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SPAIN AND THE ECONOMIC CRISIS

Statistical and Theoretical Analyses

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Summary

Presenting the Topic:

Currently, the world and especially the euro area are facing a severe economic crisis. As my Bachelor thesis subject, I have chosen to examine Spain's historical development as well as current economic situation from both a statistical and theoretical perspective.

Purpose and Demarcation:

The purpose of this paper is to find possible explanations for the on-going crisis by analysing economic statistics on Spain, to examine if Spain is a typical EU country or in what ways Spain is different, to study if Spain has applied certain economic theories and to look at if the existing economic theories could help Spain to solve the on-going economic crisis or if the country is in need of something new. This paper has no intention to fully cover the above listed issues.

Method:

To succeed with the aim of this thesis, lectures have been attended, literature and articles have been studied and homepages have been used frequently. The material has been used to gather relevant information and statistics and to gain knowledge of the mentioned theories as well as for the application of these on the Spanish situation.

Conclusion:

For a deeper understanding of Spain's situation, it is important to consider that Spain during the last decades, compared to other Western European countries, has gone through more social changes than any other country, the delay in the Spanish economic development and the fact that Spain has experienced regional autonomy, regional differences, low productivity, low efficiency, low flexibility, low skills of the workforce and lack of competitiveness in foreign trade as well as a climate change.

The deep recessions that followed the housing and construction booms are the main reasons for the economic crisis and explain the increase in the unemployment rate, the corporate sector indebtedness and the banking crisis in Spain. A weak demand and lower capital inflows from abroad further clarify the current situation. Huge amounts of capital will be needed for the Spanish banking system to repay its current debts. New structural reforms in the areas of education, innovation, increased competition and pension systems have to be enacted.

Spain has to some degree followed the different phases of capitalism and applied among others Keynes' and Friedman's theories. Both already existing economic theories and new ones can be useful to help Spain diminishing today's economic problems.

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1 Introduction

1.1 Presenting the Topic

At present, the global financial situation is more relentless than ever since the Great Depression. The 2007 – 2012 global financial crisis has turned the world economy upside-down. Large financial institutions have collapsed, bailout of banks by national governments has become commonplace and stock markets around the world have experienced downturns. Besides, e.g. the housing market has been hit hard, which has caused “*evictions, foreclosures and prolonged unemployment*”. The crisis has also among other things resulted in a downturn in economic activity, declines in consumer wealth as well as the failure of many mayor businesses.¹

One of the EU countries that has been sorely affected by the crisis is Spain, which today faces a severe economic crisis. The economic situation in Spain reflects the European sovereign debt crisis, which followed the international crisis starting from 2007.

For the purpose of this thesis, I have chosen to look into Spain’s economic situation. Last autumn, I undertook courses in Spanish economy at Universidad Complutense de Madrid, where I gained a better understanding of the on-going crisis and especially its effects in Spain. Already before I went to Spain, it was agreed that I should write my thesis about the Spanish economy and the crisis.

1.2 Purpose and Demarcation

This thesis is part of my Bachelor in Economics. The paper intends to deal with possible explanations for the economic crisis in Spain. In more detail, it is aimed;

- to understand the reasons for the on-going crisis by analysing relevant economic statistics on Spain,
- to examine if Spain is a typical EU country or in what ways Spain is different,
- to study if Spain has applied certain economic theories and
- to look at if the existing economic theories could help Spain to solve the on-going economic crisis or if the country is in need of something new.

To fulfil the stated purpose of this paper, the following is analyzed. To start with, economic data on Spain, primarily from after the Second World War and onwards, are examined. Furthermore, the paper handles aspects of whether Spain’s development is typical for Kaletsky’s first three phases of capitalism. If the crises could have been avoided if Spain during the Free Market period had applied theories from the Keynes era and/or the Monetarism is discussed as well as if the present crisis can be solved by existing theories and regulations or if something new will be required.

¹ USFN, *Global Financial Crisis Timeline: 2007 – 2012*.

When presenting and analysing the theories, I have chosen to base my disposition on Anatole Kaletsky's theories about capitalism. Kaletsky is a highly appreciated and awarded Editor-at-Large and principal economic commentator of *The Times* and elected to the Governing Council of the Royal Economic Society. The reasons for accentuating Kaletsky are that he is not a scientist in need of defending existing theories and that he, despite of this, still has an extremely wide understanding of today's economic and financial situation.

During Kaletsky's period Capitalism 2, Keynes and his theories are central. When describing the period Capitalism 3, I have chosen in excess of Friedman to study the theories of Bernanke, Fisher, Kaminsky, Mishkin, Reinhart, Rogoff and Wihlborg. The last part of the paper includes some conclusions. It should be noted that this paper has no intention to fully cover the above listed issues. Due to the limited scope of this paper, it instead gives an overview of issues relevant for the chosen topic.

1.3 Method

For the purpose of this thesis, literature, such as Anatole Kaletsky's *Capitalism 4.0: The Birth of a New Economy in the Aftermath of Crisis* has been studied. José Luis García Delgado's and Rafael Myro's *Lecciones de Economía Española*, Carmen M. Reinhart's and Kenneth Rogoff's *This Time is Different – Eight Centuries of Financial Folly* and Paul De Grauwe's *Economics of Monetary Unions* have also made an important contribution to this paper. Moreover, additional literature, articles, mainly from *SvD - näringsliv* and statistics from *Eurostat* and others have been of importance. The homepage of *Banco de España's* as well as other international homepages have been used frequently. The material has been used to gather relevant information and statistics and to gain knowledge of the mentioned theories as well as for the application of these on the Spanish situation. I have tried to approach the material critically in order to decrease the risk of presenting personal pre-understanding and the like.

Besides, I have received great support from my supervisor Lecturer Hans Hansson and his book *Internationell ekonomi* has given me a better general understanding of the subject.

1.4 Disposition

Initially, the first three phases of capitalism will be presented (Paragraph 2.1). Capitalism 1 will be dealt with shortly, followed by a more thorough study of Capitalism 2 and Capitalism 3. Thereafter, theories such as Keynes', Friedman's and others, will be examined in connection with its relevant phase (Paragraphs 2.1.2.1 and 2.1.3.1 – 2.1.3.5). Relevant information about Spain and the Spanish Economy will then be dealt with (Chapter 3). After that Capitalism 4.0 will be defined (Chapter 4). Subsequently, in the theoretical analysing part, Spain's situation during the different phases of capitalism will be assessed (Paragraph 5.1). Finally, before certain conclusions will be drawn (Chapter 6), additional relevant questions will be examined (Paragraph 5.2).

2 Background

2.1 The Three First Phases of Capitalism

Anatole Kaletsky states that Capitalism has gone through three extensive phases since 1776 and that we now are in need of a new phase called Capitalism 4.0. Each stage has been influenced by a number of politicians and economists and has commenced by a period of turmoil. The differences of most importance between the different phases concern among other things the relationships between politics and economics and between governments and markets.²

According to Kaletsky, capitalism has always been an adaptive social system, instead of following a static set of rules, and develops in response to the changing environment.³ Human compulsions, like ambition, initiative, individualism and competitive spirit, will continue powering the capitalist system and creating a new version of capitalism that will eventually be even more flourishing and fruitful than the out-phased system.⁴ In the rest of this chapter, the three first stages of capitalism will be described.

2.1.1 Capitalism I

The first phase consists of the following underlying phases:

Capitalism 1.0: from 1776, the U.S. Declaration of Independence and The Wealth of Nations, to 1815, the defeat of Napoleon at Waterloo

Capitalism 1.1: from 1820 to 1849

Capitalism 1.2: from 1848-49, Europe's Year of Revolutions, the repeal of the Corn Laws, and the Navigation Acts, until the late 1860s, during the aftermath of the U.S Civil War and the Franco-Prussian War

Capitalism 1.3: from 1870 to 1914, the United States' Gilded Age or the Second Industrial Revolution

Capitalism 1.4: from 1917 until 1932, the period of disintegration, when capitalism came closer to genuine collapse than ever before or since

Social and economic upheaval defines the first phase of capitalism, where politics and economics were basically unrelated spheres of human activity that had to stay distinct in the interests of both economic and political evolution.⁵ Government and market intervention were restricted to collect taxes and protect commanding political interests by building tariff barriers.⁶ When examining the first phase, Adam Smith, Alexander Hamilton, Lenin, Hoover, Hitler

² Kaletsky, A, *Capitalism 4.0: The Birth of a New Economy*, page 4.

³ *Ibid.*, page 2f.

⁴ *Ibid.*, page 1f.

⁵ *Ibid.*, page 38f.

⁶ *Ibid.*, page 4.

and others are of interest.⁷ They found it obvious that the capitalist economy and policy would rise or fall together; they would either cause human happiness or human distress.

In addition, the cohering ideology of the first phase of capitalism stated that due to the strict laws of market economics, government interventions should be avoided in business activity. Political reforms may have solved systematic tensions caused by capitalism but it was not part of economic theories. This separation led to *Capitalism 2.0*.⁸

2.1.2 Capitalism 2

The following underlying phases are part of the second stage of capitalism:

Capitalism 2.0: from 1931-38, the abandonment of gold and New Deal experimentation

Capitalism 2.1: from 1935-45, government-led militarism

Capitalism 2.2: from 1946-69, the Keynesian Golden Age

*Capitalism 2.3: from 1970-1980, inflation, the energy crisis, and the breakdown of the post-war gold-backed currency system*⁹

The definition of the second phase of capitalism is “*an almost romantic faith in benign, all-knowing governments and an instinctive distrust of markets, especially financial markets*”. It was commonly agreed that governments were at all times right and markets almost always wrong.¹⁰ Furthermore, “*the single most important function of government was to manage the economy, by taming and controlling unstable market forces*”. During this phase Roosevelt, Keynes, Nixon and Carter were amongst the most influential people and especially Keynes played an important role. Keynes ideology will be described in paragraph 2.1.2.1. In *Capitalism 2.0* economics became fundamentally a chunk of politics.¹¹ Many European countries¹² took part in a blockade in the mid-1970s, where most economies tried to defend their currencies against rough attacks from the currency markets, which resulted in recessions with extremely high interest rates.¹³ Additionally, at the end of the second phase, stagflation had become a fact, “*a lethal combination of high inflation and mass unemployment*”.¹⁴

2.1.2.1 John Maynard Keynes

The time period between 1946 and 1969 is described to be “*the most successful period of economic management*”. During this period, called the Golden Age of Keynesian economics, living standards were high together with great technological progress and financial stability.¹⁵

⁷ Kaletsky, A, *Capitalism 4.0: The Birth of a New Economy*, page 45.

⁸ Ibid., page 39f.

⁹ Ibid., page 49.

¹⁰ Ibid., page 4f.

¹¹ Ibid., page 39f.

¹² Great Britain, France and Italy along with many other economies.

