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Professor ***

[International Studies course]

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Spain: The Illusion of Success

Country Characteristics:

Spain is a diverse country with a rich cultural and political history. As part of the Iberian Peninsula, Spain's close proximity to the Straits of Gibraltar, the Mediterranean Sea, and the North Atlantic Ocean has always offered it a strategic location for maritime trade and commerce (CIA World Factbook, 2014). To the west, Spain is bordered by Portugal, and France lies to the northeast, separated by the Pyrenees Mountains. The climate varies from arid and hot in the south and interior, to cooler, lusher, and cloudier along its northern coastline (CIA World Factbook, 2014). Its topography consists of plateaus surrounded by rugged hills and small mountain ranges. Additionally, Spain controls the territories Ceuta and Melilla in Northern Morocco as well as two archipelagos; these include the Balearic Islands, which lie to the east in the Mediterranean, and the Canary islands, which are situated in the Atlantic Ocean off the coast of Africa (CIA World Factbook, 2014).

The origins of the Spanish Empire date back to 1492, when the Catholic King and Queen—Ferdinand II of Aragón and Isabella I of Castilla—ended the centuries-long reign of the Islamic Empire in the Iberian Peninsula. Over the next two centuries, Spain would become a strong contender in the global economy and would remain so up until the Industrial Revolution. The Spanish Civil War of the 1930s dealt a harsh blow to the Spanish economy as well as the country's morale (CIA World Factbook, 2014). At the conclusion of the civil war, newly appointed dictator Francisco Franco continued to rule the country until his death in 1975. Franco

reinstated the monarchy before his death and appointed Juan Carlos I as King of Spain. It was Juan Carlos who would eventually help the country transition to a democratic government, which is what remains in place today (Gunther and Montero, 2009). As a country with such an expansive repertoire of culture, geography, and political turmoil, it should come as no surprise that Spain also possesses a rather tumultuous economic history. Nearly seven years have passed since Spain was confronted with the worst financial crisis in its modern history, yet it still hasn't succeeded in fully recovering from the damages caused by this catastrophic event. Now, more than ever, seems an appropriate time to analyze the factors that contributed to the country's colossal economic collapse.

Past and Present Economic Performance:

For the two centuries following 1492, Spain was a force to be reckoned with. During this Golden Age of the Spanish Empire, the country's control was widespread and imposed on territories across the vast expanse of the Atlantic Ocean. Throughout the 16th and 17th centuries Spain conquered much of Latin America and received immense amounts of riches from these colonies abroad (Maltby, 2009). The Spanish Empire remained powerful throughout this time period until it eventually conceded control of the oceans to England's navy (CIA World Factbook, 2014).

The early 1800s were marked by industrial expansion throughout Europe. Britain, France, and Germany quickly capitalized on the advances that came along with the Industrial Revolution. Spain, however, was unable to keep up with the rapidly-growing economies of much of the rest of Europe. Geographic barriers and inadequacies, war-torn colonies, and various other factors limited Spain's ability to modernize along with the rest of Europe (Beck et al., 2007).

Upon entering the 20th century, Spain remained a neutral player during the first and second World Wars; however, it was experiencing its own problems back home. From 1936 to 1939 the Spanish Civil War devastated the country and concluded with the appointment of young Spanish general Francisco Franco as dictator of Spain (Beck et al., 2007). Backed by fascist, monarchist, and right-wing groups, the Franco years were marked by Nationalist pride, turmoil, and severe repression. It wasn't until the leader's death in 1975 that Spain's current political system was born (Gunther and Montero, 2009).

Between the years 1996 and 2007, the Spanish economy was one of the strongest and most rapidly-growing economies throughout all of Europe. However, things took a turn for the worse in mid-2008 when Spain began to spiral into a severe economic recession referred to as "la crisis". The unemployment rate went from 8 percent in 2007 to 23 percent in 2013 (refer to Table 1.4). In 2010, Spain became the fourth country in the Eurozone to seek an international bailout (Royo, 2013).

"La crisis" has had multi-scale effects on the economic, political, institutional, and social well-being of the country (Royo, 2013). Many reasons have been proposed as having significantly contributed to Spain's economic downturn in the wake of the global financial crisis, yet some stand out more than others. Spain's recent economic recession can be attributed to its lack of effective policymaking and fiscal regulation under the wing of the European Union over the past few decades. The damaging effects of the global financial crisis transcended the barriers of physical geography and, in doing so, highlighted the extreme interconnectedness as well as some limitations of today's global economy.

