunch where banks went from one extreme – of lending to virtually everyone – to the other almost overnight."[20]

Furthermore, some developers explain that they were struggling against a 90% drop from the previous year prior to the burst of the bubble[21].

As the Spanish property developers say, the banks have had a major impact in the evolution of the current crisis. The following section will therefore, in conjunction with the above, describe how the Spanish banks have contributed to the crisis along with the burst of the property bubble. Also, it will be illustrated how Spain differs from others PIIGS by not suffering from huge public debts but rather from private debt.

The Spanish banking sector

Only a few years ago the Spanish banking sector was characterized as one of the most solid and best equipped among the western economies to cope with the worldwide liquidity crisis, thanks to the country's conservative banking rules and practices[22]. According to a 2008 Economist article, Spain at the time possessed the right policies

---

[18] Cruz (2011)
[19] Cruz (2011)
[20] http://www.ft.com/intl/cms/s/0/ceb33b42-fce3-11dc-961e-000077b07658.html#axzz2BuL46Brv
[21] http://www.ft.com/intl/cms/s/0/ceb33b42-fce3-11dc-961e-000077b07658.html#axzz2BFTiADBR

[22] http://www.bloomberg.com/news/2012-06-14/the-eu-smiled-while-spain-s-banks-cooked-the-books.html

and regulators which dictated the best remedies in order for a country to prosper during crisis times[23]. A big reason for the success was an accounting technique called "Dynamic Provisioning". In short this meant that Spain's banks, since 2000, were required by Banco de España (BdE) to set aside the same amount of capital against assets in off-balance-sheet vehicles as they would against on-balance-sheet assets[24]. In other words the procedure was a matter of building a buffer for "rainy days", or times with a more worrying economic outlook. The whole purpose of this unusual accounting procedure was to "counter-cycle" – in other words Spanish regulators said they were trying to be countercyclical, so that any declines in lending and the broader economy would be less severe[25]. The reason was therefore to smooth earnings over the business cycle to cover economic losses. In more detail it meant that banks could devalue past profits (accumulated in the pre-crisis years), and shift them into later periods with bad results. By doing so they could minimize much of the volatility of their risky loans, and thus bury the losses on them. This was, however, also the danger of this technique.

In American accounting standards this method is also called cookie-jar accounting – because you are saving up for worse times. An article from the World Bank, which was written by the former director of Bank of Spain's financial stability, Jesus Saurina, explains this accounting standard by saying that:

"The ant cyclical nature enhances the resilience of both individual banks and the banking system as a whole. While there is no guarantee that they will be enough to cope with all the credit losses of a downturn, dynamic provisions have proved useful in Spain during the current financial crisis"[26].

However the situation Spain now faces, because of the "Dynamic Provisioning" accounting procedure, is of a wholly different character. This is because the danger of "Dynamic Provisioning" is that it can make banks look sound and profitable when they in fact are quite sick. If past profits have been accumulated for many years, a bank can go on for several years without appearing unprofitable, until they ultimately use up all

[23] http://www.economist.com/node/11325484

[24] http://www.economist.com/node/11325484
[25] The World Bank Group (2009)

[26] The World Bank Group (2009)

of their excess reserves and in the worst case crash. In fact a current example is the Spanish bank Bankia – the largest mortgage lender in the country. Bankia was one of the sacrifices of "Dynamic Provisioning", as at the time Spanish banks were not reporting all of their losses as they should have. This resulted in the takeover and bail-out of Bankia by the Spanish state.

The current state of the Spanish banks is strongly affected by external factors such as the international financial crisis, the European credit crisis and by the burst of the bubble. These factors have contributed to a restriction of the Spanish banks' access to financing on the international markets and restrictions to credit, as confidence in the banks has decreased dramatically compared to previously[27]. But also the internal factors are of importance, because some of them are self-induced by the banks. Namely, the banks' high exposure to real estate, together with the economic downturn and the consequent sharp rise in unemployment, has affected the banks. At the end of 2010, the Spanish banking sector was actually among the first in the ranking of the Euro zone, in terms of return of assets (0.47%) and return on own resources (7.9%)[28]. On the contrary though, in terms of solvency, its position is not so favorable. In fact the overall solvency rate of the banking sector in Spain is among the worst in the Euro zone, 11.9%, almost two percentage points below the average. This is also a strong indicator of the severe effects the internal factors have had on Spanish banks – namely their exposure to the real estate sector.

In a European perspective the constellation of Spanish banks has some unique features when compared to their counterparts around Europe. The constellation reveals the existence of asymmetries between the two main banking entities – this asymmetry is especially prevalent when we look at solvency[29]. The two types of banks that co-exist in Spain are traditional banks and saving banks, also known as *Cajas de Ahorros* or just Cajas. Saving banks have very different characteristics from traditional banks. Saving banks do not have shareholders – instead they are controlled by a mixture of politicians and depositors. In addition many Cajas were used by local barons as development banks that could further their political purpose in the region in which they were represented.

[27] Cruz (2011)
[28] Cruz (2011)

[29] Cruz (2011)

Cajas are a relatively old and traditional phenomenon in Spain, and some have more than 200 years of history behind them. This in turn made them very heavy in terms of bureaucracy, and they were known to award huge pay packages and golden handshakes – in short, inefficient entities with old and bureaucratic norms[30]. The saving banks are of special interest because they play a central role in the Spanish society, as they account for more than 48% of deposits and more than 46% of the loans of the banking sector[31]. According to Cruz, during the long expansion period of the banks, and before the crisis, these savings banks accumulated significant financial imbalances of various kinds. These imbalances became evident when the bubbled burst and the macroeconomic conditions changed. The imbalances of the Cajas were mostly the high exposures and amount of investments tied up in the property development industry, on both the supply and demand sides. According to Cruz, Cajas accounted for 56.3% of all financing of productive activities and 27.7% of its loan portfolio was to the resident private sector[32].

The Cajas were thus heavily involved in the property development industry, and left major footprints in the burst of the bubble. As a consequence of this the Banco de España (BdE) wanted to get a more transparent view of the books of the Cajas. The results of the exercise were significant. In 2010 the first results were published. They showed that the credit concentration of Cajas in the construction sector, real estate activities and house purchases reached nearly 60% of the credit to the resident private sector. Credit to construction and property development accounted for around 20% of the loan portfolio to the resident private sector (22% of the saving banks' loan portfolio and 17% from traditional banks), while housing loans accounted for approximately 39%[33]. These numbers serve as the root argumentation for the role of the banks in the Spanish economy, as the high concentration of risks is worrying and not very diversified. Firstly due to the continuous growth of default rates, and secondly due to the high value of real estate assets that passed into the hands of the banks as a consequence of the high failure rates.

[30] http://www.economist.com/node/21556953

[31] Cruz (2011)

[32] Cruz (2011)

[33] Cruz (2011)

Cajas played a critical role in the buildup of the property bubble, but still in 2010 they kept reporting higher levels of exposure to construction and development activities. Their total exposure to these sectors was €217 billion, of which €173 billion (80%) was related to investment credit and the remaining €44 billion (20%) to awarded properties[34]. However, a more interesting aspect is to segment the numbers and look into how much of it was down to problematic investments. According to Cruz, the problematic investments included at the time bad debts, substandard loans and awarded properties – these amounted to €100 billion (46% of the total of €217 billion). So, almost half of savings bank loans were characterized as problematic investments, yet they were still established. Cruz emphasizes that regardless of the various challenges the banking sector is currently facing, the most worrying aspect, from an economic point of view as a whole, is its inability to fulfill its basic function of financing economic growth[35]. This has resulted in a more conservative lending policy especially to companies, in that credit to companies has experienced the greatest contraction during the crisis. Credit to companies often follows the same pattern as the business cycle – it follows a pro-cyclical behavior, so when times are good credits are booming and when times are bad banks become conservative in their lending. Hence, prior to the crisis in 2008, credit to Spanish companies grew and exceeded 30%, which was twice the average of the Euro zone. Subsequently, when the crisis hit Spain, credit to companies became negative, reaching its minimum in the first half of 2010 (-4.2%), and has since then remained stagnant[36].

To further complicate matters, much of Spain's huge private debt is owed indirectly to foreigners via its banks. As we will see later, Iceland suffered from rather the same problem, because it also had significant private debt, as a result of foreign investments. In the case of Spain it resulted in a net investment deficit of 93% of GDP[37]. Net investment refers to the sums owed to foreigners by firms, householders and the government, less the foreign assets they own. Hence the most important problem of the Spanish economy is not the public debt size, as we currently see in many other PIIGS.

[34] Cruz (2011)
[35] Cruz (2011)
[36] Cruz (2011)
[37] http://www.economist.com/node/21552582

The main source of headache is the high private debt, resulting from historically high liabilities of companies and households. In fact Spain has since 2004 increased its private debt to five times higher than the Euro zone average. Credit growth rates for the private sector followed a similar trend until 2006. Here the annual growth rate approached 30%, which was a higher level than the nominal growth in GDP until the end of 2008[38].

Why was nothing done to prevent the crisis from worsening, and what has been done?

We have explained how several reasons caused the current crisis Spain is now experiencing. One might ask why nothing was done to prevent the causes from escalating to what we see today. According to the Economist, the cleanup of the Spanish banks after the colossal property boom and bust will take some time[39]. The first problem is in fact to recognize that Spain and its banks indeed have a problem and to recognize the size of the problem. Lumholdt explains that the Spanish government has been in denial, and has aimed for short-term solutions that have proved ineffective[40]. At first, senior officials at the Bank of Spain suggested that the banking system needed no additional capital in order to survive. In fact the over-confidence and naïve attitude of Spanish officials could be one of the root causes of the crisis – something that could have been prevented earlier.

When the global financial crisis hit in 2008, officials in Spain trusted in their "solid" financial system. The prime minister at that time, José Luis Rodríguez Zapatero, stated that Spain had "*perhaps the most solid financial system in the world*"[41]. This statement was possibly made on the basis of "Dynamic Provisioning" with its counter-cyclical measures. Also, after the burst of the property bubble in 2008, banks began acquiring properties from developers, only to experience that these loans would go sour. As the economy entered recession, foreclosures thus increased. According to the Economist,

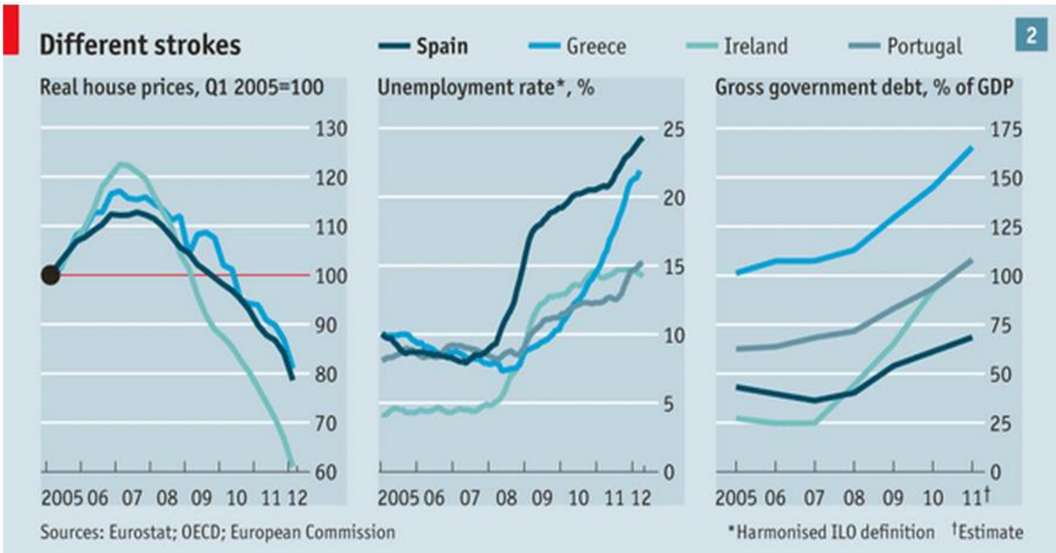
[38] Cruz (2011)
[39] http://www.economist.com/blogs/schumpeter/2012/06/spains-troubled-banks

[40] Henrik Lumholdt, mail interview, November 4th, 2012
[41] http://www.economist.com/node/21556953

banks in Spain now own fifth of the total stock of empty homes[42]. Further research reveals that the reluctance of Spanish banks to cut their losses further intensified the fall in house prices. Supply and demand cannot be matched because the banks are sitting on such a big concentration of the housing market. According to a Spanish real estate portal:

"*Banks are only giving mortgages on their own apartments. They will give you a 100% mortgage (but only) if you buy one of their flats*"[43].

So instead of preventing the crisis, Spanish banks extended it by manipulating with microeconomic factors, and making artificial mix-matches between supply and demand. According to the Economist, Zapatero had several opportunities to clean up the banking system when government financing costs were lower, but did not manage to do so. Even now with the new Prime Minister Mariano Rajoy, overconfidence can be detected. Rajoy refuses to call in the pledged money from other Euro zone countries to recapitalize Spain's banks by a bail-out. Instead officials in Madrid call it a "*loan with favorable terms*"[44]. Rajoy's unwillingness to talk about a bail-out is because he does not want to have Spain mentioned alongside other PIIGS – especially Greece, Ireland and Portugal.



[42] http://www.economist.com/node/21556953

[43] http://www.economist.com/node/21556953

[44] http://www.economist.com/node/21556953

Source: The Economist

These graphs show an overview of the different levels in terms of real house prices, unemployment rate and gross government debt from 2005-2012 for Spain, Greece, Ireland and Portugal.

As explained, the crisis in Spain differs from in some of the other PIIGS. Especially Greece and Portugal show strong differences in term of public debt, when looking at the above figures, compared to Spain. Greece and Portugal are namely affected by strong public debt, as the last graph shows. Spain ranks well below the three other countries and thus have other issues to deal with than public debt. The crisis in Spain is due to the banking system, and the drivers of that, which is the high unemployment rate and falling house values. Rajoy emphasizes that the challenges Spain is currently facing are for the banks, and not the government and its spending. He also argues that "*Spain is not Uganda. We are the fourth-largest economy in the Euro zone*"[45]. The fact of the matter is that Spain is currently ranked below Uganda in terms of both GDP growth and unemployment rate[46]. Action was needed, and as Rajoy pointed out the first challenge was to deal with the banks

To counterattack the upcoming crisis Spain decided in 2009 to create the Fund for the Orderly Restructuring of Banks – FROB (*Fondo de reestructuración ordenada bancaria*). The purpose of the FROB was to intervene in banks if needed and to support them with capital injections. The FROB should also assist in merger processes, which have been extensive among Cajas since the beginning of the crisis. Lastly the FROB should act as a bail-out fund if/when the money arrives from the other European countries[47]. According to the Economist, the fund had a capacity of €99 billion in 2009, but by 2012 it had only supplied €14 billion, and an industry deposit-guarantee of €13 billion[48]. One of the major challenges was that the Cajas, as mentioned earlier, were controlled by a mixture of politicians and shareholders. However, the establishment of the FROB and a rise in capital requirements has forced the 45 saving banks into many

[45] http://www.economist.com/node/21556953

[46] http://www.bbc.co.uk/news/magazine-18408448

[47] OECD (2010)

[48] http://www.economist.com/node/21556953

consolidations. As a result there are now only 11 Cajas left, all operated according to more modern standards. The consolidations also had some negative aspects. Bankia, which was the fourth largest bank in Spain at the time and the largest mortgage lender, was a merger of seven saving banks. Bankia tried to go public and was listed on the Spanish stock exchange. Nevertheless, it was bailed out in late May 2012 further damaging the already low confidence in the Spanish financial system – if one bank cannot perform with a loan, there are probably others too.

The current situation, the consequences of the above-mentioned factors and the origins of the Spanish crisis have deeply affected the macroeconomic climate of Spain. The next section will highlight the macroeconomic effects of the crisis.

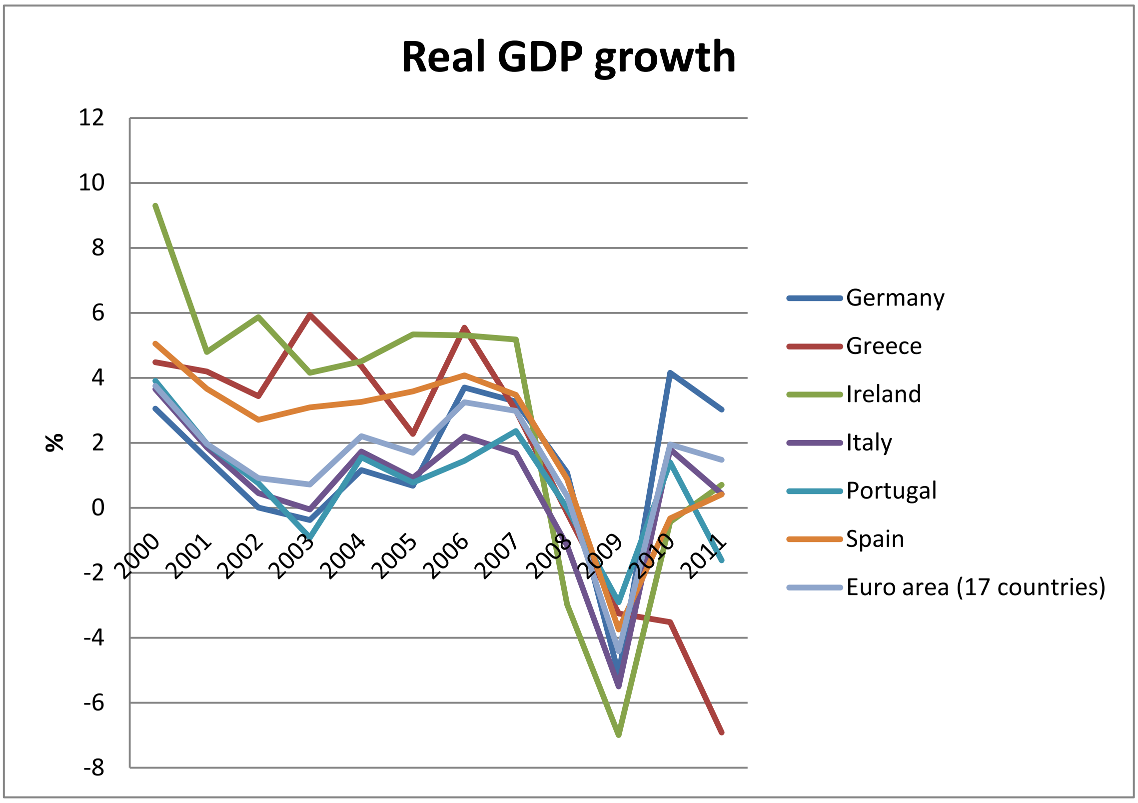
The macroeconomic effects of the crisis

Having established the root causes and origins of the Spanish crisis we will now continue our analysis by highlighting the macroeconomic impact of the crisis in Spain and seek to explain why the fiscal turmoil in Spain has adversely affected economic prosperity substantially more than in other European economies. We will draw conclusions about the macroeconomic effects of the crisis and present our forecast for the rest of 2012 and the future.

GDP growth

While the recession itself was unavoidable, seeing as the financial markets are coherently linked in the globalized world, some European economies were hit much harder than others, among them Spain. The Spanish economy began its deterioration in 2007 after more than a decade of economic expansion, prosperity and growth[49]. From 2007 and into the first quarter of 2008 economic growth slowed down significantly, and from the second quarter of 2008 to the end of 2009 the Spanish economy was in recession. Recently Spain has shown some slight signs of recovery in terms of GDP growth.

[49] OECD (2010)



Source: OECD Statistics

This chart shows the development in real GDP growth from 2000-2011 for Germany, Greece, Ireland, Italy, Portugal, Spain and the Euro area average.

The recession began at the end of 2008 and peaked in the first quarter of 2009, when the growth in GDP had fallen by almost 8% compared the top year of the boom, 2006, namely from a yearly GDP growth of around 4% to -3.7%. In 2010 the Spanish economy showed some weak signs of recovery, with a slight growth in GDP, ending 2010 with year-over-year growth of -0.32%. In 2011 Spain turned the recession into a slight positive growth rate of 0.42%. The current forecast for Spain by the OECD, however, predicts a drop in real GDP growth of -1.6% and -0.8% for 2012 and 2013 respectively[50]. Comparing the real GDP growth of Spain with the other PIIGS countries as well as Germany and the Euro zone average, it is clear that there is a clear resemblance between developments, and this cannot in itself explain the different outcomes of the European economies during the crisis. The only country standing out of

[50] OECD (2012)

the norm is Greece. Where the rest of the countries seem to be recovering some of the 2009 GDP growth loss in 2010 and 2011, Greece's development only worsens, and as of 2011 its GDP growth rate is -7%, emphasizing the currently vast discrepancy between the debt crisis of Greece and the rest of the PIIGS countries, and for the sake of our analysis, Spain.

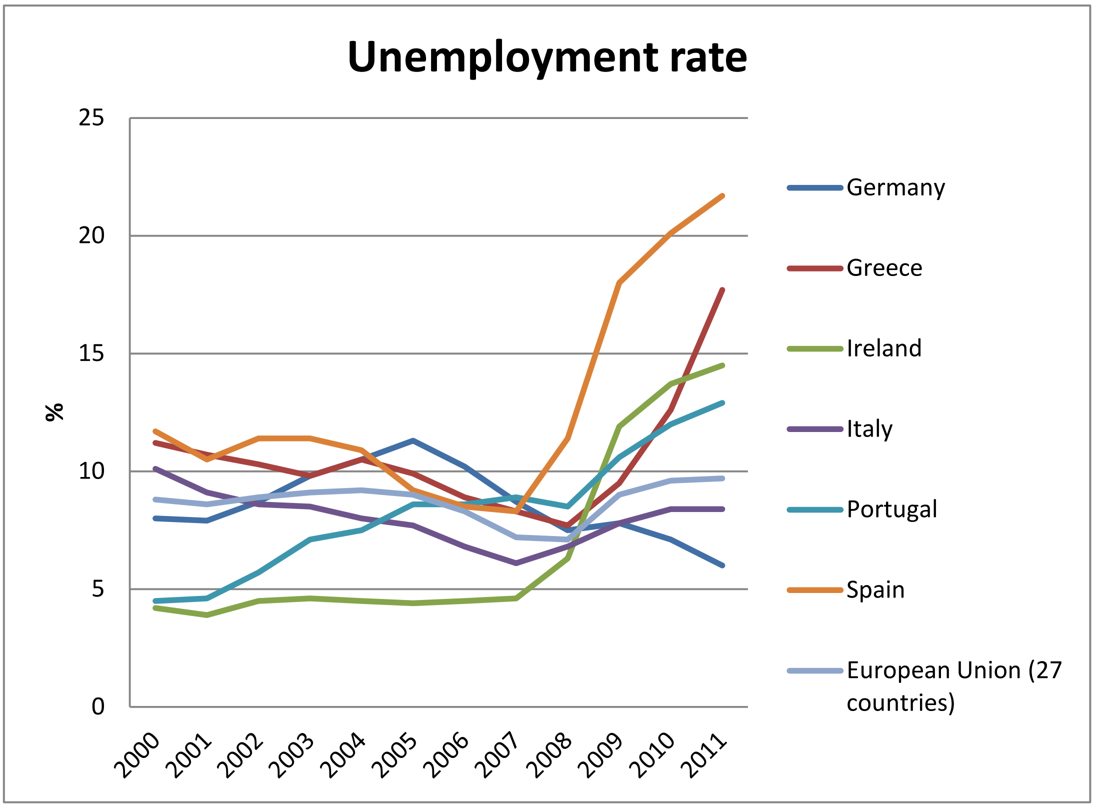
As mentioned in the previous paragraph, regarding the causes and origins of the Spanish debt crisis, Spain's growth has suffered greatly during the past 2 years due to the situation in the housing sector and the banking sector as well as the high private debt, as predicted by the OECD[51]. Spain's development in GDP growth, and later recovery, relative to the average GDP growth of the Euro zone was quite similar up until 2010, with the exception of Greece. One of the present key issues in the Spanish economy, and, as we will see, one that stands out substantially in comparison to the other economies described, other than of course the already mentioned factors, is unemployment, which is directly linked to GDP growth.

Unemployment rate

As the crisis unfolded unemployment started to skyrocket in Spain. In late 2007, prior to the crisis, the Spanish unemployment rate was at a relatively acceptable level of 8.3%, much in line with EUR 27. This rapidly grew to 20.1% by the end of 2010. 2008 and 2009 were the big sinners, when the unemployment rate increased by 41% and 60.2% respectively[52].

[51] OECD (2010)

[52] Cruz (2011)

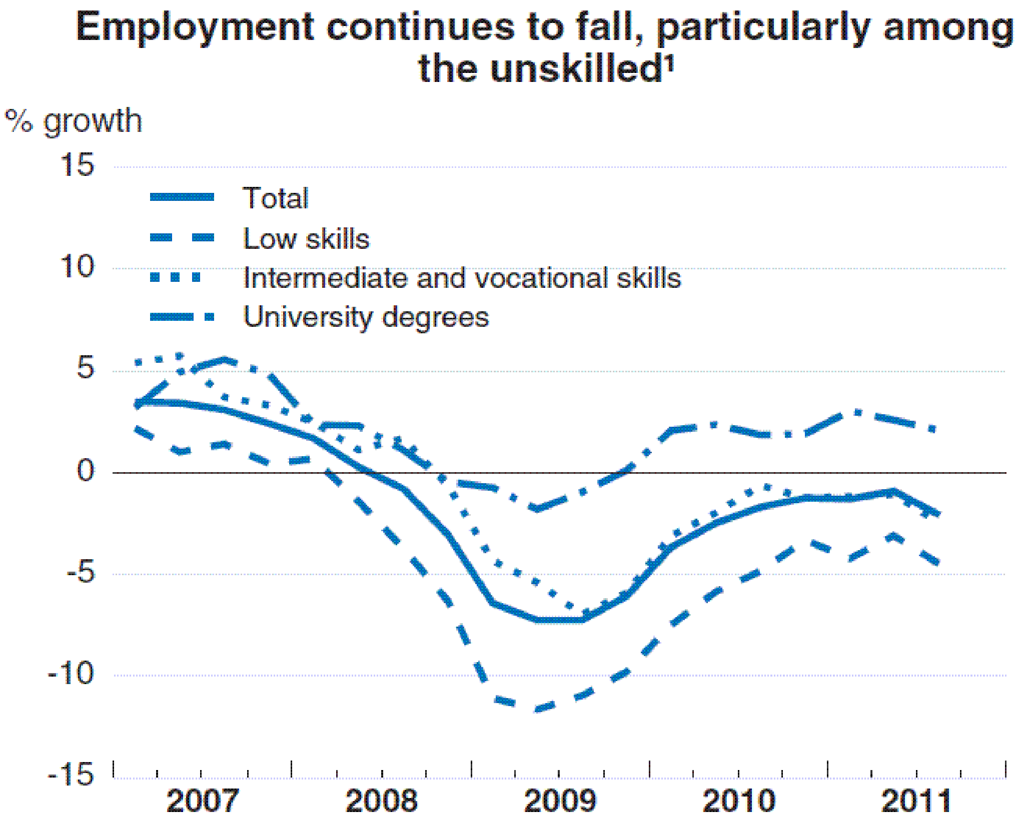


Source: OECD Statistics

This chart shows the development in the unemployment rate from 2000-2011 for Germany, Greece, Ireland, Italy, Portugal, Spain and the EU average.

In particular, unemployment is increasing mainly among young workers, particularly those with poorer qualifications and educational background, as well as foreigners[53]. This was underlined by the OECD in November 2011, as illustrated by the graph below. Low-skilled unemployment growth is proportionately larger than total unemployment. Unemployment growth for intermediate and vocationally skilled persons seems to follow the trend of total unemployment, while people with university degrees have a substantially lower growth in unemployment.

[53] Cruz (2011)



Source: OECD Economic Outlook, November 2011

This chart shows the development in the unemployment rate from 2007-2011 for Spain, distinguishing between the total unemployment rate and the unemployment rates among people with low skills, intermediate and vocational skills and university degrees.

According to the OECD, structural unemployment is high and is likely to increase further during the current crisis[54]. Furthermore the OECD points out that the Spanish labor market and employment react in a very volatile fashion to the business cycle. One of the reasons for this is how Spanish employment contracts are constructed and formed. Historically, Spain has had high protection of permanent contracts which have strongly contributed to the structural problems. Companies have thus been reluctant to turn temporary contracts into permanent ones, which in turn has increased employee turnover and encouraged a dual labor market. In addition, the high protection of workers

---

[54] OECD (2010)

on permanent contracts has also contributed to making wages less responsive to labor market conditions and has made the integration of young people into the labor market more difficult. Finally, the dual labor markets harm labor productivity, reducing job mobility and the incentives of individuals and firms to invest in human capital[55].