¹³ Kaletsky, A, *Capitalism 4.0: The Birth of a New Economy*, page 82.

¹⁴ Ibid., page 51.

¹⁵ Ibid., page 50.

Keynes' ideologies and especially his monetary theory have been of crucial importance for modern macroeconomics as well as for economic policies of governments and for “the monetarists”. He pointed out that when demand is deficient, governments should boost public spending in order to counter unemployment. His economic system states that governments are in need of an active employment policy. Besides, he advocated the use of fiscal and monetary measures to ease the adverse effects of economic recessions and depressions. These macro theoretical ideas are the basis for the concept Keynesianism.

Moreover, Keynes' doctrine emphasizes the importance of aggregate demand for full employment and orders government control of demand through public spending as the most efficient mean for cyclical policies.¹⁶ Keynes did not agree with neoclassical economics. Instead he meant that the general level of economic activity was concluded by aggregate demand at the same time as long-drawn-out periods of high unemployment could be a result of insufficient aggregate demand. Most capitalist governments adopted Keynes' ideas concerning economic policy during the 1950s and 1960s.

Unemployment can sometimes have “*a crucial disciplining effect*” in economic systems due to their “*natural tensions over the distribution of wages and profits between workers and capitalists*”.¹⁷ “*According to Keynes, business expectations could be affected by “animal spirits” reflecting changes in technology or in geopolitical and social conditions, as well as monetary policy*”. The amount of capital in the economy can be increased by high rates of investment during periods of optimism. In addition, production can be raised at an accelerating pace. On the other hand, job losses, declining incomes as well as further falls in consumptions are caused by a sharp decline in investment. Further on “*this depresses business expectations even more*” and in the long run there might be no escape. One way out of the problem may be to use “*government spending and borrowing, plus direct action to push credit into the economy*”.

Furthermore, it is commonly argued, by post-Keynesians, “*that advanced capitalism generally shifts income distribution in favor of profits and away from wages, partly because of technological progress and monopoly, and partly for political reasons such as restrictions on organized labor.*” At occasions, like the one just mentioned, government has “*to support demand with deficit financing and for the banking system to expand credit to poorer and less credit-worthy borrowers*”. As long as sufficient demand is created, rationally full employment can be operated by the economy but as soon as “*income distribution continues to move against labour*” a financial crisis becomes true.¹⁸

¹⁶ Various Authors, *Stora Fokus: inn-kol*, page 257.

¹⁷ Kaletsky, A, *Capitalism 4.0: The Birth of a New Economy*, page 52.

¹⁸ *Ibid.*, page 119f.

Due to that Keynes' thoughts about "*the crucial role of government in economic management*" turned out to be forgotten during the third phase of capitalism "*many successful businessmen and politicians genuinely believed that financial markets were automatically self-stabilizing and that government intervention in the economy would always do more harm than good*".¹⁹

2.1.3 Capitalism 3

The third stage consists of the following underlying phases:

Capitalism 3.0: from 1979-83, early monetarism and confrontations with unions

Capitalism 3.1: from 1984-92, Volcker and Greenspan, Thatcher-Reagan booms

Capitalism 3.2: from 1992-2000, the Great Moderation

*Capitalism 3.3: from 2001-08, market fundamentalism under Greenspan and Georg W. Bush*²⁰

This third phase of capitalism "*romanticized markets and distrusted government*". It was "*assumed that markets were always right and governments nearly always wrong*" and almost always inefficient. In addition, regulation was said to be ridiculous and public administration was treated with open disrespect.²¹ During the third stage, influence was given from among others, Thatcher, Reagan, Friedman, Bush, Paulson and Greenspan. Friedman's philosophy will be dealt with in paragraph 2.1.3.1. Politics was treated "*as a branch of economics*" instead of as treating economics "*as a branch of politics*". "*Markets should be empowered wherever possible to discipline and control venal politicians.*" The 2007 - 09 crisis was the end of the era of market fundamentalism.²²

Moreover, the only way to balance a capitalist economy, in other words, to produce "*efficient and rational outcomes*" such as no unemployment and economic stability, was to keep "*free, competitive markets, provided they were not distorted by state intervention*".²³ By 1989, in those countries that had adopted the new free-market model most willingly, inflationary pressures caved in. "*Structural obstacles to competition that had been largely responsible for the stagflation of the preceding decade*" had then weakened. By 1994, the persistent currency crisis in among other countries Spain had been eliminated by the development toward the monetary union, where Spain over time gained influence over the euro project.²⁴ Before the 2007 - 09 crisis, it was assumed that "*competitive markets move automatically toward equilibrium, that financial cycles have little or no effect on long-term economic performance, and that a properly functioning private-enterprise economy will always remain near full*

¹⁹ Kaletsy, A, *Capitalism 4.0: The Birth of a New Economy*, page 133.

²⁰ Ibid., page 53.

²¹ Ibid., page 4f.

²² Ibid., page 40f.

²³ Ibid., page 51f.

²⁴ Ibid., page 82f.

employment, leaving only one important role for government macroeconomic policy, which is to keep inflation under control".²⁵

2.1.3.1 Milton Friedman

Friedman emphasized the monetarism's relevance for the economy. He stated that to "*restrict growth in the money supply*" it was necessary "*to bring inflation under control*". Monetary policy had to be returned to centre stage. Friedman denied Keynes' government theories and advocated that governments could decrease unemployment under the "natural" rate of unemployment only by risking the inflation to accelerate. He underlined that "*inflation is always and everywhere a monetary phenomenon*" and that "*substantial changes in prices is almost always the result of changes in the nominal supply of money*". Friedman also stated that in the short-run, economic activity and employment will be reduced by tightening the supply of money but in the long-run, due to "*stable and predictable environment which sound money provides*", economic activity will recover.²⁶ Besides, the wisest policy was to expand the money supply slowly and constantly. He advocated a free market economic system with as little government intervention as possible, freely floating exchange rates, a negative income tax as well as volunteer military.²⁷

Milton Friedman blamed the decision to liquidate the U.S. banking system as "*the main reason of the Great Depression*".²⁸

2.1.3.2 Ben Bernanke and Irving Fisher

Ben Bernanke is an American economist and currently chairman of the Federal Reserve. He claims that preserving price stability is of huge importance, both deflation and inflation should be avoided and that "*the sources of deflation are not a mystery. Deflation is in almost all cases a side effect of a collapse of aggregate demand – a drop in spending so severe that producers must cut prices on an ongoing basis in order to find buyers. Likewise, the economic effects of a deflationary episode, for the most part, are similar to those of any other sharp decline in aggregate spending—namely, recession, rising unemployment, and financial stress.*" When a country has its currency regulated under a system that is tied to a central bank, the interest rate can be influenced by the monetary authority. Moreover, Bernanke stressed that any deflation that might occur can be ensured by the central bank to be both mild and brief if the central bank has the sufficient policy instruments needed.²⁹

According to Bernanke, the following should be done by the central bank to prevent deflation;

1. "*Increase the money supply.*"

²⁵ Kaletsky, A, *Capitalism 4.0: The Birth of a New Economy*, page 8f.

²⁶ Hague, R and Harrop, M, *Comparative Government and Politics – An Introduction*, page 144f.

²⁷ Reason Magazine, *Best of Both Worlds*.

²⁸ Kaletsky, A, *Capitalism 4.0: The Birth of a New Economy*, page 131.

²⁹ The Federal Reserve Board, *Deflation: Making Sure "It" Doesn't Happen Here*.

2. *“Ensure liquidity makes its way into the financial system through a variety of measures.”*
3. *“Lower interest rates – all the way down to 0 per cent.”*
4. *“Control the yield on corporate bonds and other privately issued securities.”*
5. *“Depreciate the U.S. dollar.”*
6. *“Execute a de facto depreciation by buying foreign currencies on a massive scale.”*
7. *“Buy industries throughout the U.S. economy with “newly created money”. ”³⁰*

Bernanke’s theory is called the Bernanke doctrine, and is defined to be the *“the overpowering use of monetary policies and lending”* to handle economic crises.³¹ In summary, the Bernanke doctrine states that *“We at the Federal Reserve will do all that we can to prevent fraud and abusive lending and to ensure that lenders employ sound underwriting practices and make effective disclosures to consumers. At the same time, we must be careful not to inadvertently suppress responsible lending or eliminate refinancing opportunities for subprime borrowers. Together with other regulators and the Congress, our success in balancing these objectives will have significant implications for the financial well-being, access to credit, and opportunities for homeownership of many of our fellow citizens.”³²*

Furthermore, Bernanke’s doctrine has been influenced by Irving Fisher’s³³ debt-deflation theory, a theory of economic crisis. Fisher’s theory states that *“the bursting of the credit bubble unleashes a series of effects that have serious negative impact on the real economy”*. Also, Fisher pointed that *“over investment and over speculation are often important; but they would have far less serious results were they not conducted with borrowed money. The very effort of individuals to lessen their burden of debts increases it, because of the mass effect of the stampede to liquidate... the more debtors pay, the more they owe. The more the economic boat tips, the more it tends to tip”³⁴*. By examining debt, price trends and balance of payments deficit you can study if price falls have caused a greater real debt for households and companies as well as for banks. If this is the case, the economy is said to have become short-circuited.

According to *Financial Post*, *“European leaders may have no choice but to invoke the Bernanke doctrine of overwhelming force now that Europe’s sovereign debt crisis threatens to send the global economy back into recession.”³⁵*

³⁰ The Federal Reserve Board, *Deflation: Making Sure “It” Doesn’t Happen Here*.

³¹ The New York Times, *With bold steps, Bernanke revamps Fed rule book*.

³² Minyanville, See *Only One Thing You Need to Know: The Bernanke Put*.

³³ Irving Fisher was one of the earliest American neoclassical economists.

³⁴ The Economist, *Irving Fisher – Out of Keynes’s Shadow*.

³⁵ Financial Post, *Is Bernanke Doctrine headed to Europe?*.

