Saving the euro: the Spanish perspective

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The Spanish perspective

Spain is in the eye of the euro crisis storm as the most vulnerable country supposedly 'too big to fail'. This paper looks at that crisis from the Spanish perspective, maps out the future scenarios it faces and sets a practical roadmap that can help Europe overcome the current crisis.

The paper argues that the origins of the crisis lie in the defective design of a monetary union born in haste without the proper political, monetary or fiscal institutions to support it. The system therefore needs a thorough restructuring aimed at completing the EMU with fiscal, banking and political union. Partial solutions will only aggravate the crisis.

Spain faces four likely scenarios: "exit", "intervention", "muddling through" and "economic Federation". Although these scenarios are dynamic and interact with each other, without decisive action at the European level, full political 'intervention' is the most probable. This will not improve Spain's growth and stability perspectives, and also risks severely undermining the political system and giving rise to popular euroscepticism.

If the crisis is to be overcome, both at the national and European level, action needs to be taken regarding trust, growth and effective and legitimate institutions at the European level. Only by bridging the trust, economic and institutional deficits can Spain walk away from intervention and Europe from disintegration.

One euro, two diagnoses

The Economic and Monetary Union (EMU) cannot continue in its present form. That EMU institutions and working rules as they exist today are incapable of resolving the crisis is a matter of consensus. Discrepancies are in fact found on how to fix it, not on whether to do it.

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Some consider the origins of the crisis to lie in a lack of compliance with a set of essentially correct rules; others attribute the crisis to the deficient design of the single currency, with compliance issues of secondary importance. The consequence of adopting one or other of these readings is evident. In the first case we are confronted with a temporary crisis; while in the second case we are immersed in an existential crisis requiring a very complicated resolution.

A matter of compliance?

The first of these diagnoses supports that the EMU´s difficulty in attaining its objectives is due to its fair-weather construction, lacking both sufficiently strong institutions to make its principles a reality, and the rules and mechanisms to deal with any problems. The current crisis is not necessarily of the euro's making, but instead a public debt crisis provoked by a decade of laxity and incompliance, and by the fiscal stimulus programme introduced following the 2008 recession. This is the dominant diagnosis within European institutions, namely the Commission, the ECB and the Eurogroup, as well as in the main capital cities, including Berlin and – until the arrival of Hollande – in Paris.

The conclusion of this diagnosis is that the EMU can be fixed from within. One can be more or less ambitious, but the idea would be to complete the design with mechanisms for adverse weather, without altering even the most basic elements of the system (intergovernmental in decision-making, supranational in execution), nor its functioning – which is to say, a set of deficit rules, together with the mechanisms for their compliance (rules and sanctions). Here, the reforms of the Growth and Stability Pact would come into play, the so-called "Six Pack", which strengthens the supervisory and control capacities of the European Commission, the change in national constitutions to introduce the deficit-limiting Golden Rule, the Treaty on Stability, Coordination and Governance in the EMU (TSCG) or the European Stability Mechanism (ESM), soon to come into force.

New and better rules then, together with new and better supervision and sanction mechanisms, an austerity drive, debt reduction and a series of profound structural reforms designed to strengthen competitiveness, will improve the credibility of the Eurozone and eventually put its economies on the path of sustainable growth. The conclusion here would be that there is a need to persevere with current efforts and not change policy, either at the domestic or European level. In Spain the equation would be *structural reforms + public spending austerity = increased foreign public and private confidence.* In consequence, since 2008 the deficit has shot up past an annual 11% while debt has surpassed 80% of GDP, leading to a severe correction from the equity markets which have called into question Spain's capacity to bear the load with such weak prospects for growth and high unemployment.

Or a crisis of the euro?

The second diagnosis is that this is a crisis of the euro itself: a diagnosis that dominates in the English speaking world in both the broader and the more specialised media. This analysis argues that the euro is a failed construction that requires greater centralisation (fiscal and political) not only to survive, but to avoid greater tensions and grievances between member states: if monetary union does not urgently reinvent itself, it will disappear.