To counter-attack such structural imbalances, the Spanish Parliament approved the labor market reform legislation in September 2010. The idea was to make it easier for firms to have dismissals accepted as "justified", which thereby could reduce their costs and make them more productive. However several concerns arise with such legislation. The OECD emphasizes that the law still leaves room for judicial interpretation, so it is not clear to what extent the legislation will change the practice whereby firms prefer to pay the highest severance payment upfront in order to avoid going to court[56]. According to the Economist, such reforms are needed in order for Spain to stay competitive. For most firms the maximum lay-off payments will be reduced from 42 months' pay to 12 months. It will not immediately affect growth, but it will boost business confidence, because the reform will change the idea companies have that the labor rules are an obstacle[57]. Further the Economist concludes that Spain's labor laws date back to the Franco era and have condemned half of the workforce to be unemployed or to have temporary jobs, while the rest enjoy ironclad contracts and huge redundancy pay-offs. The Economist believes that the new laws blur the insider/outsider divide and may thus get more people into stable employment[58]. The OECD adds to this by stating that the reform also widens the types of workers who are eligible to be hired on permanent contracts with somewhat reduced severance pay. However, different permanent contracts, some of which stipulate substantial compensation for unjustified dismissal, continue to exist side by side. Thus, even with the recent reform, severance pay may still be excessively large, making firms reluctant to transform temporary contracts into permanent ones. The OECD hence recommends that it would be more effective if these

---

[55] OECD (2010)

[56] OECD (2010)

[57] http://www.economist.com/node/21547831

[58] http://www.economist.com/node/21547831

two contracts converged. This could for instance be achieved by introducing a single contract with severance pay which is low initially but increases with seniority.

The explosive nature of the unemployment rate was caused mainly by a collapse in the construction sector as mentioned in the previous section. As GDP growth is expected to decline in 2012 and 2013, unemployment is forecast to exceed 25% by the end of 2012[59].

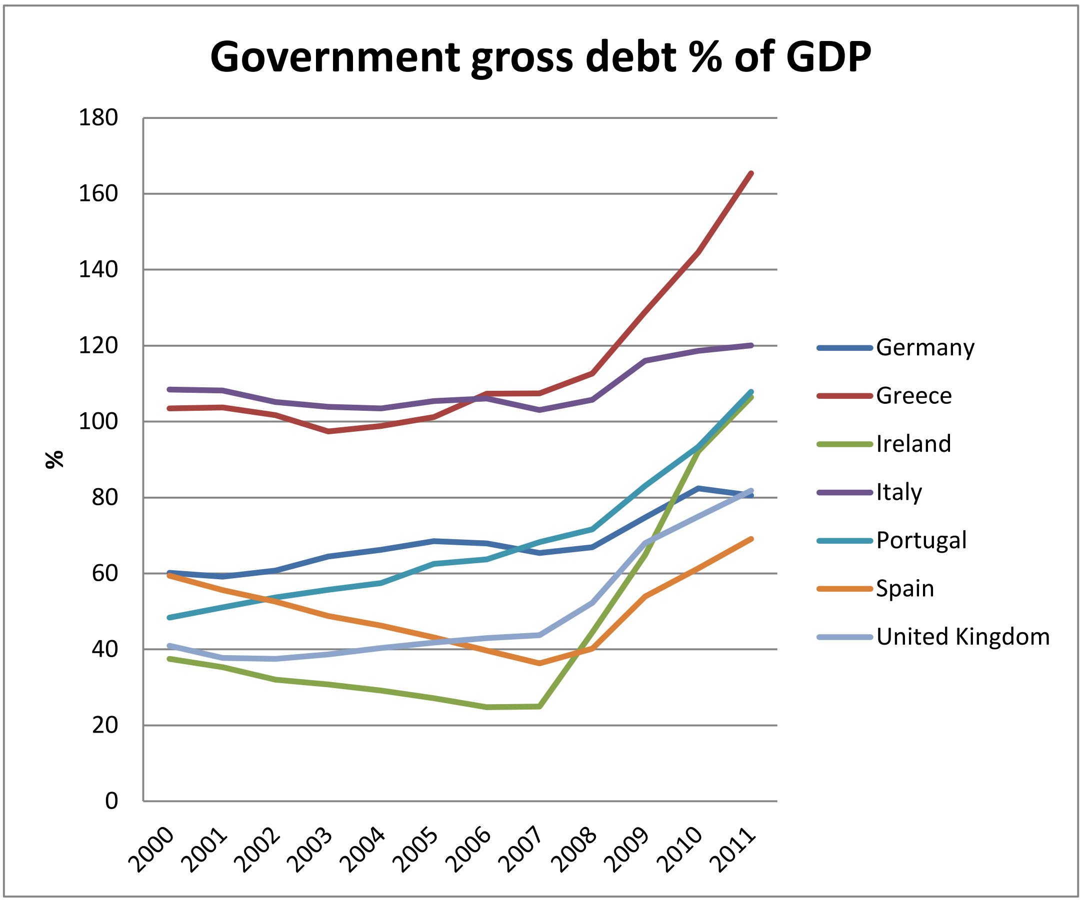
The Spanish growth model revolved heavily around domestic demand and development in construction and property. While the decline in GDP growth for Spain was similar to the average of the Euro zone, as shown earlier, Spain suffered a severe loss in public demand compared to the average of the Euro zone. From 2008 to 2010 domestic demand fell slightly by 1.6% in the Euro zone, whereas it fell by 7.6% in Spain[60]. As a result of the bursting of the housing bubble, investment in real estate fell drastically by 41% over this 3-year period. This reduction, among other things, directly fueled the crash in the construction sector.

Government debt

As opposed to many of the other crisis-hit PIIGS countries, which face huge public debt, the Spanish crisis sprung from the bursting of the housing bubble in 2007-2008, provoked as mentioned earlier, by the collapse of the American investment bank Lehman Brothers, leading to an enormous loss of private equity and a huge deficit in private debts. As the chart below shows, the public debt of Spain is the lowest among the PIIGS countries as of 2011. In 2010 the Spanish public debt was equivalent to 60.1% of the GDP, which was actually 25 percentage points below the Euro zone's average (85.1%). Spain ranks below many other countries in the Euro zone in terms of public debt, as the figure below illustrates.

[59] OECD (2012)

[60] Cruz (2011)



Source: IMF World Economic Outlook Database, October 2012

This chart shows the development in government gross debt as a percentage of GDP from 2000-2011 for Germany, Greece, Ireland, Italy, Portugal, Spain and the United Kingdom.

Specifically, Spain ranks below many of the PIIGS, and thus illustrates a different kind of debt problem from some of the other southern European countries.

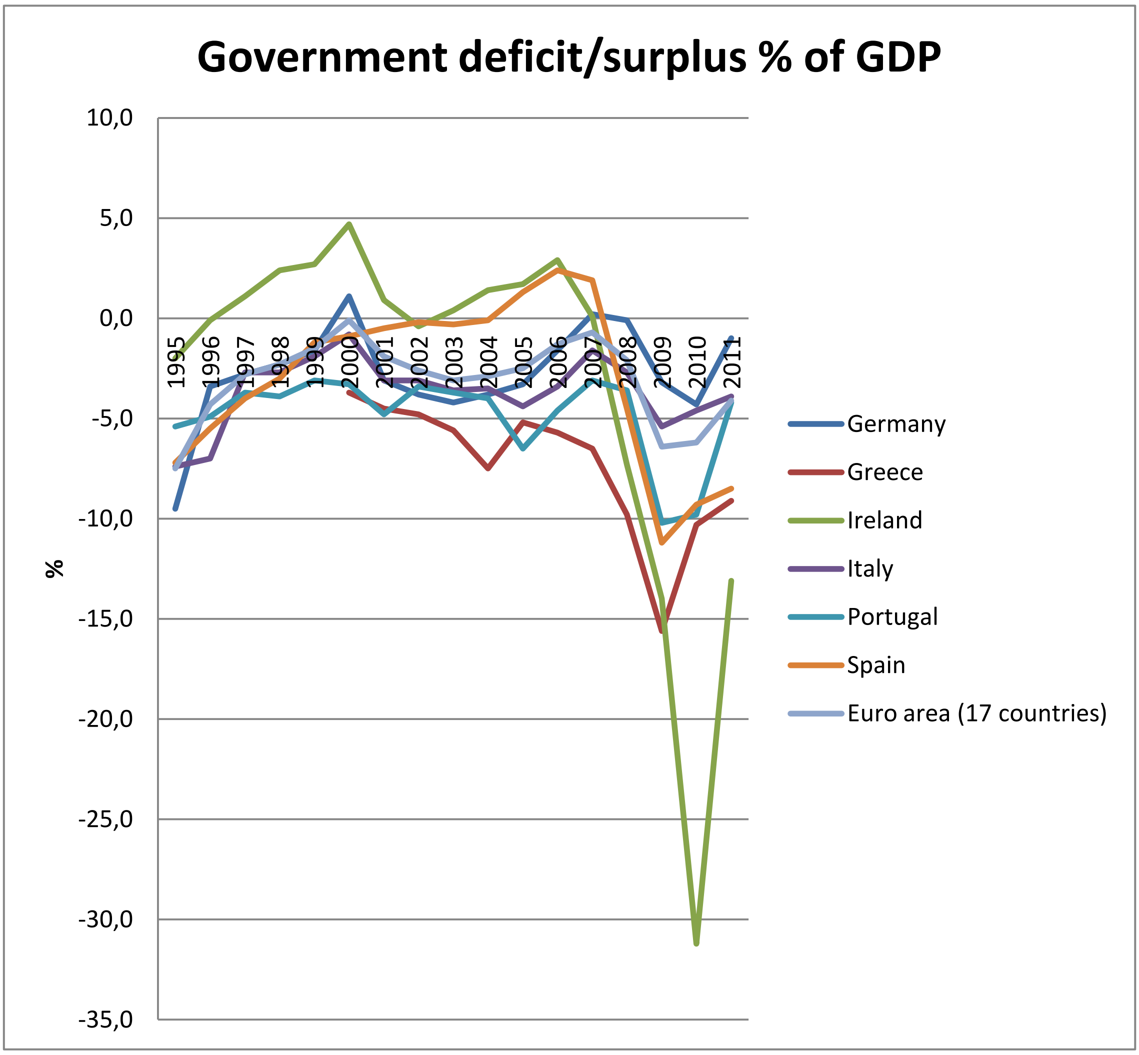
While the public debt of Spain has increased during the last few years and is forecast to reach 79.7% in 2012[61], directly caused by an evaporation of the fiscal revenues, due to adjustments in the private sector[62], it is still at a relatively respectable level, also when

[61] Ministry of Economy and Competitiveness (2012)

[62] OECD (2010)

compared with strong European economies such as Germany and the United Kingdom, that have a public debt to GDP ratio of 87% and 82.4% respectively as of 2010[63].

The increase in government debt can be attributed to the large deficit occurring in the later years, as illustrated by the chart below.



Source: Eurostat Statistics

This chart shows the development in government deficit/surplus as a percentage of GDP from 1995-2011 for Germany, Greece, Ireland, Italy, Portugal, Spain and the Euro area average.

[63] OECD Statistics

Because of the sharp drop in fiscal revenues, the public deficit of Spain has increased dramatically over the last few years. While maintaining a near zero sum up until 2004, and even with slightly positive net lending between 2005 and 2007, the years 2008 and onwards have presented public deficits of up to -11.13% of GDP (in 2009), way above the maximum of -3% dictated by the Maastricht treaty[64]. The OECD's forecast in November 2011 was for Spain to have an annual public deficit of -3% in 2013[65], which was slightly adjusted in the May forecast to -3.3%[66], and further adjusted in the Spanish government's Draft General State Budget of 30 March 2012, putting it at -3.5% in 2012. Current forecasts suggest that Spain should hit a zero deficit in 2014, which justifies the already implemented tightening of fiscal policy, namely strict austerity measures, to accommodate the ongoing crisis and prevent it from getting worse. Further analysis on this matter will follow later in this paper when we investigate crisis management and solutions to the ongoing crisis.

As stated earlier, the big sinner of the Spanish downfall mainly lies in private indebtedness, which followed the bursting of the property bubble. Private debt, however, is not always a bad thing. During a financial boom, specifically economic expansion, private debt signals consumer and business investment to fuel further economic growth as well as consumption of goods and services[67]. However, when the economy is plunged into recession, especially one as deep as that of Spain, high private indebtedness can quickly overturn the stability of the entire economy. This is caused by multiple factors, the biggest one being the financing of the debt. Because of the magnitude of the private Spanish debt it is not possible to finance it entirely domestically. Therefore, Spain has to borrow money from abroad, and in times of crisis, when all eyes are on the weakest economies, Spain suffers even more as investors require a substantially larger risk premium on their investment in Spain as opposed to other more economically well-balanced European economies.

[64] Maastricht Treaty (1992)

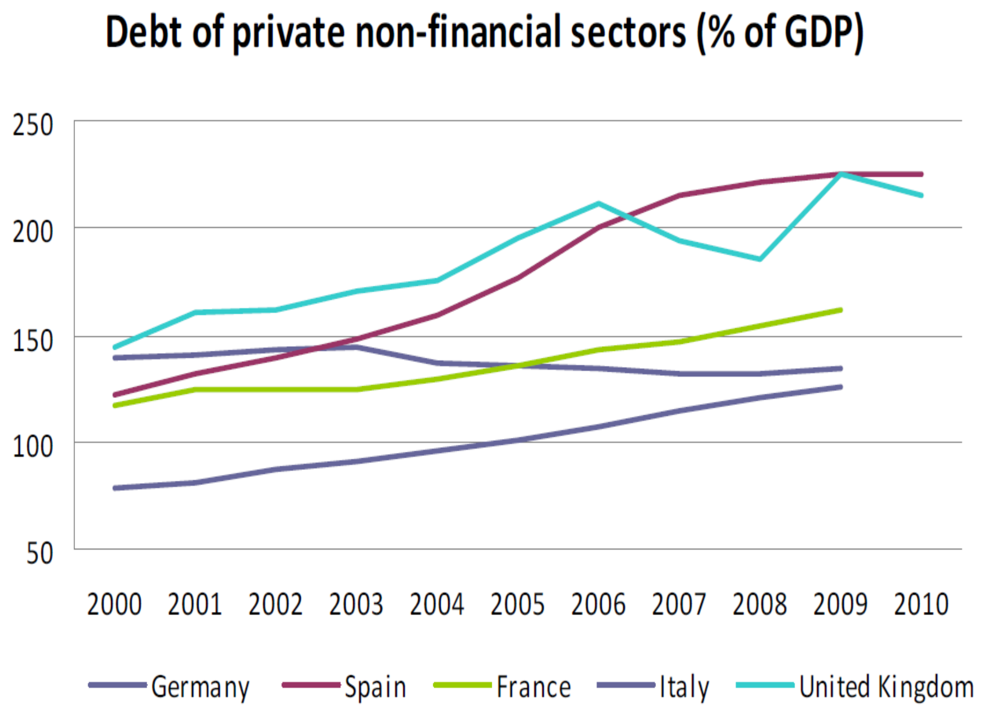
[65] OECD (2011)

[66] OECD (2012)

[67] http://blogs.wsj.com/marketbeat/2012/03/23/spains-critical-issue-is-its-private-debt/

Private debt

Taking a look at the debt of private non-financial sectors to GDP ratio of Spain, in comparison to some of the other PIIGS countries and some of the stronger European economies speaks for itself.



Source: Ministerio de Economía y Hacienda, Private Indebtedness: Some highlights

This chart shows the development in debt of private non-financial sectors as a percentage of GDP from 2000-2010 for Germany, Spain, France, Italy and the United Kingdom.

Spain has by far the highest non-financial debt to GDP ratio among the European economies, with only the UK anywhere near it. Reaching its peak in 2009, Spain's current private non-financial debt represents a stunning 220% of GDP, almost four times the public debt. The private debt has been steadily rising over the last decade from about 125% in the year 2000.

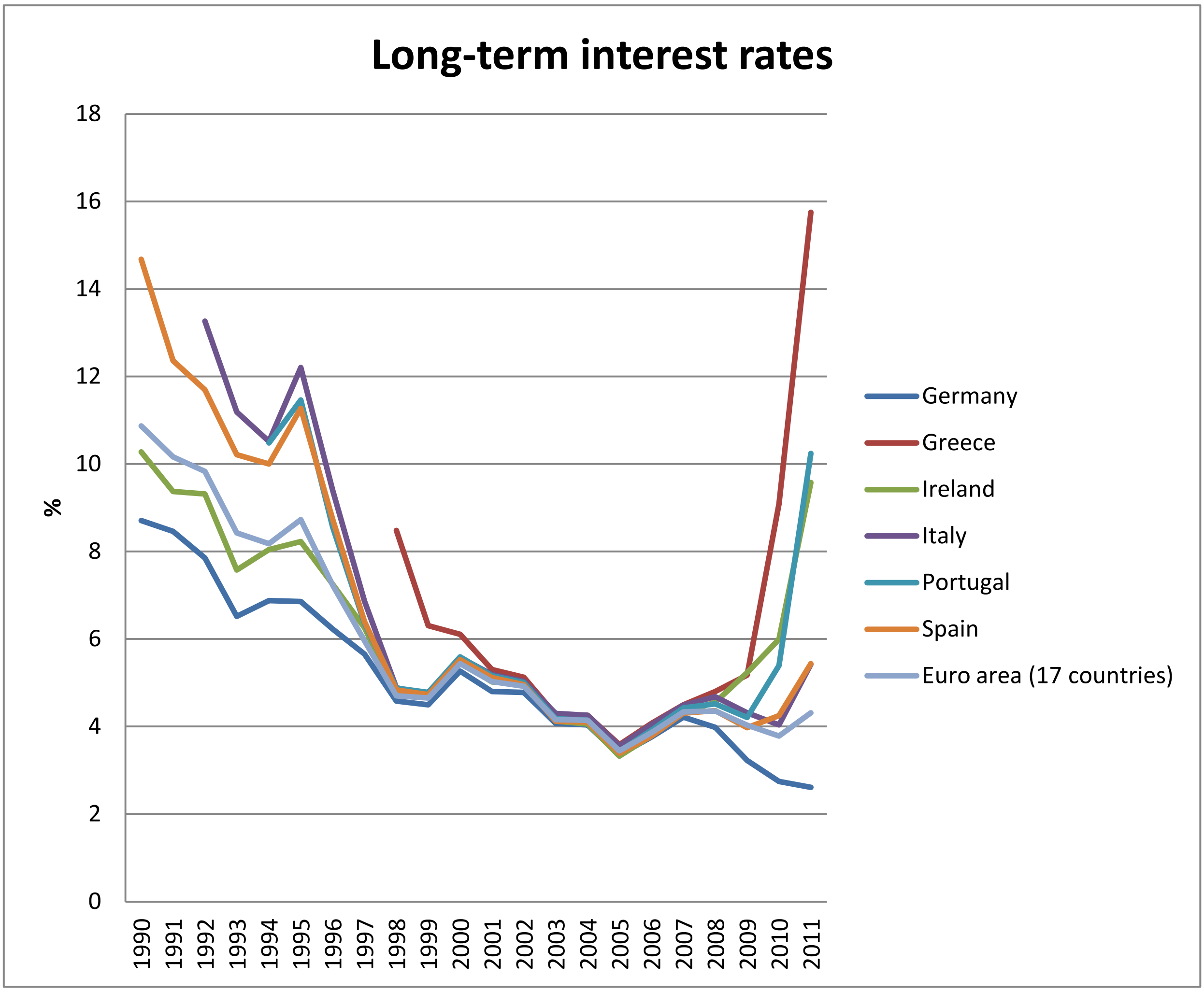
Although an increase in private debt was the case for many European economies, Spain's economy proved to be substantially more susceptible to high private debt during the boom. This enormous debt cannot be financed domestically and hence must be borrowed from abroad, and this is the root of the vicious circle. As mentioned briefly earlier, it is exactly the financing of debt by foreign investors that presents the vicious circle. Higher interest rates, due to higher risk premium demand, will worsen the debt even more. The development in interest rates is thus an important macroeconomic factor in the Spanish crisis.

As the chart a few paragraphs below shows, the long-term 10-year interest rate has been steadily rising since the unfolding of the crisis, and is presently very close to hitting 7%. More notably, however — and this phenomenon holds true for many of the other crisis hit countries as seen in the chart — Spanish interest rates took a steep drop from over 14% in the early 1990s to below 4% in 2005. This interest behavior is of course a direct effect of the decision to enter the Economic and Monetary Union and adopt the Euro as a common currency in most of the countries in the EU. As seen in many countries, these low interest rates led to high consumption and fueled massive private residential investments that eventually caused the real estate bubble.

As of now, the massive private debt of Spain is mainly responsible for constraining long term growth. The issue of the Spanish banking sector has been thoroughly investigated above, but to recap on one of the highlights, one important measure already taken by the Spanish government to dampen the crisis has forced 45 Spanish savings banks to consolidate into 14, as they were facing bankruptcy. The Spanish bank sector in general is facing a severe downfall and is in desperate need of a public bail-out to remain solvent. As mentioned earlier, one of aggravating factors for Spain, concerning the debt, is the rise in interest rates. Thus we will try to analyze the interest rate fluctuation and explain the development.

Interest rates

During a recession, and especially a crisis like the one unfolding in the Euro zone at the moment, investors tend to look for “safe harbors” for their money, or demand a high risk premium to invest in struggling countries. As a result, interest rates will generally start fluctuating as key figures of fiscal deterioration of certain countries start to show, which is illustrated in the graph shown below.



Source: OECD Statistics

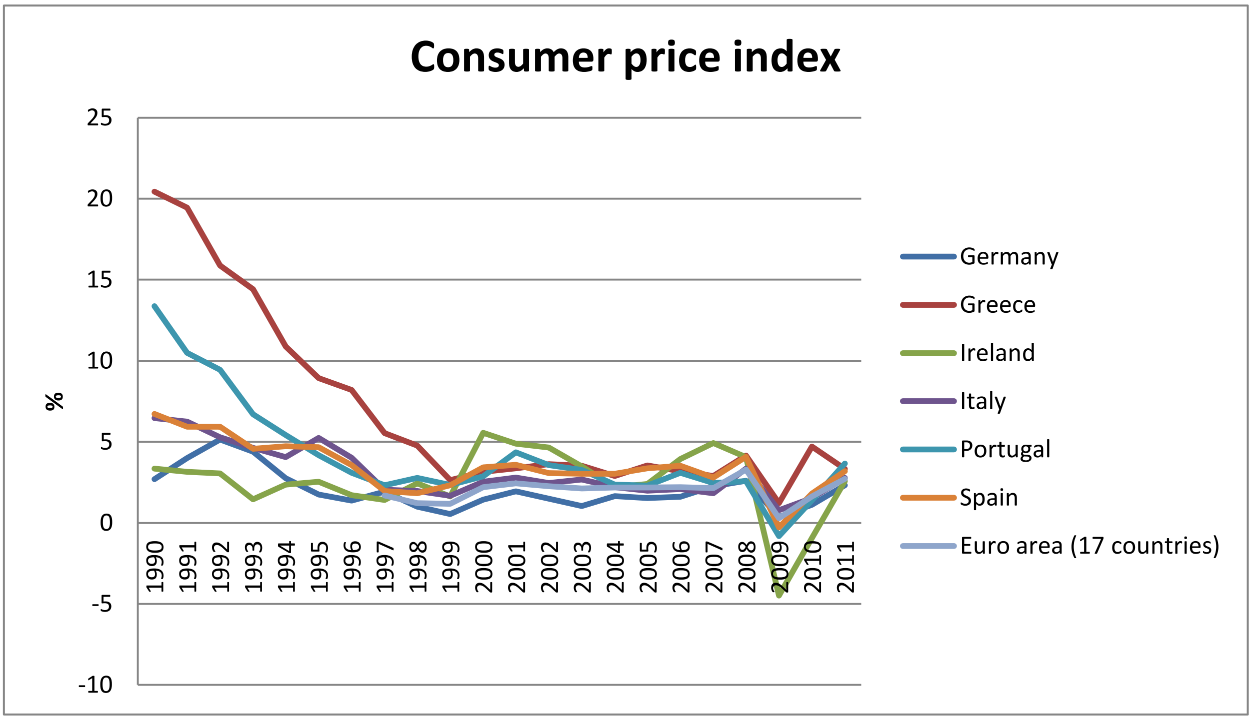
This chart shows the development in long-term interest rates from 1990-2011 for Germany, Greece, Ireland, Italy, Portugal, Spain and the Euro area average.

As anticipated, not only do the interest rates of the struggling countries skyrocket, those of Germany, as well as other strong European economies (i.e. Denmark, Sweden and Norway) fall dramatically as well. As of now, Germany is almost experiencing negative interest rates, as investors seemingly are willing to pay to have their money safe kept. On the other hand, those who choose to invest in the crisis-hit countries demand a significant risk premium as shown by the chart.

Analyzing the long-term interest rates of the PIIGS countries, Germany and the Euro zone average, it is quite obvious that Greece is in a far worse condition than Spain, with an interest rate peaking at almost 30%. Also Portugal and Ireland have had fairly high interest rates during the crisis and have, together with Greece of course, received financial emergency help packages from the EU, ECB and IMF. These countries struggle with much higher public debt than Spain, thus explaining the rather significant gap. The interest rate level that seems to determine whether a country can continue struggling on its own, or needs financial aid, is around 7%. This is often referred to as the critical level. This being so, 2012 is an interesting year for Spain, as it has come dangerously close to the barrier of 7% multiple times. The steep increase in interest rates for the suffering countries acts as a vicious circle, dragging them into even higher indebtedness.

Inflation

Going back to the macroeconomic effects of the implementation of the common currency and the EMU, other problems have arisen with the development of the monetary experiment. While interest rates were streamlined, demands were made from the EU to drastically lower inflation to accommodate the new currency.



Source: OECD Statistics

This chart shows the development in the consumer price index from 1990-2011 for Germany, Greece, Ireland, Italy, Portugal, Spain and the Euro area average.

As the graph illustrates, the 1990s were among other things the decade of consolidation in which the upcoming Euro countries sought to achieve the goals set by the EU. Much attention was therefore paid to the inflation level of many of the southern European economies, in order for them to meet the criteria for entering the Euro scheme. The goal level was set to 3% by the Maastricht Treaty of 1992 and served to streamline the Euro zone economies to prepare for the implementation of the Euro. When examining the graph it is clear that the inflation levels of both Greece and Portugal drastically exceeded that of Spain, which seemingly follows Italy from around 7% in the early 1990s to below 3% by 1999 when the Euro project was approaching full implementation and the Euro was introduced into the financial markets, replacing the former European Currency Unit (ECU).

As we can observe from the two previous charts, inflation and interest rates were closely related for the PIIGS from the beginning of the 1990s, and the birth ground of the Euro, all the way up until the onset of the crisis. These countries were now plunged into a macroeconomic environment where the pace of economic development was set by the much stronger European economies, e.g. Germany. While it was easy to follow during the boom, the current recession has been an enormous eye-opener to the huge differences in economic stability among the Euro zone countries.

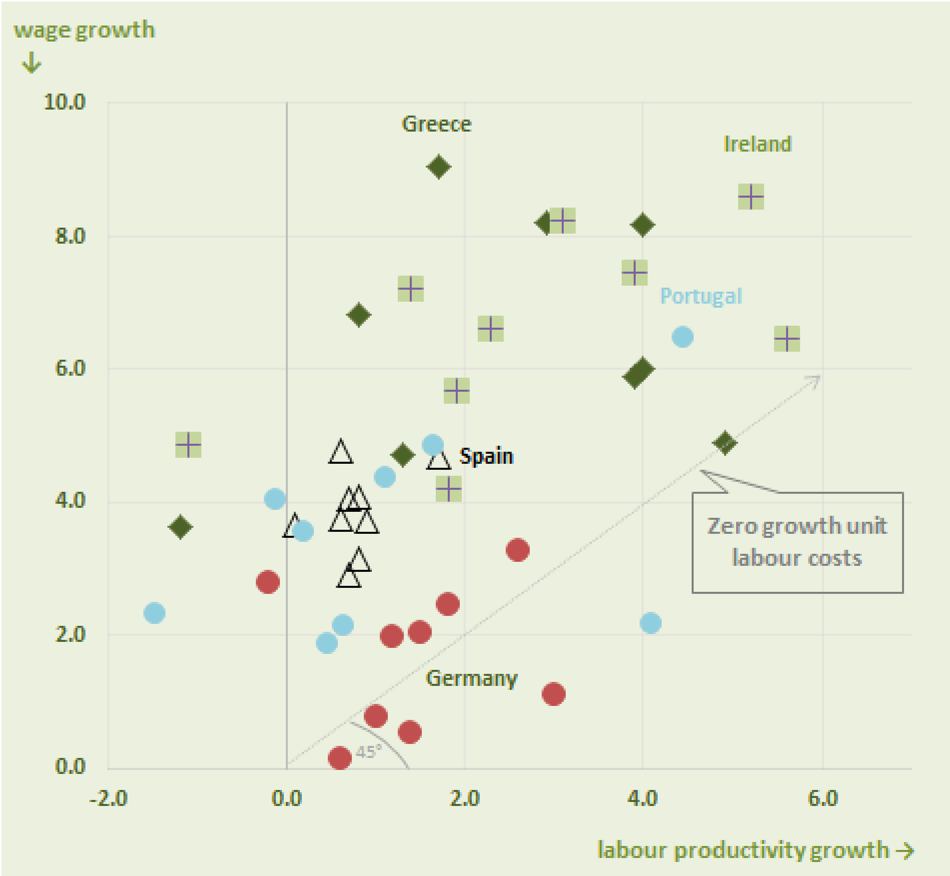
The environment created by the implementation of the Euro overheated the economies of the PIIGS much faster than was tolerable in the long run. In terms of booms, what goes up must come down at some point, and the unfolding crisis is a clear reflection of this saying. In the case of Spain private spending and lending exploded and the low interest rates stimulated real estate purchase, although house ownership was already really high in Spain compared to the rest of Europe, as explained in the previous section. This development in consumer behavior in conjunction with a public growth model based heavily on construction and real estate ultimately led to the huge private sector debt, during the burst of the bubble, that is burdening Spain today.