2.1.3.3 Frederic S. Mishkin

Frederic S. Mishkin, was a member of the Board of Governors of the Federal Reserve System, between 2006 and 2008. He considers uneven spread information to be the fundamental cause of financial crisis occurrence.³⁶

According to Mishkin, five lessons exist “*that should change how we think about the science of monetary policy and monetary policy strategy*”³⁷, namely;

1. “*Developments in the financial sector have a far greater impact on economic activity than we earlier realized.*”

“*Although central bankers generally recognized that financial frictions could play an important role in business cycle fluctuations, the 2007-2009 financial crisis made it clear that the adverse effects of financial disruptions on economic activity could be far worse than was anticipated for advanced economies.*” In the beginning of the financial crisis, it seemed to be possible for “*central bank actions to contain it*” and there was a hope among many officials at the central banks “*that the worst was over and that the financial system would begin to recover*”. But by the autumn of 2008, “*a set of shocks which sent the financial system and the economy over the cliff*” enhanced. “*The world-wide recession that resulted from the financial crisis turned out to be the most severe economic contraction since the world-wide depression of the 1930s.*”³⁸

2. “*The macro economy is highly nonlinear.*”

For example, “*economic downturns typically result in even greater uncertainty about asset values*”, which “*may involve an adverse feedback loop whereby financial disruptions cause investment and consumer spending to decline, which, in turn, causes economic activity to contract*”. Such contraction “*increases uncertainty about the value of assets, and, as a result, the financial disruption worsens*”.³⁹

3. “*The zero lower bound is more problematic than we realized.*”

One explanation why “*the zero-lower-bound problem is more serious than previously thought is that we now see that contractionary shocks to the economy can be far greater than was previously anticipated*” due to “*the presence of nonlinearities and large tail risks. Sufficiently large contractionary shocks can make the magnitude of the costs of the zero-lower-bound constraint very large. Large contractionary shocks can thus overwhelm the ability of conventional policy to counteract them, and may require massive interventions in credit markets and central bank expansion of their balance sheets.*”⁴⁰

³⁶ Hansson, H., *Internationell ekonomi*, page 259.

³⁷ Mishkin, F, *Monetary Policy Strategy: Lessons from the Crisis*, page 21f.

³⁸ Ibid., page 22f.

³⁹ Ibid., page 24f.

⁴⁰ Ibid., page 25f.

4. *“The cost of cleaning up after financial crises is very high.”*

The global financial crisis has resulted in four different types of “costs”. *“Besides the obvious cost of a huge loss of aggregate output as a result of the worldwide recession”, a very slow growth and a sharp deterioration between the budgetary position of governments are typical results. In addition, “the exit strategy for central banks from nonconventional monetary policy may be both complicated and hinder the ability of the central bank to successfully manage the economy in the future”.*⁴¹

5. *“Price and output stability do not ensure financial stability.”*

“Before the recent financial crisis, the common view, both in academia and in central banks was that achieving price and output stability would promote financial stability. The benign economic environment leading up to 2007, however, surely did not protect the economy from financial instability.” Recently, it has even been suggested *“that benign economic environments may promote excessive risk taking and may actually make the financial system more fragile.”*⁴²

Furthermore, Mishkin means that *“much of the science of monetary policy remain impact”*. However, some rethinking is necessary regarding the basic framework for monetary policy strategy. *“The linear-quadratic framework for thinking about how to conduct monetary policy when there is a financial disruption”* must be abandoned. Besides, monetary policy has to be used when pursuing financial stability goals at the same time as research on how to monitor credit conditions must be of bigger importance in the future. Also, as a result of the financial crisis, it has become a fact *“that monetary policy and financial stability policy are closely intertwined”*.⁴³

2.1.3.4 Carmen M. Reinhart, Kenneth Rogoff and Graciela L. Kaminsky.

Carmen M. Reinhart is among other things a research associate at the National Bureau of Economic Research. Kenneth Rogoff is currently the Thomas D. Cabot Professor of public policy and professor of economics at Harvard University. Graciela L. Kaminsky is a professor of economics and international affairs at the George Washington University in Washington DC.

This Time is Different: Eight Centuries of Financial Folly “presents a comprehensive look at the varieties of financial crisis.” Among other things, Reinhart and Rogoff mean that *“a boom in real housing prices in the run-up to a crisis is followed by a marked decline in the year of the crisis and subsequent years. Banking crisis tends to occur either at the peak of a boom in real housing prices or right after the bust.”*⁴⁴

⁴¹ Mishkin, F, *Monetary Policy Strategy: Lessons from the Crisis*, page 28f.

⁴² Ibid., page 31f.

⁴³ Ibid., page 21f.

⁴⁴ Reinhart, C, and Rogoff, K, *This Time Is Different: Eight Centuries of Financial Folly*, page 159.

The fact that many other countries, including Spain, experienced economic difficulties at the same time as the United States can be explained by *“that many of the features that characterized the run-up to the subprime crisis in the United States were present in other advanced economies as well”*. To start with, *“many countries in Europe and elsewhere had their own home-grown real estate bubbles”*. Secondly, *“the United States was not alone in running large current account deficits and experiencing a sustained “capital flow bonanza””*. Spain was one of the countries which were *“importing capital from abroad, which helped fuel a credit and asset price boom”*. As a result, these countries got *“vulnerable to the usual nasty consequences of asset market crashes and capital flow reversals irrespective of what may have been happening in the United States”*.⁴⁵

Moreover, in the future, *“it would be helpful to keep track of some basic macroeconomic series on housing prices and debt and calibrate them against historical benchmarks taken from past deep financial crisis”* when we are on a run-up to a subprime financial crisis.⁴⁶

Additionally, *“international institutions can play an important role in reducing risk, first by promoting transparency in reporting data and second by enforcing regulations related to leverage”*.⁴⁷

In the work *The Twin Crisis: The Causes of Banking and Balance-of-Payments Problems*, Kaminsky and Reinhart examine the links between banking and currency crisis. They come to the conclusion that *“problems in the banking sector typically precede a currency crisis—the currency crisis deepens the banking crisis, activating a vicious spiral; financial liberalization often precedes banking crises”*. In addition, they state that *“crises occur as the economy enters a recession, following a prolonged boom in economic activity that was fuelled by credit, capital inflows, and accompanied by an overvalued currency”*.⁴⁸

Moreover, they have found that *“banking and currency crises are closely linked in the aftermath of financial liberalization, with banking crises, in general, beginning before the currency collapse”*. Additionally, *“when currency and banking crises occur jointly, they are far more severe than when they occur in isolation”*.⁴⁹

Their studies have resulted in assessing *“the complex linkages between currency and domestic financial crisis”*. *“Analyzing how the authorities deal with the banking problems and how the*

⁴⁵ Reinhart, C, and Rogoff, K, *This Time Is Different: Eight Centuries of Financial Folly*, page 242f.

⁴⁶ Ibid., page 277.

⁴⁷ Ibid., page 281.

⁴⁸ Kaminsky, G, and Reinhart, C, *The Twin Crisis: The Causes of Banking and Balance-of-Payments Problems*, page 473.

⁴⁹ Ibid., page 491.

*problems affect exchange-rate expectations will help determine whether a banking crisis will lead to a balance-of-payments crisis.*⁵⁰

Most often, *“balance-of-payments crises are resolved through a devaluation of the domestic currency or the floatation of the exchange rate”*.⁵¹

Kaminsky and Reinhart further looked into the way a currency and banking crisis are linked. The probability that a country will fall prey to a currency, increases when a banking crisis occurs. It has been argued that *“in an important number of cases, the bailout of the banking system may have contributed to the acceleration in credit creation observed prior to the currency crises”*. Knowing though that a currency crisis exists *“does not help predict the onset of a banking crisis”* but to have the knowledge that *“there was a currency crisis does help to predict the probability that the banking crisis will worsen”*. *“Bailout costs are significantly larger in the twin crises than for banking crises which were not accompanied by a currency crisis”*.⁵²

Furthermore, *“the twin crises may have common origins in the deregulation of the financial system and the boom-bust cycles and asset bubbles that, all too often, accompany financial liberalization”*. They suggest that *“inadequate regulation and lack of supervision at the time of the liberalization may play a key role in explaining why deregulation and banking crises are so closely entwined”*.⁵³

2.1.3.5 Clas Wihlborg

Clas Wihlborg is professor at the Argyros School of Business and Economics, Chapman University, California. According to Wihlborg⁵⁴, *“the banks holding much of the sovereign debt of the Southern Euro-zone have become both “too big to fail” and “too big to save”*”. This fact explains why the debt problems among EMU countries get so irresolute response from the EU. The Southern European problems are said to be *“mainly self-inflicted but without resolution of the viability of the common currency it threatened”*. Fiscal profligacy is one explanation for the crisis but many more exist.

Moreover, banking risk and sovereign risk go together. Each country is in need of creating current account surpluses. Banks, which have taken “stupid” decisions, bear the debt on their shoulders. There are many uncertainties about the future, no credibility about governments and big differences between liquidity and solvency problems.

⁵⁰ Kaminsky, G, and Reinhart, C, *The Twin Crisis: The Causes of Banking and Balance-of-Payments Problems*, page 496.

⁵¹ Ibid., page 475.

⁵² Ibid., page 478f.

⁵³ Ibid., page 480.

⁵⁴ Lecture in *Crises in the Euro-zone and in Banks – “too Big to Fail” and “too Big to Save”*.

Besides, “during the tech bubble: shareholder took losses without serious repercussions, during the subprime crisis, leveraged⁵⁵ financial institutions could not absorb losses without massive failures and during the sovereign debt crisis, leveraged banks in Europe must absorb losses competitive diverging”.

In addition, one important problem is that there are no incentives to say that banks are in good shape because then they will not get any aid. Therefore, we end up in a situation where banks are neither in good nor bad shape, nor healthy nor broke, we get a credit crush and the situation get worse.

The euro system reduces transactions costs and exchange risks, but neglects macroeconomic costs. The optimal currency area should have led to labour mobility and flexibility of wages but that has not been the case. Europe has not had any labour mobility, at the same time, as wages have been relatively rigid. Initially, there was a hope for an endogenous optimal currency area, which would lead to labour mobility and flexible wages automatically.

According to Wihlborg, we have to close insolvent banks, big ones as well, due to that it would lead us out of the current credit crunch situation, but no efficient regimes to allocate losses beyond bank shareholders exist. Further on, the euro debt crisis is not just fiscal, the policy responses to resolve the sovereign debt crisis have focused on fiscal measures and bailout loans have been made conditional on fiscal austerity with increasing strictness.

⁵⁵ The definition of leverage is, for example, “to use borrowed money to buy a company”.

