

After austerity: lessons from the Spanish experience

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Introduction

The overall pattern of Spanish history has been described, crudely, as a graph shaped like an upside-down version of the letter 'V'. That is, the graph rises – bumpily at times – through 600 years under the Romans, 700 years under or partly under the Moors and a century of empire-building, to the peak of Spanish power in the 16th century. After that, the nation's history goes downhill until the 1970s. A vast empire was gradually lost, leaving Spain poor and powerless. And there was much political instability: Spain suffered 43 *coup d'états* between 1814 and 1923, and a horrendous civil war between 1936 and 1939, followed by 36 years of dictatorship under *Generalísimo* Franco.¹

After Franco's death in 1975, the graph turned upwards again. King Juan Carlos, Franco's heir, oversaw the country's return to democracy. A negotiated transition period, presented as a model for other countries, paved the way to the drawing up of a new Constitution and then the first free elections in almost 40 years. These developments were followed by Spain's progressive return to the international arena – where it had been relatively isolated during the dictatorship –. The following decade also witnessed the Socialist party's election to actual power in 1982, bringing the country a new aura of modernity. The 1980s further witnessed Spain's integration into NATO (1982) and the European Community (1986). The following two and a half decades were a period of phenomenal growth and modernisation.

¹ 'After the Fiesta', *The Economist*, 25/IV-1/V/1992, p. 60.

Indeed, before the global crisis that hit Spain in the spring of 2008 it had become one of Europe's most successful economies.² While other European countries had been stuck in the mire, Spain was much better at reforming its welfare systems and labour markets, as well as at improving their flexibility and lowering unemployment. Over the decade and a half that preceded the 2008 global financial crisis the Spanish economy was able to break with the historical pattern of boom and bust, and the country's economic performance was nothing short of remarkable. Yet all this came to a halt when the global financial crisis hit Spain in 2008. As a result, it is suffering one of the worst crises since the 1940s.

Following its transition to democracy and European integration, Spain was, prior to the 2008 crisis, a model country. But then the dream was shattered and the country's economy imploded after 2008. How did it happen? Policy choices and the structure of decision making, the role of organised interest, the structure of the state and institutional degeneration all played important roles in explaining the severity of Spain's economic crisis, as did the country's membership of an incomplete monetary union. Spain is currently (as of 2014) exiting a treble crisis: financial, fiscal and competitiveness. This working paper seeks to provide an overview of the country's evolution since its transition to democracy and to explain its economic collapse after 2008.

The paper's first section outlines the main features of Spain's growth model and the challenges it faced. Section two describes the scale of the shock it underwent from 2008 onwards and analyses the treble crisis in the financial, fiscal and competitiveness spheres. It concludes with some lessons to be learnt from the Spanish experience.

The miraculous decade³

European integration was instrumental in Spain's modernisation. Indeed, before the global crisis that hit it in the spring of 2008, it had become one of Europe's most successful economies (see Table 1). Propped up by low interest rates and immigration, in 2008 Spain was in its 14th year of uninterrupted growth and was benefiting from its longest cycle of continuing economic expansion in modern history (in the Euro zone only Ireland had a better record), which contributed to the narrowing of its per capita GDP with the EU. Indeed, in 20 years its per capita income grew 20 points, one point per year, to reach close to 90% of the EU-15 average. With respect to the EU-25, Spain had already reached the average by 2008 and since 1996 the country grew on average 1.4 percentage points above the EU.

² This article draws upon S. Royo (2000), S. Royo (2008) and S. Royo (2013).

³ This section borrows from S. Royo (2008).

Table 1. The boom years, 2000-08

Spain		Units	Scale	2000	2001	2002	2003	2004	2005	2006	2007	2008
GDP	constant prices	National currency	Billions	546.9	566.8	582.2	600.2	619.8	642.2	668.0	691.8	697.7
GDP,	constant prices	Annual % change		5.1	3.7	2.7	3.1	3.3	3.6	4.0	3.6	0.9
GDP per capita,	constant prices	National currency	Units	13,6	13,9	14,1	14,3	14,5	14,8	15,2	15,4	15,3
Output gap in % of potential GDP	% of potential GDP			1.9	1.5	0.3	0.1	0.5	1.4	2.9	3.9	3.1
GDP based on purchasing power parity (PPP) share of world total	%			2.2	2.2	2.2	2.2	2.1	2.1	2.1	2.1	2.0
Inflation, average consumer prices	Annual % change			3.5	2.8	3.6	3.1	3.1	3.4	3.6	2.8	4.1
Unemployment rate	% of total labour force			13.9	10.6	11.5	11.5	11.0	9.2	8.5	8.3	11.3
Employment	Persons	Millions		16.4	16.9	17.3	17.9	18.5	19.3	20.0	20.6	20.5
General government balance	National currency		Billions	-6.2	-4.4	-3.3	-1.6	-2.9	8.8	19.9	23.3	-41.9
General government balance	% of GDP			-1.0	-0.6	-0.5	-0.2	-0.3	1.0	2.0	2.2	-3.8
Current account balance	% of GDP			-4.0	-3.9	-3.3	-3.5	-5.3	-7.4	-9.0	-10.0	-9.6

Source: International Monetary Fund (2009), *World Economic Outlook Database*, October.

Unemployment fell from 20% in the mid-1990s to 7.95% in the first half of 2007 (the lowest level since 1978) as Spain became the second-largest creator of jobs in the EU (after Germany, which has a far bigger economy), generating an average of 600,000 jobs per year over the decade. In 2006 the Spanish economy grew by a spectacular 3.9% and by 3.8% in 2007. As we have seen, economic growth contributed to per capita income growth and employment. Indeed, labour market performance was spectacular: between 1997 and 2007 33% of all the total employment created in the EU-15 was generated in Spain. In 2006 the working population increased by 3.5%, the highest rate in the EU (led by new immigrants and the incorporation of women to the labour market, which grew from 59% in 1995 to 72% in 2006), and 772,000 new jobs were created.