Wage and productivity growth

When investigating the nature of a boom, or just a high growth rate in general, another important factor in the economic development is the relationship between growth in productivity and wages. Peeters and Den Reijer (2011) did a thorough analysis of competiveness, nominal wages and labor productivity that revealed a large measure of coherence between the ratio of growth in productivity and wages up through the 2000s and economic stability in today's EU. This subject is often neglected when performing macroeconomic analysis between countries, but is actually a key factor in explaining the discrepancies across the Euro zone.

In general the goal or ambition in economic growth is to have an at least equal relationship between growth in productivity and wages, while striving to achieve higher productivity growth than wage growth. This will result in a strong competitive advantage in the international market and a long-term increase in real wages. If the relationship is reciprocal the result will generally be a short term increase in real wages and a long-term loss of competiveness resulting in stagnation of economic growth. During the boom of the 2000s and the early stages of Euro implementation, many of the crisis-hit countries had a relatively high increase in wages compared to growth in productivity, which led to a reduction in competitiveness.

Nominal wage and productivity growth 2000-2008



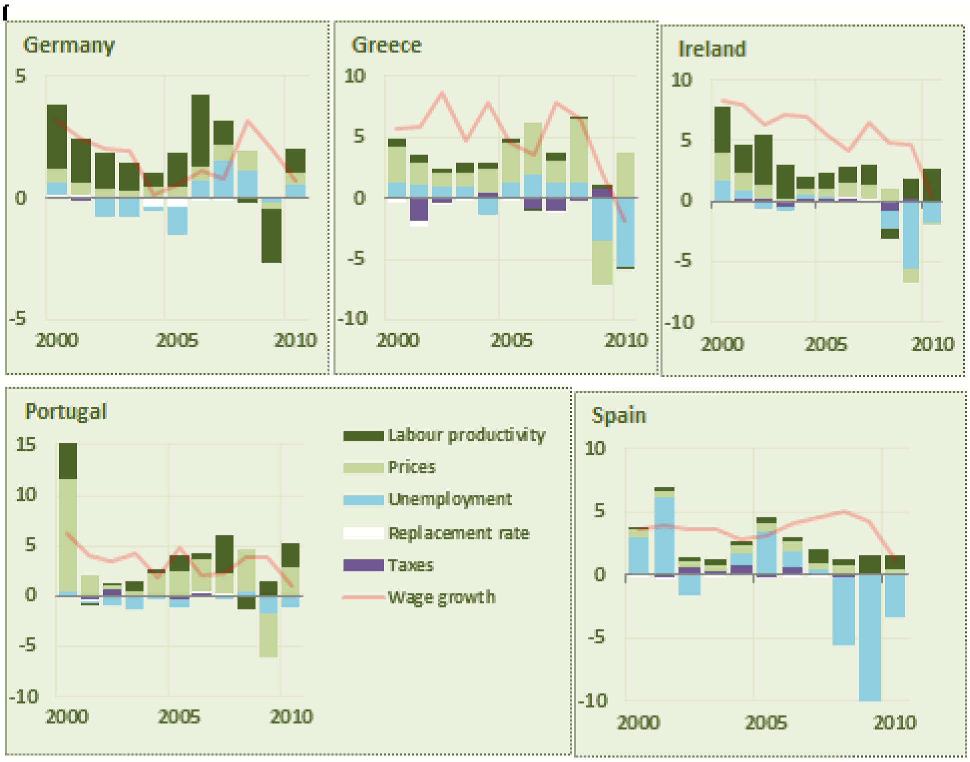
Source: Peeters and Den Reijer (2011)

This chart shows the development in the correlation between wage growth and labor productivity growth from 2000-2008 for Germany, Greece, Ireland, Portugal and Spain.

While this holds true especially for Greece, which has lost a lot of competitiveness since the introduction of the Euro, which in turn bears some of the responsibility for the deterioration of the Greek economy, the same goes also for Portugal and Ireland, showing the nature of the destructive consequences this development can have on booming economies. Although to a lesser degree, Spain has also had substantially higher wage growth compared with growth in productivity. As the chart also illustrates, the biggest economy of the EU, namely Germany, manages, as the only country in the chart, to have higher productivity growth than wage growth, emphasizing its strong economic position today, even during the crisis.

While there is a rather large discrepancy between Spain and some of the other crisis-hit countries — the worst case being Greece, which has the same growth in productivity but more than double the growth in wages, whereas Portugal and Ireland, although having higher wage growth, also have substantially higher growth in productivity — the underlying contributions to wage growth are entirely different among the respective countries.

Contributions to nominal wage growth



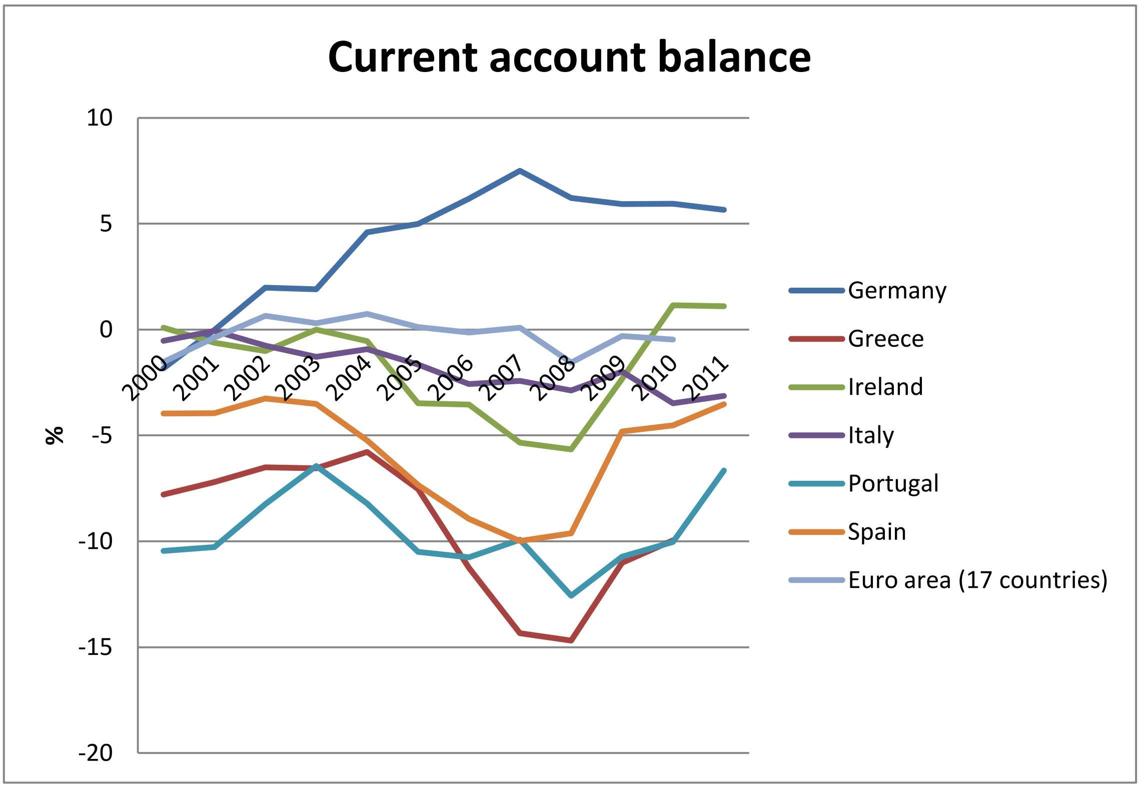
Source: Peeters and Den Reijer (2011)

This chart shows the development in the relationship between wage growth and the contribution factors for the growth from 2000-2010 consisting of labor productivity, prices, unemployment, replacement rate and taxes for Germany, Greece, Ireland, Portugal and Spain.

As illustrated by the chart above, wage growth was affected by entirely different combinations of macroeconomic factors. Wage growth in Spain is primarily linked to unemployment, as illustrated by the chart above, while the biggest contribution in Germany and Ireland consists mostly of growth in labor productivity, while for Greece and Portugal, the development in prices is the highest contributor[68]. As the chart demonstrates, Germany and Ireland seem to adjust wages reasonably around productivity growth, both upwards and downwards. Wage growth is to some extent affected by prices and unemployment, but these are minor factors. For Greece and Portugal, however, prices are the main factor in wages adjustment, and the main problem here is that wages only seem to adjust upwards when prices go up, but not downwards when prices drop. As for Spain, as mentioned earlier, the main driver of wage growth is unemployment, which seems to adjust symmetrically in similar fashion to productivity.

Current account balance

As we conclude that the development in wage growth in the PIIGS countries has had a negative effect on competitiveness, which is coherently linked to export opportunities, investigating the current account balance is an interesting measure in the macroeconomic analysis.

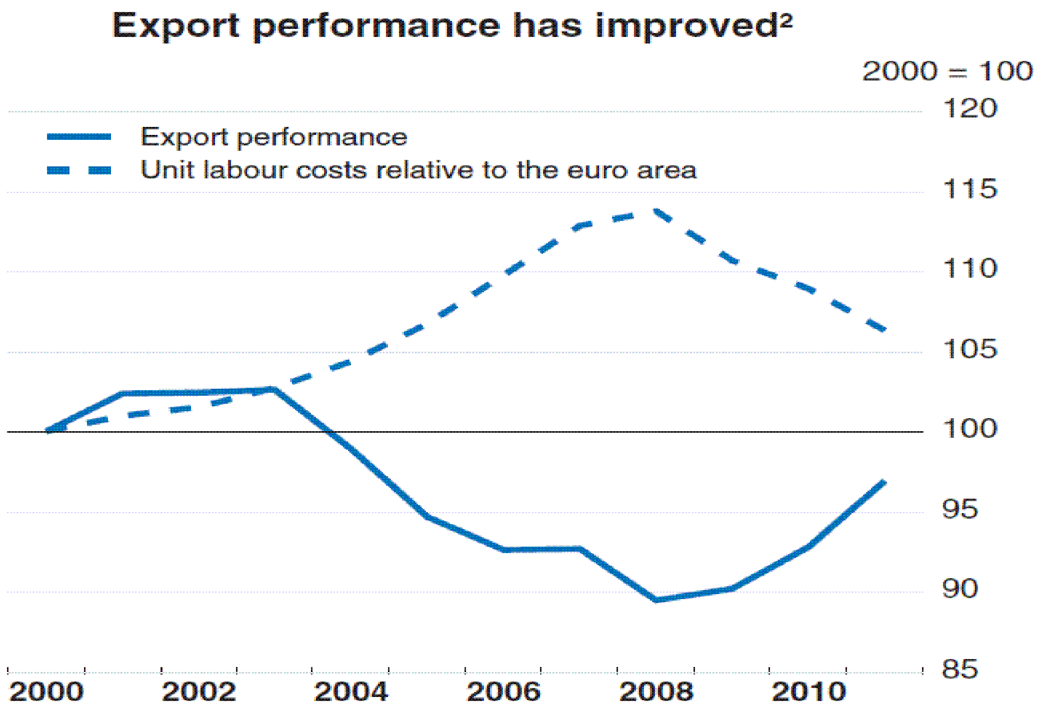


Source: OECD Statistics

[68] Peeters & Den Reijer (2011)

This chart shows the development in the current account balance from 2000-2011 for Germany, Greece, Ireland, Italy, Portugal, Spain and the Euro area average.

As the chart shows, the current account balance of especially Portugal, Greece and Spain has been declining since around 2003, emphasizing the fact that they have lost competitiveness throughout the boom. We are aware that competitiveness and the current account balance are not perfectly correlated, and that other factors can influence the current account balance. It is, though, a strong indicator of the effects of wage increase not related to productivity growth as well as the influence of the Euro scheme. While Portugal, and especially Greece, have had steeper falls in their current account balances, the tendency for Spain does reflect the development in competitiveness as previously determined. The increase of the balance during the crisis for the respective countries can reflect an increase in exports but can also represent a decrease in imports. As mentioned earlier, domestic demand in Spain has dropped significantly, which also underlines the increase in the current account balance from 2009 and onwards. This could lead one to believe that the increase in the current account balance solely came from a decrease in imports. However, Spain has actually presented an increase in exports since the beginning of the crisis, as shown by the chart below.



Source: OECD Economic Outlook, November 2011

This chart shows the development in the relationship between export performance and unit labor costs relative to the Euro area from 2000-2011 for Spain.

As the chart shows, there has been an increase in export performance since the middle of 2008. The interesting thing about the increase in export performance, as the chart also illustrates, is that the export performance is almost perfectly negatively correlated with unit labor costs. While the economy is forecasted to continue contraction throughout 2012, mainly due to budgetary consolidation and deleveraging in the private sector[69], which dampens domestic demand, the drop in unit labor cost allows for expansive world trade and a gain in competitiveness which fuels stronger exports, and thereby helps the current account balance.

Latest forecast and expectations

Having investigated the macroeconomic impact of the crisis, it is clear that the crisis in Spain is severe and specifically concerns unemployment and private debt. The latest forecast from the OECD is illustrated below.

[69] OECD (2012)

Spain: **Demand, output and prices**

	2008	2009	2010	2011	2012	2013
	Current prices € billion	Percentage changes, volume (2008 prices)				
GDP at market prices	1 087.7	-3.7	-0.1	0.7	-1.6	-0.8
Private consumption	622.4	-4.3	0.8	-0.1	-2.9	-1.8
Government consumption	212.0	3.7	0.2	-2.2	-7.7	-4.5
Gross fixed capital formation	312.0	-16.6	-6.3	-5.1	-9.3	-2.4
Final domestic demand	1 146.4	-6.1	-1.0	-1.7	-5.2	-2.5
Stockbuilding[1]	4.6	0.0	0.0	0.0	-0.1	0.0
Total domestic demand	1 151.0	-6.2	-1.0	-1.7	-5.3	-2.5
Exports of goods and services	288.2	-10.4	13.5	9.0	3.1	5.7
Imports of goods and services	351.5	-17.2	8.9	-0.1	-9.2	0.8
Net exports[1]	- 63.3	2.8	0.9	2.5	3.7	1.6
Memorandum items						
GDP deflator	_	0.1	0.4	1.4	0.5	1.4
Harmonised index of consumer prices	_	-0.2	2.0	3.1	1.6	2.1
Private consumption deflator	_	-1.2	2.4	3.2	2.1	2.1
Unemployment rate	_	18.0	20.1	21.6	24.5	25.3
Household saving ratio[2]	_	13.0	7.7	5.7	5.0	6.9
General government financial balance[3]	_	-11.2	-9.3	-8.5	-5.4	-3.3
General government gross debt[3]	_	62.9	67.1	75.3	87.9	90.9
General government debt, Maastricht definition[3]	_	53.9	61.2	68.5	81.1	84.1
Current account balance[3]	_	-4.8	-4.5	-3.5	-0.9	0.1

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of disposable income.
3. As a percentage of GDP.

Source: OECD Economic Outlook 91 database.

Source: OECD Economic Outlook, May 2012

This table shows the expectations for different macroeconomic factors from 2012-2013 for Spain.

It is clear that the near future for Spain consists of many challenges. Before engaging in a thorough analysis of crisis management for Spain, by drawing comparisons with other similar crises, in order to develop solutions for the crisis in Spain, we will highlight the framework of the EU, as it is important in determining the future solutions for Spain.

The framework of the EU

Having established the root causes and origins of the crisis and the macroeconomic effects of the crisis, we will now move on to highlighting the framework of the EU, and of course the ECB, to help us understand what went wrong and to know the framework, which Spain, among others, operates in. This will lead us closer to presenting solutions to the crisis for Spain.

There are two different perspectives to approach when discussing and implementing solutions to the crisis, namely solutions from the EU and the ECB, as the centralized authorities, and solutions from the national level of Spain. As both perspectives are important in the solutions to the crisis in Spain, it is important to factor in both when presenting possible solutions.

In suggesting solutions to the crisis, it is important, in addition to the findings of our chapter on the root causes and origins of the crisis, to assess the initial "rules of the game" for the Euro, concerning the Maastricht Treaty and the later pacts presented by the EU, as well as highlighting the charter of the ECB. This will serve as the defined background and foundation of the EMU, and will play an important role in determining what went wrong and caused the sovereign debt crisis, more specifically for our analysis, in Spain.

We will start this section off by highlighting the initiatives already implemented, in the years prior to the introduction of the Euro, by the EU and the ECB, and then move on to discuss the current ongoing solutions being suggested and implemented by the EU and the ECB. Finally, we will compare our findings from our first chapter, root causes and origins of the crisis, to those of the EU and the ECB and move on to discuss crisis management from similar scenarios in other countries. This will eventually lead us to present our own thoughts and possible solutions as to which initiatives could be adopted in order to relieve the crisis and prevent further worsening, as well as securing a stable fiscal policy to avoid similar scenarios occurring in the future.

The rules of the game for the Euro

In the wake of the American subprime crisis, when the true instability of the southern European countries was illuminated, numerous measures have been taken by different institutions to accommodate the ongoing crisis. While Greece has been the primary focus of concern and main target for the fiscal tightening in the EU, due to its excessive government debt and risk of total collapse, Spain has become the focus over the last year. There are several reasons for this change in perspective. First of all, Greece contributed with only 2.6% to the total GDP of the Euro zone in 2011[70]. Spain on the other hand, is the 4th biggest economy in the Euro zone and accounted for 12.6% of the total Euro zone GDP in 2011[71], thus having a much larger impact on the Euro zone economy, especially in a situation of default or a circumstantial exit from the Euro scheme. Another important factor, that has drawn the financial markets' attention to the Spanish economy, is the recent worsening of the government debt. While Greece's initial deterioration revolved around huge public debt, accounting for 134% of GDP in 2009 and as much as 170% of GDP in 2011[72], the level of the Spanish government debt was quite low at the wake of the crisis, even when comparing it with some of the biggest economies in the Euro zone, measuring 62.9% in 2009. However, the evaporation of fiscal revenue from the private sector has steadily increased the government debt and the rising long-term interest rates only fuel the crisis even more, digging an even deeper hole for the public debt. On a final note, the main driver, throughout the crisis, for the attention on Spain is, as earlier analyzed, the substantial private debt that requires foreign financing.

In the context of analyzing and discussing solutions to the ongoing crisis, it is important to highlight the different measures taken by different institutions over the course of the implementation of the Euro scheme, especially those from the EU. As we have seen in our previous analysis, the foundation of the EMU and introduction of the Euro has caused severe turbulence in the Euro zone, especially in the PIIGS countries. Investigating the initial "rules of the game" is thus crucial in the process of analyzing critical failures and forecasting future initiatives. One of the first and most prominent agreements among the EU member states, besides of course the Maastricht Treaty, in the context of maintaining the stability of the EMU, is the Stability and Growth Pact.

[70] OECD Statistics

[71] OECD Statistics

[72] OECD (2012)

The Stability and Growth Pact

The Stability and Growth Pact consists of agreements among the member states of the EU relating to fiscal policy. It relates to the third phase of EMU, namely the fixing of exchange rates and introduction of the single currency, the Euro, replacing the ECU, which was the common currency prior to the Euro. The pact was effective as of 1 January 1999, to ensure that the member states of the EMU maintained a strong fiscal discipline to accommodate the introduction of the Euro. "The rules of the game" for the Euro were set by the Maastricht convergence criteria and the purpose of the Stability and Growth Pact was to ensure that these rules were enforced. The following fiscal criteria have to be met by the member states:

- General government budget deficit: the general government budget deficit expressed as a percentage of GDP must not exceed 3% as of the end of the preceding financial year. If this it is not possible, then the deficit can be temporarily above the 3% level, but must still be close to it[73].
- The public debt: the gross general government debt must not exceed 60% of GDP as of the end of the preceding financial year. If this is not so, the proportion of the debt must show a tendency towards a considerable reduction and must converge on the reference value at a satisfactory rate[74].

The pact consists of three parts. A resolution of the European Council in Amsterdam of 17 June 1997[75], and two Council regulations of 7 July 1997, respectively 1466/97[76] and 1467/97[77]. Regulation 1466/97 clarified in detail *"the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies*" while Regulation 1467/97 elaborated *"on speeding up and clarifying the implementation of the excessive deficit procedure".*

[73] Kesner-Skreb (2008)

[74] Kesner-Skreb (2008)

[75] Resolution of the European Council on the Stability and Growth Pact, (97/C 236/01)

[76] Council Regulation (EC) No. 1466/97

[77] Council Regulation (EC) No. 1467/97

The economic policy of the EU is very distinctive, compared for example to the USA, in the sense that monetary policy is centralized around the European Central Bank (ECB) while fiscal policy is decentralized and comes under the jurisdiction of the national governments of the respective EU countries. We will analyze and investigate the role and challenges of the ECB in the next section, and in the following chapter we will discuss the implications of the peculiar relationship between centralized monetary policy and decentralized fiscal policy which EMU involves. While most fiscal policy is decided individually among the member states' governments, a common set of rules is applied centrally from the EU as mentioned earlier, namely fiscal criteria on budget deficit and public debt. The Euro scheme relies heavily on healthy government finances to sustain price stability and economic growth. This fact emphasizes the need for commonly defined and established rules centrally in the EU. The criteria in the Stability and Growth Pact stem from the 1992 Maastricht Treaty, where these parameters were first introduced.

Initially the idea of the Stability and Growth Pact was proposed by the German finance minister Theo Waigel in the mid-1990s[78]. In other words, Germany insisted that the regulatory framework of the EU should consist of common fiscal criteria, if it was to give up its strong currency, the D-mark, and enter the Euro scheme. Germany had a history in recent years of maintaining a high level of growth coupled with low inflation, and thus feared that some of the other economies, namely some of the southern European countries, would inflate the European economy. Thus the implementation of the Stability and Growth Pact sought to eliminate the negative development in inflation and public debt and deficit as seen in some European economies.

By 1 March 1999 the member states had to fulfill the criteria or present stabilization programs to the European Council and the Commission. These programs would be carefully reviewed and evaluated each year following the introduction of the Euro. Essentially the Stability and Growth Pact enabled the European Council to penalize member countries that did not fulfill the criteria and/or did not initiate appropriate measures to reduce excessive deficits and public debt. The penalties took the form of a non-interest-bearing deposit that could be converted to a fine if the respective country

[78] Kesner-Skreb (2008)

did not fulfill its goal within 2 years. In reality, however, the European Council had no fixed guidelines on how to administer these penalty measures. The Council had to conduct individual assessments of each case, considering all the factors of the supposedly exceeded budget deficit or public debt. The limitations on the yearly supervision and evaluation of the rule set have received substantial criticism for not being flexible in the sense that the rules apply to single years rather than a whole economic cycle. More specifically, critics feared that the barriers on public spending and budget deficit would have a severely negative consequence on some economies during an economic crisis, leading to a worsening in growth opportunities. In retrospect, we can conclude that the critics were right, as it is simply impossible to maintain the dictated criteria during a recession and especially one as grim as the Euro crisis that stems from the recession unfolded by the US financial crisis as well as flaws in the Euro scheme developing as a consequence.

While the Stability and Growth Pact's initial intention was to provide a toolset designed to enforce the criteria established in the Maastricht Treaty, time has shown enforcement to be very inconsistent. One of the milestones in inconsistency came in 2003 where the European Council did not enforce the penalty on Germany and France when they exceeded the limits of the pact[79]. This showed above all the weakness in the enforceability of the pact. It was simply impossible to apply the conditions of the pact to the big countries, which paradoxically were the ones to introduce and support the implementation of the pact, as their size and political influence clouded the judgment of the European Council. This case served as the culmination of the years of criticism on the different issues that followed the introduction of the pact. It was clear that the very purpose for which the pact was created had failed, and instead of investigating why it had failed and correcting it, the Council took a very different decision. As a result of the criticism, the European Council decided in 2005 to soften the rules of the pact[80]. Essentially, the core values of the original pact with respect to the budget deficit and public debt were retained, but the instead of reviewing on a yearly basis, the countries that were subject to supervision were reviewed every fourth year. In addition, expanding

[79] Kesner-Skreb (2008)

[80] Kesner-Skreb (2008)

economies with low public debt and growth opportunities were entitled to an additional 1% budget deficit and countries with high debt, close to over 100% of GDP, and low growth opportunities were encouraged to produce a budget surplus. The last main change in the Stability and Growth Pact was a requirement for the member countries to tighten their fiscal balances during expansion years, to accommodate for future slow growth or even recession.

Summing up on the Stability and Growth Pact, we can conclude that the initial idea behind the pact and its implementation was well intended, but when it came down to actually utilizing the toolset to punish countries that did not live up to the criteria, the European Council failed to enforce the rules. When they failed to fine Germany and France in 2003, they responded by relaxing the rules in 2005, thus worsening the regulatory framework they were supposed to enforce. It is important to note that Spain has been within the rules since the introduction of the Euro and all the way up to the crisis, as shown in the chapter concerning the macroeconomic effects of the crisis. As we have earlier underlined, the public debt and deficit of Spain have not been the center of the crisis, and thus Spain must be applauded for not breaking the rules.

All in all, central regulation by the Council has been too weak, allowing many countries to break the criteria without penalty. Referring to our analysis on the macroeconomic development, it is clear that many countries failed to live up to the rules set by the Stability and Growth Pact. While the ongoing recession itself was unavoidable, as explained earlier, many of the crisis-hit countries would have been in a far better position to tackle the recession had they respected the rules of the pact. Therefore it is crucial that the authority of the Stability and Growth Pact, and the fear of penalties for breaking the rules, is rebuilt. We will keep these findings in mind when we later in this chapter analyze what the EU and other institutions have done after the crisis to accommodate it.

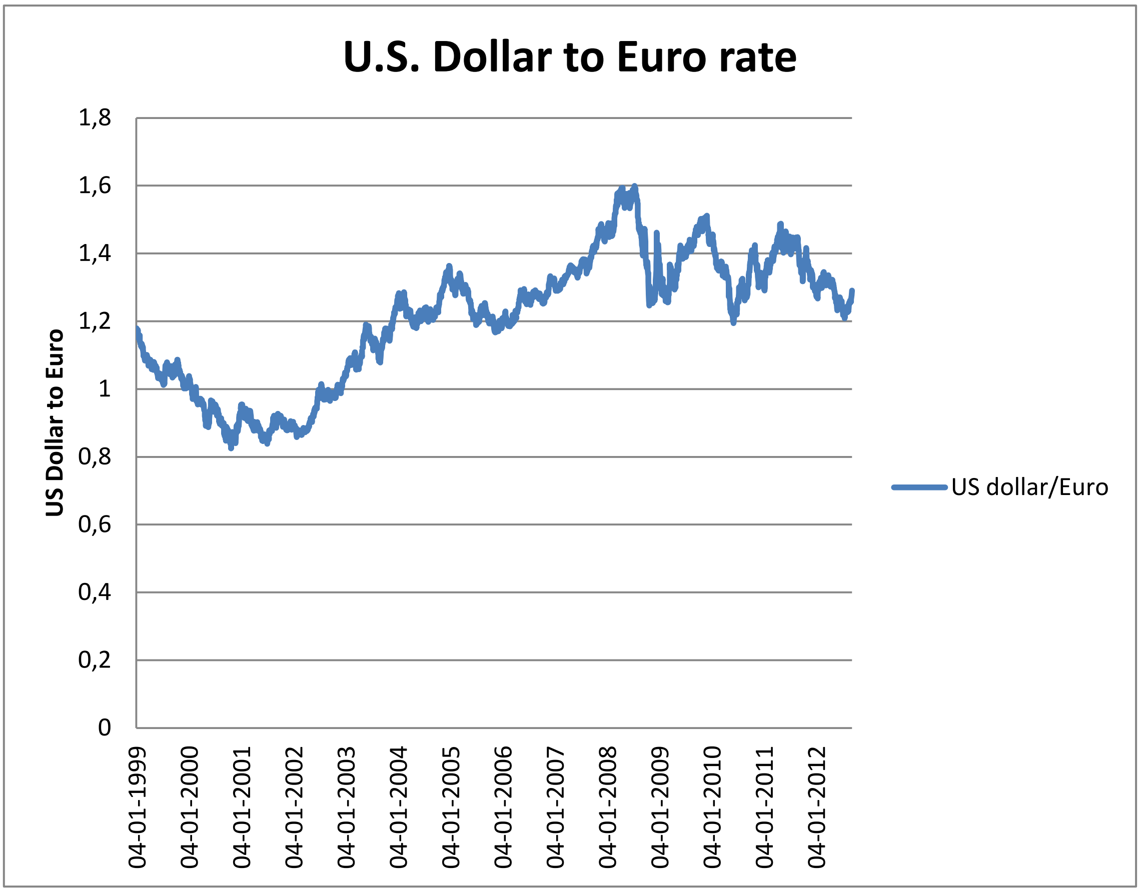
While the central rules of the EU play a huge role in the Euro scheme, another important factor is the role of the European Central Bank (ECB). In the next section we will highlight the establishment and role of the ECB in the implementation of the EMU and the Euro.