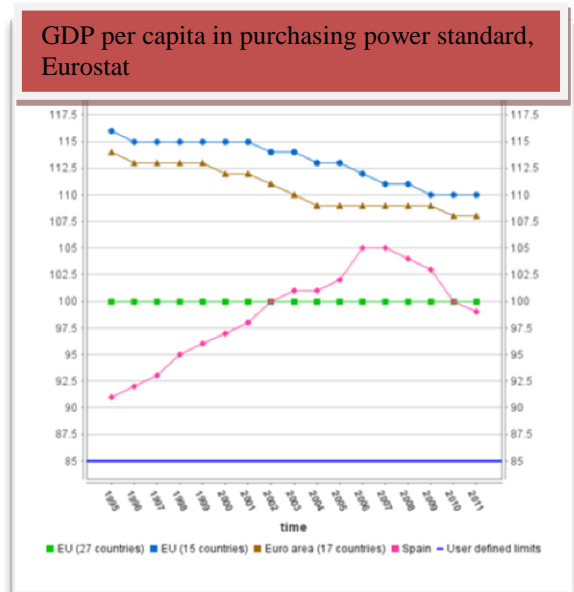
3 The Spanish Economy and a Statistical Analysis

3.1 Information and Statistics on Spain

3.1.1 Overview

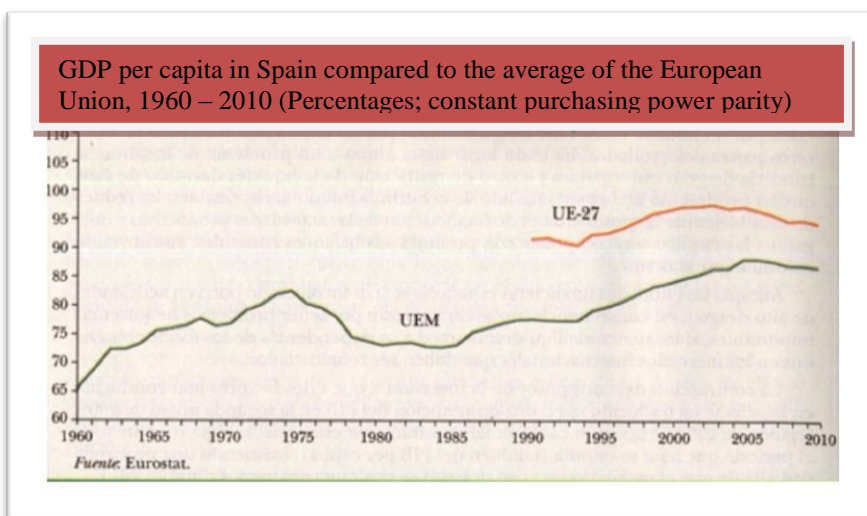
Spain has, compared to other Western European countries, undergone more social changes than any other country in the last 40 years. In the 1950s, Spain experienced poverty and was mainly a rural country. Consequently, Spain was internationally isolated due to the Franco regime and nearly “starved”. The possibility to import from the West was strictly limited. Thanks to that the US helped Spain by giving aid in return for accepting military bases, Spain could rise again and start investing.⁵⁶

In the 1930s, Spain was a republic, which was ruined during the Spanish Civil War. Before that, during the 1920s, Spain had been a dictatorship caused by the political instability of the late 19th and early 20th centuries. The dictatorship was relatively benign and was supported by parts of the working class. During the Franco-era, Spain suffered during a devastating draught, the black market flourished and Franco taught people his extreme form of isolationism and self-sufficiency.⁵⁷



A remarkable economic growth took place in the 1960s, mostly due to a growing tourist industry. General Franco ruled by authoritarianism until his death in 1975 and since then Spain has been a democratic state. Furthermore, during the 1980s, Spain started modernizing and both service industries and manufacturing expanded, which led to that Spain could enjoy an economic boom. Even though this was the case, the European Union GDP average has

remained higher than Spain's GDP and growth in Spain has been very unequally spread around the country. The GDP per capita in PPS diagram shows Spain's, the euro area (17)'s and the EU (15)'s GDP growth compared to EU (27) as an index. Agriculture is of big



⁵⁶ Various Authors, *Eyewitness Travel Guides: Spain*, page 18f and 62f.

⁵⁷ *Ibid.*, page 43.

importance, but its efficiency differs among the regions. Up until the mid-1990s, Spain's international standing has been increased by the Socialists and Spain's memberships of NATO and the European Union have strengthened Spain's international relations.⁵⁸

A common culture has several times tried to be imposed by a succession of rules, but Spain's cultural diverseness has always remained. A strong sense of their own independent identities has been maintained by several regions and a considerable power has been devolved to the different regions. Basques and Catalans are examples of inhabitants who do not consider themselves to be Spanish.⁵⁹

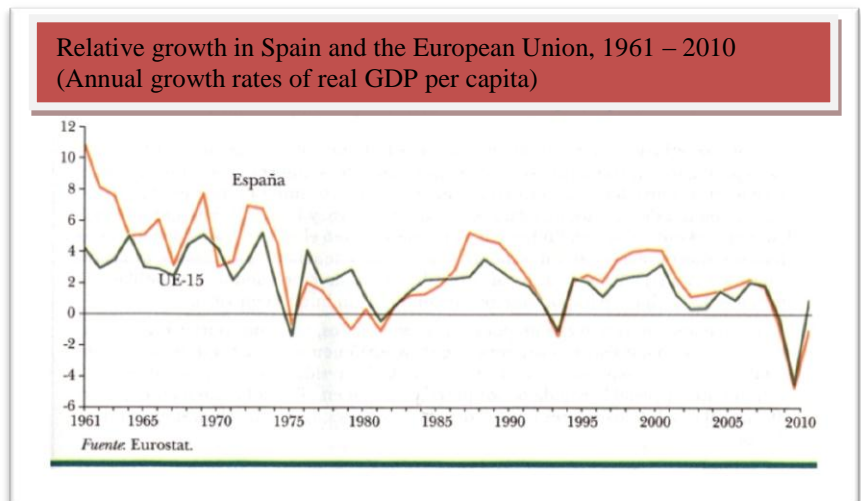
Even though improvements have been made in providing public services, Spain's government has traditionally been very inefficient. Subsequently, to seek assistance in a crisis, the Spanish people have always relied on their families and relatives.⁶⁰

3.1.2 Economic Growth and Structural Changes

During the second half of the 20th century, especially until the mid-1970s, Europe and Spain have experienced a fast economic growth in GDP per capita. Consequently, the labour market has experienced many changes.⁶¹

In comparison with other EU-15 countries, Spain has shown a greater economic growth, 3.1 per cent annually compared to 2.4 per cent annually, which may be due to the delay in Spain's economic development. It is possible to differentiate four phases for the economic growth in Spain, namely;

1. From 1960 until the first half of the 1970s: fast economic growth given the structural changes in industry, agriculture, foreign investments, and so on after the 1950s.
2. Second half of 1970s until 1984: economic crisis and divergence with Europe given the changes in the social and institutional situation in Spain.
3. 1985 to mid-1990s: ten years with a complete economic or business cycle after the introduction of Spain in the European Union.
4. From mid-1990s to 2007: macroeconomic stability.⁶²



⁵⁸ Various Authors, *Eyewitness Travel Guides: Spain*, page 18f.

⁵⁹ *Ibid.*, page 15f.

⁶⁰ *Ibid.*, page 16.

⁶¹ Lectures in *Spanish Economy*.

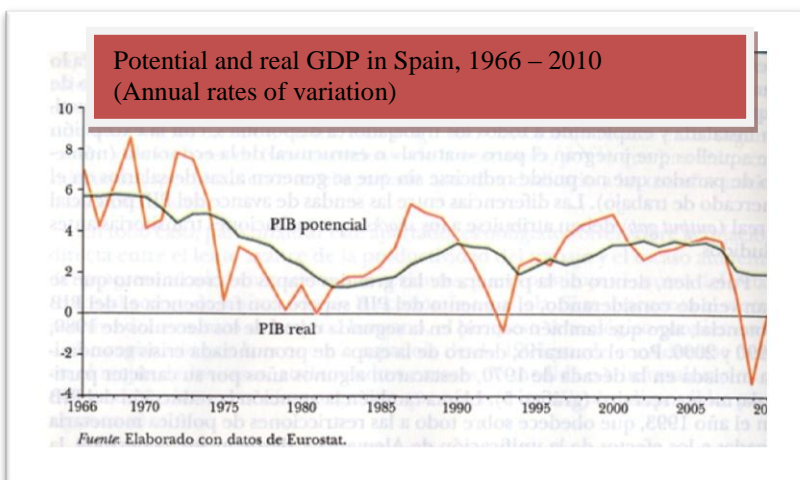
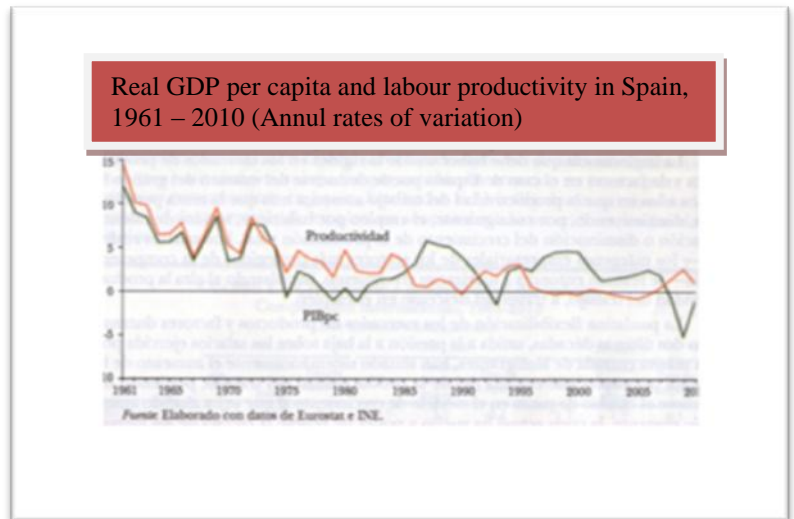
⁶² *Ibid.*

An increase in the GDP per capita might be caused by an increase in the proportion of the population actually working or might be due to an increase in the ratio of productivity or average production per worker. Thus, when examining economic growth in the long run, labour productivity and employment rates are of importance. In 1991, the labour force in Spain accounted to 15 813 897 people and in 2010 to 23 232 546 people.⁶³ Between 1961 and 1985, the annual cumulative real GDP per employee was 4.9 and the annual cumulative proportion of the total population employed was -1.3. Between 1986 and 2010 the same numbers were 1.0 and 1.3.⁶⁴

Labour productivity is based on capital, labour and technological progress. In the 1960s, Spain experienced an increase in the production level as well as a parallel increase in the productivity compensating the increase in wages. The Spanish government, in order to limit the inflation and the enormous differences between exports and imports during the second half of the 1970s and the first half of the 1980s, reduced economic activity. Also, a

reduction in production and employment together with an increase in prices occurred due to the increase in wages and social security expenses for companies dealing with petroleum, since Spain was dependent on petroleum, and socio-political changes. Since 1970, growth in productivity has decreased and technological progress has slowed down. Later, since 1986, economic growth in Spain and Europe has been based more on labour creation than on productivity than before but economic growth in Spain has mainly been determined on the labour productivity. In addition, Spain has historically had one of the lowest employment rates in Europe due to among other

things low flexibility in both the capital and labour markets as well as in the productivity market. When labour productivity increases more than the GDP per capita, the employment rate decreases, which means that a country is normally in a recession.⁶⁵



⁶³ Index Mundi, *Labor Force, Total*.

⁶⁴ García Delgado, J., L., and Myro, R, *Lecciones de Economía Española*, page 46.

⁶⁵ Lectures in *Spanish Economy*.