The reasoning is that Europe is a far from an ideal monetary zone, with an insufficiently mobile workforce, and central institutions that lack the necessary instruments to guarantee stability, correct imbalances, and survive a crisis. Its central budget is insufficient; its central bank is unable to back the sovereign debt of member states except indirectly; nor does it have a crisis resolution banking mechanism at the European level. The EMU's design error lies not in crisis management mechanisms for adverse weather conditions, but rather in a structure which seemed to be generating economic convergence (in the case of Spain, its best decade in terms of growth and employment) but which in practice was undermining real convergence due to loss of competitiveness, the rise of real wages, and the creation of an enormous trade deficit.

As it was conceived the EMU introduced a series of perverse incentives and disincentives into the system. The influx of cheap money, thanks to low ECB interest rates, and the reduction of the member state sovereign debt risk differentials, activated a time-bomb which has led a series of countries into a trap with no easy way out. Instead of securing full economic integration and economic convergence, we are witnessing centrifugal political tendencies, divergences between countries, and economic decoupling between those experiencing growth (albeit moderate) and those others subject to intervention or trapped in a vicious debt cycle.

The Spanish situation confirms, at least in part, this analysis. All of its governments in the first decade of the new millennium benefited from tax returns generated by easy growth based on a property bubble and near full employment, while neglecting productivity, labour relations, wage policies, competitiveness, and investment in research, innovation and development. Instead of pressing on with a profound reform agenda, governments succumbed to the temptation of complacency, and a false sense of security took over. The upshot was a property crisis, trade deficit, a dual labour market, lack of competitiveness between companies, with autonomous, regional and local government spending spiraling out of fiscal and budgetary control, politicised savings banks, and a finance sector overly exposed to the property sector. The apparent successes of Spain's wonder decade (1998-2008) were therefore little more than skin deep precursors of a more self-destructive period.

This analysis suggests that it is not so much errors of design in the EMU that made member states vulnerable to external shocks (such as those dating from 2008) but instead, going one step further, it was the euro itself that detonated the crisis. Given time, the structural imbalances generated by the euro, together with its problems of design, turned a private credit crisis into a public debt one, which the EMU will not be able to withstand without a strong political and fiscal centralisation process. In short 'monetary union' does not exist without both a central bank to act as lender of last resort and underwrite debt, and a treasury which backs both public and private debt. Without a common fiscal policy, a budget of its own or a central bank, monetary union is simply a system of fixed exchange rates with no way out.

The trap in which member states find themselves in this case would not be so much a debt trap as a political one: saving the EMU would mean fitting it out with institutions which would radically alter its political and economic configuration, turning it in practice into a federation. This in turn explains just why it is so difficult to secure such institutions, for Europe today lacks a sentiment of common identity which would allow for a successful institutionalisation of the solidarity between the different peoples making it up. Without substantial redesign towards the centre, therefore, the EMU will be unable to survive in its current shape (or only with great difficulty). This does not imply the disappearance of the euro, but it does mean a horizon in which the EMU would survive in a minimalist version of the Eurozone, reduced to the members of the north which have overcome the crisis ("neuro"), and an exclusion of the countries of the south of Europe, which would be encompassed in a ("pseuro") zone.

Scenarios for Spain

The conclusion of either one of these diagnoses is that Spain cannot come out of this crisis by itself, as the internal policy of cuts is a necessary condition, but not one sufficient in itself. A redesign of the Eurozone is needed, but that is equivalent to rethinking the blueprint of an airplane in mid-air without any chance of landing first. The urgency is all the greater if the second diagnosis is chosen, the understanding being that we are faced with a structural problem. This might lead to paralysis thanks to the enormous effort required to carry out the task of reworking the EMU from top to bottom, in the midst of the economic downturn.

This context of crisis, whether temporary or structural, sets Spain before four possible scenarios:

Scenario 1: Exit from the euro

This scenario is widely considered so catastrophic as to be deeply unlikely, although this does not mean that it is impossible. A euro exit could take place if outside intervention were to fail, politically or economically (the Greek path). It could also take place in the event of the euro breaking up and reconfiguring itself with a limited number of (northern) members.

A voluntary exit, however unlikely, might be contemplated if the two main parties reached a consensus on the impossibility of remaining in the euro, believing the political, economic and social costs of austerity measures at home were insupportable taken together with scant and insufficient aid from European institutions.

A second (and more worrying) scenario would be a euro exit that follows the collapse of the two main political parties. It is easy to imagine a turnaround in public opinion that wiped out the government in elections without the opposition being able to benefit commensurately. This could result from the failure of austerity measures, internally through the loss of growth and externally through failure to win over market confidence or the solidarity of European governments, added to a failure of the political system to offer the necessary stability to stay on the path of reform.