The ECB Charter

In 1998, the European Central Bank was created prior to the introduction of the common European currency, the Euro, which replaced the former ECU[81]. The purpose of the ECB is similar to the roles of any national central bank (NCB) in the sense that it operates to safeguard the currency, the Euro, in respect to other currencies and to manage interest rates for the Euro on a European scale. However, the ECB differs from NCBs in the sense that most NCBs pay equal attention to the unemployment rate and inflation, while the ECB Charter dictates that ECB should first and foremost be concerned about the inflation level[82]. In relation to the matter of inflation, it is important to note that the ECB is not allowed to print money as it sees fit, like other central banks. In sharp contrast to the execution and enforceability of the Stability and Growth Pact, the ECB has proved itself extremely effective. Along with the fiscal criteria mentioned in the Stability and Growth Pact, EU countries were also asked to lower their inflation prior to the introduction of the Euro. As illustrated in the chapter concerning the macroeconomic effects of the crisis, it is clear that the inflation level of all countries, and especially some of the southern European economies, fell drastically to accommodate the implementation of the Euro, and the ECB has managed to keep the inflation low and the currency strong throughout the period, including the post crisis years. When benchmarking a currency's strength, the best opponent to compare it to is of course the U.S. Dollar.

[81] http://topics.nytimes.com/top/reference/timestopics/organizations/e/european_central_bank/index.html

[82] http://topics.nytimes.com/top/reference/timestopics/organizations/e/european_central_bank/index.html



Source: ECB Statistics

This chart shows the development in the relationship between the U.S. Dollar and the Euro from 1999 to 2012.

As the chart shows, the Euro has held a strong position up through the boom, compared to the US Dollar. After the financial crisis, the Euro fell slightly but recovered again. The recent development is of course a combination of uncertainty about the future of the Euro and the crisis management of the Euro crisis, as well as stronger economic signs from the US.

The ECB would not have to wait more than a decade from its foundation before the first big and very real test him it, namely the aftershock of the global financial crisis, triggered by the collapse of the US investment bank Lehman Brothers, known to most as the European debt crisis[83]. As so, the ongoing challenges of the ECB are vast and we will cover the role of the ECB post crisis in a few paragraphs.

Having established the initial rules of the game for the Euro we will jump right into the mist of the crisis and analyze the measures being taken by the same institutions in order to dampen the crisis and fuel the future with growth and prosperity.

The new rules of the game for the Euro

As the crisis has unfolded across Europe and in the most severe character in the PIIGS economies, naturally the EU has taken it upon the unity to develop and implement different measures to drag the Euro zone out of the grip of the crisis. These measures take the role of both monetary character, sought after by the ECB, and fiscal character which is of course, as underlined in the Stability and Growth Pact but also the foundation of the EMU, handled decentralized by the respective governments, while some important and general rules are being tailored centralized by the EU. This paragraph aims to capture the initiatives taken post crisis and analyze the intended effect and actual effect.

The EU has implemented two new major pacts after the impact of the crisis, namely the fiscal pact and the growth pact.

The Fiscal Compact

The Fiscal Compact, also known as the fiscal pact or the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)[84], was drafted and finalized on the 30th of January 2012 by all the member countries of the EMU, and was signed on the 2nd 2012 of March, with the sole exception of two countries, namely the United Kingdom and the Czech Republic[85]. The fiscal pact will be effective as of the 1st of January 2013, provided that twelve member countries, whose currency is in Euro, have ratified the pact, or on the first day of the following month in

---

[83] http://topics.nytimes.com/top/reference/timestopics/organizations/e/european_central_bank/index.html

[84] http://european-council.europa.eu/home-page/highlights/the-fiscal-compact-ready-to-be-signed-(2)?lang=en

[85] http://european-council.europa.eu/home-page/highlights/the-fiscal-compact-ready-to-be-signed-(2)?lang=en

which ratification of the twelfth country is achieved, whichever date occurs first[86]. As of September 2012 a total of 9 countries have ratified the Fiscal Compact: 6 out of 17 countries in the Euro zone and 3 out of 8 other committed EU countries[87]. This pact stems from the Stability and Growth Pact, which we examined earlier, and serves as an extension to the previous pact and invokes increased centralization to key fiscal figures, promoting the thought of a fiscal union. The thought of a fiscal union was initially proposed in 2007 by Jean-Claude Trichet, former president of the ECB[88]. This idea of a fiscal union was later encouraged by The Economist in 2009[89].

The introduction of the Fiscal Compact is one of many steps from the EU in order to accommodate the ongoing Euro crisis. While the necessity and focus of the pact of course lies in the solving the crisis, it is also another step in the direction of a more centralized fiscal EU. While many of the member countries would with no doubt be reluctant to give away their fiscal sovereignty, it is unarguably a step in the right direction, if the Euro scheme is to survive in the long run. Just like the initial idea of the Stability and Growth Pact, the foundation of the Fiscal Compact began in the early 2010, as Germany enforced its view on the requirement of a rule set containing the idea of a balanced budget. By late 2010 proposals on reforming the Stability and Growth Pact were made and by March 2011, the new reform was initiated. While the changes to the content were minor, in the sense of fiscal numbers, the reform introduced an automatic procedure for applying the penalty fees, in the case of countries overstepping the criteria on either budget deficit or public debt, thus tightening the enforceability of the previous pact[90]. Finally, by the end of 2011, only months before the final draft, Germany among others vowed to create a fiscal union across the Euro zone, thus laying the final touch on the pact prior to its release[91].

---

[86] The Fiscal Compact (2012)

[87] http://www.consilium.europa.eu/policies/agreements/search-the-agreements-database?command=details&id=&lang=en&aid=2012008&doclang=EN%22

[88] http://www.ecb.int/press/key/date/2007/html/sp071023.en.html

[89] http://www.economist.com/node/13767419

[90] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/119888.pdf

[91] http://www.guardian.co.uk/business/2011/dec/02/angela-merkel-eurozone-fiscal-union

The main objectives of the Fiscal Compact is, in extension of the Stability and Growth pact, to secure strong fiscal discipline by introducing automatic sanctions and stricter surveillance, as well as the "balanced budget rule"[92]. The balanced budget consists of rules for the budget surplus/deficit. Much like the rule set of the Stability and Growth Pact, the new rules define a "balanced budget" as a general budget deficit below 3% and a structural deficit below 0.5%. In addition, and this is what implies the balance or flexibility of the rules, countries that have a government debt level below 60% and possess very low risk regarding long-term sustainability of government finances, are allowed to have a structural deficit of 1%.

While the changes made in the pact seem rather insignificant, the signal it sends is far stronger than that of the Stability and Growth Pact. The old pact suffered from inefficiency and lack of enforcement. Thus, the new and updated pact was a crucial step from the EU to signal zero tolerance on fiscal slack of the member countries, and set the sails for a future possible tighter fiscal union amongst the Euro zone. The goal of the pact is essentially to ensure that responsible fiscal policy is being held, even in good times, to sustain prosperity through tough times as well. We believe that the next few years, where the new treaty will begin effectiveness, are crucial in illuminating the determination of the EU in the matter of fiscal responsibility. As with the Stability and Growth Pact, the intensions are very good. The utilization and result is the key to success however, thus we hope that the EU will set things right this time.

In addition to the Fiscal Compact, the EU has launched yet another initiative as of the summer 2012. While establishing and maintaining strong fiscal positions among the Euro zone is of the outmost importance, another natural and vital factor in recovering from the recession and ongoing Euro crisis is growth. With the latest growth pact, the EU is sending a strong message regarding the responsibility of economic development and impact the Euro zone has in international context. Thus, being one of the most important initiatives by the EU post-crisis, we will examine the pact.

[92] http://european-council.europa.eu/home-page/highlights/the-fiscal-compact-ready-to-be-signed-(2)?lang=en

The Growth Pact

The growth pact was concluded on the 28-29th of June 2012 on the summit of the European Council[93]. The pact was welcomed by especially the French president François Hollande, who had previously promised his voters a growth pact to defy the Germany, being a strong speaker of austerity measures[94]. The pact supports and extends a lot of the already stated fiscal demands from the Stability and Growth Pact and later the fiscal pact but also provides certain measures specifically meant to stimulate growth in the Euro zone. The pact emphasizes the resolute need to strengthen the financing of the economy and thus agrees to mobilize 120 bn. Euro (making up for around 1% of the BNP of the EU)[95]. This substantial amount will be deployed to accommodate fast paced and immediately enforced growth measures and consists of three elements:

- The paid in capital of the European Investment Bank (EIB) should be increases by 10 bn. Euro to strengthen the capital position and increase the total lending capital to 60 bn. Euro. This measure will free up to 180 bn. Euro for further investments among the EU, with specific focus on the crisis hit countries. This decision must be concluded by the Council of the EIB to ensure that the decision takes effect before the 31st of December 2012[96].
- The final phase of the project bond scheme should be initiated, providing further investments of up to 4.5 bn. Euro in various infrastructure projects[97]. Investors receive EU guarantees of up to 1 bn. Euro[98]. If this project is successful it can be deployed in all countries in the future.
- The EU structural funds will provide 55 bn. Euro to growth promoting measures for the ongoing period, in addition to the funds already given. These funds

---

[93] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/da/ec/131406.pdf

[94] http://www.spiegel.de/international/europe/the-eu-s-new-growth-pact-a-841243.html

[95] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/da/ec/131406.pdf

[96] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/da/ec/131406.pdf

[97] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/da/ec/131406.pdf

[98] http://www.spiegel.de/international/europe/the-eu-s-new-growth-pact-a-841243.html

> should support research and innovation, as well as providing financing for small to medium sized companies and promote youth employment[99].

In addition to these specific goals on mobilization of the 120 bn. Euro package, the growth pact contains stimulus suggestions concerning the EU inner market, energy, innovation, tax policy and employment, mobility of labor, trade and financial stability. In all aspects the pact encourages each of the EU members to strive to achieve the common goals set, in order to promote growth and future prosperity. These new measures, including the distribution of the funds from the EU, will of course benefit countries in crisis, here among Spain.

While much of the content resembles already taken initiatives, and thus some would argue does not bring much new to the table, the pact serves to provide an updated framework for the parameters of the Stability and Growth Pact from the late 1990s. As necessary initiatives vary widely between times of high growth and times of recession, it is in our eyes a very welcomed pact that seeks to present a consolidated view of the initiatives being implemented by the EU. Some do argue that the pact is simply a media stunt for the politicians to strengthen their credibility and not lose face, with emphasis on the French president who promised his voters a growth pact as part of his presidential campaign[100]. In the same context, Daniel Gros, director of the Center for European Policy Studies, was quoted saying: *"It is all just old wine on new bottles"*. While this holds true to some extent for the growth pact, so was the case for the newly introduced fiscal pact.

We believe, that even if both the fiscal pact and the growth pact are consolidated versions of initiatives and rule sets that are known and implemented already, the reasoning behind the two newly introduced pacts is to a greater extend the political signal from the EU. It is a way of illustrating responsibility, recognizing the problems in the existing rule set of fiscal- and growth policy, and emphasizing the need for action, both on EU- and national level. As earlier mentioned, one of the major issues in the earlier pacts, has been the lack of enforceability. When presenting these new pacts, the

---

[99] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/da/ec/131406.pdf

[100] http://www.spiegel.de/international/europe/the-eu-s-new-growth-pact-a-841243.html

EU sets a strong example in taking responsibility and accommodating the ongoing crisis, and demands, in a harder tone than earlier, that these newly consolidated criteria are followed by the member nations, to promote future growth and avoid similar crisis scenarios from occurring in the future.

The ECB charter

The ECB charter has not been changed notably since the introduction in the late 1990s as described earlier. However, there have been a lot of recent changes and development in the organization that are of very high importance to the ongoing Euro crisis, and thus we will highlight them here.

On 9 May 2010, in the wake of the sovereign debt crisis, the EU decided to create the European Financial Stability Facility (EFSF). The EFSF takes on the task of safeguarding the financial stability of the EU by assisting member states financially[101]. It is authorized to use the following instruments, linked to appropriate conditions[102]:

- Provide loans to countries in financial difficulties.
- Intervene in the debt primary and secondary markets. Intervention in the secondary market will be only on the basis of an ECB analysis recognizing the existence of exceptional financial market circumstances and risks to financial stability.
- Act on the basis of a precautionary program.
- Finance recapitalizations of financial institutions through loans to governments.

The EFSF is financially backed by guarantee commitments from the member states of the EU, accounting for a total of 780 bn. Euro, and can issue loans of 440 bn. Euro[103]. To underline the credibility of the EFSF, it has received the AAA rating from Moody’s and Fitch, and AA+ from Standard & Poor’s (S&P). Thus, this establishment provides necessary capital for crisis-hit areas to prevent the crisis from worsening, and is a step in

[101] http://www.efsf.europa.eu/about/index.htm

[102] http://www.efsf.europa.eu/about/index.htm

[103] http://www.efsf.europa.eu/about/index.htm

the right direction from the ECB, which is thus taking one a leading role in solving the ongoing crisis.

Another important change to note during recent years is the presidency of the ECB. On 24 June 2011, the EU leaders appointed Mario Draghi as the new president of the ECB from 1 November 2011 until 31 October 2019, replacing the former president Jean-Claude Trichet[104]. Mario Draghi obtained a PhD in Economics from MIT in 1976 and, prior to taking on the ECB presidency, served as executive director at the World Bank, managing director at Goldman Sachs and Governor of the Banca d'Italia[105]. Starting almost a year ago, it has been one of the most turbulent periods to start a presidency. Draghi has initiated several projects since he took up his position, including a 489 bn. Euro three-year loan program for the struggling European banks in December 2011[106]. In February 2012, Draghi initiated yet another portion of ECB loans for the struggling European banks, this time in a larger amount exceeding 500 bn. Euro, under the name Long-Term Refinancing Operation (LTRO)[107]. In addition to the bank loans, Draghi has increased bond purchases from crisis-hit Euro zone nations, to calm the financial markets[108].

In relation to the act of buying debt from crisis-hit members of the EU, some much discussed proposals have been tabled concerning the creation of a common European bond[109]. This proposed European bond would be similar to the US Treasury Bill, serve as a collective guarantee among the members of the EU and provide an even distribution of risk throughout the Euro zone. While this initiative would significantly strengthen the solvency of the Euro zone as a whole, Germany (among other wealthy and strong EU countries) is very reluctant to introduce such bonds. The idea that German taxpayers should be debtors towards other governments in the Euro zone is

[104] http://uk.reuters.com/article/2011/06/24/uk-eu-summit-draghi-idUKTRE75N1JO20110624

[105] http://www.independent.co.uk/news/business/analysis-and-features/what-price-the-new-democracy-goldman-sachs-conquers-europe-6264091.html

[106] http://www.marketwatch.com/story/unlike-bernanke-draghi-doesnt-aim-to-be-hero-2012-01-12

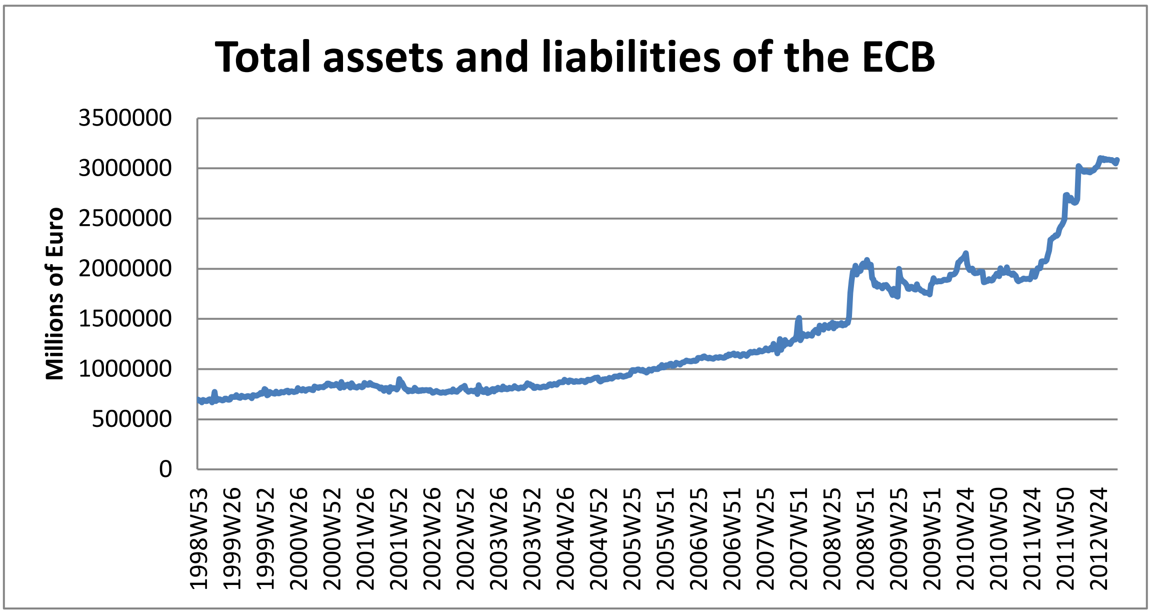
[107] http://www.marketwatch.com/story/what-central-banks-provide-oil-markets-take-away-2012-02-29

[108] http://www.marketwatch.com/story/unlike-bernanke-draghi-doesnt-aim-to-be-hero-2012-01-12

[109] http://online.wsj.com/article/SB10001424052748704156304576003760628199904.html

very unappealing, as German workers are already considered to the backbone keeping the European economy together today[110]. While the creation of a European bond is very unattractive to several of the strong European economies, it might be one of the key factors in the solutions to the problems currently facing the Euro zone.

In stepping up all the financial aid to accommodate the sovereign debt crisis, the ECB naturally needs to bolster itself, and thus it was decided on 17th of December 2010 by the ECB that it would double its capitalization[111]. When investigating the balance sheet of the ECB, more specifically its total assets and liabilities, it is clear that capitalization has stepped up quite heavily through the years.



Source: ECB Statistics

This chart shows the development in the balance sheet of the ECB from 1998 to 2012.

In general, the ECB has been heavily involved in solving the crisis, and has recently upped bond purchases significantly. As with many of the other European institutions, most of its attention is on Spain at the moment, especially concerning the possible bail-out in the near future, and of course the stabilization of the Spanish economy.

---

[110] http://online.wsj.com/article/SB10001424052748704156304576003760628199904.html

[111] http://online.wsj.com/article/SB10001424052748703395204576023732485094802.html

As we have now highlighted the initiatives and measures already taken by the EU and ECB to address the crisis, we will now engage in discussing crisis management for Spain, by drawing comparison to other recent crises, before suggesting possible future solutions and initiatives to solve the ongoing crisis.

Crisis management

Having investigated the origins and root causes of the crisis, as well as defining the macroeconomic effects of the crisis for Spain compared to other crisis-hit countries and Germany, we will now discuss crisis management for Spain, by drawing comparisons with other recent crises.

Crisis management in general

According to the OECD, it is useful to identify three phases when dealing with financial crises in the crisis management process: ***initial containment; resolution and deleveraging; and management of impaired assets***[112]. The countries used as examples to compare with Spain vary in their crisis handling. Thus the phases cannot be standardized between the different countries in the following analysis, because the crises are different and have been handled differently. Instead, these phases are intended guidelines, to give an overview of the different complicated crises. Therefore, the three different phases are applied differently in relation to the examples. Consequently the phases, and to which phases certain events in the crises are assigned, are solely chosen by the authors to provide an overview for the reader, and to ultimately draft solutions on how to act in the case of Spain. By using recent economic crises in different parts of the world, we can see the different crisis management measures that have been used.

Crisis management is the process of making decisions to head off or take the edge off the effects of a crisis, often while the event itself is unfolding. This regularly means making decisions about your institution's or country's future while you are under stress and while you lack key pieces of information. The present Spanish crisis is characterized by having many of these elements. Currently officials in Spain and the EU are making crucial decisions on how to head off and/or mitigate any further worsening of the crisis and ultimately a bail-out. Furthermore, the crisis is unfolding as these decisions are being considered, and many key pieces of information are not present, as officials do not know the certain outcomes of their decisions. It is therefore safe to say that the current climate in Spain can be characterized as a process of crisis management in which officials are working under constant stress to find new ways and solutions which will help Spain out of the recession.

[112] OECD (2011)

Crisis management in similar economic crises

History can provide some insight into what has been done in similar economic climates to that currently prevailing in Spain and into how other crises have been managed.

Ireland

The first crisis which will be examined is a recent one - the Irish banking crisis which started in 2007. The Irish crisis resembles the crisis in Spain in many ways, and shares many of the same features. Hence it is of interest to analyze it, as this can provide some answers and crisis management pointers.

At first, one of the initial common denominators of the two countries was the strong dependence on the banking system. Ireland had a banking system which played a leading role in the accumulation of microeconomic imbalances. During the pre-crisis years the borrowing and lending of Irish banks expanded at an extraordinary pace, which helped to create a positive housing sector and a strong increase in domestic demand. The extraordinary growth of bank assets (namely assets in the housing industry), in the context of negligent supervision and easy access to foreign wholesale funding, led the Irish banking system to grow at several times the rate of the Irish economy[113]. As in Spain, many of the investments of Irish banks were tied up in the housing and property market. When this collapsed in 2007, in the mist of the international financial crisis, the Irish economy was exposed to enormous bank losses (just like in Spain). Ultimately, this fueled a housing bubble, which was doomed to burst.

As we can observe, the crisis in Ireland shares almost all the same characteristics as the current one in Spain. Both crises happened at the same time, in the aftermath of the international financial crisis, which stemmed from the US subprime crisis. Both crises had their deep root in excessive lending by a banking system without any strict regulation or supervision. Also, this lending was mostly tied to the housing industry in both countries, which at the end of the day caused a property bubble to build up and then burst. The burst of the bubble in both countries had dramatic domestic consequences. As so many similarities appear, the interesting thing is therefore to look

[113] OECD (2011)

at what has been done in Ireland after the crisis. More specifically, one would look at Ireland's crisis management the impact this crisis management has had on the country.

In response to the crisis the Irish government considered several measures for their crisis management plan. At first, insufficient information led it to interpret the crisis as a problem of liquidity, rather than solvency[114]. Put differently, the initial mind-set was that Ireland had enough cash, but at the moment the crisis hit, it did not have it in the bank and thus could not repay the loans that were due. The story, however, was quite different, because Ireland had a solvency problem. This term refers to the fact that people, organizations and government can become insolvent and thus unable to pay back their loans. Hence there is quite a large difference between a liquidity crisis and a solvency crisis. Ultimately, the crisis in Ireland can be characterized as a solvency crisis

Crisis management of Ireland vs. Spain

The first step, according to the above three mentioned phases, is the *initial containment*. The authorities thus issued an extensive guarantee of bank liabilities under the now expired Credit Institutions Financial Scheme (CIFS) of € 375 billion (240 % of GDP), which was more widespread than the approaches adopted in many other countries[115]. The guarantee covered all deposits (including corporate and interbank), bonds, senior debt and certain subordinated debt. According to the OECD, government guarantees have both pros and cons when used on such a large scale as in Ireland. They are described as follows:

"Generally, the benefit of a guarantee is to stop the loss of confidence in the financial system and buy breathing space to resolve underlying problems. Since deposits and bank bonds made up a significant proportion of total funding in Ireland, guaranteeing them did succeed in bringing some calm to the markets. However, extensive guarantees have their dangers. They bail out investors who should have done a better job at managing risks and at disciplining financial institutions. They introduce potential distortions to competition, create contingent fiscal liabilities that can lead to widening of sovereign bond spreads and transform banking sector risk into sovereign risk. They

---

[114] OECD (2011)

[115] Schich (2009)

also cause moral hazard, so should be accompanied both by a credible exit strategy and by measures to avoid the perception that such extensive guarantees will be available in the future (2011)".

Baer and Klingebiel argue that favoring extensive guarantees for all institutions – solvent or insolvent – prevents a massive run from anxious depositors and helps to avoid the loss of interbank funding[116]. The theory of Baer and Klingebiel applied in Ireland, because the guarantee was extended to all institutions. According to the OECD the suddenness of the crisis made it almost impossible for the Irish authorities to tell the difference between viable and non-viable banks. Due to this suddenness and hence the unpreparedness of the authorities, unlimited deposit guarantee were granted to help preserve the payment system and create the breathing space necessary to plan a restructuring strategy, as the above recommendation by the OECD also states[117]. Nonetheless, this breathing space was not used effectively and the benefits of confidence were not fully utilized. This was largely because the bank restructuring process was slow and the total uncertainty regarding the total costs of the crisis was high. The OECD notes that the most crucial point about this action in the initial phase was that the guarantee was not followed by a resolution mechanism to deal with the situation where an initial liquidity problem turned out to be one of solvency. Honohan and Klingebiel show in a study of 40 crises that when liquidity support and bank deposit guarantees are used, fiscal costs are higher and economic recovery is not faster[118].

The next phase in the crisis management plan is the *resolution and deleveraging phase.* In this phase the authorities established a state-owned bank restructuring agency, the National Asset Management Agency (NAMA). The prime purpose of NAMA was to take over the property development loans of banks and to restore confidence. NAMA was also labeled as the "bad bank", because it was designed and created to clean Irish banks from toxic property loans[119]. NAMA completed the acquisition of 115 000 loans from 850 debtors with a nominal value of € 72.3 billion (46% of GDP) by December 2010. Of the total of 850 debtors, 180 accounted for € 62 billion of the total portfolio of

[116] Baer, H. & D. Klingebiel (1995)
[117] OECD (2011)
[118] Honohan & Klingebiel (2000)

[119] http://online.wsj.com/article/SB10001424052702304019404577420300134053184.html

72.3 billion. This shows that banks not only suffered from high exposure to property development, but also from high exposure to a small number of borrowers. The OECD goes on to suggest that such skewed exposures could have been contained. This could have been done by limiting industrial lending or by using instruments such as loan to value ratios or a credit register to which financial institutions are obliged to report their lending in detail to assist credit appraisal by lenders and supervision[120].

According to Honohan and Klingebiel, the quick detection of the extent of the problems in a banking crisis coupled with a complete recapitalization at an early stage are key components to the start of recovery[121]. This was not the case for Ireland. The mentioned suddenness of the crisis also led to incomplete information. This in turn led to a slow capitalization process in 2009-2010. The turning point in the Irish crisis came with the introduction of the EU/IMF programs and the subsequent capital injection and requirements to establish a stable economy and banking sector. Among other things the EU and IMF required recapitalizations of banks in line with extensive capital assessment reviews. Furthermore the publication of the Financial Measures Programme ("stress test") by the Central Bank of Ireland proved to be an important turning point in the bank restructuring process[122]. Market uncertainty and lack of confidence in the financial system were major factors which affected lending to banks and the Irish government. The "stress testing" was therefore designed to remove this uncertainty and rebuild confidence in the financial system. The "stress testing" proved to be a fundamental factor that changed perceptions. It created belief in the banking system as it was recognized as credible. According to the OECD it was a step on the road to a more "slim" and focused banking system[123]. This means a banking system that is smaller, focused on core operations, well capitalized, has stable market-based funding and is able to meet the credit needs of the Irish economy.