Economic success extended to Spanish companies, which expanded beyond their traditional frontiers. In 2006 they spent a total of €140 billion on domestic and overseas acquisitions, putting the country third behind the UK and France in the EU. Of this, €80 billion went to buying companies abroad (compared with the €65 billion

spent by German companies). In 2006 Spanish FDI abroad rose by 113% to €71.5 billion (the equivalent of 7.3% of GDP, compared with 3.7% in 2005).⁴ In 2006 Iberdrola, an electricity supplier, purchased Scottish Power for US\$22.5 billion to create Europe's third-largest utility; Banco Santander, Spain's largest bank, purchased Britain's Abbey National Bank for US\$24 billion; Ferrovial, a family-owned construction group, took over BAA (which operates the UK's three main airports) for £10 billion; and Telefónica bought O2, the British mobile phone company. Indeed, 2006 was a banner year for Spanish firms: 72% of them increased their production and 75.1% their profits, 55.4% hired new employees, and 77.6% increased their investments.⁵

The country's transformation was not only economic but also social. Spaniards became more optimistic and self-confident (eg, a Harris poll showed that they were more confident of their economic future than their European and American counterparts and a poll by the Centre for Sociological Analysis showed that 80% are satisfied or very satisfied with their economic situation). Spain became 'different' again and according to public opinion polls it had become the most popular country to work for Europeans.⁶ Between 2000 and 2007 some 5 million immigrants (645,000 in 2004 and 500,000 in 2006) settled in Spain (8.7% of the population, compared with 3.7% in the EU-15), making the country the biggest recipient of immigrants in the EU (accounting for 10% of the contributors to the Social Security system). This is a radical departure for a country that used to be a net exporter of people, and more so because it has been able to absorb these immigrants without falling prey (at least so far) to the social tensions that have plagued other European countries (although there have been isolated incidents of racial violence).⁷ These immigrants contributed significantly to the country's economic success in that decade because they boosted its economy's aggregate performance. They raised the supply of labour, increased demand as they spent money, moderated wages and put downward pressure on inflation, boosted output, allowed the labour market to avoid shortages, contributed to consumption and provided greater flexibility to the economy with their mobility and willingness to take on low-paid jobs in sectors such as construction and agriculture, which no longer interested Spaniards.⁸

⁴ Emilio Ontiveros, 'Redimensionamiento Transfronterizo', *El País*, 15/VII/2007.

⁵ Deloitte's 'Barometro de Empresas', from 'Un año de grandes resultados', *El País*, 14/II/2006.

⁶ According to the *Financial Times*, 17% of those polled selected Spain as the country in which they would prefer to work, ahead of the UK (15%) and France (11%). See 'España vuelve a ser diferente', *El País*, 19/II/2007, and *Financial Times*, 19/II/2007.

⁷ K. Calavita provides a detailed analysis of the immigration experience in Spain and exposes the tensions associated with this development. She also highlights the shortcomings of governments' actions in regard to integration, and the impact of lack of integration on exclusion, criminalisation and radicalisation. See K. Calavita (2005), *Immigrants at the Margins*, Cambridge University Press, New York.

⁸ 'Immigrants Boost British and Spanish Economies', *Financial Times*, 20/II/2007, p. 3.

Indeed, an important factor in the per capita convergence surge after 2000 was the substantive revision of Spanish GDP data as a result of changes in the National Accounts from 1995 to 2000. The changes accounted for a 4% increase in GDP in real terms (the equivalent of Slovakia's GDP). This dramatic change was the result of the significant growth in Spain's population from 1998 as a result of the surge in immigration (in 2003, for instance, it grew by 2.1%). The key factor in the acceleration in convergence, given the negative behaviour of productivity (if productivity had grown at the EU average, in 2007 Spain would have exceeded the EU's per capita average by 3 points), was the significant increase in the participation rate, which was a result of the reduction in unemployment, and the increase in activity (the proportion of people of working age that have a job or are actively seeking one) that followed the incorporation of female workers into the labour market and immigration growth. Indeed, between 2000 and 2004 the immigrant population multiplied threefold.

Most of the 772,000 new jobs created in Spain in 2006 were taken by immigrants (around 60%). Their inclination for hard work also opened the way for productivity improvements (which in 2006 saw the largest increase since 1997, up 0.8%). It is estimated that immigrants contributed 0.8 percentage points to GDP in the four years to 2007.⁹ Immigration accounted for more than 50% of employment growth and 78.6% of demographic growth (as a result, Spain led Europe's demographic growth between 1995 and 2005, rising 10.7% compared with the EU-15's average of 4.8%).¹⁰ They also contributed to the huge increase in employment, which was a key reason for the country's impressive economic growth. Indeed, between 1988 and 2006 employment contributed 3 percentage points to the 3.5% annual rise in Spain's potential GDP (see Table 1).¹¹

The basis for success

What made the transformation possible? The Spanish economy's modernisation in the past two and half decades has been intimately connected to the country's integration in the EU. Indeed, European integration was a catalyst for the final conversion of the Spanish economy into a modern Western-type economy. Yet membership was not the only reason. Economic liberalisation, trade integration and modernisation started in the 50s and 60s and Spain became increasingly prosperous over the two decades prior to EU accession. However, one of the key consequences of its entry into Europe was that it consolidated and deepened its development and accelerated the modernisation of the country's economy. EU membership facilitated the micro and macroeconomic reforms that successive Spanish governments undertook throughout the 80s and 90s. Spain also benefited

⁹ Guillermo de la Dehesa, 'La Próxima Recesión', *El País*, 21/II/2007.

¹⁰ 'La Economía española creció en la última década gracias a la aportación de los inmigrantes', *El País*, 28/VIII/2006.

¹¹ See Martin Wolf, 'Pain Will Follow Years of Economic Gain', *Financial Times*, 29/III/2007.

extensively from European funds, with around €150 billion entering from agricultural, regional development, training and cohesion programmes.

Moreover, European Monetary Union (EMU) membership was also very positive: it contributed to macroeconomic stability, it imposed fiscal discipline and central bank independence and it dramatically lowered the cost of capital. One of the key benefits was the drastic reduction in short- and long-term nominal interest rates from 13.3% and 11.7% in 1992 to 3.0% and 4.7% in 1999 and 2.2% and 3.4% in 2005. The lower cost of capital led to a significant surge in investments from families (in housing and consumer goods) and businesses (in employment and capital goods). Indeed, EMU membership (and the Stability Pact) provided the country with unprecedented stability because it forced successive governments to consolidate responsible economic policies that led to greater credibility and improved ratings in Spain's public debt (and consequently lower financing costs).