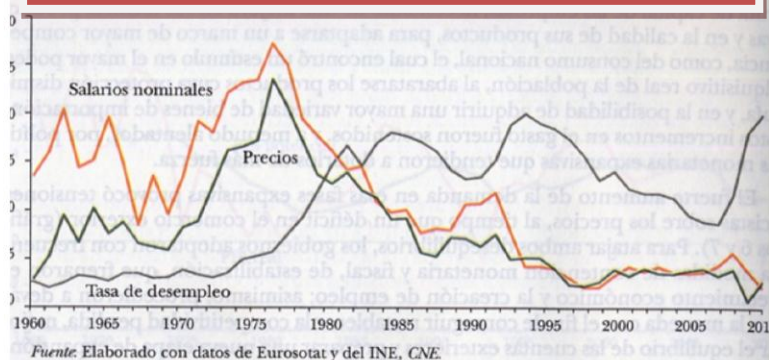
It is important to analyse the comparison between real and potential GDP. The real GDP has over time fluctuated more than the potential GDP and in 2008 the real GDP experienced negative growth. First in the third quarter of 2011, the GDP growth was positive again, 0.8 per cent but it is expected to fall this year by 1.5 per cent.⁶⁶ Import and export have become of greater importance to the GDP.

Spain was part of an expansion phase during the last part of the 1980s and the beginning of

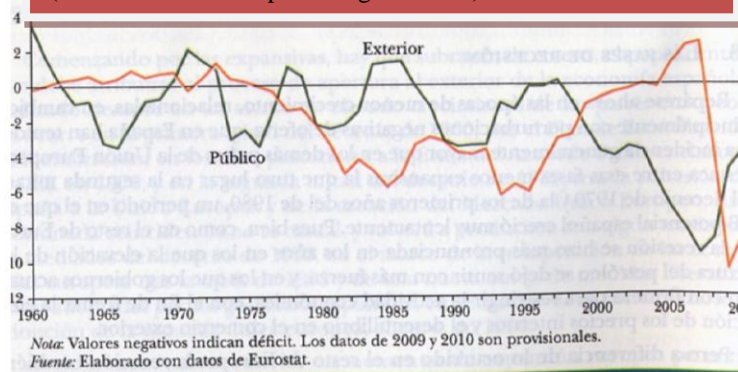
the 1990s. Firstly, the unemployment rate reduced rapidly, which led to an increase in real wages while the labour market remained rigid. Moreover, the external deficit stalked due to that international, internal and national demand increased as well as the national prices. Additionally, positive shocks on the supply side

stimulated the production levels. Unfortunately, the increase in demand led to a higher inflation rate, which caused a growing deficit. These results were a result of Spain's entry into the European Union. For example, the unemployment rate fell from 23 per cent in 1986 to 8 per cent in mid-2007. After having entered the European Monetary Union, Spain's interest rates decreased and housing prices and investments increased. Spain's flourishing period stopped when the international financial crisis started, as for most other European countries, and led to a recession starting from 2008. Among other things, there was a dramatic decline in housing sales and construction activities and by the end of 2011, the unemployment rate fell to the same level as in 1986.⁶⁷

Evolution of the unemployment rate and the rates of variation in prices and wages in Spain, 1960 - 2010



External and public deficit in Spain, 1960 - 2010 (Current values as a percentage of GDP)



⁶⁶ BBC, *Spanish unemployment hits record 5.64 million.*

⁶⁷ Lectures in *Spanish Economy.*

3.1.3 Productive Activities

Largely, the productive sector consists of the primary sector (agriculture, forestry and fishing), which stands for 4 per cent of the Spanish GDP, the secondary sector (industry, energy, construction and mining), which stands for 32 per cent of the Spanish GDP, and the tertiary sector (services), which stands for 64 per cent of the Spanish GDP.⁶⁸

Structural production changes have led towards a lower weight of the agriculture sector and consequently towards a greater weight of the industry and services sectors. Spain has experienced an increase in the qualification of the labour force as well as openness in the economy.⁶⁹

3.1.3.1 The Agricultural Sector

Regarding *the primary sector*, the physical conditions for the natural environment in Spain have become very adverse to the agriculture's development. Natural disasters can lead to substantial economic losses. For example, in 1999, Spain suffered from 3 billion euros in losses due to a severe drought. The European Environment Agency as well as El País means that Spain will be the country most affected by the coming climate change among the EU countries. Among other things, rainfalls are few and very unevenly distributed at the same time as the heat is limiting the water resources, which likely will cause droughts, floods and storms.⁷⁰ Last winter was the driest winter Spain has ever faced and the lack of rain and snow falls lasted throughout February. This fact puts Spain in a very severe situation.⁷¹ Consequently, due to the high average height of Spain only 10 per cent of the territory in Spain is today suitable for productive agriculture.⁷²

The increasing loss of significance in the Spanish economy, in terms of both output and employment and foreign trade of agriculture, is the most important characteristic for the evolution of agriculture.⁷³

The great polarization in Spain between small and large farms has influenced the social, historical and economic complexity of Spain's agriculture. Employment in agriculture has declined but due to the increase of investment in capital, agriculture has become a sector with high capital per employee.⁷⁴

⁶⁸ Lectures in *Spanish Economy*.

⁶⁹ Ibid.

⁷⁰ Iberia Nature, *Climate Change in Spain*.

⁷¹ Guerrero, M, *Still No Rain in Spain*.

⁷² Lectures in *Spanish Economy*.

⁷³ Ibid.

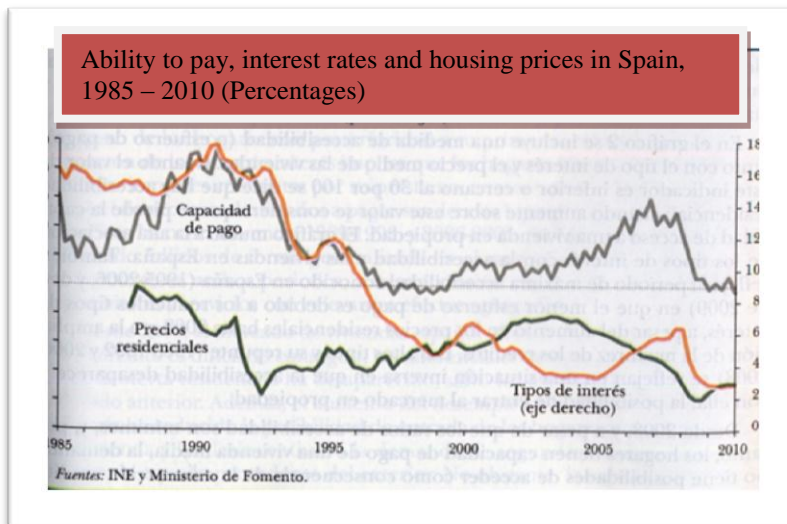
⁷⁴ Ibid.

3.1.3.2 The Industrial Sector

Some important features of the Spanish industry, *the secondary sector*, are the following. Advanced production in Spain progressed between 1986 and 1995. Thereafter followed a decrease and now the advanced production has stagnated at a rate that is half the EU-25. Spain's industries are mostly financed by foreign capital. Besides, more traditional industries have lost in weight even though they still are of importance for Spain.⁷⁵

In relation to non-EU European countries and major manufacturing industries, Spain has some comparative weaknesses. Spain experiences low productivity, due to a smaller proportion of capital/labour ratio and a lower total factor productivity. Besides, Spain spends less on R&D and innovation, 1.2 per cent of GDP, compared to the European Union's average, 1.9 per cent of GDP. Other weaknesses are low skills of the workforce, undeveloped international marketing as well as lack of competitiveness in foreign trade.⁷⁶

3.1.3.3 The Construction Sector and the Housing Market



The financial crisis is limited to parts of the financial system and its main problems concern housing and construction companies.⁷⁷

Since the 1960s, the home-ownership ratio in Spain has been high and in 2011, the ratio reached 82.30 per cent.⁷⁸

Spain was one of the European countries which got most

badly affected by the present crisis and the construction sector, which previously was behind the economic boom in Spain, has stopped abruptly. Many major building projects have been stopped half-finished and housing prices have been and are falling.⁷⁹

Between 1985 and 1991, the real estate prices in Spain increased extremely, almost tripled. Thereafter, between 1992 and 1996 there were almost no fluctuation and the prices remained stable. Up till the crisis started, the real estate prices increased massively again but since 2008

⁷⁵ Lectures in *Spanish Economy*.

⁷⁶ Ibid.

⁷⁷ SvD, *Bankproblem hotar fälla Spanien*.

⁷⁸ IMF Country Report No. 11/216, *Spain: Selected Issues*, page 13.

⁷⁹ GP, *Ökad press på regeringen*.

they have, as already mentioned, been falling drastically. The percentage increase of real housing prices between 2002 and 2006 was higher than 50 per cent.⁸⁰

*“Spain’s long period of economic expansion relied on a double boom that produced two large and interlinked private sector imbalances.”*⁸¹ Moreover, *“the weight of construction and real estate in GDP, employment, and new lending has largely adjusted from previous excessive levels, but will likely remain weak as overhangs (including of housing prices and unsold units) persist. Private sector debt levels have stabilized at high levels – how much they have to fall is unclear, but it could be significant and long lasting.”*

Currently, as mentioned, Spain is facing many imbalances in form of fiscal deficits/debt, external deficit/debt, high household and corporate debt/borrowing, the oversize construction sector and low private savings. Among these imbalances, excessive weight of residential real estate in GDP, rapid expansion of credit and leverage in the private sector and current account deficit are the most exposed ones.⁸²

Compared to other countries in the euro area, Spain is facing relatively high household debt and, particularly, corporate debt since the boom. Ireland is the only country in the EU, which has a level of corporate debt that exceeds the Spanish one. *“Spain’s household debt to income ratio has also significantly diverged from the average of the euro area since 2001.”*⁸³

*“The construction and real estate sectors are large, highly leveraged and rely more on bank financing than in other countries.”*⁸⁴ The increased lending to construction and the real estate activities as well as to the strong co-movement of housing prices and credit shows that *“housing and leverage have been moving in tandem”*.⁸⁵

Between 2004 and 2008, *“construction explained 8 percent of private sector credit growth, real estate activities 22 percent, and the acquisition of real estate (mortgages) 33 percent”*. This boom in housing is the main element responsible for the increase in the corporate sector indebtedness.⁸⁶ In 2006, more than 20 per cent of the Spanish labour force was working in the construction sector.⁸⁷

⁸⁰ Lectures in *Spanish Economy* and Reinhart, C, and Rogoff, K, *This Time Is Different: Eight Centuries of Financial Folly*, page 245.

⁸¹ IMF Country Report No. 11/216, *Spain: Selected Issues*, page 22.

⁸² *Ibid.*, page 5.