The third and last phase in overcoming the banking crisis in Ireland was *managing the impaired assets.* In this phase, ethics and rightfulness count, in order for countries and institutions to appear as credible entities after a major crisis. With regard to Ireland, the

[120] OECD (2011)
[121] Klingebiel (2000)
[122] OECD (2011)

[123] OECD (2011)

management of impaired asset from failing institutions by NAMA comes under this phase. Klingebiel states that even though asset management companies are necessary, the empirical evidence of their success is mixed[124]. This is largely due to the fact that asset management companies needs to be coupled with certain factors in order to be successful. According to the OECD, NAMA would be effective in resolving insolvent and unviable financial institutions and selling their assets if certain conditions were met, such as having less complex assets (e.g. real estate), good management, political independence, appropriate funding, adequate bankruptcy laws and transparency[125]. In other words an asset management agency cannot stand alone if it is to be successful. It will need to be supported by certain outside factors. Also, asset management agencies are long-term commitments and processes. Therefore NAMA also aims to manage its assets in a way that results in the best possible return for the taxpayer in a timeframe of 7-10 years[126].

Lessons for Spain (in the case of Ireland)

The collapse of the property bubble in Spain has not been as dramatic as in Ireland. The fall in property prices has been more gradual in Spain, as illustrated by the following figures. Property prices in Ireland fell 56.8% from their peak levels by 2011. Property prices in Spain have only dropped 22% between their peak in 2007 and the end of 2011. According to the IMF they will probably fall another 15-20%[127]. In specific terms this means that the Spanish government has not poured as much into its banking system as Ireland has. Despite this positive outlook for Spanish banks compared with the Irish ones, it does not necessarily mean that they are any healthier. This is mainly because Spanish property is likely to fall further and thus unemployment will continue to increase. This in turn leads to an increase in mortgage default and thus even more bad loans for Spanish banks. The root of the concern is therefore the lack of confidence in the Spanish financial system. As for Ireland, it is extremely difficult to estimate the size of the hole in the Spanish banking sector – even though a recent report states that the system needs €59 billion. This uncertainty therefore generates a lack of confidence –

[124] Klingebiel (2000)

[125] OECD (2011)
[126] OECD (2011)
[127] IMF (2012)

just like it did in Ireland. To counterattack this, Ireland established NAMA and several "stress testing" measures

NAMA is therefore a good case-study to use in order to create crisis management measures for Spain. NAMA has in many ways been a positive stimulant for the Irish economy. According to the founder and architect of NAMA, Peter Bacon, Spanish banks have failed to recognize the extent of their bad loans, which then prevents these banks from escaping from their current troubles[128]. Bacon also notes that Spain is currently struggling with the same initial containment problems as Ireland did – namely to restore confidence in the financial markets. He believes that an asset-management agency along the lines of NAMA will offer the best prospects of removing doubts regarding the Spanish banks. Bacon goes on further by stating that:

"The principal lesson Spain could draw from Ireland's experience is that painful as the NAMA outcome is, it is probably better in the longer run than the kind of approach that has been followed by Spain and other countries that has really failed to provide for the losses on banks' books that resulted from property bubbles"[129].

However the pitfall in setting up an agency like NAMA is that there is a bill to pay in the future. In the case of Ireland the bill for NAMA grew as lenders' property losses were much larger than first anticipated. As explained above, the cost to the Irish government of recapitalizing its banks therefore escalated further. When bond investors took fright at the bank rescue costs, Ireland was forced to seek an international bail-out from the EU. Now Spain is fighting a similar battle, in trying to restore confidence in its banks and ultimately avoid having to accept a bail-out by the EU and IMF. However, many analysts are not too optimistic that Spain can handle the crisis itself through a state-owned asset management agency like NAMA, without a full bail-out by the EU and IMF. Officials in Spain might have taken notice of the example given by Bacon and of how to use an agency like NAMA as a mediator and part of a solution. In late august 2012, the Spanish government approved the creation of a bad bank to absorb the troubled real estate assets of the country's financial institutions. The FROB was to

[128] http://blogs.wsj.com/eurocrisis/2012/05/22/architect-of-irelands-bad-bank-sees-lessons-for-spain/

[129] http://blogs.wsj.com/eurocrisis/2012/05/22/architect-of-irelands-bad-bank-sees-lessons-for-spain/

become a "bad bank", and carry out the operations of a "bad bank", such as absorbing real estate assets.

So, ultimately, does the relative success of the crisis management handling of Ireland, serve as an example for what to do in Spain? First, it is about regaining market confidence. By doing so Spain might potentially be able to avoid accepting a full bail-out. If this does not succeed, the ultimate solution will eventually be to accept the bail-out from the EU and IMF. So, if this were the case, can the relatively success of the Irish bail-out (also from the EU and IMF) then be used as a sneak preview of how things would turn out for Spain? According to the EU and IMF the bailout of Ireland has been a success. This can be proved by looking at two other PIIGS that have been bailed out by the EU and IMF, Portugal and Greece. Of these three bail-out PIIGS countries, Ireland has done by far the best. On the other hand, however, it is worth noticing that Ireland went back into a recession in the second half of 2011. Moreover, analysts believe that domestic and foreign demand is set to contract further in 2012. This will result in unsustainable growth in the next few years and consequently Ireland will need a second bail-out when the first one expires.

A crucial difference between Spain and Ireland is the size of the country in terms of both population and total output (GDP). In a matter of bail-out, the size of a country matters. Ireland is small enough for a second round of EU and IMF funding. Spain, which is the fourth largest economy in the EU, is not. If Spain received a first round of funding, this would require roughly €59 billion, which is a large sum even for the EU and IMF combined. If Spain failed after the first round of funding there would not be enough money to bail out Spain once again. In other words, if Spain fails to generate sustainable growth and economic awareness, it will not get a second chance. The alternative for Spain is debt restructuring, which will have harmful effect on the global economy, given the size of Spain.

Iceland

The next example is another European state – Iceland. This country is indeed much smaller than Spain in terms of both GDP and population. Yet it serves as a good example, as Iceland has acted very differently from Ireland.

Iceland was, prior to the crisis in 2008, one of the richest and most prosperous countries, in terms of GDP per capita. It was ranked as one of the best places to live in the world, according to the UN Development Index[130]. Iceland is a small nation with only 300 000 inhabitants. Traditionally the small country has relied on natural resources, namely its underground geothermal energy and the fish products of its seas, as its main source of economic growth[131]. However at the start of the 2000s the country embarked on market capitalism and deregulation of its banks. This exercise fueled a massive increase in wealth. Within few years the stock market grew 900% and the domestic banks expanded their operations abroad. The banks increased their assets from 100 % of GDP to 1000 % of GDP[132]. Investors saw good opportunities in Iceland, and thus foreign investments poured into the country, which helped raising the standard of living[133] . Investments also went out of the country. The Icelandic up-swing was also characterized by Icelandic investors heavily investing abroad with their new found Icelandic wealth[134]. Major Icelandic investors acquired well-known brands such as West Ham United and Woolworths. According to the Financial Times a fanatical atmosphere developed and (just like Spain) no one thought that an investment would not pay off when it had its footprints in the Icelandic economy[135]. Therefore Icelandic investors began investing in sophisticated (and risky) financial options within Iceland and abroad.

According to the IMF the size of the country also made the nation's bankers and regulators an exceptionally close-knit group – this lead to moral hazard problems as, for instance, the offices of Prime Minister and Central Bank Chairman had both been held by one man, David Oddsson[136]. One concern which the Financial Times pointed out was for example that the Central Bank did not intervene when the foreign-denominated debts of the three largest banks – Kaupthing, Landsbanki, and Glitner – grew to eight times the nation's GDP[137]. However, things were to turn bad, because of this

---

[130] http://hdr.undp.org/en/statistics/hdi/
[131] IMF (2008)
[132] IMF (2008)
[133] IMF (2008)
[134] http://www.ft.com/intl/cms/s/0/8a0390dc-78c7-11e1-9f49-00144feab49a.html#axzz2BFTiADBR

[135] http://www.ft.com/intl/cms/s/0/8a0390dc-78c7-11e1-9f49-00144feab49a.html#axzz2BuL46Brv
[136] http://www.ft.com/intl/cms/s/0/8a0390dc-78c7-11e1-9f49-00144feab49a.html#axzz2BuL46Brv
[137] http://www.ft.com/intl/cms/s/0/8a0390dc-78c7-11e1-9f49-00144feab49a.html#axzz2BuL46Brv

overextension of the banking sector. In late September 2008, after the bankruptcy of Lehman Brothers in the US, the domestic currency, the *krona*, declined dramatically. This made the three above-mentioned banks unable to meet or renew their maturing short-term obligations with their weakened Icelandic currency.

A crisis was now underway. In an interview with IMF Survey, the IMF's chief for Iceland and Deputy Director of the European Department, Poul Thomsen, stated that Iceland had allowed the bank sector to grow out of proportion[138]. He added that the sector had grown so big that the authorities had lost the ability to act as the lender of last resort when the system ran into the above-mentioned troubles. Eventually, the lack of confidence in the Icelandic system caused it to collapse, because the market realized that the system was too big relative to the small Icelandic economy. This also brought the three large banks down. Ultimately, the Icelandic crisis can be characterized as the worst collapse of any country when compared to the size of the economy[139].

When holding Iceland up against Spain, one would again see striking similarities. The crises happened at the same time. Both were caused by an over-enthusiastic banking sector. Stimulated by excessive lending policies, banks in both countries lost control of their lending. Also in Iceland, a lot of this lending was granted for doubtful property projects, so today we still see empty office and apartment buildings in Iceland. Like Spain, many of the investments within the country were made by foreigners wanting a part of the adventure. So, in conclusion, many similarities can be drawn to Spain (and also Ireland), but as we will see below, crisis management in Iceland has been of a different character from that currently applied in Spain – and especially from that practiced in Ireland.

Crisis management of Iceland vs. Spain

During the *initial containment* phase, Iceland acted very differently from in other past and recent crises. At first it is worth noticing that Iceland shielded taxpayers and government finances from bearing any losses. Because of the size of the country and the economy the government could thus not support the country financially because of this bloated size. The choice to not let taxpayers and government bear any losses was

[138] IMF (2008)
[139] http://www.economist.com/node/12762027?story_id=12762027

therefore more because of the inability of the country to support itself, rather than an actual choice. Nevertheless, the initial containment was hence to let the banks go bust. This included the three largest banks in Iceland at the time. The move was untraditional, since many of the investments these banks supported were made by foreigners. As described later, this affected foreign investments heavily, thus it is arguable whether the problem was contained, in line with the name of the phase. Even so, the crisis was contained from an Icelandic point of view, as we will see in the following. In Spain the current crisis management is of a different character. Here a large bank, like Bankia, has been nationalized and saved by taxpayer's money. The initial containment in Spain is characterized by giving priority to saving domestic banks over the risk of letting them go bust. This is ensured by the FROB and the recently the new formed "bad bank". Ireland can also be used as a reciprocal example. Iceland also largely differs from Ireland. As mentioned above, Ireland guaranteed all the liabilities of its banks, injecting capital - €46 billion Euro - to support them. That brought the country to the brink of ruin, forcing it to accept a rescue package from the EU and IMF. In conclusion, Iceland made untraditional moves in the initial containment phase.

The resolution and deleveraging phase was also out of the ordinary compared to other financial crises. A few days after the collapse of the three banks, Iceland gave priority to retail depositors over bondholders. At the same time, all domestic assets were transferred to new (and existing) banks at what was meant to be a "fair value", which was the shrunken market price of the debt. The big advantage of such a move was that it kept the wheels turning – it simply kept the vital payment system going in Iceland. The reaction of Spain in this phase was instead to pump millions of Euros into the banks through the FROB to keep them going. The cost of such procedures is therefore born by the taxpayers. In the case of Iceland, the cost was paid by foreign investors. Evidently, the three major banks had gone bust, and had therefore already had taken some of the costs. The biggest losers though, were the foreigners who had made investments in Iceland. Therefore it was ultimately these foreign investors who took by far the largest loss from the Icelandic collapse – in fact Iceland's banking assets shrank from 10 times to twice the size of the economy during this liquidation process of foreign assets.

The big advantage of Iceland, and how it could make use of such procedure, was the fact that it had its own currency, the *krona*. During the resolution and deleveraging phase this currency took a serious beating because of the decision to transfer the shrunken market price of the debt to new and recapitalized banks. So not only did foreigners suffer (the most). The *krona* collapsed by 90% at one point, which in turn caused a spike in import costs. Inflation reached 18% and unemployment jumped from 2% to 9%. According to Paul Krugman Iceland can thank the *krona* for its economic recovery[140]. In other words he is implying that adopting the Euro does not automatically mean that it will guard against economic imbalances. Instead, having its own currency gives a country the leeway to decide its own outcome. It does not have the same contagion effects as countries within the Euro zone will give rise to if they decide to act like Iceland did.

The final stage of crisis management is the *management of impaired assets*. In the Icelandic economic crisis this meant accepting a bail-out from the IMF. In November 2008 Iceland received $. 2.1 billion. The IMF tied the money to capital controls and decisions not to tighten fiscal policies in the first year of the bail-out. The most important action for the IMF was that the bail-out should not be a burden for the taxpayers, who should shoulder private sector losses[141]. The IMF aid was an immediate stabilizing measure for the Icelandic economy. Instead of using tough austerity measures, like the government of Spain has been preaching, the IMF backed a state-sponsored stimulus package. This package, as described above, included the postponement of planned cuts for a year. Poul Thomsen from the IMF elaborated on this in December 2008 by saying that: "*We think it is wrong in the face of deep recession to embark on fiscal consolidation"*[142]. Four years later Iceland has emerged as a country which is not affected by any crises. Employment is growing, emigration (due to the lack of jobs) has eased and, most importantly, Iceland is growing economically once again[143].

---

[140] http://krugman.blogs.nytimes.com/2010/11/24/lands-of-ice-and-ire/
[141] http://www.imf.org/external/pubs/ft/survey/so/2011/surveyartf.htm

[142] IMF (2008)
[143] http://online.wsj.com/article/SB10001424052702304203604577396171007652042.html

Overall Iceland can therefore be seen as one of Europe's success stories when it comes to fighting an economic crisis. Should Spain therefore follow in the crisis management footsteps of Iceland? In order to answer such question one should first be able to understand the crucial differences between Iceland and Spain.

Lessons for Spain (in the case of Iceland)

First of all, having your own currency plays a huge role. During the crisis Iceland benefited from having its own *krona*, because it was heavily devaluated. According to the Wall Street Journal, when the currency was devalued by half, this boosted exports, because foreigners could now buy the relatively cheaper Icelandic goods with their own stronger currencies[144]. Also, the relatively more expensive foreign goods led the residents of Iceland to buy less from abroad and shift their purchasing to home-based goods and services. This helped Icelandic unemployment, because more domestic goods were consumed. In particular, the important fish sector was preserved. One of the reasons for this is that the devaluation of the currency also made labor costs much lower than prior to the crisis. The Wall Street Journal brings the following example of how the *krona* is now worth half as much as it was in 2007. This means that when the *krona* is converted into dollars when fishermen sell their fish, the fishermen take home twice as many *kronar* for the same amount of fish. Even with inflation, they have come out way ahead. Inflation is a key in this equation. As foreign goods became more expensive, inflation was triggered. Consumer prices have risen 26% since 2008[145]. This is one of the major drawbacks of devaluing a country's currency. However, Iceland's fishermen prove that this drawback can be leveled out through lower labor costs. In fact, due to inflation, fishing companies have higher expenses, for fuel, equipment and financing, because they are bought abroad – this also offsets some of the revenue. But this is where labor costs matter. Prior to the crisis an Icelandic fish plant on average paid a worker €20 an hour. Now, after the crisis they pay them half - €10 an hour. Hence profits are rising and new investments are made which lead to even more Icelandic jobs.

In Spain the Euro and the shared rules of a Union dictate the outcome of the economy, and thus Spain cannot benefit from devaluing its currency. And this is also the second

[144] http://online.wsj.com/article/SB10001424052702304203604577396171007652042.html

[145] http://online.wsj.com/article/SB10001424052702304203604577396171007652042.html

crucial difference between Iceland and Spain, which is that Spain is a member of the EU and thus also governed by its common rules. Spain does not have its own currency and has to act within the EU rules – even more if it accepts to receive the full bail-out. Hence the Wall Street Journal points out that the success of Iceland provides a good case study of what Euro countries gave up when they joined the monetary union[146]. Further evidence on this is how the imbalances of the economy in Spain and Iceland have differed. Imbalances refer to the fact that a country has consumed more it has produced. This then requires borrowing from abroad to fill in the hole. With the impact of the worldwide liquidity crisis, foreign lending stopped. This is currently one of the major concerns of Spain. According to Gylfi Magnusson, the Icelandic Minister of Economic Affairs during the crisis, the imbalances in the Icelandic economy were by most standards worse than those currently faced by Spain – however, Iceland emerged from these imbalances relatively quickly[147].

A reason for this difference between Spain and Iceland is the dependence upon the EU. According to the Wall Street Journal, correcting imbalances is difficult within the Euro zone[148].With a common currency, a similar approach to Iceland's would require a policy of internal devaluation – by officials in the EU – which is also known as making populations poorer. Thus, correcting imbalances would mean reducing wages. Pushing down wages would make export industries more competitive compared to foreign competitors. In the case of Spain, it would be difficult to lower wages without hurting the Spanish economy. Ireland is a good example to illustrate this. The country is, so far, the most successful country that has received a bail-out package[149]. Here the internal devaluation policy has stimulated exports. However, the cost of the procedure has been high unemployment and lower domestic demand. In Spain unemployment is already a serious issue, and with the austerity measures already announced, the country cannot afford even lower domestic demand. Iceland therefore proves that it is easier to adjust financially through a currency, than adjusting through the labor market. Furthermore,

---

[146] http://online.wsj.com/article/SB10001424052702304203604577396171007652042.html

[147] http://online.wsj.com/article/SB10001424052702304203604577396171007652042.html

[148] http://online.wsj.com/article/SB10001424052702304203604577396171007652042.html

[149] http://online.wsj.com/article/SB10001424052702304203604577396171007652042.html

Iceland did something worth noticing for Spain. Instead of spending cuts and austerity, Iceland improved social welfare to stimulate domestic spending further.

The third and final difference between Spain and Iceland is obviously size of the economy and population. The success story of Iceland may be irrelevant to the global financial system, whereas Spain's correlation is much stronger. The IMF, nevertheless, states that there are lessons to be learned from the Icelandic crisis management. Top economists share the same thought. Regardless of the size of the economy Adriaan van der Knaap, a managing director at UBS AG, states that "*Countries with larger banking systems can follow Iceland's example… it wouldn't upset the financial system*". The IMF mission chief for Iceland, Julie Kozack, states that the accomplishment of economic revival is not just one of these three differences – it was all these differences or pieces put together that brought the economy to recover[150]. In the case of Spain, Iceland can hence serve as a good example, but, as explained, Spain differs from Iceland in these three crucial aspects. The question is for Spain to find its own medicine to recover – perhaps with a mixture of some of the medicines which Iceland used.

Other examples of crisis management

After deregulation of the financial markets in Finland, an overheating of the economy mainly by lending to the property market generated a banking bubble of bad loans. Also the collapse of the Soviet Union as the main export country contributed to the crisis. The first crisis management measure in Finland was for the Central Bank of Finland to intervene. It took over several of the banks that were insolvent, and made general capital injections into the whole system. Later, a special crisis management institution, the Government Guarantee Fund, was established to create confidence in the markets and prevent bank runs (just like the Irish one). Also Finland, like many other countries hit by crises, established an asset management agency. The exercise was successful, and Finland emerged relatively successfully from the crisis, without creating significant "noise" by borrowing money from the IMF. Finland is also interesting to mention because today one would see the country as a magnet for Spanish workers wanting to work there, – and because the country is a part of the Euro and hence subject to the shared rules which Spain also observes. Yet, Finland currently attracts Spanish citizens

[150] http://online.wsj.com/article/SB10001424052702304203604577396171007652042.html

in great numbers to find work. Many of them have found work especially in the health care industry. A weak Spanish economy and a high unemployment rate have for instance attracted nearly 4 000 Spanish nurses to Finland. It appears that Finland has drawn some vital lessons from its crisis in the early 1990s. First, supervision of banks has been improved and incentives have been decreased in order to reduce risky investments. Also the institutions being supervised have improved. In particular the banks and other credit institutions have shown a stronger degree of market discipline, in the sense that they have appeared more transparent and disclosed more information than prior to the crisis. As a result Finland has learned many lessons from this crisis, and today works as one of the best examples of the sound and healthy Nordic economies within the EU, which also include Denmark and Sweden.

Examples of other economic crisis management measures can also be traced outside of Europe. In June 1997 few observers would have anticipated that the East Asian economies would collapse. They had been among the fastest growing economies and had developed tremendously through the last couple of decades prior to the crisis. The drivers of the crises in these countries were firstly a liberalization of the financial and capital markets which generated a further boom in the economies. The liberalization fueled a flood of (foreign) investments in short-term capital – according to Stiglitz, such investments look for the highest return in the next day, week, or month, as opposed to long-term investment in assets such as factories[151]. These investments created, for instance in Thailand, a property bubble, which like many other bubbles was doomed to burst. So, just as suddenly as capital flooded into the region, just as fast it left again, which caused a serious meltdown in these economies[152]. Like many other economic crises, it was triggered by financial overextension in the banking sector to the property development sector. The Asian crisis was also characterized by a strong degree of contagion effect. Starting in Thailand, the crisis quickly spread to Malaysia, Indonesia, the Philippines and South Korea – at the end of the crisis it even spread to Russia. The crisis was as the time one of the most serious, and thus required foreign intervention. The IMF stepped in with substantial amounts of money through bail-out packages and requirements for fiscal austerity. Its involvement in the region met with considerable

[151] Stiglitz (2000)

[152] Stiglitz (2000)

criticism. One of the criticisms was that the IMF tried, through fiscal austerity and reforms, to replicate the restored Asian currencies to resemble those of the US and Europe – so by some experts the IMF involvement was seen as an act to implement neoliberal economic policies[153]. The IMF required less government spending, allowed insolvent banks and financial institutions to fail, and aggressively raised interest rates. According to Stiglitz, such kinds of policies were correct during the Latin American economic crisis in the 1980s, because of bloated public deficits and loose monetary policies which led to high inflation[154]. However, the countries affected by the East Asian crisis were already running budget surpluses. In Thailand the government had such large surpluses that it was starving the economy of much needed investments in education and infrastructure – both essential for economic growth. Unlike the Latin American countries, inflation was low and falling, and the East Asian nations already had tight monetary policies. So in reality the problem was not irresponsible government actions – instead the problems were to be found in irresponsible private sectors, namely banks and borrowers that had gambled on the real estate bubble[155]. Just the same problem as we currently see in Spain. As many countries were affected by the crisis, the IMF used the same above-described remedy for each and every country, despite the fact that they were very different in culture, religion, size etc.

The East Asian crisis provides a thoughtful lesson on how IMF intervention also can be harmful and does not always come as a helping hand in the crisis management process. Crises can become so large and complex that a large body like the IMF can misunderstand the situation. Also, it exemplifies how contagion effects can be very dangerous. Not only did the crisis spread from Thailand to many other East Asian countries. It also spread to Russia, which only a few years after market liberalization, had a vulnerable economy. In the case of Spain, the East Asian crisis can work as a good example in contrast to some of the others explained above. First, Spain is a large country and is thus exposed to the same risk as Thailand – is the country too big and complex to bail out? Also, due to the size of Spain, the contagion effects can become very large and damaging for other countries.

[153] http://www.jpri.org/publications/workingpapers/wp93.html

[154] Stiglitz (2000)

[155] Stiglitz (2000)

Preliminary conclusion

Economic crises happen all over the world at different times. Each separate crisis has its own country-specific elements, but they do however also share common denominators with each other. First, economic crises often occur after long periods of economic expansion and booms, coupled with over-confidence in the valuation of assets. Furthermore, banks often play a vital role in these crises by contributing with overrated loans to certain sectors (mainly the property development sector). Lastly, supervisory intuitions also play central a role, as they often appear negligent in their supervision of the loans given by the banks. Also, crises tend to have contagion effects, and this should be addressed immediately in order to limit these effects.

The current crisis in Spain shares many (and almost all) of these characteristics. The different countries and their crises explained above hence serves as examples on how to solve such a crisis. Pros and cons can be identified in all the solutions. The critical issue is to not only find one remedy, but couple the different solutions together to draft the best overall crisis management measures as possible. The following section will try to do so.

Solutions to the crisis

Spain can draw lessons from previous and similar crises, as explained earlier in the paper. The following section will firstly explain what has already been done and how to perhaps enhance these efforts. Secondly, it will draft several solutions in conjunction with the efforts already made, and thirdly come up with new solutions to the crisis. In order to create continuity in these solutions, and what has been done, they will follow the same pattern as the crisis management section, i.e. follow the path of ***initial containment,*** followed by ***resolution and deleveraging*** and lastly ***management of impaired assets.*** As crises differ in their nature, there is no standardized way of resolving them. Therefore, the three different phases and their solutions cannot be exactly replicated and vary in the way they are used, depending on the country-specific elements.

Initial containment phase

The first thing to establish, in order to contain the crisis, was for Spain to determine if it suffered from a liquidity crisis or solvency crisis. Ireland misinterpreted its crisis because it initially thought it had a liquidity crisis, but later realized that it was suffering from a much worse situation, as it had a solvency crisis – it had no ability to pay back its debt. This initially made Ireland issue a bank deposit guarantee to prevent bank runs and calm the markets. However, it underestimated the severity of the crisis and initially had to ask for a bail-out. When looking at Spain, one would therefore first pay attention to its "dynamic provisioning" accounting measures. These measures made the banks look "healthy" when they were in fact the opposite. Therefore we also believe that Spain initially interpreted its crisis as a liquidity crisis, when it was in fact a solvency crisis. Lumholdt states that the Spanish perception was that namely the Cajas suffered from solvency problems and initially thought that the FROB could solve it. Further he explains that the government was too late in realizing that Spain suffered from a solvency problem and thus not reacted in time[156]. Hence the initial containment phase matters and Spain still has time to react.

[156] Henrik Lumholdt, mail interview. November 4th, 2012

Guaranteeing bank deposits

To *initially contain the* problem, Spain, like Ireland, guaranteed deposits and securities held by credit institutions through the *Fondos de Garantía de Despositos* (FGD). FGD was at first the main crisis management tool to be used and works in conjunction with the BdE. Later, in 2009, the role of the FGD was taken over by the FROB which originally was created to assist and foster the consolidating and restructuring of the Spanish banking system (especially the Cajas). The FROB has, unlike FGD, the power to take over managerial functions in distressed banks. Hence, FGD was, and is, still in place – though now with more limited powers[157]. We believe that this was done because it was now recognized that the crisis had changed from a liquidity crisis to a solvency crisis. In other words, the practices of managing the crisis changed over time, reflecting the nature of the economic crisis from a housing bubble to a recession. Along with this comes one of the first problems and one solution/recommendation that can be implemented in the *initial containment* phase. First, one concern is that the FGD currently reports very low amounts of accumulated assets[158]. Recent support for a failed bank has depleted the resources of the institution, and as the chance of defaults by Spanish banks in the future is high, the deposits cannot be fully guaranteed. Lumholdt argues that Spain never have had the ability to fully guarantee all deposits – he states that modern economies and banks are based on illusions and trust[159]. In addition, we also believe that having a low amount of resources in the institution that actually guarantees other banks sends mixed signals to struggling banks. If the safety net of the system is insecure, then one would only assume the same of the latter. Lastly, Spain is in a crisis situation and refilling the funds of the FGD seems highly unlikable when the country is struggling. Altogether, the FGD seems to be in a grey zone, where its real purpose is hard to identify. We therefore recommend that the FGD and its triggers for action need to be reconsidered. The FROB, as explained above, has since 2009 taken over many of the responsibilities of the FGD. In charge of both the FGD and the FROB is BdE. Hence three agencies in many ways take care of somewhat the same. This creates downsides of the system and especially makes them less flexible to interact or to

[157] IMF (2012)

[158] IMF (2012)

[159] Henrik Lumholdt, mail interview. November 4th, 2012

monitor, because responsibilities overlap – simply generating a lack of clarity as to the divisions of roles for each agency. This can prove dangerous because, without intervention or monitoring, banks, as we have seen, can go on for a long period of time with many bad loans and can also make extremely risky investments. As a result of this, the following is recommended. First, as it is now, both the FGD and FROB can provide liquidity assistance to struggling banks. Therefore the respective roles of both the FGD and FROB should be clarified in order to avoid any confusion and danger of losing any banks out of sight[160]. The IMF states that the current co-ordination of the three agencies is in line with good accounting standards[161]. Thus they should be resumed, and not closed – however in a better and more efficient way. Hence, in the long run, the agencies should be re-aligned and streamlined within the current framework. The Spanish government would preserve its overarching political entity in charge of safeguarding financial stability at the same time as it will have specific expertise from BdE, FGD and FROB. By doing so, the Spanish government will still stay accountable for public expenditure and will play a vital role when systemic risk is at stake. On the other hand the government should not intervene when non-systematic risk is at stake. According to the IMF this is beneficial, because many countries have experienced that political involvement in failed banks, when not necessary, might have had negative repercussions[162].