Indefinite, unqualified support of European policies cannot be taken for granted from the Spanish people. In the most recent polls[2] more than 34% of respondents thought that Spain's membership of the euro made it more difficult to escape the crisis (only 20% thought it facilitated it). 57.5% said that belonging to the euro has been negative for Spain, and 33.5% were convinced that Spain would be better off outside the Eurozone.

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[2] *ABC* newspaper, 29/04/2012, pp.18&19

Scenario 2: Intervention

In this scenario, the Spanish government would go beyond the "light" bailout package it received on June 9th, requesting a European loan to maintain the lifeline for its banking sector. The government, given negative unemployment, debt and deficit figures, would then show itself to be incapable of restoring confidence in the markets, submitting Spanish debt to prohibitive interest rates and forcing an intervention (Portuguese variant). Likewise, intervention could take place if contagion from a Greek exit spread to the weaker Eurozone countries (Greek variant).

Governing under further intervention would be challenging, with additional cuts and reforms on the table. As in Greece and Portugal, many measures would focus on sensitive parts of the welfare state, such as pensions, education and health, and public administration (reordering of local powers and finance, reduction of the number of civil servants, etc). These would have a great impact on public opinion, political stability and the governability of the country, and consequently could move Spain closer to an exit scenario.

This scenario also seems the most likely, unless decisive action on banking and debt is taken at the European Council meeting on June 22nd. Political consequences of such an intervention may include pressure on Prime Minster Rajoy to step down, the inclusion of the main opposition Socialist PSOE in coalition with Rajoy's PP to generate public support, or the formation of a new government headed by a technocrat. Intervention would inevitably lead to an erosion of popular support for the EU, and potentially the rise of eurosceptic parties.

Scenario 3: Muddling through

In this scenario, Spain carries on much as before. There is neither a euro exit nor outside intervention, nor are there any big changes in the European arena. Germany and the other countries might adopt a more flexible position, but not one with any substantial changes – no Eurobonds, no easy road to rapid growth. With the fiscal pact and the ESM in force, Hollande may secure some stimulus measures through the European Investment Bank (EIB) and/or the mobilisation of untapped structural funds in the EU budget. However, these would not be channeled through Spain, which would continue with a confidence problem abroad, a financial sector in a critical condition, public debt approaching 90% of GDP, and reforms (with the unstable, complex Spanish autonomous regional state system as an added difficulty) having no noticeable effect on growth and employment during Rajoy's term of office. In this scenario, the crises would have a knock-on effect, due to external or internal events (Greek exit; high differentials in Portugal; political instability in Italy as Monti´s term of office runs its course; another bank rescue in Spain), although the possible exit of Merkel, and the arrival of the Social Democrats or a grand coalition including them might offer some relief. In general, Spanish government policy would be reactive and survival driven, lacking the capacity to contribute to the design of common institutions, and with no prospects or plans in the medium term.

This might result in a serious erosion of support for the government at the polls and possibly in the street, with levels of public disaffection and a possibility of minority governments. The ground would be open for the rise of parties able to capitalise on the failure of the PSOE and PP to get Spain out of the crisis. On the other hand, 'muddling through' could lead to the current sacrifices and reforms overcoming the acute crisis, staving off foreign intervention and the collapse of the political system through the concrete support of the ECB and other partners. This would require a very narrow consensus between the two main parties likely to govern, and the adoption of a series of profound reforms, devoted to improving the credibility of Spain in the eyes of its EU partners and the financial markets.

Scenario 4: Steps towards an economic Federation

In this scenario, there would be a turnaround in the handling of the economic crisis. European leaders would recognise the critical need for centralisation within the Eurozone and seize it. This about-turn might stem from sustained and compelling pressure on Angela Merkel from leaders of other big countries in difficulties, a political crisis in Italy, or the collapse of the Spanish government and the subsequent need for intervention in Spain, with the resulting threat to stability across the entire Eurozone.

This scenario would see the emergence of a powerful dynamic in favor of political negotiation aimed at complementing economic and monetary union with political and fiscal union. This would include European taxes; a European Treasury; a change in the role of the ECB which would allow it to buy up sovereign debt; the issuing of Eurobonds; the conversion of the ESM into a European IMF; the setting up of a bank resolution mechanism; and a Europe-wide deposit guarantee fund. Such measures would demand significant constitutional reforms (in Germany, and Spain too), including uncertain national referendums that may result in some current Eurozone countries ending up outside the single currency. The result would be the formation of an economic federation with the objective of a viable single currency (that may allow for the future return of countries that exited).