Another important factor for the country's economic success was the remarkable economic policy stability that followed the economic crisis of 1992-93. There were few economic policy shifts throughout the 1990s and early 2000s despite changes in government. Between 1993 and 2009 there were only two Ministers of Finance, Pedro Solbes (from 1993 to 1996 and from 2004 to 2009) and Rodrigo Rato (from 1996 to 2004), and the country only had three Prime Ministers (Felipe González, José María Aznar and José Luis Rodríguez Zapatero). The pattern was further reinforced by the ideological cohesion of the political parties in government and the strong control that party leaders exercised over cabinet members and members of parliament.

Furthermore, stability was reinforced by the shared (and rare) agreement between Conservative and Socialist leaders regarding fiscal consolidation (the balanced budget objective was established by law by the Popular Party) as well as by the need to stand firm in the application of restrictive fiscal policies and the achievement of budgetary surpluses. As a result, a 7% budget deficit in 1993 became a 2.2% surplus in 2007 and public debt fell from 68% of GDP in 1998 to 36.2% in 2007.

Finally, other contributory factors included limited corruption and the fact that politics were fairly clean and relatively open, that Spain had a flexible economy and the success of Spanish multinationals. There were eight firms in the *Financial Times* list of the world's largest multinationals in 2000 and 14 in 2008.¹²

The challenges

However, economic success was marred by some glaring deficiencies that came to the fore in 2008 when the global financial crisis hit the country, because it was

¹² According to the latest data (2007) from the *World Bank Governance Indicators* (http://info.worldbank.org/governance/wgi/sc_chart.asp), Spain is ranked in the 75th-100th country percentile in control of corruption, government effectiveness, regulatory quality, rule of law, and voice and accountability.

largely a ‘miracle’ based on bricks and mortar.¹³ The foundations of economic growth were fragile because the country had low productivity growth (contributing only 0.5 percentage points to potential GDP between 1998 and 2006) and deteriorating external competitiveness.¹⁴ Over the decade that preceded the 2008 crisis, Spain failed to address its fundamental challenge, its declining productivity, which grew by an average of 0.3% during the decade (0.7% in 2006), a full point below the EU average, placing Spain at the bottom of the EU and ahead of only Italy and Greece (a Spanish worker’s productivity was 75% of one in the US). The most productive activities (energy, industry and financial services) only contributed 11% of GDP growth.¹⁵

Moreover, growth was largely based on low-intensity economic sectors, such as services and construction, which were not exposed to international competition. In 2006 most of the new jobs were created in low-productivity sectors such as construction (33%), services associated with housing –such as sales and rentals (15%)–, and tourism and domestic service (30%). These sectors accounted for 75% of all new jobs created in Spain in 2006 (new manufacturing jobs, in contrast, accounted for only 5%). The temporary labour rate reached 33.3% in 2007 and inflation was a recurrent problem (it closed 2006 with a 2.7% increase, but the average for that year was 3.6%), so that the inflation differential with the EU (almost 1 point) did not decrease, reducing the competitiveness of Spanish products abroad (consequently making Spanish companies lose market share abroad).¹⁶ To this was added a deep process of economic de-industrialisation, low value-added and complex exports, and a low degree of insertion in the global value chains.

Furthermore, family indebtedness reached a record 115% of disposable income in 2006, and the construction and housing sectors accounted for 18.5% of GDP (twice the Eurozone average). House prices rose by 150% from 1998 and the average price of a square metre of residential property increased from €700 in 1997 to €2,000 at the end of 2006, despite the housing stock having doubled. Many wondered whether the bubble was sustainable.¹⁷

¹³ According to Martínez-Mongay and Maza Lasierra, ‘The outstanding economic performance of Spain in EMU would be the result of a series of lucky shocks, including a large and persistent credit impulse and strong immigration, underpinned by some right policy choices. In the absence of new positive shocks, the resilience of the Spanish economy to the financial crisis might be weaker than that exhibited in the early 2000s. The credit impulse has ended, fiscal consolidation has stopped, and the competitiveness gains of the nineties have gone long ago’. See C. Martínez-Mongay & L.A. Maza Lasierra (2009), ‘Competitiveness and growth in the EU’, *Economic Papers*, nr 355, January 2009, p. 1-42.

¹⁴ ‘Fears of Recession as Spain Basks in Economic Bonanza’, *Financial Times*, 8/VI/2006.

¹⁵ ‘Los expertos piden cambios en la política de I+D’, *El País*, 18/XII/2006.

¹⁶ Angel Labourda, ‘El comercio en 2006’, *El País*, 11/III/2007, p. 20.

¹⁷ Wolfgang Munchau, ‘Spain, Ireland and Threats to the Property Boom’, *Financial Times*, 19/III/2007; and ‘Spain Shudders as Ill Winds Batter US Mortgages’, *Financial Times*, 21/III/2007.

The crisis that started in 2008 confirmed the worst and the housing bubble's implosion fuelled corruption and bad practices in the *cajas* sector of the financial system.

Between 40% and 60% of the profits of the largest Spanish companies came from abroad. But in the years prior to the crisis the figure decreased by approximately 10 percentage points and there was a decline in direct foreign investment of all types in the country, falling from a peak of €38.3 billion in 2000 to €16.6 billion in 2005.¹⁸ The current account deficit reached 8.9% of GDP in 2006 and over 10% in 2007, which made Spain the country with the largest deficit in absolute terms (€86,026 million), behind only the US; imports were 25% higher than exports and Spanish companies were losing market share in the world. And prospects were not very bright, with the trade deficit up to 9.5% in 2008.¹⁹

While there is an overall consensus that the country needed to improve its education system and invest in research and development to lift productivity, as well as modernise the public sector and make the labour market more stable (ie, reduce the temporary rate) and flexible, the government failed to take the necessary actions to address these problems. Spain spends only half of what the Organisation of European Co-operation and Development (OECD) countries spend on average on education; it lags behind most of Europe in investment in Research and Development (R&D) and it is ranked 29th by the UNCTAD as an attractive location for research and development. Finally, other observers note that Spain is failing to do more to integrate its immigrant population, and social divisions are beginning to emerge.²⁰

By the summer of 2008 the effects of the crisis were evident, and since then the country has suffered one of the worst recessions in history, with unemployment reaching over 27% in 2012 (more than 6 million jobless). This collapse was not wholly unexpected. The global liquidity freeze and the surge in commodities, food and energy prices brought to the fore the imbalances in the Spanish economy: the record current account deficit, persisting inflation, low productivity growth, dwindling competitiveness, increasing unit labour costs, excess consumption and low savings had all laid the groundwork for the current devastating economic crisis.²¹

¹⁸ 'Spanish Muscle Abroad Contrast with Weakling Status among Investors', *Financial Times*, 11/XII/2006.