Preliminary conclusion

Overall, the first solution and recommendation is therefore to reconsider the role of the BdE, the FGD and FROB. This recommendation fits under the *initial phase containment*, where the purpose is to prevent further weakening of the already unstable Spanish financial system. We believe that the recommendation will have some of the above-mentioned positive aspects (compared to the present). In addition, as we have earlier explained in the crisis management section, guarantees in general also have other benefits, such as stopping the loss of confidence, and buying a breathing space to resolve the underlying issues. The downside of such an action is that it among other

[160] IMF (2012)

[161] IMF (2012)

[162] IMF (2012)

things introduces distortions to a healthy competition among banks[163]. The next issue, involving guarantees, is that it needs to be backed up and followed by a resolution mechanism in order to remain effective. If the recommendation about re-aligning the three agencies in a more efficient way is followed, it will also enable a proper resolution mechanism to back up guarantees and ultimately the FGD. If responsibilities of the agencies can be better shared rather than overlapping each other, the FROB has the mandate to take care of the resolution/recapitalization process.

Resolution and deleveraging phase

When the crisis is contained and the safety net of the system is established, Spain will have to consider its options in the *resolution and deleveraging* phase. Simply, the government, along with the EU, will have to consider various actions which can directly improve the current situation.

A bail-out

One of the most debated solutions has been to receive a bail-out from the EU and IMF. Many other crises similar to the Spanish one have benefited from a bail-out. As explained, both Ireland and Iceland had some immediate effects of receiving their bail-outs. However Spain differs from both of these countries mainly in size of population and economy. So would a bail-out be as effective for Spain?

At first Spain was promised a bail-out of 100 bn. Euro for its banks by the EU. This dates all the way back to 9 June 2012[164]. It was granted as a response to the request from Spain. Now, more than 5 months later, the bail-out package has yet to be implemented, mostly due to hesitation from the Spanish government to accept the bail-out before the reports on capital needs were available. These reports have been much delayed but were finally released on 28 September 2012[165]. The conclusion was very positive compared to the expectations, showing a relative capital need of 59 bn. Euro in comparison to the estimate of up to 100 bn. Euro. The bail-out is constructed with the purpose of recapitalization and deleveraging of the banking sector. Its purpose is also to

[163] OECD (2011)
[164] http://www.economist.com/node/21556953

[165] http://www.guardian.co.uk/world/2012/sep/28/spanish-banks-stress-test-blackhole

avoid the panic and fear of bank runs, and enabling the banks to eliminate their balance sheets of dud loans – in short, prevent the sector from further shocks, “buy” some time and, ultimately, restore some confidence in the financial system[166]. Also, as explained in the crisis management section for Ireland, the bail-out of Ireland had positive effects. The country performed much better than the other PIIGS (Greece and Portugal) which had been bailed out. These are some of the positive and immediate factors of the bail-out to Spain. Although these can contribute to an immediate positive effect, one would also need to look at the long-term effect of such a bail-out.

The long-term effects have received substantial criticism. Firstly the bail-out adds even more debt to an already indebted country. The FROB and the newly formed “bad bank”, will be in charge of channeling the money into the banking system if needed. When doing so, the debt will count as public debt and potentially add 10% to Spain’s debt burden this year. This will result in a debt burden of 90%, which is still less than the debt burden of other PIIGS and other Euro countries. The worries are therefore not the size of the public debt the bail-out might result in, rather it is how the debt is going to be prioritized – the possibility that the new loans might take priority over private creditors and thus the private debt in Spain is the main concern. What is more, the Spanish lenders accepting the bail-out money can be subject to EU state aid rules. This of course will be very welcome, as many will be forced to clean up their boards and sell stakes in large industrial companies. This action will in other words spread the credit risk, and hopefully generate more independent boards in the larger Spanish companies. The problem with this, however, is that it also forces many banks to reject the loans and thus keep their independence. But an IMF report states that only three banks could survive and be able to cope on their own without intervention. These three banks, BBVA, CaixaBank and Santander, account for 47% of assets. More than half of the banks in Spain would not be able to cope on their own without the necessary loans provided by the bail-out. Hence one of the first recommendations regarding the bail-out is the role of the FROB and how to channel the money. We believe that the banks should not have the options of either rejecting or accepting the bail-out if needed. It should be the sole responsibility of the FROB to determine if the bail-out is needed for a struggling bank.

[166] http://www.economist.com/blogs/newsbook/2012/06/spains-banks

This would eliminate the doubt about banks rejecting the bail-out because they do not want to be dictated to by EU aid rules. By stating such a rule, Spain will also appear more credible towards the other countries in the EU and more importantly regain some of the confidence in their financial markets, which is key in the current economic climate.

The first bail-out was pledged to pay Spain €100 billion. Now, as explained, it has been stress-tested that Spain only needs €59 billion. So the question then arises: is this enough if things go really bad? So to be conservative, let us say that €100 billion would be pumped into the system. The WSJ stresses that this amount in fact will not be enough[167]. According to the newspaper a €100 billion bail-out would not be enough, as Spain easily can face losses of three times that amount. Real-estate loans amount to €298 billion, construction credits to €98 billion, mortgages to €656 billion and other loans for families and firms to €683 billion. To show that the pledged EU bail-out is not enough, the WSJ suggests the following scenario:

”*Assuming a 50% loss in real-estate and construction loans, a 5% loss in mortgages, and a 10% loss in other credits to the national private sector brings us quickly to the worrying figure of €300 billion in losses"*[168].

If such a scenario were a correct projection, the bail-out of only €59 billion would clearly not be enough, and further money would be needed. Additionally the WSJ emphasizes that banks have additional exposures of €78 billion to Portugal and €10 billion to Greece and Ireland, which could add losses of between €40 billion or more to the above calculation.

The bail-out by the EU and IMF can thus leave Spain needing more money if things go wrong again. Currently Spain reports total equity of €377 billion, and the scenario just explained would leave Spain with just €50 billion to €70 billion in remaining equity[169]. Ultimately it is believed that Spain would need €150 - €170 billion to bring it back to reasonable levels of capital. Other perspectives are also delivered by the WSJ. It states

[167] http://online.wsj.com/article/SB10001424052702303822204577466590595992160.html

[168] http://online.wsj.com/article/SB10001424052702303822204577466590595992160.html
[169] http://online.wsj.com/article/SB10001424052702303822204577466590595992160.html

that it would actually be in the interest of the EU and IMF to avoid a full bail-out, which could cost further billions on top of the €59 billion already earmarked for the banks. The Euro zone funds are not limitless and a full bail-out would severely deplete the rescue funds[170]. This will fuel doubts about its ability to support other troubled members of the currency bloc and in turn lead to heightened contagion. In particular, other vulnerable PIIGS such as Italy, which has the world's third largest bond market, would be affected.

An additional challenge, which Spain faces with the choice of accepting the bail-out, goes in conjunction with the naïve attitude by Spanish officials and their unwillingness to actually call it a bail-out – simple overconfidence that they can manage the crisis themselves[171]. Therefore the Spanish government is determined to be in charge of the overhaul of the economy – even after the bail-out. For this, the government needs to show that reforms and actions are in progress in order to improve the situation. There are currently two schools of thought as to how Prime Minister Rajoy and his government have performed after less than one year in office. One school, with especially German politicians as advocates, are stressing that Rajoy has performed well. They have acknowledged him for his labor reforms, his efforts to clean up the complex and hard-hit banking system, the tough austerity measures and his effort to cut the spending of the regions in Spain. These actions are, according to the first school of thought, highly needed and they show a government doing everything that could reasonably be expected to lead the country out in the right direction. However, on the other hand, many critics firmly believe that Rajoy bears a large share of responsibility for the risky position Spain still is in. The second school of thought firstly comes from domestic voices saying that he has been too hesitant in his economic policies, and this has therefore undermined the credibility of his government – which is simply seen to be not capable enough to be in charge of the crisis management of the country. Secondly it comes from abroad, from the country's Euro zone allies. Spain and finally Rajoy have weakened political stability and trust among the Euro countries. Spain has done so by

[170] http://online.wsj.com/article/SB10001424052702303933704577528611823965878.html

[171] http://online.wsj.com/article/SB10001424052702303933704577528611823965878.html

breaking Euro zone rules on deficit targets. In the end Rajoy is, according to the second school of thought, therefore stressed as a result of both internal and external factors

The WSJ explains that the second view on Rajoy is currently the most realistic and truthful view[172]. It states the measures on reductions in unemployment benefits, cuts to public-sector pay, energy-sector liberalization, the privatization of airports, ports and other infrastructure, and the latest plans for bank recapitalization have discredited Rajoy and the government. The measures were announced and implemented in the summer of 2012, but this should have been done much earlier. Instead, these measures have largely been dictated by Brussels through the bail-out and the Euro zone fiscal compact. As so, Madrid is actually operating under the full Euro zone program, even though with the purpose of ensuring that Spain retains access to bond markets, rather than being forced to accept a full bail-out. And this is an important distinction, when one would also think about Spanish pride, as explained earlier. A full bail-out would result in Spain's credit rating being downgraded to junk status[173]. That would have devastating effects on Spain. It would shut Spanish banks out of the market regardless of any recapitalization plan, and thus leave them reliant on EU funding. Spain differs from other PIIGS countries such as Greece, Ireland and Portugal, in that it has a very large corporate-bond market which would also face downgrading, which in turn will push up borrowing costs for domestic companies. Lastly, it should also be mentioned that previous bail-outs (as experienced in the East-Asian crisis) have also to some extent harmed regions and countries. The East-Asian crisis proved to be large-scale and very complex – thus leading the IMF to intervene in a wrongful manner. Spain is also a large country, and a big economy. So if the bail-out is needed it is advised to take account of Spain's country-specific characteristics.

So, in short, the pledged bail-out will have some immediate positive effects that Spain will benefit from. However, one would also need to consider the long-term effects of bailing out such a large country. Conflicts of interests, size of the bail-out and the government's ability to control the money are the main concerns. Another main concern

[172] http://online.wsj.com/article/SB10001424052702303933704577528611823965878.html

[173] http://online.wsj.com/article/SB10001424052702303933704577528611823965878.html

is that by accepting the bail-out, the taxpayers are eventually paying the price, because ultimately the money has to be paid back by them.

Bail-in instead of a bail-out

Eliminating the concern of letting the taxpayers pay the price of the bail-out, another solution could be a bail-in. In brief terms, this entails letting the authorities force domestic banks to recapitalize from within, using private capital, and thus not taxpayers' money[174]. According to PWC, capital alone is insufficient to make a bank safe – confidence in an institution is a key factor. In order to have such confidence PWC further states that bail-in capital can prove to be an important factor in gaining this confidence[175]. When looking at what has previous been explained, Iceland fits into such a scheme to regain market confidence. It first let its largest banks go bust, and then transferred their assets to existing banks. The remaining banks were also required to recapitalize from within and revalue their assets to what was meant to be a "fair value". Hence an alternative solution, instead of an expensive bail-out, could be to perform a bail-in and shield taxpayers.

Following the "Swedish model"- bail-in put into practice

According to Henrik Lumholdt the Swedish model has been highlighted as the one for countries with economic crises to follow[176]. At first, and in the *initial containment* phase, the government of Sweden did like Spain and guaranteed all deposits to prevent bank-runs and let households and firms feel secure[177]. Secondly, Sweden also established a "bad bank" to absorb the bad loans, known as the *Bankstödsnämnd*, 2009[178].So, in short, Sweden actually did what Spain has already done. However, the next thing that Sweden did was interesting, also when holding up the fact that Spain has just recently launched its "bad bank" and has thus has the ability to shape it in the most efficient way. What Sweden did was to minimize the moral hazard issues that bad banks

[174] http://www.economist.com/node/15392186

[175] PWC (2011)

[176] Henrik Lumholdt, mail interview, November 4th 2012
[177] Jonung (2009)

[178] Jonung (2009)

involve – simply it wanted to save the banks, not the owners of the banks. They did this by forcing owners to absorb their own losses. According to the EU Commission, by forcing owners of banks to absorb losses, public acceptance of the bank resolution was fostered[179]. Public acceptance was granted – something that is advisable for Spain in the current situation with high unemployment and distrust in the government. Hence a bail-in would immediately strengthen the public's trust by letting the bank owners pay the price. Sweden forced its banks to absorb some of their own loans before asking for a bail-out. They did this by dividing banks into three categories depending on whether the statutory capital adequacy ratio would be breached and, if so, whether this breach was temporary[180]. Category one banks (close to breaching, but able to achieve enhanced solvency on their own) were encouraged by the *Bankstödsnämnd* to find private sector solutions. Shareholders were requested to inject additional capital, and the *Bankstödsnämnd* was prepared to grant temporary guarantees. Category two banks (banks with short-term problems but with a good prospect of future solvency) were dealt with differently. Here private institutions were not ready to give support, so the *Bankstödsnämnd* was ready with more extensive support in the form of capital contributions and the above-mentioned guarantee. Lastly, the third category (banks beyond hope) received strong support from the *Bankstödsnämnd*, which sold their bad assets and consolidated the remainder of the bank, either on its own or through a merger with other banks[181]. As mentioned, the Swedish model illustrates how the system shaped the banks through a bail-in before any capital support was given. The advantage of this was that it made the banks face their own problems immediately instead of postponing them until later. By the end of the crisis the Swedish government had captured most of the troubled banks. When the markets in the post-crisis years stabilized, the banks could benefit by being allowed to go public one again. The policies by the Swedish government were tough, but "quieter" than a full bail-out – either by the government or by foreign institutions as the IMF. Thus, the policy also managed to restore confidence in the international markets, which was the strongest concern. Spain could draw lessons from this and use this model as a benchmark for how to deal with

[179] Jonung (2009)
[180] Jonung (2009)

[181] Jonung (2009)

the banks. We recommend that if the bail-out money is to be distributed, it should firstly involve some sort of bail-in system where banks are forced to absorb some of their own loans.

If put into action in Spain, as an alternative solution to an expensive bail-out, the debt from Spanish banks should (artificially through new reforms) be lowered, hence increasing equity. This will in turn reduce the banks' high leverage and increase the capital available for further losses. The WSJ explains this scenario by stating that if 100% of the €88 billion of subordinated liabilities were converted into equity, plus 40% of the €160 billion of senior unsecured debt, this would generate more than €150 billion of equity which could be used for loss-absorbing. Furthermore, Spain could generate €25 billion in expected operating profits for 2012, before loss provisions, and thus in total have about €175 billion in new bank equity. This is without increasing the debt burden and at the same time shields the taxpayers from further loans[182]. A bail-in would be the opposite example of the above mentioned bail-out and hence let investors bear the vast majority of the cost of their own mistakes. The WSJ states that such a procedure would also lead to some disorder. As with all other solutions, a bail-in also has its cons. First of all investors would without a doubt complain about such a policy by the authorities. To counter-attack this, the Economist emphasizes that such a policy should be adopted quickly so that investors would have no time for fine-tuning their investments. Especially, investors should have no time for shorting their investments. According to PWC this would lead to a "death-spiral"[183]. Furthermore, the Economist states that the fair value of the assets and the new structure of investments should be valued in accordance with investors' seniority, ensuring that each class of investors would be better off than in liquidation[184]. However, a bail-in can still produce drawbacks. Even though the Swedish bail-in was successful, it still ended up costing the taxpayers, because the assets could not be sold for what the loans were worth. However, the Swedish example shows how justification matters, as the Swedish government forced banks to absorb loans and gained public acceptance. So, in short, a bail-in could

[182] http://online.wsj.com/article/SB10001424052702303822204577466590595992160.html

[183] PWC (2011)

[184] http://www.economist.com/node/15392186

be a potential solution. The literature on a bail-in of Spain is still very limited, as the main solution mechanism at the time tends to be on a bail-out. Nevertheless, Spain has this tool as a solution mechanism. Now it needs to consider if its banks can withstand such a procedure.

Austerity measures vs. stimulus spending

In previous economic crises and recessions one of the classical dilemmas for governments has been to choose between austerity measures or stimulus spending – both with the purpose of regaining financial strength. In conjunction with the above bail-in measures, the WSJ also points out that neither government nor taxpayers can afford more debt in Spain. Both the private and public sectors need to deleverage themselves – and real public austerity is so important here. Real public austerity is based on spending cuts, not tax increases[185].

In general, the term austerity refers to a policy of deficit-cutting by lowering spending often via a reduction in the amount of benefits and public services provided. Austerity policies are often used by governments to try to reduce their deficit spending and are sometimes coupled with increases in taxes to demonstrate long-term fiscal solvency to creditors. In the spring of 2012 Rajoy claimed that austerity in Spain had failed, and turned to the Euro zone for help. Observers, however, state that it is wrong to talk about austerity in Spain, since it has not yet been put into practice – despite what Rajoy says. Observers state that, instead of full austerity, the government has made modest spending cuts while significantly raising taxes[186]. So real public austerity has not yet been exercised. The overall fiscal debate is therefore about whether a country should fight economic downturn and unemployment with austerity measures or growth and stimulus spending. In the case of Spain, evidence shows that austerity has not really been tried to prevent the crisis. During the property boom the Spanish government made large new long-term spending commitments in areas such as social benefits, public infrastructure and public sector wages. The problem with this long-term spending is that it was financed with short-term and temporary revenues, which skyrocketed the deficit when the property bubble burst. Therefore, it appears as if Spain

[185] http://www.economist.com/node/15392186

[186] http://online.wsj.com/article/SB10001424052702303703004577474150572474144.html

engaged in stimulus spending, mainly in the public sector, to generate growth. Numbers also help us to understand this development. According to the WSJ, in 2011, total public-sector spending in Spain was 13% higher than in 2007, and almost double what it was in 2000. Further evidence shows that from 2007 to 2011, government spending as a percentage of GDP increased by 4.4 percentage points in Spain, more than double the equivalent figure in Germany, which was 2.1 percentage points[187].

It is now evident, when looking at these numbers, that Spain did engage in heavy stimulus spending as a crisis management tool. However, it seems that it proved ineffective, as today we see continuous increases in unemployment in the private sector, while public spending was driven up by increasing the number of public-sector employees. Observers believe that the consequences of such fiscal stimulus growth strategies are large. Firstly, they lead to the deterioration of public finances by crowding out bank credit from the private sector and preventing the healthy deleveraging of the economy as a whole. Secondly, stimulus spending also caused some sectors of the economy to get more attention than others – both in the case of the USA and Spain. The USA also tried similar stimulus spending at the same time as Spain, but also failed to experience positive financial results from it. The common denominator for both countries was that they had overgrown sectors of the economy, respectively the housing and the automobile industries, that were overfed by easy-credit policies during the boom phase. This has sequentially halted the necessary adjustment of the economy's structure of production. Thus, overinflated industries must shrink and free resources for use by more profitable and efficient sectors of the economy.

As a consequential solution Spain could move to the other side of the ditch and start engaging in austerity measures. Indeed, this has started. From 2011 and onwards, Rajoy and his government have introduced cost-cutting measures of a substantial nature which have resulted in numerous demonstrations around the larger Spanish cities. These measures are needed, but also daring, as Spain according to projections will not see any growth in the economy in 2013. Nevertheless, the austerity measures for 2013 will among other things contain, first, a VAT increase from the current 18% to 21%. Secondly, a 12 % average cut in ministerial spending. Third and lastly a freeze in public

[187] http://online.wsj.com/article/SB10001424052702303703004577474150572474144.html

sector pay for the third consecutive year. Also the new measures dictate cuts to unemployment benefits[188]. According to Rajoy the situation in Spain is "*extraordinary serious*" and thus calls for large transformations[189].

We believe that austerity measures are needed in order for Spain to grow. But most importantly they are needed in order to show some willingness to solve their crisis. Spain is a large country, and a country that needs to demonstrate responsibility for past failures. However, for these measures to work efficiently, other elements and policies should be implemented to help pave the way for a faster transition. The following will highlight what policies and elements could work, together with the austerity measures, in order to bring about improvements.

Improve the labor market to pave the way for austerity

Along with Malta, Spain ties the European list of public holidays. Furthermore, the Spanish Workers' Statute (SWS) also guarantees 22 days of paid vacation annually. Lastly the SWS also guarantees 15 days to get married and two to four days if any in the family of an employee has a wedding, birth, hospitalization or death[190]. As Danes we (the two authors) also enjoy the benefits of many public holidays and tolerant employers. However, Denmark is not witnessing the same degree of economic crisis as Spain. Hence Spain needs to think of new and radical ways to make its employees more productive. One idea and solution can be to abolish the provision in the SWS that states that employees cannot trade vacation time for extra pay. By doing so, Spanish workers get rewarded for taking fewer (public) holidays and have an incentive to work on state-mandated vacations[191].

Another main concern in Spain and its labor market is the very large rate of youth unemployment. Currently the government has numerous training programs and tax exemptions for businesses to get young people into the labor market. However, these

[188] http://online.wsj.com/article/SB10001424052702303919504577520213420179248.html

[189] http://online.wsj.com/article/SB10001424052702303919504577520213420179248.html

[190] http://online.wsj.com/article/SB10001424052702303740704577522412881267278.html

[191] http://online.wsj.com/article/SB10001424052702303740704577522412881267278.html

programs do not work and they are very expensive[192]. In addition, the SWS also protects young workers quite well. It forbids most trainees and apprentices from earning less than 60% of the wages of full employees and from working more than 85% of a regular shift[193]. Spanish companies thus have an incentive to not hire these people, as especially young people need training and on the job experience before they can become profitable. Instead the SWS should be repealed and thus make room for hiring younger people at lower wages and maybe on longer hours. Yes, it is not optimal – but instead of having them on government-paid training programs, they will now generate tax which will go back to the government. This could potentially decrease the very high youth unemployment rate. In combination with this proposal, it is also recommended that Rajoy and his government look into dismissals and severance payments. Presently 99% of Spanish companies have fewer than 50 employees. This is because if a company has above 50 employees its workers must also elect five workplace reps to negotiate wages and conditions. These five workers also enjoy benefits such as receiving at least 15 paid hours off their monthly duties. Once companies grow to have 751 employees they must have at least 21 workplace reps[194]. If companies have less than 50 employees they can after the first year dismiss new employees with severance payments. A daring solution for Spain could be to eliminate these intermediaries and let individuals negotiate on their own. This will without a doubt, in the short run, provoke demonstrations and have trade union bosses up on their feet. However, according to the WSJ, fewer than 16 % of Spanish workers choose to join a union, and far fewer participate in demonstrations.

Overall, it is important to pave the way for the austerity measures to work. Currently one would assume that they will not have a strong effect if, the labor market is not reformed. Currently the Spanish labor market is protected, regulated and heavily mandated by taxes. We therefore believe that the system should be reformed, starting with a closer look at the labor market, which, as just described, is heavily protected. It discourages companies from hiring and creates a dual labor market of people with

[192] http://online.wsj.com/article/SB10001424052702303740704577522412881267278.html

[193] http://online.wsj.com/article/SB10001424052702303740704577522412881267278.html

[194] http://online.wsj.com/article/SB10001424052702303740704577522412881267278.html

experience and people without, who have problems getting into the job market on permanent contracts. So the labor market is currently hard to get into in Spain, so why not then let entrepreneurship thrive? Here Spain, among many other Euro countries, again lacks incentives and also makes it hard for entrepreneurs to start up through innovative thinking. The following section will therefore work as another solution in order for austerity to work, to let people start up on their own and generate income for the Spanish state, instead of being a liability.

Improve entrepreneurship and innovations

According to the Economist many parts of Europe have become inhospitable environments for entrepreneurs – including Spain[195]. Furthermore, the Economist states that a lot of European countries foster many corner shops, hairdressers and so on, but lack innovative companies that grow fast and end up become big – and in the case of Spain, will generate jobs and income for the state[196]. As a result, European nations do not produce large companies. A study cited by the European Commission shows that during the 1990s 19% of mid-sized firms in America were classified as fast-growers, compared with an average of just 4% in six EU countries[197]. This is also why the USA has seen fast-growing companies like Apple, Amazon and EBay (just to mention a few) that have grown big in a short amount of time and generated many new workplaces. In fact, (continental) Europe has in the period between 1950 and 2007 produced 12 Fortune 500 companies, whereas the USA has produced 52[198]. There are, nevertheless, success stories to be found in Spain in terms of entrepreneurship. One of the richest people in Spain is Amancio Ortega, who founded Intidex, which is a fashion company. The problem of these successes is that there are simply too few of them compared to the USA. So, clearly, there is a lack of new innovations, risk seeking and culture of starting a business in some of these European countries, including Spain. One of the main reasons is simply that the risk of failing is too high. In many of these countries one will not get a second chance. If you become bankrupt in Spain the typical maximum time

[195] http://www.economist.com/node/21559618

[196] http://www.economist.com/node/21559618

[197] http://www.economist.com/node/21559618

[198] http://www.economist.com/node/21559618

from the end of the liquidation process until the bankrupt person is freed from debts is 2 years[199]. Another big obstacle for Spanish entrepreneurs and their counterparts around Europe is the labor laws. As explained earlier, the structure of the labor market and laws make it difficult to hire and fire people, thus making it difficult to develop a new innovative company. As volatility is high for small and medium-sized companies, the demand for hiring and also firing can hence be high. Therefore the law should also enable staff to be reduced quickly when necessary. However, the complexity of firing people without severance pay is a great concern, thus making companies reluctant to hire and thus grow. In addition the Economist points out, that companies can face having to pay six months of severance pay even for recently hired employees who are fired – this drains small companies and drastically hinders their ability to grow[200].

In the current circumstances with an economic crisis and consequently high (youth) unemployment, it is advisable to use these forces combined with help from the government to quick -start the entrepreneurial spirit in Spain. First, one should already now consider the fact that with a 50% unemployment rate among young, educated and skilled people, there is high potential for a talented workforce at a low price. So, in short, unemployed talent can be contracted cheaply – while the price is low the quality is not. Spain hence has a competitive advantage compared to its US and British counterparts. The country and its entrepreneurs should embrace this advantage – in fact salaries for software engineers are currently 70% lower in Spain than in California[201]. So clearly there are advantages from which Spain can reap the benefits. However, they need to be coupled with some of the recommendations described above – mainly to deal with the protection of workers and make it easier to fire people. Another obstacle for Spain is to wake the entrepreneurial spirit in the population. Many young people still prefer the safety of working for well-known companies. Furthermore, the Spanish prefer cash over stock options. In the USA more would prefer the stock options. This also illustrates the strong risk aversion that the Spanish have towards the uncertainty of small start-ups. The downside for these small start-ups is that it is better for their cash flows to

---

[199] http://www.economist.com/node/21559618

[200] http://www.economist.com/node/21559618

[201] http://www.economist.com/node/21559618

grant rewards with stock options than with cash – yet again another obstacle for innovation and entrepreneurial spirit to thrive.

ECB buying bonds

As a final solution in the *resolution and deleveraging* phase, Spain can also team up with the EU and ask for it to help by letting the ECB buy bonds. In securing a stable monetary policy throughout the Euro zone, and attempting to reduce the discrepancy between interest rates among the member states, the ECB, under the leadership of Mario Draghi, has recently stepped up bond purchases from the crisis-hit countries including Spain[202]. This announcement had a direct effect on Spanish government bonds, reducing the borrowing cost of the Spanish government sharply. The reason for the steep drop in interest rates can most likely be attributed to the size of the new program. *"No ex-ante quantitative limits are set on the size of outright monetary transactions"*, Draghi said in relation to the announcement, essentially ensuring that the new bond-buying programs were limitless[203]. This represents a strong signal from the ECB that it will do whatever it takes to save the Euro[204]. This is defiantly a very plausible solution to the part of the crisis concerning the interest rate discrepancy throughout the Euro zone, and should be welcomed, not only by Spain, but also by Greece, Portugal and Ireland, who are still struggling with high interest rates, but also by Italy, for whom the interest rate has also started to become a concern[205]. By buying bonds and guaranteeing for crisis-hit countries, the risk is distributed more evenly throughout the Euro zone, and thus the interest rates would naturally equalize, as the risk premium of lending to crisis-hit countries becomes more lucrative.