⁸³ *Ibid.*

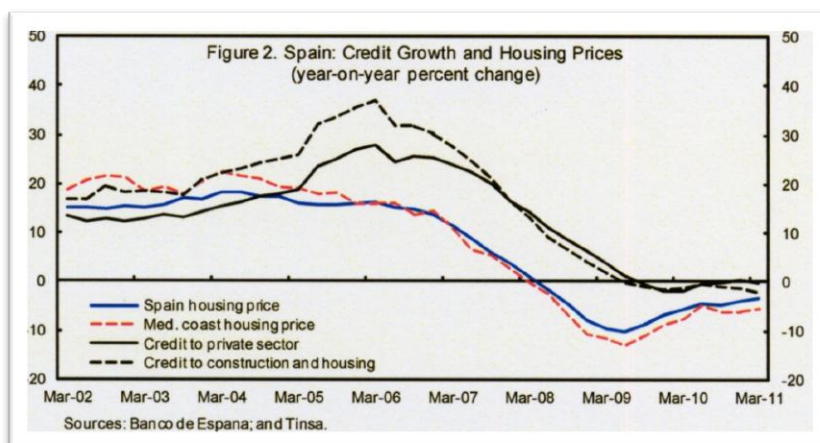
⁸⁴ *Ibid.*, page 9.

⁸⁵ *Ibid.*, page 6.

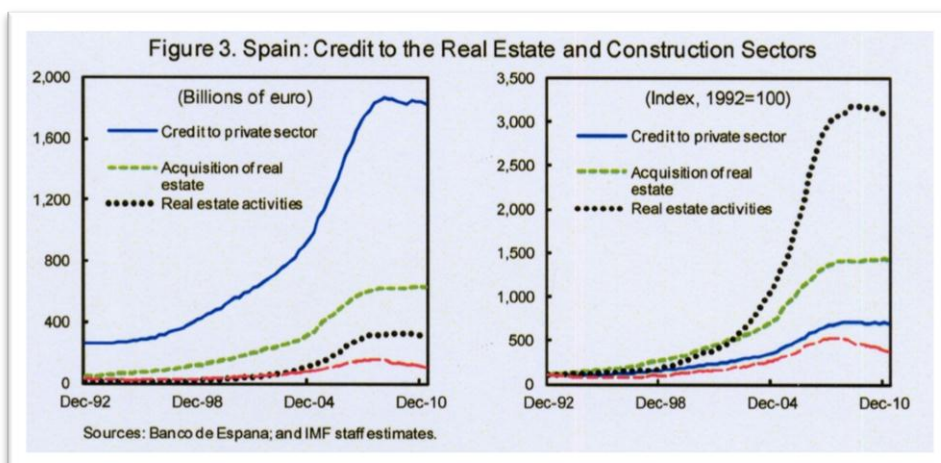
⁸⁶ *Ibid.*, page 7.

⁸⁷ Eurostat, *Construction (NACE Section F) Structural profile- ranking of top five Member States, 2006*.

“Spain differs from other countries with significant house price appreciation in that it has seen not only a house price boom but a construction boom as well.” Due to this, Spain has suffered from a payoff in terms of productivity and a decrease in total factor productivity. Besides, *“a legacy of stocks”*, housing units, unemployment and debt, have been left and the trade balance has been affected negatively.⁸⁸



Consequently, the housing boom has made the Spanish household suffer from concentrated debt burdens. Eighty per cent of the Spanish households’ debt is largely concentrated in mortgages. *“Still, those households who have debt tend to be more leveraged.”* With *“a high proportion of the young living with their parents and a high youth unemployment rate”*, the incidence *“of mortgages and the median debt to income ratio among the young”* compared to other countries is surprisingly high in Spain.⁸⁹



Until the second half of 2008, the euro area average of households’ gross saving rate had been above the Spanish one for a long time. When the crisis started, the Spanish household’s gross saving rate increased to above the euro area average but in early 2010, *“the ratio fell sharply back to below the euro area average”* again. This change has been the sharpest among the euro area countries.⁹⁰

From a historical perspective, credit per capita is today below the trend.⁹¹ *“Credit to the construction sector is falling significantly, but not credit to the real estate sector.”* It is

⁸⁸ IMF Country Report No. 11/216, *Spain: Selected Issues*, page 8.

⁸⁹ *Ibid.*, page 12.

⁹⁰ *Ibid.*, page 15.

⁹¹ *Ibid.*, page 19.

estimated that credit to the private sector will continue falling. To stop this evolution it is of importance:

- to ensure “*that the ongoing financial sector reform promptly delivers the needed “cleansing”, especially in fully recognizing losses in the real estate sector”*”,
- to avoid “*a situation of “zombie lending” (to real estate activities) and delayed adjustment”*”,
- to reallocate “*credit towards the more productive and innovative sectors of the economy, which “might require more decisive action to resolve unviable real estate developers and shrink the size of sector”*”, and
- to continue “*the reform of the housing market with the primary purpose of allowing the market to clear, either through enhanced price discovery or through greater development of the rental market”*”.^{92,93}

Average interest rates on home loans have decreased sharply from around 6.25 per cent in July 2008 to around 2.5 per cent in December 2010. On the other hand, the average interest rates on consumer loans have only decreased from around 11 – 12 per cent in July 2008 to around 10 per cent in December 2010.⁹⁴

3.1.3.4 The Service Sector

In *the tertiary sector*, services stand for 60 per cent of all employment in Spain and since 1985, it has continued increasing. Exporting tourism services is among Spain’s specializations and other service sectors of importance are, for example, real estate and business services, wholesale and retail trade and health care as well as transport and communication.⁹⁵

Spain is specifying on traditional, lower productivity and lower technological levels also within services, a sector, which often is subjected to high inflation. While wages rise, the productivity grows less than the industry. To keep the service profit margin, it is necessary for the employers to increase prices and give the service sector strong inflationary pressures over the rest of the economy. Spain is in need of specializing in higher value-added services.⁹⁶

3.1.4 The Labour Market and Financial Resources

3.1.4.1 The Labour Market

In 1964-1974, the outward migration that occurred led to a low unemployment rate for Spain. Thereafter, during 1975-1984, started a period of massive unemployment due to massive destruction of jobs. The decrease in employment during the end of the 1970s and the beginning

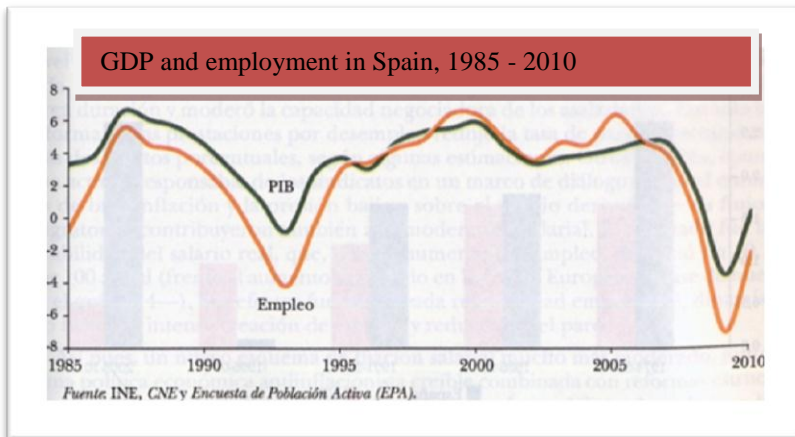
⁹² IMF Country Report No. 11/216, *Spain: Selected Issues*, page 22.

⁹³ For more information about housing see the IMF Country Report No. 11/216, *Spain: Selected Issues*, chapter 1.

⁹⁴ Directorate-General for Internal Policies, *Financial Economic and Social Crisis: Household Indebtedness in the EU*, page 11f.

⁹⁵ Lectures in *Spanish Economy*.

⁹⁶ *Ibid.*

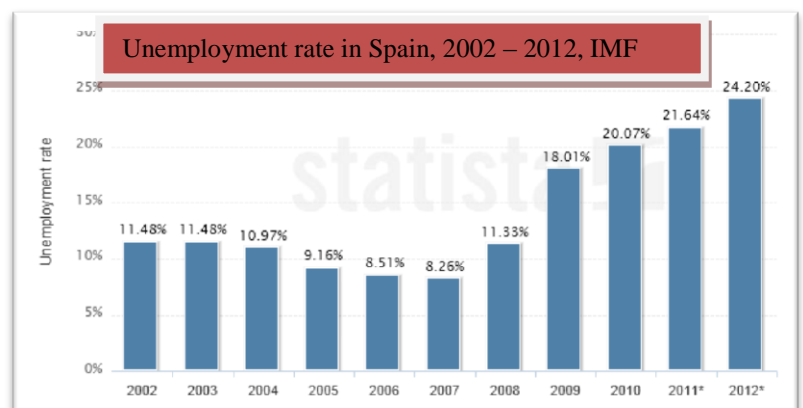


of the 1980s can partly be explained by the destruction of 2 million jobs, the oil crisis, political transition instability and a structural weakness of the economy. Why just Spain suffered so much can be due to that Spain was one of the countries with lowest activity rates in the OECD, the legalization of temporary contracts in

Spain in 1984 and a mismatch between educational level and job characteristics. The following decade, when there was creation of jobs but also destruction as well as an increase in active population, the unemployment rate remained high. The increase in active population was due to an increase in the rate of female participation in the 1980s. Furthermore, the unemployment rate started decreasing after the crisis in 1995, due to the creation of many new jobs. Before the international crisis and the euro debt Spain faced its highest level of unemployment in 1994.⁹⁷ In 2008, Spain reached its highest level of employment rate of women, 55.7 per cent of the female population between 15 and 64 years old. The OECD-Total was 57.6 per cent. Last year, the same number was 52.8 per cent for Spain and 56.7 per cent for the OECD-Total.⁹⁸

There have always been significant and persistent regional differences in Spain. The unemployment rate has always been higher in the south than in the north. One explanation may be that the regional economic activity influences the weak migration and regional labour markets.⁹⁹

In 2007, there was a high number of temporary jobs, 32 per cent, which caused problems even though the number of unemployed was not too high. Since the on-going crisis started, Spain's unemployment rate has increased sharply by 16.3 percentage points, to 24.2 per cent (estimate), which is the highest ever and shows that Spain has fallen back into recession.¹⁰⁰



⁹⁷ Lectures in *Spanish Economy*.

⁹⁸ OECD iLibrary, *Employment Rate of Women*.

⁹⁹ Ibid.

¹⁰⁰ BBC, *Spanish unemployment hits record 5.64 million*.