¹⁹ 'La Comisión Europea advierte a España de los riesgos de su baja competitividad', *El País*, 4/II/2007.

²⁰ 'Zapatero Accentuates Positives in Economy, but Spain Has Other Problems', *Financial Times*, 16/IV/2007, p. 4.

²¹ See S. Royo (2013).

After the fiesta: the global crisis hits Spain

The imbalances in the Spanish economy became obvious in 2007-08 when the real-estate market bubble burst and the international financial crisis hit the country (see Table 2). In just a few months the 'debt-fired dream of endless consumption' turned into a nightmare. By the summer of 2013 Spain faced the worst economic recession in half a century. According to government statistics, 2009 was the worst year since reliable data have been kept: GDP fell 3.7%, unemployment reached over 4 million and the public deficit reached a record 11.4% of GDP (up from 3.4% in 2008). Consumer confidence was shattered, the implosion of the housing sector reached historic proportions and threatened to endure for several years, while the manufacturing sector was also suffering.

Table 2. The economic crisis, 2008-13

Subject descriptor	Units	200						13
		7	08	09	10	11	12	(1)
Gross domestic product, constant prices	% change	3.5	0.9	-3.8	-0.3	0.4	-1.4	-1.6
Output gap in % of potential GDP	% potential GDP	3.8	2.3	-2.8	-3.4	-3.2	-4.5	-5.4
Total investment	% GDP	31.0	29.1	24.0	22.8	21.5	19.6	18.1
Inflation, average consumer prices	% change	2.8	4.1	-0.2	2.0	3.1	2.4	1.9
Unemployment rate	% total labour force	8.3	11.3	18	20.1	21.7	25	27
General government structural balance	% potential GDP	-1.1	-5.4	-9.5	-8.0	-7.8	-5.7	-4.5
General government net debt	% GDP	26.7	30.8	42.5	49.8	57.5	71.9	79.1
Current account balance	% GDP	-1.0	-9.6	-4.8	-4.5	-3.7	-1.1	1.1

(1) Estimates.

Source: International Monetary Fund (2013), *World Economic Outlook Database*, April.

Initially, the Rodríguez Zapatero government was reluctant to recognise the crisis, which was becoming evident as early as the summer of 2007, because of electoral considerations: the country was holding general elections in March 2008. And after the election, the Zapatero government was afraid to admit that it had not been entirely truthful during the campaign. While this pattern has been quite common in other European countries, in Spain the increasing evidence that the model based on construction was already showing symptoms of exhaustion in 2007 compounded it. Yet the Spanish government not only refused to recognise that the international crisis was affecting the country, but also that in Spain the crises would be aggravated by the very high levels of private indebtedness. As late as 17 August 2007, Finance Minister Solbes predicted that 'the crisis would have a relatively small effect' on the Spanish economy.

When it became impossible to deny what was evident, the government's initial reluctance to recognise and address the crisis was replaced by frenetic activism. The Zapatero government introduced a succession of plans and measures to try to confront the economic crisis, and specifically to address the surge in unemployment.²²

The sharp deterioration of the labour market was caused by the economic crisis and the collapse of the real estate sector, and it was aggravated by a demographic growth pattern based on migratory inflows of labour: in 2007 there were 3.1 million immigrants in the country, of which 2.7 million were employed and 374,000 unemployed. In 2008 the number of immigrants increased by almost 400,000, to 3.5 million (accounting for 55% of the growth in the active population), but 580,000 of them were unemployed (and 2.9 million employed), an increase of 200,000. In the construction sector alone, unemployment increased 170% between the summer of 2007 and 2008. Meanwhile, the manufacturing and service sectors (also battered by the global crisis, lower consumption and the lack of international competitiveness) proved unable to incorporate these workers.

The pace of deterioration caught policymakers by surprise. The Zapatero government prepared budgets for 2008 and 2009 that were utterly unrealistic in the face of rapidly changing economic circumstances (as did all other advanced countries which in the G-20 agreed on a plan for fiscal stimulus that would later prove to be ineffective and dangerous for Spain, as it increased debt) As a result, things continued to worsen over the next four years. The most significant decline was in consumer confidence, which was hammered by financial convulsions, the dramatic increase in unemployment and the scarcity of credit. As a result, household consumption, which accounts for 56% of GDP, fell 1% in the last quarter of 2009 for the first time in 15 years. According to the Bank of Spain the decline in household consumption was even more significant in contributing to the recession than the deceleration of residential investment, which had fallen 20% driven down by worsening financial conditions, uncertainties and the drop in residential prices. So far the government's actions have had limited effect in stanching the haemorrhage and their efficacy has been inadequate.

The impact of the global economic crisis was felt well beyond the economic and financial realms. The crisis also had severe political consequences. Spain followed in the wake of many other European countries (including Ireland, Portugal, Greece and France) that saw their governments suffer the wrath of their voters and were ousted from office.

The Socialist Party (PSOE) was re-elected in a general election on 9 March 2008. Soon thereafter, economic conditions deteriorated sharply and the government's

²² See S. Royo (2013).

popularity declined rapidly. Between March 2008 and March 2012 there were a number of electoral contests in Spain at the local, regional, national and European levels. At the national and European levels the one common pattern was the outcome: the defeat of the Socialist Party and the victory of the Popular Party (PP). And at the regional and local levels the Socialists suffered historical losses, losing control of regional government that they had ruled for decades (notably Castilla-La Mancha and Extremadura), and even lost the elections for the first time in one of their historical strongholds, Andalusia (although they were able to forge a coalition with a smaller leftist party to remain in power).