Table 1.4 The Impact of the Crisis (2007–2013)

	2007	*2008*	*2009*	*2010*	*2011*	*2012**	*2013**
GDP, constant prices	3.479	0.888	−3.74	−0.07	0.71	−1.826	0.125
Output gap in percentage GDP	3.843	2.387	−2.693	−3.319	−3.069	−4.457	−4.338
Gross national savings	20.999	19.512	19.201	18.698	18.35	18.526	18.538
Inflation, average	2.844	4.13	−0.238	2.043	3.053	1.893	1.561
Unemployment rate	8.263	11.327	18.01	20.065	21.638	24.2	23.9
Government structural balance	−1.131	−5.056	−9.06	−7.331	−6.5	−3.402	−3.136
General government gross debt	36.301	40.173	53.929	61.173	68.471	79.041	84.027
Current account balance	−9.995	−9.623	−5.2	−4.604	−3.706	−2.143	−1.721

*Estimates

Source: IMF, World Economic Outlook Database, April 2012.

Source: Royo 2014, p. 52

Reasons behind Spain's Recent Economic Performance:

Experts and critics point to various culprits having caused Spain's recent economic crisis. Some fault its integration into the European Union in 1986 as being a driving force, with economic powerhouses like Germany setting impossible standards. Others cite fiscal irresponsibility and out-of-control public debt as another. Spain's economic success in the decade prior to the crisis, however, quickly delegitimizes these arguments. While these factors were influential in Spain's economic downfall, the true situation is more complex and cannot be boiled down to such simplistic conclusions. A more compelling argument is one that names Spain's inability to implement prudent fiscal policies in the wake of joining the EU as being largely at fault for the economic crisis the country experienced in mid-2008. This particular approach to deconstructing Spain's recent economic history is multi-fold. It recognizes an overall trend of an illusion of success concealing instability which could only be revealed in the most spectacular of ways: with the largest economic crisis is Spain's modern history.

In his book "Lessons from the Economic Crisis in Spain," author Sebastían Royo (2013) calls the years from 1990-2000 the 'Miraculous Decade' (p. 40) for Spain. During this time

period Spain's economic performance was incredible in comparison to other European countries. By 2008, Spain had been reveling in its 14th year of economic growth as well as its longest cycle of continuous economic expansion in the country's modern history (Crawford, 2007). The unemployment rate fell to 7.95 percent in 2007, which is the lowest it had been since 1978 (EFE World News Service, 2007). Additionally, GDP growth had reached 3.9 percent in 2006 (Country Monitor, 2007). What's more, the public deficit was eradicated and the public debt was reduced to 39.7 percent of GDP, which was a huge drop from 70.1 percent in 1996 (European Central Bank, 2014). These facts and figures are just a small sample of Spain's economic success during the Miraculous Decade, but the statistics are remarkable. It's no wonder the sudden economic downturn came as a shock for Spain's leaders and citizens.

So why *did* Spain's economy take a turn for the worst? Rather than public indebtedness, the economic crisis can be better linked to Spain's lack of sufficient regulation and poor policymaking after its integration into the EU. Issues regarding excessive lending, external imbalances, and deteriorating competitiveness in a global market were all revealed when the housing market crashed. The Miraculous Decade proved prosperous for Spain; however, this level of success also sugar-coated some blatant weaknesses with Spain's economic model. For one thing, the economy's growth during this time was focused on low-intensity economic sectors like construction and services (Loría and Salas, 2014). At the same time, the country's low productivity and capacity for competitiveness at an international scale had become an afterthought (Country Monitor, 2007). Spanish exports were concentrated in just a few markets (70 percent of exports went to the EU15); inflation due to euro appreciation reduced Spain's ability to compete with other countries in export demand; and a weak labor market with a high temporary rate created little incentive for employers to invest in their workers (Loría and Salas,

2014). All of these factors, combined, proved costly for Spain because its feeble economy couldn't hold its own once influxes of foreign capital were cut off and borrowing prices skyrocketed. As the illusion of success dissipated, Spain's weak economic foundation crumbled.