After the labour market has been reformed, it will be both easier and cheaper for companies to fire employees.¹⁰¹ Besides, the “natural”¹⁰² rate of unemployment in Spain is much higher than in other European countries due to Spain’s rigidities of its labour market and since the economic crisis started Spain has doubled its natural unemployment rate.¹⁰³

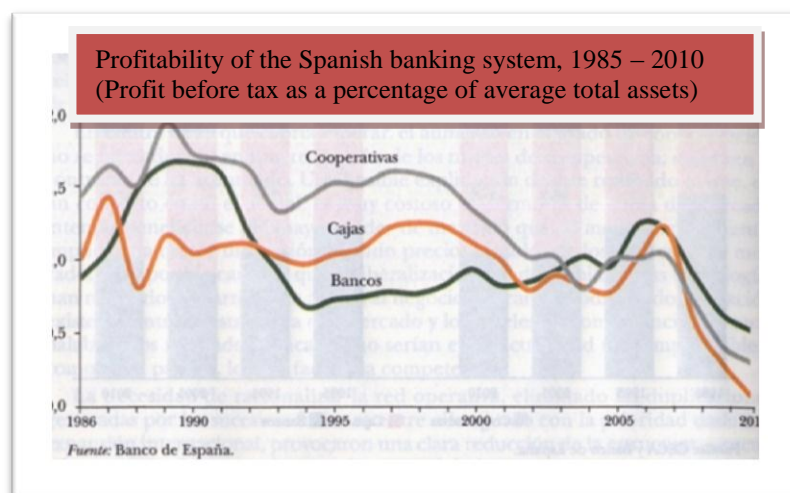
Currently, the average employee in the private sector is working 38.5 hours per week at the same time as public employees only work until the early afternoon. In the future, public employees in Spain may have to work as many hours as those working for the private sector. “By closing the gap between the working hours of the private and public sector” the government hopes that the employees’ salaries as well as public efficiency will increase.¹⁰⁴ The average annual working time in Spain was 1690 hours per worker in 2011. In the OECD-Total the same number was 1776 hours per worker.¹⁰⁵

3.1.4.2 The Financial System

Since the mid-1980s, the number of banks in Spain has increased, while the number of Cajas, saving banks, and Cooperatives has decreased. Between 1986 and 2003, the cooperatives had the highest profitability. Additionally, the Cajas did not fluctuate much in profitability. The Cajas got most badly affected from the crisis and their profitability has declined heavily since 2007.¹⁰⁶

The Spanish banking system is currently facing many difficulties. Bankia is Spain’s third largest bank and resulted from a merger of a number of debt-ridden saving banks.¹⁰⁷ Probably,

Bankia will need 19 billion euros in capital to solve its current situation.¹⁰⁸ “The restructuring of the Spanish financial sector is focused on the savings banks, because some of these institutions were subject to a series of weaknesses accumulated during the prolonged period of growth of the Spanish economy.”¹⁰⁹ Both during the crisis in 1993 and today’s crisis, Spain



¹⁰¹ GP, *Spanien drar åt svångremmen*.

¹⁰² Unemployment that occurs even in a healthy economy due to frictional, structural and surplus reasons.

¹⁰³ The Wall Street Journal, *Spain Largely Avoids Unrest Even as Economy Slumps*.

¹⁰⁴ Economy Watch – Follow the Money, *Spain to Increase Working Hours of Public Employees*.

¹⁰⁵ OECD iLibrary, *Average Annual Working Time*.

¹⁰⁶ Lectures in *Spanish Economy*.

¹⁰⁷ SvD, *Katalonien väddar om akut miljardstöd*.

¹⁰⁸ SvD, *Bankproblem hotar fälla Spanien*.

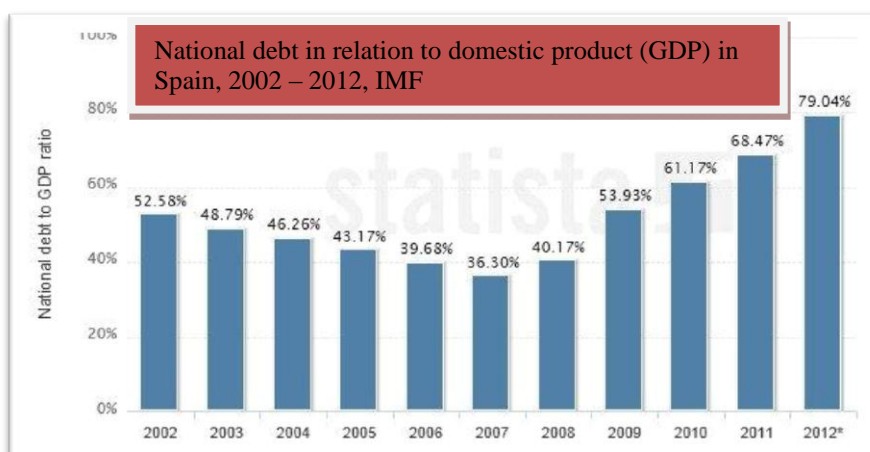
¹⁰⁹ Banco De España, *The Spanish Banking Sector: Outlook and Perspectives*.

has had lower doubtful loans ratios of credit for house purchase, but today's crisis' numbers are worse.¹¹⁰

“With the unprecedented deepening of the country's housing crisis, Cajas are known to have delayed the registering of bad loans, especially those backed by houses and land, to avoid declaring losses. This has occurred despite the fact that these credits are backed by the borrower's present and future assets.”¹¹¹

The leverage ratio of the Spanish banking system; assets/capital and reserves, is low compared to current financially “strong” countries such as Germany and Belgium and in September 2011, it was equal to fully ten per cent. The same ratio in Germany was 22 per cent, in Belgium 21 per cent and in the EMU fully 15 per cent.¹¹²

According to IMF, Spain's national debt, between 2002 and 2007, has been less than 395 billion euros. Since the on-going crisis started, it has increased heavily. In 2012, the national debt was as high as 839.95 billion euros. National debt in relation to GDP has increased from 36.30 per cent in 2007 to 79.04 per cent (estimate) in 2012.



The total external debt of Spain was at the end of March 2012

1 779 973 million euros or twice the national debt.¹¹³ The share of external debt issued in euros is higher than 96 per cent.¹¹⁴ In case Spain would have to leave the EMU, the probability is high that the pesetas would be weak compared to the euro, which would make it more costly for Spain to repay their external debt.

Standard and Poor's has lowered Spain's credit rating, which will rise the borrowing costs for the already financially pressed country, and warned of risks to come.¹¹⁵ Besides, Spain got placed on “*negative outlook*”, which means that there is a risk that Spain will be further

¹¹⁰ Lectures in *Spanish Economy*.

¹¹¹ Duthel, H, *Spanish Financial Crisis: Eurobonds? No Thanks. Debt Isn't Solved With More Debt*, page 11.

¹¹² BBVA, *The Spanish Financial System*, November 2011.

¹¹³ Banco de España, *External Debt*.

¹¹⁴ Eurostat, *Debt by Currency*.

¹¹⁵ GP, *Spansk kris ökar oron i EU*.

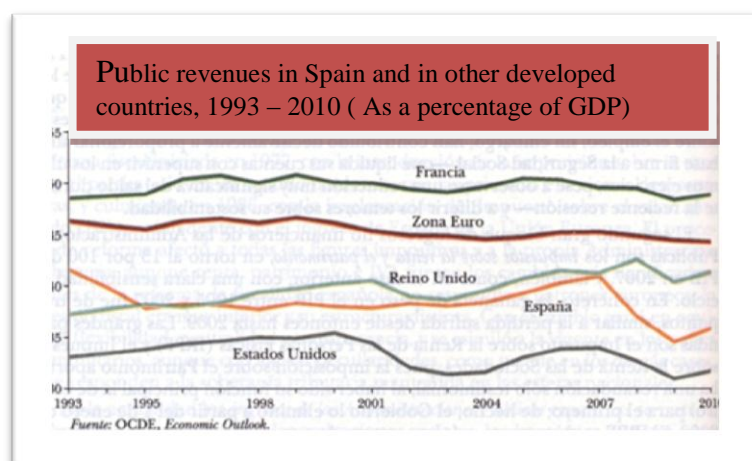
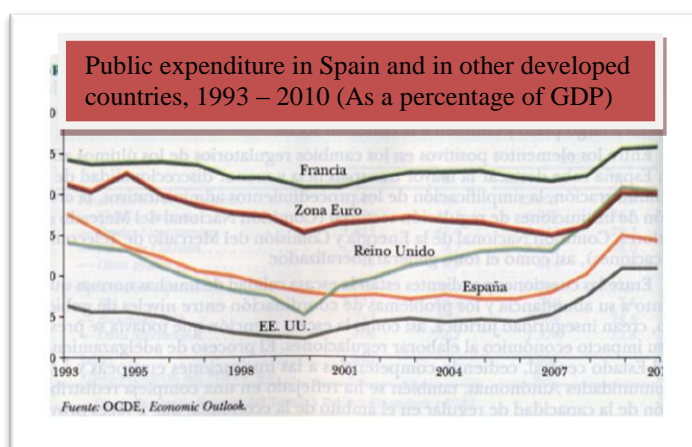
downgraded.¹¹⁶ Spain's rating is now BBB+ and to support its banking system, Spain may not have any other choice than "to take on more debt".¹¹⁷

The yield on 10-year bonds has recently risen, which indicates that "investors have become more wary of Spain's ability to repay its debts".¹¹⁸

3.1.5 The Public Sector, Macroeconomic Policies and Distribution of Income

3.1.5.1 The Public Sector¹¹⁹

In 2009, the Spanish government's expenditures amounted to about 46 per cent of GDP, which was almost the same as the OECD average at that time. Before that, between 2002 and 2007, Spain had balancing budgets or was operating at a surplus. Just after the crisis, revenues started falling at the same time as expenditures remained constant, which resulted in a sharp increase in deficit. Regional governments account for 35.7 per cent of Spain's spending while central governments only account for 20.8 per cent. This shows that Spain's government expenditures are greatly decentralized. The government expenditures are going to be reduced by 16.9 per cent, 27.3 billion euros.¹²⁰



Between 1995 and 2007, Spain experienced a steady growth in public revenues. Before the revenues started declining in 2007, they reached the level 40 per cent of GDP. Less than half of Spain's central government revenues are provided by the personal income tax, which has remained more or less constant over time. The corporate income tax as well as the globally

considered consumption tax have also remained constant over time while the excise taxes have declined with a growth in value added tax. In 2009, tax revenues fell by over 29.4 million euros, a 17-point decrease over the previous year, due to among other things stimulus

¹¹⁶ BBC, *S&P Reduces Spain's Credit Rating*.

¹¹⁷ BBC, *Spanish unemployment hits record 5.64 million*.

¹¹⁸ Ibid.

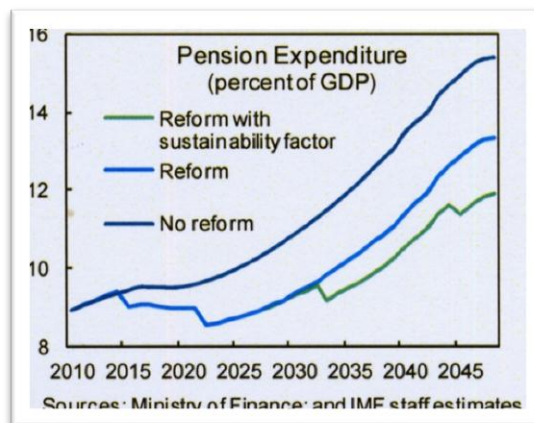
¹¹⁹ Lectures in *Spanish Economy*.