Spain's economic crisis was mainly due to a mismanaged financial sector, which by overlending freely to property developers and mortgages contributed to a real estate property bubble. The bubble helped conceal the fundamental structural problems of the Spanish economy outlined in the section above, and had an effect on policy choices because no government was willing to burst the bubble and risk suffering the electorate's displeasure. Furthermore, cheap credit also had inflationary effects that contributed to competitiveness losses and a record balance of payment deficit. Therefore, there were three dimensions of the crisis (financial, fiscal and competitiveness) that were interlinked in their origin. The crisis exposed the underbelly of the financial sector and showed that many banks (particularly the *cajas*) were not just suffering liquidity problems but risked insolvency, which led to the EU's financial bailout of June 2012. The bailout had onerous conditions attached and it limited national economic autonomy.²³ Finally, the financial and fiscal crises were made worse by the incomplete institutional structure of EMU and by bad policy choices at the EU level (excess austerity and the refusal to act as a lender of last resort for sovereigns by the ECB). We shall now turn to the elements of domestic policy that underlined the treble crisis in financial, fiscal and competitiveness performance.²⁴

The treble crisis

The fiscal crises

One of the most common misinterpretations regarding the crisis in Southern Europe is to attribute it to mismanaged public finances. Many policymakers across Europe, especially in the creditor countries (crucially Germany), still insist that the crisis was caused by irresponsible public borrowing and this, in turn, has led to misguided solutions. In fact, with very few exceptions, notably Greece, the interpretation is incorrect. In Spain the current crisis did not originate with mismanaged public finances. On the contrary, as late as 2011 Spain's debt ratio was still well below the average for countries that had adopted the euro as a common currency: while Spain

²³ S. Dellepiane & N. Hardiman (2011), 'Governing the Irish Economy', *UCD Geary Institute Discussion Series Papers*, Geary WP2011/03, University College Dublin, Dublin, February.

²⁴ This section borrows from S. Royo (2013).

stood at less than 60% of GDP, Greece stood at 160.8%, Italy at 120%, Portugal at 106.8%, Ireland at 105%, Belgium at 98.5% and France at 86%.

Before 2007 Spain seemed to be in an enviable fiscal position, even compared with Germany.²⁵ It ran a budget surplus in 2005, 2006 and 2007. It was only when the crisis hit the country and the real estate market collapsed that the fiscal position deteriorated markedly and the country experienced huge deficits.

The problem in Spain was the giant inflow of capital from the rest of Europe; the consequence was rapid growth and significant inflation. In fact, the fiscal deficit was a result, not a cause, of Spain's problems: when the global financial crisis hit Spain and the real-estate bubble burst, unemployment soared and the budget went into a steep deficit, caused partly by depressed revenues and partly by emergency spending to limit the human cost. The government responded to the crisis with a massive €8 billion public-works stimulus. This decision, combined with a dramatic fall in revenue, blew a hole in the government's accounts and resulted in a large deficit.

The conditions for the crisis in Spain were created by the private sector's excessive lending and borrowing rather than by the government's. In other words, the problem was private debt and not public debt. Spain experienced a problem of ever-growing private-sector indebtedness, which was compounded by the reckless investments and loans of banks (including the overleveraged ones) and aggravated by competitiveness and current account imbalances. In Spain, private sector debt (households and nonfinancial corporations) was 227.3% of GDP at the end of 2010; total debt increased from 337% of GDP in 2008 to 363% in mid-2011.

Though Spain entered the crisis in a relatively sound fiscal position, it was not sound enough to withstand the effects of the crisis, especially as it was a member of a dysfunctional monetary union with no lender of last resort. The country's fiscal position deteriorated sharply –collapsing by more than 13% of GDP in just two years–. Looking at the deficit figures with the benefit of hindsight, it could be argued that Spain's structural or cyclically-adjusted deficit was much higher than its actual deficit. The fast pace of economic growth before the crisis inflated government revenues and lowered social expenditure in such a way that it masked the vulnerability of Spain's fiscal accounts. The problem was that it is very difficult to determine a country's structural position. The only way in which Spain could have prevented the deficit disaster that followed would have been to run massive fiscal surpluses of 10% or more during the years prior to the crisis in order to generate a positive net asset position of at least 20% of GDP.²⁶ This, for obvious reasons, would not have been politically feasible.

²⁵ See Martin Wolf's blog: 'What Was Spain Supposed to Have Done?', 25/VI/2012, <http://blogs.ft.com/martin-wolf-exchange/2012/06/25/what-was-spain-supposed-to-have-done>.

²⁶ From Martin Wolf's blog: 'What was Spain supposed to have done?', 25/VI/2012.

The loss of competitiveness

There is also another way of looking at the problem. Many economists argue that the underlying problem in the euro area is the exchange-rate system itself, namely the fact that European countries locked themselves into an initial exchange rate. This decision meant, in effect, that they believed that their economies would converge in productivity (which would mean that the Spaniards would, in effect, become more like the Germans). If convergence was not possible, the alternative would be for people to move to higher productivity countries, thereby increasing their productivity levels by working in factories and offices there (or to create a full fiscal union to provide for permanent transfers, as argued by OCA theory). Time has shown that both expectations were unrealistic and, in fact, the opposite occurred. The gap between German and Spanish (including other peripheral countries) productivity increased, rather than decreased, over the past decade and, as a result, Germany developed a large surplus in its current account; Spain and the other peripheral countries had large current-account deficits that were financed by capital inflows.²⁷ In this regard, it could be argued that the incentives introduced by EMU worked exactly in the wrong way. Capital inflows in the South made the structural reforms that would have been required to promote convergence less necessary, thus increasing divergence in productivity levels.

Adoption of the euro as a common currency fostered a false sense of security among private investors. During the years of euphoria following the start of Europe's economic and monetary union and prior to the onset of the financial crisis, private capital flowed freely into Spain and, as a result, the country ran current account deficits of close to 10% of GDP. In turn, these deficits helped finance large excesses of spending over income in the private sector. The result did not have to be negative. The capital inflows could have helped Spain (and the other peripheral countries) invest, become more productive and catch up with Germany. Unfortunately, in Spain's case, they largely led to a massive bubble in the property market, consumption and unsustainable borrowing levels. When the bubble burst the country's real economy contracted and brought down the banks that had gambled on loans to real estate developers and construction companies.

At the same time, the economic boom also generated large losses in external competitiveness that Spain failed to address. Successive Spanish governments also missed the opportunity to reform institutions in their labour and product markets. As a result, costs and prices increased, which in turn led to a loss of competitiveness and large trade deficits. This unsustainable situation came to the fore when the financial shocks that followed the collapse of Lehman Brothers in the autumn of 2007 brought 'sudden stops' in lending across the world, leading to a collapse in private borrowing and spending, and a wave of fiscal crises.

²⁷ Simon Johnson's blog: 'The end of the euro: what's austerity got to do with it?', 21/VI/2012.