To explore the concept of the illusion of success more thoroughly, Spain's integration into the EU must be addressed. Spain's accession into the European Union in 1986 would come as a blessing and a curse for the country. On one hand, Spain's EU membership allowed for liberalization, trade integration and its overall transformation into a Western-like economy by the late 20th century (Royo, 2013). One of the key benefits was the reduction in interest rates, which encouraged private investment throughout the country, especially from foreign investors and other members of the EU. On the other hand, this reduction in perceived risk after Spain's integration into the EU also fostered a false sense of security that overshadowed Spain's true fiscal instability and lack of economic safety nets. Subsequently, these faults rendered it unable to compete in a single market under monetary union. Ultimately this resulted in rapid growth and astronomical inflation rates (see Table 1.4). Though Spain reported fiscal surpluses from 2004 to 2007, the data was reviewed and, in fact, showed that the actual deficit during these years was much higher than the cyclically adjusted deficit (refer to figure 4.2).

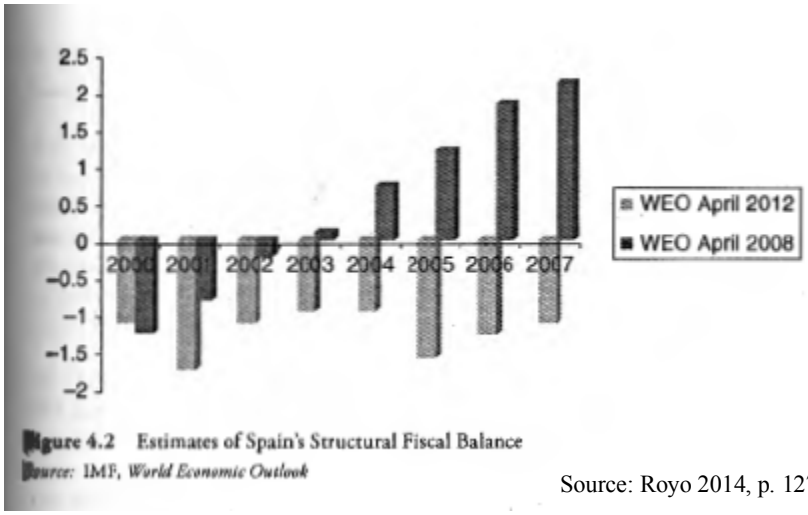

Figure 4.2 Estimates of Spain's Structural Fiscal Balance
Source: IMF, *World Economic Outlook*

Source: Royo 2014, p. 127

There were a few main reasons behind Spain's mirage of success. Spain's accession into the EU produced a low-interest-rate environment that encouraged construction sector growth and increased the demand for goods and services through credit (Loría and Salas, 2014). This, in turn, boosted the demand for real estate and captured the attention of foreign investors. Unfortunately, the fiscal prosperity that resulted wasn't all that it was chalked up to be. Nevertheless, governmental decisions were based off of the incorrectly reported fiscal data. This false sense of security created by the safety net of the EU resulted in the Spanish government's complacency concerning fiscal consolidation and slowed progress surrounding structural solutions that would have improved the country's competitiveness and productivity (Royo, 2013). Had more forward-thinking and economic regulation been put in place before the global financial crisis, Spain's economy may not have suffered as large of a blow. However, instead of using the giant inflow of capital that followed Spain's EU accession to improve the country's productivity and competitiveness, a great deal of money, instead, went to funding the private sector to appease the upsurge in housing demand and resulted in irresponsible banking practices. Banks became guilty of loosely distributing loans to fund real estate developers and construction companies in an attempt to keep up with rapid growth (Loría and Salas, 2014). When the global financial crisis hit, cross-border finance came to a crashing halt and resulted in a massive bubble in the property market along with significant inflation. Because Spain had failed to address deeply-rooted structural problems and improve its competitiveness earlier on, the collapse of the construction sector that followed the global financial crisis of 2008 had dire consequences for the country's economic well-being. At the end of 2010, private sector debt was 227.3 percent of GDP (Royo, 2013).

As much as the impacts of "la crisis" could have been softened with better economic policies, it is also true that some contributing factors were outside of Spain's control. The question of the EU's role throughout the series of crises that affected other Eurozone countries at the same time as Spain begs to be asked. Besides Spain, Portugal, Italy, Ireland, and Greece were all on the cusp of, if not already experiencing, crises of their own. It seems reasonable to assume that being part of the larger EU entity would have provided the hardest-hit countries with more bailout options. It is, in fact, this argument that underscores some of the major problems with the current state of the European Union. As Young and Semmler (2011) explain, unlike the U.S., the Eurozone has "no mechanism for tax and transfer policies to provide for regional equalization and stability" (p. 9). Thus, economic deficits experienced by individual EU countries aren't merely a quick fix. In fact, rather than compromising to rebalance surpluses and deficits between core and periphery countries, deficit countries are expected to adjust by fixing their structural problems, reducing domestic demand, and increasing their exports (Wolf, 2012). This expectation is further exacerbated by the fact that, as a member of the European Monetary Union, Spain's external competitiveness depends on the exchange rate, which is outside of the country's control (Royo, 2013). Thus, Spain can only look to improve its competitiveness directly with its Eurozone partners, to whom the idea of being bogged down by the deficits of periphery countries could not be less appealing. Germany, an economic power player in the EU, was quick to scold the periphery countries for their lack of fiscal responsibility after the global economic crisis; however, German banks were also some of the key investors that drove the housing market boom in Spain (Loría and Salas, 2014). These blatant power and fiscal gaps evident among EU countries need to be addressed sooner rather than later. In doing so, some of