Preliminary conclusion

Spain faces many issues and thus problems that need a solution in their *resolution and deleveraging* phase. First Spain can consider accepting the full bail-out of €100 billion for recapitalizing its banking industry. The bail-out comes with many pros and cons that

---

[202] http://www.bbc.co.uk/news/business-19499950

[203] http://www.reuters.com/article/2012/09/06/us-ecb-eurozone-bondplan-idUSBRE8850LW20120906

[204] http://www.guardian.co.uk/business/2012/sep/06/ecb-bond-buying-what-the-economists-say

[205] Refer to the interest chart in the chapter concerning the macroeconomic effects of the crisis.

have been described. One of the biggest cons is that it is primarily the taxpayers of Spain that will eventually pay the price of the bail-out. Another solution could therefore be to engage in a bail-in, where the bill is paid by the ones responsible, that is the banks. Thirdly, Spain will need to choose between stimulus spending or austerity measures to get the economy back on track. Stimulus spending has to some extent been tried with moderate success, so now the government has started substantial cost cutting measures. However, these only prove successful if they are backed up by labor market reforms which will eventually lead to a larger degree of entrepreneurial spirit and innovation. Lastly, Spain can also get help from the ECB in the form of the purchase of Spanish bonds. Overall, there are many solutions in the *resolution and deleveraging* phase. We have presented the ones that we believe will have the largest impact, and stated the pros and cons of these without giving a final solution for Spain to follow. The next phase is to determine how the damages of the banks best can be resolved. This phase is labeled *management of impaired assets* and will be described in the following.

Management of impaired assets

Creation of a bad bank (just like NAMA in Ireland)

As explained, Spain has already copied Ireland and established its own bad bank to absorb the toxic real estate assets from the banks. According to Honohan and Klingebiel, quick detection of the extent of the problems coupled with complete recapitalization at an early stage are key components to start a recovery[206]. First of all, it can be argued whether the crisis was detected at an early stage. This detection does not really matter in order to find new solutions, as it is something that we cannot change. What can be changed and where one could draft new solutions is in the recapitalization phase, which translated into Spain is their new “bad bank” and the FROB. Peter Bacon states, also explained above, that Spain failed to recognize the extent of its bad loans[207]. In other words, Spanish officials were too hesitant to recapitalize their bad loans. At first the FROB was used as a mechanism in order to tackle this recapitalization, mainly of the Cajas, the main lenders of property loans. The FROB initially worked with overlapping responsibilities to both the FGD and BdE. Hence the recapitalization

[206] Klingebiel (2000)
[207] http://online.wsj.com/article/SB10001424052702304019404577420300134053184.html

process has been somewhat overshadowed by other duties. One would therefore be reluctant to suppose that the recapitalization process has been lacking in full effect in the early stages of the crisis. In addition the FROB will now work as an extension of the "bad bank". As of late august this year Spain will operate a "bad bank". The bank will work in conjunction with the FROB – so once again the borders between the agencies seem to vanish into each other. Hence it is advised that before using the "bad bank" to manage the assets and bad loans of the property bubble burst, the responsibilities of both the FROB and the new "bad bank" should be clearly defined. In addition, the first solution of re-aligning the three agencies, BdE, FROB and FGD, should be met before taking any further action.

Asset management agencies like the newly formed one in Spain have, as explained earlier, both pros and cons. The asset management agency of Spain is being established to restructure the sector, get credit flowing and to maintain the confidence of the analysts. As noted by the Spanish Finance Minister Luis de Guindos, the "bad bank" will be running by late November or early December and will exist for 10-15 years. According to the Economist, "bad banks", like NAMA and now the newly formed Spanish counterpart, are seldom profitable, but nevertheless are still useful. History provides answers in the pros and cons of bad banks around the world. In the 1990s Sweden used asset management agencies to force banks to recapitalize (or be nationalized) and to absorb troubled loans. The move was to allow cleaned-up banks and lenders to operate as "good banks" that lent to the real economy once again. The Swedish "bad bank" example can be classified as a success, as growth bounced back quite quickly. The pitfall, however, was the cost to the taxpayers. Sweden paid about 4% of its GDP to bail out its financial system, yet got back only about half of that from selling off loans and stakes in banks[208]. Other successful attempts at bad banks can also be traced. The Economist emphasizes that NAMA has been a relative success in managing the €74 billion ($93 billion) in loans it took over, mainly because it bought the assets from Irish banks for just €32 billion. Yet it is now in the invidious position of being a long-term manager of a large portfolio of state-owned properties with all the

[208] http://www.economist.com/node/21562231

risks of political interference that this entails[209]. Spain should therefore already now consider the pros and cons which a state-owned “bad bank” may offer. Hence, the lessons from other “bad banks” and NAMA should be taken into consideration. First, officials need to be conservative when valuing the assets that will go into the “bad bank”. The Economist stresses that a cautious valuation will help set a floor for property markets and make it easier for the “bad bank” to sell assets quickly[210]. The second lesson is that borrowing costs matter. Previous “bad banks” in Britain and the USA turned good because they could borrow cheaply. If the borrowing costs of Spain do not fall sharply, the government will be hard-pressed to make a return on even deeply discounted banking assets. The last lesson is from Sweden, where “bad banks” can be judged successful even if they incur large losses in the form of increased taxes to the public. Like Ireland, the newly formed “bad bank” in Spain should not stand alone. It should be supported by various political measures and aims in order to be successful. Lumholdt states that the creation of a bad bank is a good idea. He believes that it will force banks to realize their losses and normalize the lending when the markets have been stabilized. However he also has his doubts about the concept. First, he worries that the assets will be sold to the bad bank at a reasonable price. He believes that foreign investors are not willing to invest in Spanish bonds from the bad banks, hence the Spanish state will need to purchase them with loaned money from the ECB. Second, he worries that the bank will not sell the weak assets at a low price that the market demands. If this is the case he argues that the bad bank simply pushes the problem away and let a future agency deal with the problem[211]

Preliminary conclusion

The above chapter of this thesis is written to present a 360 degree picture of the solutions and the associated pros and cons that follow with these solutions. The chapter should not be seen as taking all the mentioned solutions and compiling them into one big solution. Rather, it is written to show how Spain faces many different solutions in the three different phases in order to solve the crisis. What is important to recognize is

209 http://www.economist.com/node/21562231
210 http://www.economist.com/node/21562231
211 Henrik Lumholdt, mail interview, November 4th, 2012

that in order for one solution to work, it is dependent on another. For instance, for austerity to work most efficiently, it is important that the labor market is reformed.

The outlook for the Euro

Summing up on our findings, in investigating the root causes and origins of the crisis concerning Spain, it is clear that the EMU has some structural problems that caused the crisis to unfold. While the current recession stems from the US financial crisis, and is thus not directly caused by flaws in the EMU scheme, it is clear that a lot of the problems occurring in the Euro zone are caused by structural problems in the design of the EMU. Therefore, this chapter will investigate the said problems of the EMU, and suggest stabilizing measures for the future to benefit the health of the Euro scheme as a whole. Finally, we will conclude this chapter by providing different views on the future outlook for the Euro, as well as our own forecast, based on the findings and discussion in this chapter.

In making predictions for the future outlook for the Euro, it is important to recognize the structural environment in which the EMU was introduced and operates, in terms of economic consequences of the substitution of national currencies by a single currency. One of the world's most prominent economists, Martin Feldstein, wrote extensively on the matter of the EMU between 1992 and 1997, prior to the actual implementation, and drew some very interesting conclusions concerning the economic benefits and costs involved in the introduction of the EMU and the single currency. While it is no secret that Feldstein strongly discouraged the implementation of EMU, it is important to note that he is completely politically unbiased, in regards to the EU, and thus bases his conclusions solely on his economic insight and assessment. Accordingly, we will highlight the economic benefits and costs implied by Feldstein, and compare his conclusions to the actual development of the EMU, before finally drawing attention to the current situation and forecasting the future outlook.

Theory on gains and losses of the EMU

Evaluating a monetary union, from an economic point of view, boils down to balancing the sum of the potential trade gains, against the macroeconomic losses[212]. Essentially, introducing a single currency, the Euro, to replace existing national currencies reduces the transaction costs of trade within the EU single market. Effectively this saves a lot of

---

[212] Feldstein (1997)

resources, and may serve to stimulate increased trade among the member nations of the monetary union[213]. In contrast to the possibly positive trade outcome of the single currency, there are the macroeconomic losses of creating a monetary union, namely increased unemployment due the fact that national differentiations on interest rates and exchange rates are essentially eliminated. Thus, the monetary union implies a lack of national monetary policy making, which again leads to the deterioration of the autonomous market reactions related to interest rates and exchange rates in response to exogenous demand shocks[214]. This mechanism will increase the cyclical instability of the respective economies and hence, in terms of the labor market, increase cyclical unemployment.

Feldstein argues that the EMU would become an economic liability. He elaborates on this by stating that potential gains from the reduction in transaction costs on the single market would be relatively small, and when looking at it from a global point of view, it might even be negative. Furthermore, the creation of the EMU would result in increased cyclical instability which would increase cyclical unemployment. In addition, he fears that the establishment of the EMU will make the reduction of structural unemployment a more difficult task as well as heighten the incentive to create protectionist policies against non-EMU countries. He justifies his conclusions with the following reasoning.

EMU effect on transaction cost

The first, and possibly most certainly positive, effect of the EMU is the reduced trade cost among the EMU member countries implied by the single currency. By eliminating the requirement for businesses to buy and sell foreign exchange in spot and forward markets, similar to the case of global world trade, trading in the single market, namely the EMU area, would come at a significant reduction in transaction costs, and thus promote internal trade[215]. Technological development in the financial markets has made transactions cheaper, by digitalizing payments to be electronically processed. In addition to the reduction in transaction costs, the implementation of the EMU would also reduce the currency risk in trading and investing in the EMU area, encouraging

[213] Feldstein (1997)

[214] Feldstein (1997)

[215] Feldstein (1997)

increased trade in the single market. Feldstein argues though that this risk is insignificant as forward exchange contracts are relatively cheap and widely available[216]. He therefore does not give much credit to supposed beneficial effects following the implementation of the EMU.

In 1990, the European Commission published the document “One market, one money”, evaluating the potential benefits and costs of forming an EMU[217]. Essentially, the document concludes that the implementation of the EMU would give advantages to microeconomic efficiency and macroeconomic stability in the Union, and thus implies that the single market needs a single currency. Feldstein, however, is not persuaded by this analysis and its conclusion, and argues that these implications have no basis in either theory or experience[218]. The huge expansion of European and world trade, following globalization, has taken place even in the absence of a single currency or fixed exchange rates, and thus does not support the conclusions of the European Commission’s document. Furthermore, Feldstein points out that there is no evidence to suggest that the reduced exchange rate volatility, following the introduction of the European Monetary System (EMS), had an impact on the relationship between trade and investments among EMS member countries and other countries. Feldstein argues that equalizing tax rules and other legal structures would contribute more to the stimulation of trade within the single market than exchange rate stability. He compares the rules of the single market to the North American Free Trade Agreement, although they differ in many ways, and points out that that the trade agreement has led to increased trade and investment without any plans for a unified North American currency or exchange rate stability within the region[219].

In addition to the above-mentioned implications of the EMU, Feldstein highlights another important factor. While currency fluctuations between members of the single currency would be eliminated, the Euro would still fluctuate against other currencies. The actual effect of moving from EMS to EMU is hard to predict but Feldstein provides

[216] Feldstein (1997)

[217] European Commission (1990)

[218] Feldstein (1997)

[219] Feldstein (1997)

an example of a plausible scenario. He considers the scenario of a Dutch company that primarily exports to Germany, and on that market competes with a Japanese company. Under the EMS, the exchange rate fluctuation between the German Mark and Dutch Guilder has been very low, and thus a single currency will not have any significant impact on this volatility. However, the fluctuation between the Euro and the Yen might exceed that of D-Mark and Yen, due to higher interest rate instability of the Euro or the fact that the exchange rate fluctuations have to accommodate the entire Euro zone and not just Germany[220]. Thus, the shift from EMS to EMU would actually in theory have a negative effect on the risk for the Dutch company on the German market. In addition, Germany's trade with Japan would also become more risky. This example shows that the introduction of the single currency would not only negatively impact internal EMU trade, but also trade on foreign markets[221].

Having analyzed the EMU effect on the transaction costs, Feldstein proceeds to describe the EMU's effect on cyclical unemployment.

EMU effect on cyclical unemployment

When a country experiences a decrease in aggregate demand, there will be two automatic responses on the financial markets: the real value of the currency will decrease and real interest rates will decrease[222]. This is due to the decline in exports and the decline in demand for money and credit as a consequence of the decreased exports. The direct effect of this market response will be increased exports of other products and reduced imports, which in turn will reduce the increasing unemployment that would occur due to the initial decrease in demand for certain exported products. These two distinctive market responses are very crucial in sustaining global competitiveness as well as maintaining healthy fiscal conditions nationally. The introduction of the EMU would thus cause a huge problem for all member states, as neither of these market responses would occur when countries give up their national currency for the Euro. Under the EMU, the member countries of the Union would have the same exchange rate

---

[220] Feldstein (1997)

[221] Feldstein (1997)

[222] Feldstein (1997)

and interest rate. Consequently, these market effects will only occur in the scenario where all member states experience a similar decline in demand.

In conjunction with these automatic market responses, Feldstein draws attention to another important measure, exclusively applicable only by sovereign monetary nations, and that is the use of discretionary monetary policy. The ability to manipulate and adjust exchange rates and interest rates to accommodate a sudden drop in demand provides a very useful toolset for countering the unfortunate occurrence of cyclical unemployment as a product of decrease in demand. Under the EMU, member countries would not be able to use this discretionary policy to reduce cyclical unemployment, and would thus be at a disadvantage in comparison with being monetarily sovereign.

In coherence with these findings, Feldstein draws attention to the initially formulated theory on the subject conducted by Robert Mundell in the paper “A Theory of Optimum Currency Areas”[223] that assesses a monetary union as a balance between a reduction in transaction costs and the adverse macroeconomic effects embodied in the monetary union, concerning exchange rates and interest rates. This perspective is shared by Feldstein as described previously. Mundell identifies four primary factors in his paper, which establishes the framework concerning the necessity of variable exchange rates and interest rates, as it co-varies with cyclical unemployment. Thus, for a monetary union to be successful, as concluded by Mundell and outlined by Feldstein, these four factors should be considered[224]:

- Homogeneity of the countries within the monetary union.
- Flexibility of domestic prices and wages.
- Mobility of the labor force.
- Responsiveness of fiscal transfers.

As the shift to a monetary union for the EU is often compared to the USA., in the sense that the states of the USA could be compared the countries of the EU, which in terms or size and economy seems very rational, Feldstein comments on these factors and their

[223] Mundell (1968)

[224] Feldstein (1997)

importance and relevance for the EMU, in addition to comparing the relevant differences between the EU and the USA.

Homogeneity of the countries within the monetary union

In a monetary union, homogeneity of the participating countries is of high importance. If the countries have similar economies, the demand shocks, corresponding market responses and discretionary monetary policies would be the same. Thus, there would be little or no difference between having different national currencies as opposed to a single currency. The composition of the EMU candidates of the EU is entirely different though. While some economies are comparable in terms of GDP composition and comparative export preferences, others differ substantially. One of the major discrepancies, and a very relevant one for our thesis, is, as an example, the difference in demand shocks between Germany and Spain[225]. This example also holds true for many other strong economies in the EU (UK, France, Scandinavia) as opposed to weaker growing economies (Portugal, Greece, Italy), just to name a few. Monetary policies under the EMU would be conducted by the ECB, and the adjustment of the exchange rate and interest rate of the Euro for the EMU as a whole would not be sufficient to accommodate the individual needs of the member countries.

Unemployment would therefore inevitably fluctuate increasingly throughout the EMU, and hence the effect of this increased unemployment on the EMU as a whole relies more heavily on the three factors.

Flexibility of domestic prices and wages

In addition to the market responses regarding exchange rate and interest rate adjustments following a demand shock, the flexibility of prices and wages can have a significant impact on cyclical unemployment. If the flexibility of domestic prices is high, a demand shock would provoke instant adjustments of prices and wages in such a way as to maintain the level of employment prior to the decrease in demand. This mechanism will essentially create a drop in the real exchange rate without the need to adjust the nominal exchange rate, and thus would reduce cyclical unemployment domestically under a monetary union. In reality, however, Feldstein argues that the

[225] Feldstein (1997)

historical level of structural unemployment, as well as numerous direct observations, show that prices and wages in the EU are very inflexible and thus do not offset demand shocks[226]. On the other hand, price and wage flexibility in the USA is relatively higher, and as so counteracts the cyclical unemployment fluctuation implied by having a single currency.

Thus the members of the EMU cannot be counted on to adjust prices and wages to decrease unemployment. This is not necessarily needed though, if workforce mobility is present. This leads us to the next primary factor concerning the evaluation of a potential monetary union.

Mobility of the labor force

If a demand shock strikes a few countries within the EMU, unemployment does not necessarily have to rise, if the labor force is mobile and moves to other countries with job opportunities. Within the framework of the EU, legal barriers on labor mobility have been removed, and thus nothing prevents movement of labor across the EU. In reality, the EU workforce is very hesitant to move within the zone both in terms of temporary and long-term movement[227]. This is naturally linked to the barrier implied by different languages and different cultures among the member countries, as opposed to the states of the USA, which are much more similar both in terms of, of course, language, but also in the cultural aspect, promoting cross-border movement between states in the USA. In addition to these natural barriers of movement across the EU, the citizens of the countries of the EU are also reluctant to move internally within each country, as opposed to the USA, where there is a tradition of immigration and national settlement. Thus US citizens are to a much higher degree willing to move internally in states, where as Europeans are much more hesitant to move internally in each country.

Hence we can conclude that these three factors do not support the implementation of the EMU throughout the region. This leads us to the last of the four factors.

[226] Feldstein (1997)

[227] Feldstein (1997)

Responsiveness of fiscal transfers

When a state of the USA experiences a decline in demand, which in turn causes income to decrease in that state, the federal government will initiate fiscal transfers to that state to counteract the drop in demand[228]. In the EU, and also under the EMU, taxes in the member countries are paid to the national governments and not to the EU as a whole, and thus will not be distributed among the members of the union in the case of individual national demand shocks. This presents a big problem that will increase cyclical instability and unemployment.

Concluding on Feldstein's theory, we can see that the initial economic valuation of the EMU project strongly discourages the implementation of the said union. The EMU, however, became a reality and is now facing its first real test concerning the current sovereign debt crisis, following the US financial crisis. Therefore, we will apply the theory provided by Feldstein and Mundell to the actual development of the EMU and afterwards present our expectations and outlook for the future.

Applying theory on actual outcome of the EMU

As we know, the EMU was established in its third phase on 1 January 1999, and has been in effect ever since. But how has the EMU actually performed compared to the predictions by Feldstein?

One of Feldstein's main concerns was the stability of the Euro as a currency in contrast to the former stability of some of the strong European currencies, in particular the German mark. This concern has, however, proved wrong. The Euro has maintained a strong relationship to the US dollar since the introduction in 1999 (See the graph in the chapter concerning the ECB charter). While the crisis has caused some turbulence for the Euro, it is still considered a strong currency. The development can be tied to the strong focus on inflation from the ECB, and has thus proved to be a success for the EMU scheme. Hence we can conclude that the transaction costs among the EMU members have been reduced, without causing extensive increases in risk, due to higher currency fluctuations. The problems for the EMU, however, are quite extensive when we look at the development in macroeconomic effects.

---

[228] Feldstein (1992)

In terms of cyclical instability and cyclical unemployment, the ongoing sovereign debt crisis has shown that the Euro is flawed, and has caused more harm than good for many of the southern European countries. The centralization of monetary policy and strict dictation of fiscal demands of the Maastricht Treaty, and later the fiscal pact, have affected the southern European economies, by forcing them to drastically reduce inflation, and thereby interest rates, which in turn overheated their economies and reduced their competitiveness, and directly amplified the state of the current global recession, following the US financial crisis. Because the member countries of the EMU are so heterogeneous, in terms of GDP composition and comparative export abilities, the single currency, with its implied single exchange rate and interest rate, has sharply increased cyclical instability in the zone, as we have been witness to during the evolving crisis. While this crisis is extensive, and one could argue that Europe would have been in debt and recession even without the EMU, there is no doubt, that the EMU has amplified the crisis. As a result, Feldstein's concerns, as initially presented by Mundell, regarding the macroeconomic effects in terms of cyclical instability, as a consequence of heterogeneous economies in the monetary union, have proved to be right.

When looking at the flexibility of prices and wages in the EMU, it is clear that the entire region has been hit, although to different extents, by the crisis, and thus, all countries have to adapt on prices and wages. The problem for many of the southern European countries lies in the extensive wage development following the implementation of the EMU. As shown in the chapter concerning the macroeconomic impact of the crisis, wages have increased relatively more compared to increases in productivity for many of the southern European economies, resulting in a loss of competiveness and thereby demand. It is clear that prices and wages have not adjusted is the wake of the crisis as they should. This is mostly due to political and judicial factors, as well as employee unions, making it difficult to enforce a wage cut. If the severely crisis-hit countries had their own currency, natural market responses on exchange rates and interest rates would have counteracted the drop in demand, but as the exchange rate is of course dictated by the ECB for the whole EMU, as well as the interest rate, with the exception of the risk premium investors demand from risky countries, these market responses do not occur, and thus the crisis worsens. Cyclical unemployment remains high, especially in Spain, where unemployment is projected to exceed 25% by the end of 2012, but also in Greece and Portugal.

It is difficult to perceive the actual mobility in the labor force, as many EMU countries struggle with high unemployment, and thus cannot welcome an external workforce. This being so, we will avoid drawing comparisons to Feldstein's thoughts, as there has not yet, under the EMU, been a scenario of some countries booming while others were in recession. It is clear though that the language barriers and cultural differences will reduce the incentive to move across borders.

The last concern implied by Feldstein and Mundell, regarding the fiscal transfers from government to states of the USA experiencing demand shocks, that this would not occur under the EMU, has during the crisis proved to be wrong. While the EMU project of course presents an enormous political value that would increase the incentive to preserve the union, the EU has acted very swiftly, and exercised necessary fiscal transfers to member economies facing the risk of default. While this does not solve the structural flaws of the Euro scheme at all, it serves as a lifeline in order to preserve the union and gain time to develop additional solutions.

On the basis of the highlighted initial concerns of the monetary union, as well as the actual performance of the EMU under the first big and very real stress test, namely the sovereign debt crisis, we will now discuss the future outlook for the Euro, and in addition present our recommendations for the survival of the EMU.

Future outlook for the Euro

It is clear that the future outlook for the Euro is surrounded by many challenges, and thus we will aim at presenting our expectations for the future development in the aftermath of analysis of the development of the EMU over the last decade.

As the sovereign debt crisis continue to evolve, it is clear that the EMU project is flawed in many ways. In more recent writings, Feldstein deems the Euro as a failed experiment, and encourages this to be recognized[229]. The EMU has proved to be an economic liability that is now causing high unemployment, high debt and huge trade

[229] Feldstein (2011)

deficits throughout the zone. This leaves two options for future development of the EMU.

The first option is to recognize that the flaws and macroeconomic effects implied by the EMU heavily outweigh the transaction costs reduction resulting from the single currency, to phase out the EMU over the coming years and to attempt to restore the old system and currencies. This is, however, a very unlikely scenario. First of all, the establishment of the EMU holds so much political value that the leaders of the EU will do almost anything to preserve the monetary union. Admitting its failure and letting it fall would be considered a major loss on the global scene, and thus everything will be done to avoid this. Moreover, the cost of restoring the old system will be overwhelming, not only in terms of the direct costs but also the short-term instability of the entire region, which would follow a breakdown of the EMU. Thus, deeming the probability of this option close to non-existent, this leaves the second option, which is of course the attempted preservation of the Euro.

The first steps towards preserving the Euro have already been taken. Both of the above-mentioned pacts, namely the Fiscal Pact and the Growth Pact, underline the need for uniform fiscal austerity, concerning central fiscal factors, and the common acknowledgement of central measures in the process of sustaining growth and prosperity throughout the EU. While the complications of the monetary union are very present, it is, with political will, possible to overcome these macroeconomic burdens, brought about by the monetary union. One of the core values, for the future stability of the EMU, is to centralize more fiscal policy from national governments to the EU. In addition to centralization, it is important to enforce punishment on countries that break the rule set. These measures have already been set in motion by the above-mentioned pacts, and it is important to focus on successful implementation. In short, the EMU, or even the EU as a whole, should evolve to be, in addition to a monetary union, a fiscal union. More centralization will equal more stability, and will also seek to make the member countries more homogenous over time. Will all member countries give up their fiscal sovereignty and leave it in the hands of the EU? Most definitely not, and this will continue to fuel the differences between the member countries and in turn the instability of the union.

Another possible solution to the EMU, in terms of improving stability, would be to rework the requirements and therefore the members. Greece has encountered the worst struggle during the crisis, since its economy was very susceptible to overheating following the Maastricht rules. Greece even cooked the books in order to join the EMU[230]. Its economy was far from ready to share an exchange rate and interest rate with, among others, Germany, and thus, ironically, Germany is paying the price today, in contributing most of the funds to save Greece from default. Many have argued that Greece, among others, should leave the EMU. There are of course pros and cons of this scenario, but all in all, Greece is a relatively minor economy in the EMU. But what about Spain, Italy and Portugal? Should they leave the Euro? They represent a vast amount of the EU's GDP, and the consequences of them leaving the Euro scheme would be a total collapse, since the core driver of the union would seem pointless, as it would more or less only be Germany and France that would be strong enough to remain in the union under the strict requirements, which in turn points right back to the dissolving of the union, and is thus an unrealistic scenario.

All in all, the future for the Euro is very uncertain. Most likely, the EU will continue to provide assistance to countries in crisis, and seek to hold the strings together. As of now, all eyes are on Spain and the potential release of the 100 bn. Euro bail-out. As mentioned earlier, there are different views on whether the implementation of said bail-out is a good idea. Some even argue that it is not enough. It is certain, though, that developments in the near future will be crucial, not only in terms of the bail-out for Spain, but also the implementation and enforcement of the Fiscal Pact and the Growth Pact.

Conclusion

This thesis has investigated and analyzed the problematic situation that Spain, as a member of the EU, is currently facing in accordance with the following problem formulation:

What were the origins and root causes of the Spanish crisis? What were the macroeconomic effects of the impact of the crisis? What was the framework of the EU

[230] http://www.bbc.co.uk/news/world-europe-16834815

and the EMU, what changes have been made, and how does this affect Spain? How has crisis management been conducted in similar crises? Which solutions can be applied to Spain, to accommodate the crisis? What is the outlook for the Euro?

Spain is today in a recession. The recession is as serious as in other PIIGS countries, but the recession in Spain has led to a much larger increase in unemployment and a sharper deterioration in government finances. The massive building boom in the pre-crisis years led banks to engage in high risk loans. This building boom was stimulated by favorable macroeconomic conditions, the introduction of the Euro as a currency which leads to lower interest rates and demographic factors. When the bubble burst, these loans fueled a massive private debt, which in turn led to high unemployment. The Spanish banks therefore also had a large share in the crisis. At first the Spanish banking system was seen as one of the most solid systems of the world. This statement was made on the bias of "Dynamic Provisioning". This countercyclical method made ailing banks look healthy, when they in reality were close to bankruptcy. Also, the Spanish banking system consisted of asymmetries in the form of solvency. The traditional banks had healthy books, but the Cajas were highly involved in lending to the housing industry and thus had a highly non-diversified portfolio which was made worse by the burst of the bubble. To counterattack such imbalances and to pave the way for a potential bail-out from the ECD and IMF, the FROB was established.

The macroeconomic effects of the crisis for Spain have been severe and distinctive in comparison to other crisis-hit countries. Initially, the public debt and public deficit were very low, in some cases even lower than the strong economies of the EU, namely Germany. Spain, however, suffered from huge private debt and skyrocketing unemployment, which represent one of the biggest problems. This in turn has drastically increased the public debt and public deficit. As a consequence of the increased risk faced by Spain, interest rates have increased drastically, and have been close to the crucial 7% border many times. The huge increase in private debt and unemployment is directly caused by the relatively high wage development, compared to productivity development, which has made Spain less competitive on the global market. This has had a substantial impact on the current account balance during the boom of the 2000s. Recently, however, Spain has to some extent succeeded in adjusting wages, making exports increase. Moreover, domestic demand has been catastrophic in Spain since the impact of the crisis, and has had a high impact on consumption and GDP growth.

The framework of the EU has played a huge role in the deterioration of the Spanish economy. Strict rules, dictated by the Maastricht Treaty and the Stability and Growth Pact, have forced Spain to drastically lower inflation and interest rates, to prepare for the EMU. These caused massive household borrowing and let the economy run out of control, similar to the scenarios in Greece, Portugal and Ireland. In addition to the problems implied by the strict rules, the fact that the rules were not enforced caused some economies, among them Greece, to carelessly overspend their public finances during the boom. The result of this is now massive debt and fear of default. Recently, a new Fiscal Pact and a new Growth Pact have been set in motion, to accommodate the ongoing crisis, by enforcing austerity and kick-starting growth with stimulus packages from the EU. Both of these pacts come into effect at the beginning of next year, and will be crucial for the future prosperity of the Union.