The financial crises

A third problem has to do with the banks. This was slow to develop. Between 2008 and 2010 the Spanish financial system, despite all its problems, was still one of the least affected by the crisis in Europe. During that period, of the 40 financial institutions that received direct assistance from Brussels, none was from Spain. In December 2010 Moody's ranked the Spanish banking system the third strongest of the Eurozone, behind only Finland and France, above the Netherlands and Germany, and well ahead of Portugal, Ireland and Greece. Finally, Santander and BBVA had shown a new strength, with profits of €4.4 billion and €2.8 billion, respectively, during the first half of 2010. Spain's regulators had put in place regulatory and supervisory frameworks which initially shielded the Spanish financial system from the direct effects of the global financial crisis. Indeed, the Bank of Spain had imposed a regulatory framework that required higher provisioning, which provided cushions to Spanish banks to initially absorb the losses caused by the onset of the global financial crisis. And there were no toxic assets on the banks' balance sheets.

Nevertheless, success proved to be short lived. In the summer of 2012 Spain's financial institutions seemed to be on the brink of collapse and the crisis in the sector forced the EU to devise, in June 2012, an emergency €100 billion rescue plan for the Spanish banking sector. When the crisis intensified, the financial system was unable to escape its dramatic effects. By September 2012 the problem with toxic real-estate assets forced the government to intervene and nationalise eight financial institutions. Altogether, by 9 May 2012 the banking sector's reorganisation involved €115 billion in public resources, including guarantees.

There are a number of factors that help account for the deteriorating performance of Spain's banks after 2009. The first is the direct effect of the economic crisis. The deterioration in economic conditions had a severe impact on the bank balance sheets. The deep recession and record-high unemployment triggering successive waves of loan losses in the Spanish mortgage market coupled with a rising share of non-performing loans. Like many other countries such as the US, Spain had a huge property bubble that burst. Land prices increased 500% in Spain between 1997 and 2007, the largest increase among the OECD countries. As a result of the collapse of the real estate sector had a profound effect in banks: five years after the crisis started, the quality of Spanish banking assets continued to plummet. The Bank of Spain classified €180 billion euros as troubled assets at the end of 2011, and banks are sitting on €656 billion of mortgages of which 2.8% are classified as nonperforming.

A second factor is concern over the country's sovereign debt. As mentioned above, the crisis in Spain did not originate from mismanaged public finances. The crisis was largely a problem of ever-growing private-sector debt, compounded by reckless bank investments and loans, particularly from the *cajas*, and aggravated by competitiveness and current-account imbalances. To place the problem in

perspective, gross household debt increased dramatically in the decade prior to the crisis, and by 2009 it was 20 percentage points higher than the Eurozone average (86% of GDP versus 66%). The austerity policies implemented since May 2010 aggravated the country's fiscal position. The ratio of Spain's debt to its economy was 36% before the crisis and is expected to reach 84% by 2013 (and this is even based on optimistic growth assumptions). In sum, Spain seems to have fallen into the 'doom loop' that has already afflicted Greece and Portugal and led to their bailout. The sustainability of Spanish government debt was affecting Spanish banks (including BBVA and Santander) because they had been some of the biggest buyers of government debt in the wake of the ECB's long-term refinancing-operation liquidity infusions (the percentage of government bonds owned by domestic banks reached 30% in mid-2012). Again, the doom loop was a result of EMU weakness, namely the lack of a banking union with a centralised EU-funded mechanism to bail out banks.

Spanish banks are also suffering the consequences of their dependence on wholesale funding for liquidity since the crisis started, and, in particular, their dependence on international wholesale financing, as 40% of their balance sheets depend on funding from the international markets, particularly the ECB. Borrowing from the ECB reached €82 billion in 2012 and Spanish banks have increased their ECB borrowings more than six times since June 2011, to the highest level in absolute terms among Euro area banking systems as of April 2012.

The crisis also exposed weaknesses in the policy and regulatory frameworks. The most evident sign of failure was the fact that the country had already adopted five financial reforms in three years and had implemented three rounds of bank mergers. The results of these reforms have been questionable at best. The fact that Spain has had five reforms in less than three years, instead of one that really solved the problem, says it all. They have been largely perceived as 'too little and too late' and they failed to sway investors' confidence in the Spanish financial sector.

Finally, the current financial crisis can also be blamed on the actions (and inactions) of the Bank of Spain. At the beginning of the crisis, the Bank of Spain's policies were praised and taken as a model by other countries. Time, however, has tempered that praise and the Bank of Spain is now criticised for its actions and decisions (or lack thereof) during the crisis. Spanish central bankers chose the path of least resistance: alerting about the risks but failing to act decisively.

Lessons from the Spanish experience²⁸

It is essential to prepare for EMU

The crisis has also shown that countries need to undertake the necessary structural reforms to fully adapt to the demands of a single market and a monetary union. Somehow there was an expectation that membership on its own would force structural reforms, and this (naturally) did not happen. On the contrary, the crisis has shown the limits (and also adverse incentives) of EU/EMU membership in imposing institutional reforms in other areas (eg, the labour market, the financial sector and competition policy) and to balance domestic and external economic objectives.

Nominal convergence is faster than real convergence

Spain's economic record for the past two decades shows that nominal convergence is faster, but that real economic convergence is a slow process. Spain still lags behind many of the EU's richest countries in terms of per capita GDP.

EMU membership carries risks

The Spanish experience also provides an interesting insight into the pitfalls of integration into an incomplete monetary union (one not backed by political union): lower interest rates and the loosening of credit are likely to lead to a credit boom, driven by potentially overoptimistic expectations of future permanent income, which in turn may increase housing demand and household indebtedness, as well as lead to overestimations of potential output and expansionary fiscal policies. The boom also leads to higher wage increases, caused by the tightening of the labour market, higher inflation and losses in external competitiveness, together with a shift from the tradable to the nontradable sector of the economy, which have a negative impact on productivity.

In order to avoid these risks, countries should develop stringent budgetary policies in the case of a boom in demand and/or strong credit expansion. At the same time, they should guard against potential overestimation of GDP, and carefully measure the weight of consumption on GDP, because they might inflate revenues in the short term and create an unrealistic perception of the budgetary accounts, as in Spain's case. Furthermore, to avoid unsustainable external imbalances, countries should also carry out the necessary structural reforms to increase flexibility and productivity, as well as improve innovation in order to allow their productive sectors to respond to the increasing demand and to ensure that their economies can withstand the pressures of increasing competition. They should also set wages based on Eurozone conditions to ensure wage moderation, instead of on unrealistic domestic expectations and/or domestic inflation. Countries should also take the opportunity presented by the boom to move into higher value-added and faster growth sectors towards a more outward-oriented production structure. Finally, the current global

²⁸ From Royo (2013).

crisis has illustrated the need for strict financial supervision to avoid excessive lending and misallocation of resources.