the economic instability that comes along with integration into the EU will be alleviated, thus helping to prevent future economic crises.

The Factor that Least Explains Spain's Economic Performance:

Determining which factors have not had a major impact on Spain's recent economic performance requires a more speculative than quantitative approach. Of everything that played a role in Spain's economic downfall, geography can be considered an insignificant player in comparison to other contributing factors. This is because "la crisis" occurred in the wake of a global financial crisis on a scale which surpassed physical geography and barriers to the point where they were virtually negligible.

Almost seven years have passed since the global financial crisis struck and the data reveals that not all countries suffered equally. What factors separated the hardest-hit countries from those more fortunate? Most economists now agree that the global economic crisis started in the US with the fall of Lehman Brothers and the subsequent housing bubble (Edey, 2009). As was previously discussed, for Spain, in particular, much of the capital inflow during the Miraculous Decade came from abroad. This fact held true for the other countries most affected by the global financial crisis: Portugal, Ireland, Italy, and Greece (Krajewska, 2014). As author Phillip R. Lane (2012) ascertains in his review paper entitled "Financial Globalisation and the Crisis," cross-border financial exchange and financial globalization "plausibly contributed" (p. 564) to the global financial crisis. Thus, aspects of Spain's physical geography were hardly considered with reference to international market decisions.

A paper by Bhattacharya and Dasgupta (2012) further compliments Lane's idea of cross-border financial exchange being causally related to the global financial crisis. Their argument shows that "strong macroeconomic fundamentals along with weak integration with international

financial markets acted as major buffers for least developed countries (LCDs) against fallouts of the recent global financial and economic crisis" (p. 673). Geography, therefore, can be considered a rather insignificant factor in Spain's recent economic performance due to the fact that its economic trajectory rode more on the interconnectedness of the modern-day global economy than geographic features such as rough terrain or impassable waterways.

The Future of Spain:

Spain has been tested on a multitude of levels in the wake of "la crisis." Not only did it shatter the economic progress Spain had become accustomed to in the decades prior, it also came as a blow to the morale of Spanish citizens. Self-esteem and hopelessness resounded throughout the country after the financial crisis (Royo, 2013). More recently, in 2011, the Spanish royal family underwent an investigation for alleged corruption and King Juan Carlos I abdicated the throne in June of 2014. He was succeeded by his son, Felipe VI. In a speech given by the new king on Christmas Eve of 2014, he made it very clear that he would not stand for corruption from public figures (World Briefing, 2014). Furthermore, the political atmosphere was shaken up this year when the upstart far-left party, Podemos, appeared to be gaining popularity over the Spanish Socialist Workers Party in the polls. This excitement, however, proved short-lived once the results of the March elections in Andalusia were revealed (The Economist, 2015).

Though the worst appears to be over for Spain, the economic situation hasn't managed to make much positive progress. As of 2013, Spain's future is still uncertain. While inflation has decreased significantly from 2008 and exports of goods and services (as percent of GDP) have been going strong, the unemployment rate is still high at 26.6 percent of the labor force and annual GDP growth remains slightly negative (The World Bank, 2015). There is no denying that the country needs to reinvent itself. Stepping stones to economic stability will undoubtedly

include: improved productivity, increased competitiveness, fiscal regulation, and enhanced policy across a wide front. Collaboration from every member of the EU to improve competitiveness on all fronts will be vital if the Eurozone wants to avoid a potential breakup. Once EU equality and stability is achieved (if this is even possible) and Spain can regain its competitiveness in the global market, it will be well set-up for job-creation and wealth accruement. Things are already looking up for the country, but it will take time for the wounds inflicted by the crisis to fully heal. The best thing Spain and the EU can do, now, is learn from the past and prevent history from repeating itself.

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