In terms of crisis management, other similar crises can prove to be important benchmarks for Spain in its own crisis management handling. The framework of the OECD has been used in order to illustrate the different phases of crisis management: *initial containment, resolution and deleveraging* and finally *management of impaired assets.* Ireland faced similar issues as Spain, with a booming property market which crashed and left the country with high private debts. To overcome this crisis Ireland guaranteed all deposits to prevent bank-runs and further shocks. Secondly, Ireland established NAMA, to take over the bad loans and to restore confidence in the financial system and received capital injections from the IMF and ECB. Spain can draw lessons from the crisis in Ireland, namely the establishment of a "bad bank" to restore confidence. However, Ireland is a relatively small country when compared to Spain, hence the solutions for Ireland might not be directly replicable for Spain. The next benchmark for Spain was the Icelandic example of crisis management. The small country has witnessed the worst collapse of any country when compared to the size of the economy. This crisis was also mainly fueled by risk-taking banks and high private debt. Yet crisis management in Iceland was very different from in Ireland. Instead of "saving" the banks, it let them go bust, and thus shielded the taxpayers. In other words

Iceland performed a bail-in before asking for money from abroad in the form of a bail-out. Iceland, however, strongly differs from Spain mainly because it has its own currency and because of its small size. Nevertheless, many experts still believe that some of the elements of the Icelandic crisis can be replicated on a larger scale. Alongside the two major crises explained, the Irish and the Icelandic, the Finnish and the East Asian crises have also been highlighted – the East Asian crisis proved the lesson that an IMF injection can also be harmful if the scale of the crisis is substantial.

Having highlighted other similar crises, the solutions for Spain can be drafted with inspiration from these. At first Spain misunderstood its crisis because it initially thought that it was suffering from a liquidity crisis when in fact it was suffering from a solvency crisis. This is also reflected in its *initial containment phase.* Hence it is advised that Spain should continue to have the FGD, FROB and BdE. However the responsibilities and remits should be clearly stated and more re-aligned in order for them to work more efficiently. They should simply be updated, because the crisis has evolved and at first was misinterpreted as a liquidity crisis.

Having contained the crisis, Spain should then focus on the *resolution and deleveraging phase.* Many options are important to consider. Other past crises have almost all benefited from receiving a bail-out – Spain can possibly do so too. However, it is important to understand the drawbacks of such an action, mainly the liability of the taxpayers. This can however be limited, if Spain considers a bail-in. The Swedish model has been highlighted by experts as a success, and a way of performing a bail-in, before asking for money in the form of a bail-out. Spain can also resolve its crisis itself without involvement from outsiders. Recently Spain has exercised severe austerity. However, this does not seem to have had a substantial effect. Rather, it is advised that austerity, instead of stimulus spending, can be enhanced by abolishing many of the labor laws that exist in Spain. This will help decrease unemployment and pave the way for austerity. In conjunction with this it is also believed that, with new innovations and enhanced entrepreneurship, austerity will have a larger impact. Finally, Spain can also let ECB buy its bonds.

In the last phase, *management of impaired assets,* it is advised that Spain continue with its newly formed “bad bank”, and use this institution to resolve some of the damages that the domestic banks have caused to the system. Furthermore, it is recommended to look into earlier examples of bad banks around the world, namely the Swedish and Irish ones, to see what lessons can be learned from them

It is clear that the Euro has some structural problems. In general, a monetary union can be evaluated by balancing the potential gains on transactions and macroeconomic losses. While the Euro no doubt has eased trading among the members, there is no evidence that trade has increased substantially or that trade would have been lower, had the Euro not been introduced. However, the macroeconomic consequences of imposing a single currency on countries as heterogeneous as those in the EMU have been severe. Cyclical instability and thus cyclical unemployment have grown out of control for some nations, as they are unable to use the natural market effects of currency and interest rate fluctuation which a national currency would allow. Therefore, the future outlook for the Euro is very uncertain. Politically, the project is too big to fail, and thus we expect the leaders of the EU to do everything in their power to save the Euro. Whether some inconsistent problematic countries such as Greece will have to leave the EMU is also uncertain. Time will tell. At the moment, however, all eyes are on Spain and the potential bail-out from the EU, as this poses the single most important issue for the zone at the moment.

Bibliography

Articles and research papers

Éltetö, Andrea (2011). *The economic crisis and its management in Spain.*

Carballo-Cruz, Francisco (2011). *Causes and Consequences of the Spanish Economic Crisis: Why the Recovery is Taken so Long?*

Himmerberg, Charles. Mayer, Christoper. Todd, Sinai (2005). *Assessing High House Prices: Bubbles, Fundamentals, and Misperception.*

Maastricht Treaty (1992). *The Treaty on European Union.*

Peeters, Marga & Den Reijer, Ard (2011). *On wage formation, wage flexibility and wage coordination: A focus on the wage impact of productivity in Germany, Greece, Ireland, Portugal, Spain and the United States.*

Council of the European Union (2011). *Council reaches agreement on measures to strengthen economic governance.*

Schich, Sebastian (2009). *Expanded Guarantees for Banks: Benefits, Costs and Exit Issues.*

Baer, H. & D. Klingebiel (1995). *Systemic Risk When Depositors Bear Losses: Five Case Studies.*

Honohan, P. and D. Klingebiel (2000), *Controlling the Fiscal Costs of Banking Crises.*

Klingebiel, D. (2000), *The Use of Asset Management Companies in the Resolution of Banking Crises*

Cross-Country Experiences.

Stiglitz, Joseph E. (2000). *The Insider – What I learned at the world economic crisis.*

Jonung, Lars (2009). *The Swedish model for resolving the banking crisis of 1991-1993. Seven reasons why it was successful.*

Feldstein, Martin (1992). *Europe's Monetary Union – The case against EMU.*

Feldstein, Martin (1997). *The political economy of the European Economic and Monetary Union: Political sources of an economic liability.*

Feldstein, Martin (2011). *The Failure of the Euro.*

Mundell, Robert A. (1961). *A Theory of Optimum Currency Areas.*

European Commission (1990). *One market, one money.*

Resolutions, treaties and pacts

Resolution of the European Council (1997). *On the Stability and Growth Pact.*

Council Regulation (EC) No. 1466/97

Council Regulation (EC) No. 1467/97

Kesner-Skreb, Marina (2008). *Stability and Growth Pact.*

The Fiscal Pact (2012)

The Growth Pact (2012)

Reports

OECD (2011). *Economic Outlook*, November 2011.

OECD (2012). *Economic Outlook*, May 2012.

OECD (2010). *Economic Surveys: Spain*, 2010.

OECD (2011). *Overcoming the Banking Crisis in Ireland,* 2011.

The World Bank Group (2009). *Dynamic Provisioning,* July 2009.

Ministry of Economy and Competitiveness (2012). *Spanish Debt – Some Highlights,* 18th May 2012.

IMF (2012). *World Economic Outlook,* April 2012.

IMF (2012). *Spain: Safety Net, Bank Resolution, and Crisis Mangement Framework – Technical Note*, June 2012

PWC (2011). *Basel III and beyond – The trillion dollar question: can bail-in capital bail out the banking industry?*

Internet and News

The Guardian – *Spain's 90s greed is at the root of its banking crisis*, 8th June 2012.
http://www.guardian.co.uk/commentisfree/2012/jun/08/spain-90s-greed-banking-crisis

The Guardian – *Angela Merkel vows to create 'fiscal union' across eurozone,* 2nd December 2011.
http://www.guardian.co.uk/business/2011/dec/02/angela-merkel-eurozone-fiscal-union

The Guardian – *Spanish banks stress test reveals €59 bn. black hole,* 28th September 2012.
http://www.guardian.co.uk/world/2012/sep/28/spanish-banks-stress-test-blackhole

The Guardian – *ECB bond buying: what the economists say*, 6th September 2012
http://www.guardian.co.uk/business/2012/sep/06/ecb-bond-buying-what-the-economists-say

International Monetary Fund – *Iceland's Recovery: Can the Lessons Be Applied Elsewhere?*, 24th October 2011
http://www.imf.org/external/pubs/ft/survey/so/2011/surveyartf.htm

The Economist - *How To Save Spain*, 2nd June 2012.
http://www.economist.com/node/21556238

The Economist – *Spanish steps*, May 15th 2008.
http://www.economist.com/node/11325484

The Economist – *Going to extra time,* 16th June 2012.
http://www.economist.com/node/21556953

The Economist – *After the sugar rush*, 14th April 2012.
http://www.economist.com/node/21552582

The Economist – *Spanish practices*, 18th February 2012.
http://www.economist.com/node/21547831

The Economist – *Soft centre*, 11th June 2009.
http://www.economist.com/node/13767419

The Economist – *Cracks in the crust*, 11th December 2008.
http://www.economist.com/node/12762027?story_id=12762027

The Economist – *From bail-out to bail-in, 28th January 2010.*
http://www.economist.com/node/15392186

The Economist – *Les Misérables*, 28th July 2012.
http://www.economist.com/node/21559618

The Economist – *Bad or rubbish?*, 8th September 2012.
http://www.economist.com/node/21562231

The Economist – *Truth hurts*, 21st June 2012
http://www.economist.com/blogs/schumpeter/2012/06/spains-troubled-banks

The Economist – *Just don't call it a bail-out*, 10th June 2012.
http://www.economist.com/blogs/newsbook/2012/06/spains-banks

Wallstreetpit - *International Comparison of Home Ownership Rates*, 6th October 2010.
http://wallstreetpit.com/47205-international-comparison-of-home-ownership-rates/

The Age – *Spanish divorce rate soars to EU highest*, May 23rd 2007.
http://www.theage.com.au/news/World/Spanish-divorce-rate-soars-to-EU-highest/2007/05/23/1179601495413.html

Financial Times – *Dark Clouds over 'La Mancha's Manhatten',* 28th March 2008.
http://www.ft.com/intl/cms/s/0/ceb33b42-fce3-11dc-961e-000077b07658.html#axzz2BFTiADBR

Financial Times – *Iceland: Recovery and reconciliation*, 29th March 2012.
http://www.ft.com/intl/cms/s/0/8a0390dc-78c7-11e1-9f49-00144feab49a.html

Bloomberg – *The EU Smiled While Spain's Banks Cooked the Books,* 15th June 2012.
http://www.bloomberg.com/news/2012-06-14/the-eu-smiled-while-spain-s-banks-cooked-the-books.html

BBC – *Spain is not Uganda. Discuss*, 12th June 2012.
http://www.bbc.co.uk/news/magazine-18408448

BBC – *ECB's Mario Draghi unveils bond-buying euro debt plan,* 6th September 2012.
http://www.bbc.co.uk/news/business-19499950

BBC – *How 'magic' made Greek debt disappear before it joined the euro,* 3rd February 2012.
http://www.bbc.co.uk/news/world-europe-16834815

The Wall Street Journal – *Spain's Critical Issue Is Its Private Debt,* 23rd March 2012.
http://blogs.wsj.com/marketbeat/2012/03/23/spains-critical-issue-is-its-private-debt/

The Wall Street Journal – *A Way Around European Bonds*, 7th December 2010.
http://online.wsj.com/article/SB10001424052748704156304576003760628199904.html

The Wall Street Journal – *Bailout Deal Fails to Quell EU Rifts*, 17th December 2010.
http://online.wsj.com/article/SB10001424052748703395204576023732485094802.html

The Wall Street Journal – *Ireland's Bad Bank Expert Urges Spain to Follow Suit,* 22nd May 2012.
http://online.wsj.com/article/SB10001424052702304019404577420300134053184.html

The Wall Street Journal – *Architect of Ireland's 'Bad Bank' Sees Lessons for Spain,* 22nd May 2012.
http://blogs.wsj.com/eurocrisis/2012/05/22/architect-of-irelands-bad-bank-sees-lessons-for-spain/

The Wall Street Journal – *In European Crisis, Iceland Emerges as an Island of Recovery,* 21st May 2012.
http://online.wsj.com/article/SB10001424052702304203604577396171007652042.html

The Wall Street Journal – *A 'Bail-In' Could Save Spain's Banks,* 14th June 2012.
http://online.wsj.com/article/SB10001424052702303822204577466590595992160.html

The Wall Street Journal – *Rajoy Needs to Stand Up to Spain's Banks,* 16th July 2012.
http://online.wsj.com/article/SB10001424052702303933704577528611823965878.html

The Wall Street Journal – *The Truth About Spanish Austerity*, 18th June 2012.
http://online.wsj.com/article/SB10001424052702303703004577474150572474144.html

The Wall Street Journal – *Madrid Austerity Plan Boosted to $80 Billion*, 11th July 2012.
http://online.wsj.com/article/SB10001424052702303919504577520213420179248.html

The Wall Street Journal – *How Europe Can Create Jobs*, 16th 2012.
http://online.wsj.com/article/SB10001424052702303740704577522412881267278.html

The New York Times – *European Central Bank*, 5th October 2012.
http://topics.nytimes.com/top/reference/timestopics/organizations/e/european_central_bank/index.html

Council of the European Union – *The fiscal compact ready to be signed*, 31st January 2012.
http://european-council.europa.eu/home-page/highlights/the-fiscal-compact-ready-to-be-signed-(2)?lang=en

Council of the European Union – *Ratification details on the fiscal pact*, 2nd March 2012.
http://www.consilium.europa.eu/policies/agreements/search-the-agreements-database?command=details&id=&lang=en&aid=2012008&doclang=EN%22

ECB – *Building Europe in a globalised world*, 2007.
http://www.ecb.int/press/key/date/2007/html/sp071023.en.html

Spiegel – *The empty promise of Europe's 'Growth Pact'*, 27th June 2012.
http://www.spiegel.de/international/europe/the-eu-s-new-growth-pact-a-841243.html

European Financial Stability Facility – *About EFSF*.
http://www.efsf.europa.eu/about/index.htm

Reuters – *EU appoints Draghi to ECB, Bini Smaghi to leave*, 24th June 2011.
http://uk.reuters.com/article/2011/06/24/uk-eu-summit-draghi-idUKTRE75N1JO20110624

Reuters – *Draghi gets ECB backing for unlimited bond-buying*, 6th September 2012.
http://www.reuters.com/article/2012/09/06/us-ecb-eurozone-bondplan-idUSBRE8850LW20120906

The Independent – *What price the new democracy? Goldman Sachs conquers Europe*, 18th November 2011.
http://www.independent.co.uk/news/business/analysis-and-features/what-price-the-new-democracy-goldman-sachs-conquers-europe-6264091.html

Marketwatch – *Unlike Bernanke, Draghi doesn't aim to be a hero,* 12th January 2012.
http://www.marketwatch.com/story/unlike-bernanke-draghi-doesnt-aim-to-be-hero-2012-01-12

Marketwatch – *What central banks provide, oil markets take away*, 29th February 2012.
http://www.marketwatch.com/story/what-central-banks-provide-oil-markets-take-away-2012-02-29

Japan Policy Research Institute – *South Korean Anti-Americanism*, July 2003
http://www.jpri.org/publications/workingpapers/wp93.html

Data Sources

OECD – *Statistics*
http://stats.oecd.org/

European Central Bank – *Statistics*
http://www.ecb.int/stats/html/index.en.html

International Monetary Fund – *Statistics*
http://www.imf.org/external/data.htm

World Bank – *Statistics*
http://databank.worldbank.org/ddp/home.do

Eurostat – *Statistics*
http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/

Human Development Reports – *Statistics*

http://hdr.undp.org/en/statistics/hdi/

Interview

E-mail correspondence with Henrik Lumholdt from BBVA. See appendix

Appendix

Appendix 1

Email correspondence with Henrik Lumholdt from BBVA. Correspondence is in Danish.

Questions:

Kære Henrik Lumholdt,

Vi har fået din mail og kontakt info igennem Finn Østrup, som er vejleder på vores speciale, som omhandler krisen i Spanien.

Vi vil i den forbindelse høre om du ville give din mening om disse 6 korte spørgsmål. Vi har også vedlagt de 18 sider (vi vil også gerne sende hele specialet, hvis det har interesse) som er relevante for disse 6 spørgsmål.

De 6 spørgsmål er som følger:

Vi har skrevet lidt om at garantere bank indeståender (ligesom vi har Finansiel Stabilitet i Danmark). I vores research har vi fundet ud af at Spanien har *Fondos de Garantía de Despositos *(FGD). Vi har dog også stillet spørgsmål tegn ved dets legimitet og magt når man også tænker på at FROB og Banco de Espana (BdE) har mandater:

1. Hvad er dit syn på FDG – sammen med FROB og BdE. Er der interessekonflikter involveret og overlapper deres ansvar hinanden?

Vi har skrevet lidt om ligheder mellem Irland og Spanien og deres krisehåndteringer. Her fandt vi ud af at Irland først troede at de havde en likviditetskrise, men senere fandt ud af at det havde en solvenskrise. Dette gjorde at de reagerede alt for sent i deres krisehåndtering:

2. Mener du også at Spanien først troede at de havde en likviditetskrise og dernæst opdagede at de havde en solvenskrise og reagerede for sent i deres krisehåndtering?

En af de meget omtalte løsninger er den lovede ”bail-out” på €100 milliarder:

3. Hvad er dit syn på den – er de 100 milliarder nok?

4. Vi har også nævnt at man kunne lave en bail-in? Hvad er dit syn på det?

Vi mener at en af løsningerne for Spanien er via at regeringen skærer ned på offentlige tilskud samtidigt reformerer arbejdsmarkedet og gør det nemmere at fyre ansatte. Dette vil åbne op for iværksættere og være med til at læse ungdomsarbejdsløsheden.

5. Hvad er dit syn på det Spanske arbejdsmarked og dets stærke sikkerhed til ansatte? Ville en lempelse af denne sikkerhed være med til at åbne op for større produktivitet – flere skatter i den Spanske statskasse?

Nu har Spanien lige oprettet en bank (i forlængelse af FROB) som skal tage sig af de dårlige lån. Lidt ligesom Irland har NAMA:

6. Hvad er dit syn på sådan en bank? Fordele/ulemper?

Vi ser meget frem til at høre dine meninger, som vi vil implementere i
specielt hvis du giver tilladelse til dette?

Med venlig hilsen,

Anders Ladegaard & Daniel Galliano Dalgaard (Cand.Merc. FSM)

First answer:

Kære Anders og Daniel,

Tak for jeres e-mail. Som jeg sagde til Finn Østrup er jeg lidt hængt op i disse dage, men det skulle blive lidt bedre i de kommende uger. Så jeg lover at komme tilbage med noget feedback til jeres spørgsmål i næste uge. Vi kan også tage en sludder på telefonen ved lejlighed.

Det er bestemt et interessant emne, men også meget vidtspændende. Inden jeg kommer tilbage vil jeg foreslå, at I måske prøver at finde noget litteratur om den svenske bankreform fra starten af 1990erne (det er muligt jeg har noget et eller andet sted i mine filer). Den svenske model er blevet nævnt mange gange som et forbillede, og selvom hvert land har sine egne problemstillinger er den en relevant "benchmark" for andre lande.

Men som sagt, jeg kommer tilbage næste uge.

De bedste hilsener,

Henrik Lumholdt

Second answer:

Add 1. Garanti for bankindeståender

Jeg tror ikke den spanske stat reelt har haft dækning for sin garanti for bankindeståender på noget tidspunkt siden indgrebet blev bekendtgjort. Den samlede masse af bankindeståender er et gigantisk beløb (noget i retning af 140 % af GDP), og selv hvis vi sætter delen af indeståender på under 100.000 euros meget lavt (f.eks. 60-70 %) ville det stadig være umuligt for staten at dække et større “run” på det spanske finansielle system. Dette er så meget desto mere rigtigt under de nuværende omstændigheder, hvor det er klart, at staten har svært nok ved at dække sit eget finansieringsbehov.

Spørgsmålet er så, hvad der kunne give anledning til et sådant “run”. Der har givetvis været en voksende tvivl i befolkningen mht. dele af sparekassesektoren, og offentligheden har trukket indskud ud af disse institutioner. Men det har til gengæld begunstiget banksektoren, specielt de store banker, der har set en stigning i deres indskudsmasse. Der er meget lidt der tyder på at borgerne reelt føler nogen risiko for konkurser eller defaults i den almindelige banksektor, uanset om den tillid er berettiget eller ej.

Hvad der derimod kunne give anledning til et “run” mere generelt ville være en voksende frygt for, at Spanien var på vej til at forlade euroen og genindføre pesetaen. Vi så nogle tegn på den frygt for nogle måneder siden Givet ECBs OMT er vi pt. ret langt fra den situation, men det er klart, at i en stresssituation kunne “manden på gaden” frygte, at han vågner op mandag morgen og regeringen har tvangsindført en konvertering af alle bankindskud til (nye) pesetas. Selvom det sikkert ville finde sted til den valutakurs Spanien gik ind i eurosamarbejdet på er det klart, at den nye peseta derefter ville blive kraftigt deprecieret i valutamarkedet og den internationale værdi af bankindeståender ville falde voldsomt. Hvis sådan en stresssituation opstod i større stil – og jeg gentager, at vi pt. er langt fra det scenario – ville statsgarantien for indskud hverken have den tilstrækkelige dækning eller den rigtige *form*, al den stund at den væsentlige del af frygten blandt borgerne ville vedføre denomineringen af deres indskud snarere end bankernes solvens. I den situation kunne regeringen så se sig nødsaget til at begrænse adgangen til at trække penge ud af bankerne i kontant form, og Spanien kunne ende i en situation a la Argentinas “corralito” i begyndelsen af 2000-tallet.

Men for at vende tilbage til det grundlæggende spørgsmål om dækningen for bankindskuddene i en situation hvor der ikke er frygt for, at Spanien forlader euroen, er det klart at spørgsmålet er forbundet med FROB og BdEs mandater. Hvis (når?) FROB bliver udstyret med de tilstrækkelige midler til at rekapitalisere bankerne, maa tilliden til banksystemet samtidig at blive forbedret. BdEs mandate vedrører først og fremmest dens mulighed for at tilføre euro-likviditet til bankerne udover hvad ECB gør, et mandat der har klare begrænsninger. Man kan selvfølgelig argumentere, at FROB, BdE og garantien for bankindeståender konkurrerer om de same midler, Men som sagt tjener de også et langt stykke af vejen det samme formå, al den stund at bankernes kapitaliseringsgrad er forbundet med behovet for kapital til at bakke en garanti for bankindeståender. Hvis offentligheden mener bankerne er tilstrækkeligt kapitaliserede er der jo reelt ingen grund til at trække bankindeståenderne ud (hvis man altsaa ikke tror landet er på vej ud af euroen). FROB, BdE og statens egne midler er under alle omstændigheder utilstrækkelige til reelt at kunne bakke garantien op, men det aendrer ikke ved, at det givetvis er en god ide at indgyde tillid i offentligheden, uanset om der så er et element af illusion i det (vi må jo ikke glemme, at hele pengesystemet I moderne økonomier et langt stykke af vejen er bygget på u-underbygget tillid og "illusioner").

Det er klart, at hele dette spørgsmål ville være overflødigt, hvis et land som Spanien stadig havde sin egen valuta og sin egen selvstændige pengepolitik. BdE ville så være "lender of last resort" for sin egen banksektor og kunne til enhver tid tilbringe banksektoren den nødvendige likviditet i egen valuta. Dette er en af omkostningerne ved at være i euroen.

<u>Add. 2 Likviditets eller solvenskrise</u>

Det er svært at vide nøjagtig, hvad man troede i den spanske regering. I den første del af krisen var holdningen i regeringen nok et langt stykke af vejen, at Spanien basalt set var blevet "smittet" af problemerne i Graekenland selvom der var en erkendelse af at det offentlige underskud var skudt i vejret. Mht. banksektoren har det nok hele tiden været opfattelsen, at hvis der var problemer med insolvens vedrørte det sparekassesektoren og Spanien kunne selv løse problemet vha. FROB.

Men det er nu klart for enhver, at det ikke holder, og at problemet ikke går væk bare fordi tiden går, tværtimod bliver det værre. Jeg er enig i, at regeringen kunne have taget fat om nællen for lang tid siden, og så vidt jeg har hørt var der modstand ideen om en "Bad Bank" indtil for ganske nylig. Regeringen har været "in denial", som det hedder indenfor psykologien – og har selvfølgelig skelet alt for meget til kortsigtede politiske hensyn.

Add. 3 Er 100 milliarder euros nok?

Jeg tror beløbet er tilstrækkeligt, kombineret med den bankpakke på 30 milliarder markedet regner med. Men det er kun nok for 2013, og det kræver jo at regeringen søger om hjælpen. Men man har tydeligvis meget svært ved at krybe til korset, først og fremmest pga. af den "conditionality" der vil blive føjet til hjælpen og det politiske prestigetab det indebærer for regeringen. Statens funding for 2012 er så godt som i hus, og markederne er jo faldet til ro (og rentespændet er indsnævret betydeligt) efter at ECB præsident Draghi bekendtgjorde OMT programmet i sommer. Så der er (desværre) ikke meget der presser regeringen til at søge om hjælp på kort sigt, selvom 2013 er en betydelig udfordring med et kæmpe finansieringsbehov.

De længeresigtede spørgsmål er så:

1) Kan Spanien nedbringe statsunderskuddet tilstrækkeligt med nedskæringer og skatteforhøjelser? Economist havde en glimrende artikel forleden der diskuterer relevansen af "the fiscal multiplier" i den sammenhæng

   http://www.economist.com/news/finance-and-economics/21565150-short-term-austerity-aftermath-severe-crisis-may-prove-more-painful

   Jeg har mine tvivl på det punkt, netop af de grunde Economist-artiklen fremfører.

2) Vil Eurozone tage skridt i retning af en fiscal union og en bankunion? Det er klart, at hvis markeder ser fremgang på det punkt vil rentespændet (risikopræmien) blive reduceret hvilket vil gøre arbejdet med at nedbringe underskuddet så meget desto lettere. Sker der ingenting på de punkt, tror jeg et land som Spanien vil være i en evig kamp med markederne om finansiering og den længere sigtede nedbringelse af statsunderskuddet vil blive utrolig vanskelig.

Add 4 Bail-in og det spanske arbejdsmarked

Der er faktisk gennemført en ret kraftig arbejdsmarkedsreform der generelt goer det en hel del billigere for virksomhederne at afskedige uønskede medarbejdere. Dette vil givetvis hjælpe på lysten til at ansatte igen, når virksomhedernes fremtidsudsigter i øvrigt peger i den retning. Men det er nok vigtigt at forstå, at mens en liberalisering af arbejdsmarkedet er absolut afgørende for Spaniens konkurrenceevne og virksomhedernes evne til at skabe arbejdspladser på længere sigt (og der skal endnu mere til end det vi har set), gør den ikke meget på kort sigt, hvor det hele står og falder med den generelle konjunktur og stemningen i de finansielle markeder. Det betyder ikke, at regeringen ikke boer tage de tiltag, blot at man næppe skal forvente den store effekt på kort sigt. Det samme gælder tiltag der vil gøre det lettere for iværksættere, hvor Spanien desværre scorer meget dårligt i alle internationale undersøgelser. Generelt er man lidt for "forlibt" i de store (delvis monopol) foretagender (der jo også har effektive lobbyer) og har for lidt forståelse for værdien af nye virksomheder og "the entrepreneur". Jeg tror ikke Spanien er alene i Europa på det punkt, men der brug for en større kulturrevolution for at lave om på disse ting. Hvis der er noget positivt ved krisen er det nok, at den presser nogle strukturreformer igennem, vi ellers har meget svært ved at tage os sammen til at gennemføre. Men det er langsigtede, snarere end kortsigtede tiltag.

<u>Add 6 "Bad Bank"</u>

Jeg er tilhænger af ideen med en "Bad Bank". Jeg tror det kan være en made at tvinge de finansielle institutioner til at realisere deres tabsgivende aktiver og dermed, forhåbentlig, normalisere kreditgivningen, når deres balancer er blevet forbedret. Den svenske model var på det punkt meget gunstig, fordi man fik forbedret bankernes balancer på ca. 2 år og fik rekapitaliseret sektoren (selvom det kostede skatteyderne penge). Min bekymring er om 1) en tilstrækkelig del af aktiverne bliver solgt over i Bad Bank og til en nogenlunde realistisk pris. Hvis prisen er for høj vil det være til bankernes gunst, men det bliver så godt som umuligt at få internationale investorer til at deltage i Bad Bank'ens egenkapital og købe dens obligationer. Det vil så blive den selvsamme spanske banksektor der må købe Bad Bank'ens obligationer der så kan garanteres af staten og belånes i ECB. Det er en rimeligt syg model, efter mine begreber, men det ser foreløbig ud til, at vi går i den retning. 2) Vil Bad Banken selv gå til makronerne og så solgt de svage aktiver fra til den meget lavere pris det kræver i markedet. Jeg håber det, men er langt fra sikker. Hvis det ikke sker, har vi blot sendt problemet over i en ny enhed som både staten og banksektoren er involveret i og som kan ende med at sende problemerne tilbage til de to sektorer på længere sigt.