Fiscal discipline matters, but is not enough

Prior to the crisis, Spain was perceived to be one of the most fiscally-disciplined countries in Europe. Initially, fiscal surpluses allowed the country to use fiscal policy in a countercyclical way to address the global financial crisis. However, although Spain entered the crisis in 2008 in an apparently excellent fiscal position, its structurally or cyclically adjusted deficit turned out to be much higher than its actual deficit. As a result of the crisis, the country's fiscal performance collapsed by more than 13% of GDP in just two years. This shows that Spain's structurally or cyclically adjusted deficit was much higher than its actual deficit, and illustrates how difficult it is to know the structural position of a country.

In order to avoid such a situation countries should further tighten budgetary policies in the case of a boom in demand and/or strong credit expansion. It is also important that they use fiscal policies in a countercyclical way to be prepared for recessions; finally, higher revenues, as in Spain prior to the crisis, should not drive budget surpluses. On the contrary, governments need to address the structural reasons for the deficits and avoid one-off measures that simply delay reforms but do not address the long-term budgetary implications.

Address deficiencies in policymaking and challenge the dominant paradigm

Prior to and during the crisis, there was strong consensus in Spain among economic elites, as well as among Conservative and Socialist leaders, regarding fiscal consolidation and the balanced-budget objective. Indeed, before the crisis, Spain presented itself as the model of a country applying the budget surplus policy mantra. This consensus may have worked well in the short term, contributed to the credibility of the government policies, and allowed the country to become a founding member of EMU, but a more accommodating policy would have positively contributed to upgrading the country's productive base with investments in necessary infrastructure and human capital that could contribute to a faster change in the model of economic growth as well as to a reduced dependency on the construction sector.

Learn from traditional financial crises

The financial crisis in Spain did not involve subprime mortgages, collateralised debt obligations, structured investment vehicles or even investment banks. In many ways, the financial crisis in Spain has strong similarities with traditional banking crises: banks should not lend excessively to property developers, governments and central bankers should be proactive in bursting the bubbles before it is too late, bankers should recognise that retail banking is not a low-risk activity and should avoid overconcentration in property loans, and, finally, governments and central bankers should avoid any complacency (as occurred in Spain) and instead be vigilant and proactive in order to avoid the mistakes of the past and to anticipate all

possible scenarios, including the most negative ones. In Spain, a misplaced and excessive confidence in the financial sector's strength and the almost unquestioned belief in the Bank of Spain's regulatory and oversight prowess led to hubris.

Financial regulation matters

As for the experience of the Spanish financial sector during the crisis, there are also several lessons to be learnt (Royo, 2013). First, there is consensus that the Bank of Spain's strict regulations played a key role in the initially positive performance of Spain's banks because it forced them to set aside 'generic' bank provisions during the good years in addition to general provisions for specific risks. In addition, it made it so expensive for them to establish off-balance sheet vehicles that they stayed away from such toxic assets. Secondly, no model is perfect. Indeed, the Spanish financial sector's experience shows that it is impossible for banks not to be affected from a collapsing real estate bubble. Spain is still suffering a property-linked banking crisis aggravated by financing obstacles from the international crisis. In 2012 the Bank of Spain announced that bad loans on the books of the nations' commercial banks, mostly in the real estate sector, reached 7.4% of total lending.

Finally, the Spanish government (and the ECB) failed to cope with the asset bubble and its imbalances. Hence, the Spanish experience shows that financial stability cannot be divorced from economic policy and macroprudential supervision; while regulation matters, macroeconomic factors do too. And they had options: the government should have eliminated housing tax breaks and/or establish a higher stamp duty on property sales, or higher capital-gains tax on second properties.

It IS politics, stupid!

Throughout the crisis the focus has been largely on its economic dimension, as well as on its economic causes and consequences. It would be a mistake, however, to underplay the political dimensions of the crisis, and not just at the Spanish national level, but also at the European and global ones. This has been as much a political crisis as an economic one, and as much a failure of the markets as a failure of politics. Political decisions have marked the course of the crisis.

The need to address current-account deficits and competitiveness

While the focus during the Eurozone crisis largely centred on the fiscal challenges, it is essential to note that we are also dealing with a crisis of competitiveness. EMU membership fostered a false sense of security among private investors, which brought massive flows of capital to the periphery. As a result, costs and prices rose, which in turn led to a loss of competitiveness and large trade deficits. Indeed, below the public debt and financial crisis there was a balance of payment crisis caused by the misalignment of internal real exchange rates. The crisis will largely be over when Spain regains its competitiveness.

Between 2000 and 2010 the loss of competitiveness vis-à-vis the Eurozone deteriorated: 4.3% taking into account export prices and 12.4% taking into account

unit labour costs in the manufacturing sector. Spain's experience in EMU also shows that there have been lasting performance differences across countries prior to the crisis. These differences can be explained at least in part by a lack of responsiveness of prices and wages, which have not adjusted smoothly across sectors, and which, in the case of Spain, have led to accumulated competitiveness losses and large external imbalances. While Germany (and other EMU countries) implemented supply-side reforms to bring labour costs down, through wage restraint, payroll tax cuts and productivity increases, making it the most competitive economy with labour costs 13% below the Eurozone average, Spain continued with the tradition of indexing wage increases to domestic inflation rather than the European Central Bank target, and it became one of the most expensive ones with labour costs rising up to 16% above average (Portugal leads at 23.5%, Greece 14% and Italy 5%).²⁹ A lesson for EMU members has been that it is critical to set wages based on Eurozone conditions and not on unrealistic domestic expectations, to ensure wage moderation.

A crucial problem for Spain has been the dramatic erosion of its comparative advantage. The emergence of major new players in world trade, like India and China, as well as the eastern enlargements of the EU were somewhat damaging to the European economies because those countries have lower labour costs and compete with some of Spain's traditional exports (as exporters of relatively unsophisticated labour-intensive products), leading to losses in export market shares (aggravated by the appreciation of the euro and the increase in unit labour costs relative to those in its trading competitors). Yet while this was particularly true for Portugal, Italy and France, in Spain the problem has been that too few companies export, and that those that export have differentiated products because they are large multinationals. This explains why the market share of Spanish products in world trade have not fallen in the last 15 years. At the same time, Spain's attempt to specialise in medium- and higher-technology products was also hindered by the accession of the Eastern European countries to the EU, as they were already moving into the sectors specialising in these products.