Proposals

Assuming that the plan is to avoid both a Spanish euro exit as well as full-scale intervention, and move as quickly as possible from the current precarious situation towards stability and greater integration, Spain and Europe need a road map. Three factors in particular would have to be tackled:

1. *A confidence deficit*. The EU is victim of a "clash of narratives", with the north charging that the south has a credibility deficit and the south charging that the north has a solidarity deficit. Although the south is potentially more credible and the north offers more solidarity than is charged, a negative dynamic has been created whereby the north offers less solidarity because it does not believe in the south, while the south does not recognise the sincerity and permanence of the north's commitment.

2. *A convergence deficit.* The economic decoupling between north and south introduces asymmetries into the Eurozone and the perception of a zero-sum game which feeds into the break up, material and psychological, between the two parts. Without economic convergence, economic and monetary union is not a viable project.

3. *An institutional and political deficit:* We have witnessed a process of institutional asset-stripping, fundamentally of the Commission, and a movement of power towards the battered Franco-German axis, where France has been a junior, docile partner; and also

towards the ECB, which has become a centre of power in the EU despite itself (a role which it plays without much conviction, well aware of its limitations). Spain has largely shared the reading of the crisis and the policy proposals which have been flowing out of the main European institutions, whether the Commission, the Eurogroup and the European Parliament. However, in practice these actors, especially the Commission and the Parliament, have hardly been at the helm of the attempt to solve the crisis. The perception that European institutions have been hollowed out and that there has been a major shift of power to Berlin and Frankfurt is now widespread. There is a need to restore checks and balances and institutional procedures, rehabilitate the Community method and re-empower these actors so as to be able to effectively and legitimately act again for the overall European interest and in the name of Europe.

A European "*new deal*" is thus required, one dealing with all three of these deficits. The idea would be to restore confidence, boost convergence and strengthen common institutions. The objective would be to establish a positive-sum dynamic in these three areas (confidence, convergence and institutions). This requires the political will for member states to trade structural reforms and austerity measures for financial support, growth and flexibility measures at the European level, in three interrelated areas:

1. *Overcoming the confidence deficit:* Confidence could be restored by trading structural reforms (gaining credibility) for financial support (expressing solidarity), by means of a new, more ambitious or more flexible role for the ECB, the activation of the European Investment Bank (EIB), or the gearing up of a program of Eurobonds acceptable to Germany and other countries. The idea would be to gradually restore confidence and solidarity between both sides.

2. *Overcoming the convergence deficit:* This would require austerity (meeting deficit and debt goals) to be traded for growth measures (structural funds), or flexibility over areas crucial for reforms, like education, research, innovation and development.

3. *Overcoming the political and institutional deficit:* The idea here would be to trade the relinquishing of sovereignty, transparency and control for a strengthening of the EU's democratic and political institutions (the very mechanisms required to enable a European government to apply a programme derived from the European Parliamentary elections). The centralisation of new powers to strengthen economic government should not lead, however, to an unlimited expansion of powers at the hands of the EU, as a possible "union of general powers" would not enjoy the legitimacy of the population. Mechanisms should thus be established to allow some European policies to be renationalised when advisable in order to uphold the idea of an EU with wide-ranging but limited powers, allowing the compatibility between national democracies and European democracy to be upheld.

The conclusion from Spain: an urgent debate

Spain needs to promote measures making its national interests compatible with those of Europe as a whole. But here Spain finds herself in a difficult situation: she cannot confront Germany with balance of power policies, or "coalitions of losers", because Spain needs

German cooperation. At the same time, however, Spain has to build a solid union of interests and principles around the three deficits. Our country needs to promote measures which are positive for the country, and which can also create acceptance and legitimacy at the European level. That is why moving quickly forward towards a "Europe of results" is not enough. The transference of new powers to the EU can only be justified by an improvement in governance in democratic terms and the acceptance of a new social contract between Europeans. This would help resolve the tensions and political and economic imbalances which have introduced so much uncertainty into the European project, and, in doing so, would play an important part in relaunching it.

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