Finally, in order to avoid unsustainable external imbalances, countries should also carry out the necessary structural reforms to increase flexibility (particularly internal flexibility which may be even more important for companies to allow them to deploy their human capital effectively, than the external one, despite the traditional fixation on dismissal costs) and improve productivity. This would be the most effective way to allow their productive sectors to respond to increasing demand and to ensure that their economies can withstand the pressures of membership of a single market. Finally, countries should also take the opportunity presented by the boom to move into higher value-added and faster-growth sectors, towards a more outward-oriented production structure.

²⁹ Stefan Collignon, 'Germany keeps dancing as the iceberg looms', *Financial Times*, 20/11/2009, p. 13.

Address EMU institutional constraints

The crisis has shown that the EMU is a flawed construction. The ECB's President, Mario Draghi, acknowledged as much when he noted that it was like a 'bumblebee' and declared 'it was mystery of nature because it shouldn't fly but instead it does. So the euro was a bumblebee that flew well for several years'. Lately it has not been flying well, and according to him, the solution should be 'to graduate to a real bee'.³⁰

The crisis in Spain has illustrated the EMU's institutional shortcomings: Spain had a huge bubble that burst with the crisis. The 'bumblebee' flew for a while and convinced investors that they could invest (and lend) massively within the country; thus, money poured into Spain. However, when the crisis hit, the country could not count on the EU to guarantee the solvency of its banks or to provide automatic emergency support. And when unemployment soared and revenues plunged, the deficits ballooned. As a result, investor flight followed and drove up borrowing costs. The government's austerity measures and structural reforms so far only contributed to deepen the country's slump. The country needs relief with its borrowing costs and hopes that the ECB plan will help (but resists the conditionality attached to it). It also needs support with its exports. Europe has so far largely come short on both accounts. The crisis has shown the fragility of an institutional framework that tried to balance fiscal sovereignty with monetary union. The model failed to combine flexibility, discipline and solidarity. Fear is what is keeping it all together. But is fear enough to hold it together? If anything, the crisis exposed the shortcoming of EMU institutions. This is a replication of the mistakes of the gold standard.

Discipline and austerity are not enough

Can expansionary fiscal contraction work? The problem for Spain is the feeble outlook for growth: the Spanish economy contracted 1.7% in 2013, the country has high external indebtedness and it has a tremendous private sector debt. As a result, Spain's sovereign debt was repeatedly downgraded throughout the crisis. Unemployment has also reached record levels at over 24% (and the unemployment problem is particularly acute among young people, at over 50%). Furthermore, deep-seated structural weaknesses are still holding back growth and weighting on market assessment: overregulated product and labour markets, poor productivity and low education achievement in international tests. And the effects of austerity are affecting not only Spain: by the end of the summer of 2014 the risk of deflation in the Eurozone was acute.

In this regard, the contrast with the US is striking. Since 2007, the US Congress has passed the equivalent of three stimulus bills:

- (a) A bipartisan US\$158 billion package of tax cuts signed by President George W. Bush in early 2008.

³⁰ Paul Krugman, 'Crash of the bumblebee', *The New York Times*, 30/VII/2012.

- (b) A US\$787 billion bill pushed by President Obama as he took office in 2009 in the wake of the financial system's collapse.
- (c) A tax cut and unemployment fund extension agreement reached by President Obama and Congressional Republicans in December 2010.

Many studies show that these measures are a key reason why the US unemployment rate is not now at double digits.

Conclusions

The crisis has largely been a problem of ever-growing private sector debt, compounded by reckless bank investments and loans, particularly from the *cajas*, as well as aggravated by competitiveness and current-account imbalances. In the end, the crisis has exposed the weaknesses of the country's economic model. Indeed, despite the previous two decades' significant progress and achievements, the Spanish economy still faces serious competitive and fiscal challenges. Unfortunately, the country's economic success prior to the crisis fostered a sense of complacency which allowed a delay in the adoption of the necessary structural reforms. And this was no surprise; some economists had noted that the Spanish economy was living on borrowed time. Indeed, despite all its significant progress Spain still had considerable ground to cover to catch up with the richer EU countries and to improve its economy's competitiveness. Given its existing income and productivity differentials with the richer EU countries, Spain will have to continue and deepen the reform process.

The Spanish economy's sudden collapse came as a shock. In retrospect, however, it should not have been such a surprise. The policy choices taken during the previous decade led to an unsustainable bubble in private-sector borrowing that was bound to burst. Moreover, the institutional degeneration that led to systemic corruption and contributed to the implosion of parts of the financial sector made the crisis almost unavoidable.

Much of Spain's growth during the 2000s was based on the domestic sector and particularly on an unsustainable reliance on construction. Tax incentives favoured developers, property owners and bankers. In addition, the particular regulation of the *cajas* proved fatally flawed and led to a form of crony capitalism Spanish-style, in which they invested massively in the construction sector in search of rapid growth and larger market shares. These decisions proved fatal once the real-estate bubble burst and led to the nationalisation of several *cajas*, including Bankia, and to the EU's financial bailout.

Membership in the European single currency was not the panacea that everyone expected. Adoption of the euro led to a sharp reduction in real interest rates that contributed to the credit boom and the real-estate bubble. However, it also altered economic governance decisions. Successive Spanish governments largely ignored the implications of EMU membership and failed to implement the necessary

structural reforms to ensure the sustainability of fiscal policies and to control unit labour costs. These decisions led to a continuing erosion of competitiveness (and a record current-account deficit) and a huge fiscal deficit when the country was hit by the global financial crisis.

Indeed, the country's experience shows that EU and EMU membership did not lead to the implementation of the structural reforms necessary to address these challenges. On the contrary, EMU contributed to the economic boom, thus facilitating the postponement of necessary economic reforms. The challenge, however, is not a problem of European institutions but of national policies. Indeed, the process of economic reform must be domestic, led by domestic actors willing to carry it out.

The Spanish case serves as an important reminder that in the context of a monetary union, countries only control fiscal policies and relative labour costs. Spain proved to be weak at both. It failed to develop an appropriate adjustment strategy to succeed within the single currency and it ignored the imperative that domestic policy choices have to be consistent with the international constraints imposed by euro membership. To the contrary, in Spain domestic policies and the imperatives of participating in a multinational currency union stood in uneasy relationship to one another. The crisis was the tipping point that brought this inconsistency to the fore, leading to the worst economic crisis in modern Spanish history.

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