¹²⁰ GP, *Spanien drar åt svängremmen*.

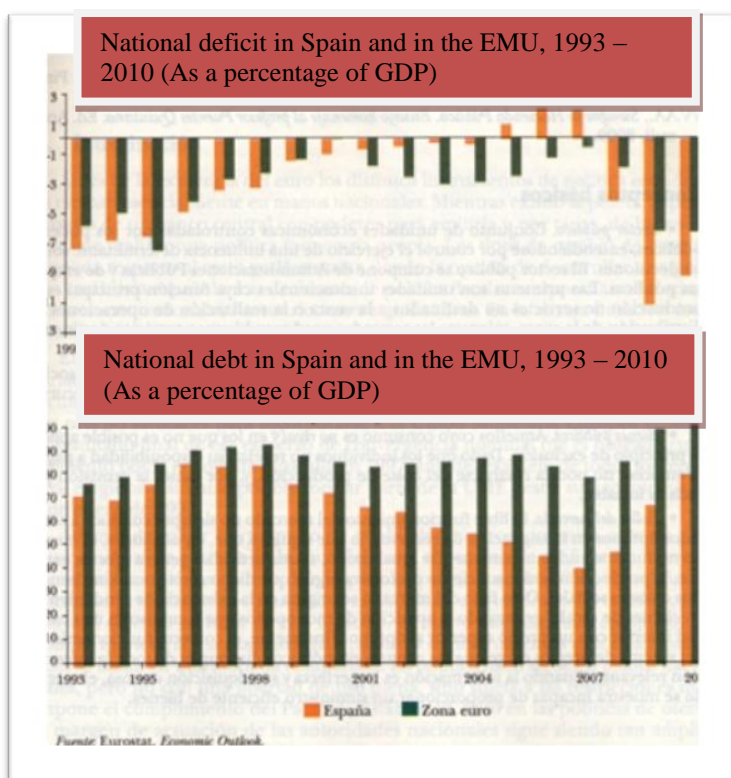
measures and support for liquidity, residual effects of income and corporation tax reforms and downturns in employment and real GDP along with price reductions.

The tax on electricity and gas has been increased by 7 per cent but the government has chosen not to change the pensions and compensation from the unemployment insurance fund. The value-added tax will also remain intact. Besides, the company tax will be raised and the government would also like to implement a tax amnesty to increase the future tax revenues.¹²¹

Pension reforms, which will reduce pension expenditure, have been discussed. The expenditures will increase heavily if no reforms will be implemented.¹²²



Since 1993, Spain has only had public surpluses three times, namely 2005, 2006 and 2007, which is more times than in the EMU. The highest deficit, 11 per cent of GDP, was reached in 2009. Moreover, last year's budget deficit landed at 8.5 per cent of GDP. Under pressure from the EU, the government have decided to cut the deficit to 5.3 per cent this year and after further cut downs the budget deficit is to be three per cent in 2013.¹²³



The national debt in Spain has always been lower than in the EMU. In 2007, the national debt in Spain was 36.2 per cent of GDP. Last year it reached 68.5 per cent of GDP, higher than in 1996.¹²⁴ Most of Spain's regions have large debts and are drawn with large deficits in their regional budgets. For example, Catalonia, which accounts for as much as 20 per cent of the Spanish economy, has more than 13 billion euros in debt maturing this year.¹²⁵

¹²¹ GP, *Spanien drar åt svångremmen*.

¹²² IMF Country Report No. 11/216, *Spain: Selected Issues*, page 29.

¹²³ GP, *Ökad press på regeringen*.

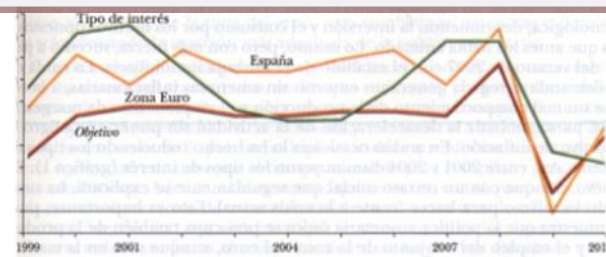
¹²⁴ Eurostat.

¹²⁵ SvD, *Katalonien vädjar om akut miljardstöd*.

3.1.5.2 Inflation

The average inflation rate in Spain between 2002 and 2012 has been 2.78 per cent. In April 2012, the inflation rate in Spain reached 2.1 per cent.¹²⁶ Furthermore, in 2008, the inflation rate was as high as 4.1 per cent, the highest since 1995, and in July 2009, the inflation rate was as low as -0.3 per cent, in other words deflation occurred.¹²⁷

Inflation in the euro area and in Spain as well as the ECB target and interest rate, 1999 – 2010
(Percentage of annual variation of HICP and the annual average interest on main refinancing operations)



3.1.5.3 Distribution of Income

In 2005, 19.7 per cent of the Spanish population had an income below 60 per cent of the median income distribution, while in 2009 only 19.5 per cent. Spain's poverty rate has always been higher than for the EU-27, which counted for 16.4 per cent in 2005 and 16.3 per cent in 2009. The inequality ratio between the 20 per cent richest and the 20 per cent poorest of the Spanish population has increased with 0.6 percentage points between 2005 and 2009.¹²⁸

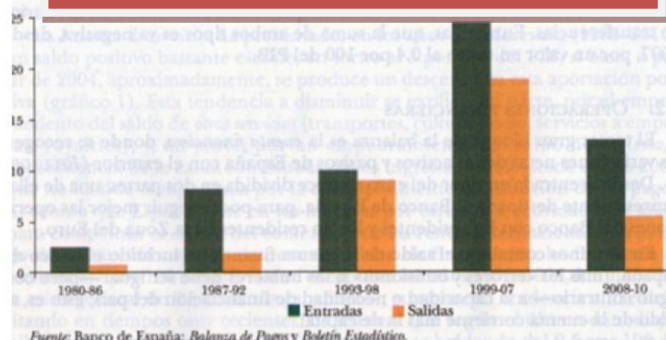
3.1.6 The Foreign Sector

3.1.6.1 Balance of Payments

For the first quarter of 2012, Spain's balance of payments accounted to a current account deficit of 14 849.7 million euros and a capital account surplus of 630.3 million euros. In total the current and capital account accounted to a deficit of 14 219.5 million euros.¹²⁹ Moreover, the financial account was equivalent to a surplus of 8 481.4 million euros.

Regarding inflows and outflows of capital, Spain has always had more inflows than outflows. Since the 1980s, the difference between inflows and outflows has never been bigger than during the 2008 - 2010 period but the percentage rate of inflows and outflows were though higher during the 1999 - 2007 era. Between 1993 and 1998 inflows and outflows were almost equal. After the first three months of 2012, the net outflow of capital amounted to 97.090 million euros due to among other things the flight of portfolio investment, loans and deposits.

Capital inflows and outflows, 1980 – 2010
(Annual average percentage of GDP)



¹²⁶ Trading Economics, *Spain Inflation Rate*.

¹²⁷ The World Bank.

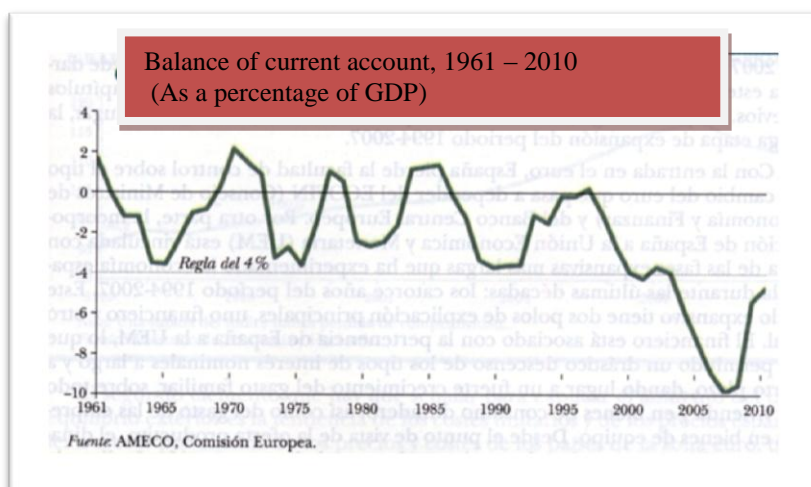
¹²⁸ Lectures in *Spanish Economy*.

¹²⁹ Banco De España, *Balanza de pagos en marzo 2012*.

This result was a drastic change from the same period of 2011 when there was a net inflow equal to 20.887 million euros.¹³⁰

Spain is among those three countries receiving most money in form of grants and support from the EU. In 2010, Spain received net flows of capital of 3 billion euros from the EU, a decrease of about 11.4 billion euros since 2005.¹³¹

By tradition, *“Spain’s trade deficit has been partially offset by surpluses in other external balances, partially service trade, as a result of large net tourism inflows, but since 2005, the current account deficit has been as large as the trade deficit.”*¹³² Between 1961 and 2000, the



current account balance each year has approximately landed in the range of a surplus of 2 per cent of GDP and a deficit of 4 per cent of GDP. In 2007, the deficit was as high as almost 10 per cent of GDP. Thereafter the deficit has declined. Spain’s current account deficit in August 2011 was equivalent to 1.45 billion euros.¹³³

Spain is ranked as the 36th most competitive country and today Spain’s economic competitive rating is equal to 4.54, which is described as high.¹³⁴ *“High private debt and weak external competitiveness cause long adjustments. Spain cannot devalue the currency to bolster competitiveness, so reforms that cut costs and improve productivity are of key importance.”*¹³⁵ Spain is competitive in the pharmaceutical industry and companies specializing in international infrastructure.¹³⁶

When entering the European Monetary Union, the exchange rate of the peseta, was too high. Since the monetary policy in Spain mainly focused on controlling the supply of money to the market from the Bank of Spain, it was impossible to reduce the external deficit and

¹³⁰ El Mundo, *La salida de capitales de España marca niveles récord hasta marzo.*

¹³¹ EU-upplysningen, *Vad EU-länderna betalar och vad de får tillbaka* and Europaportalen, *Spanien fick mest av EU:s pengar.*

¹³² European Commission, *The Spanish External Deficit: Cyclical or Structural?*

¹³³ Lectures in *Spanish Economy.*

¹³⁴ Global Property Guide, *Economic Competitiveness Rating – Spain Compared to Continent.*

¹³⁵ Euro Challenge, *Spain: An Overview of Spain’s Economy.*

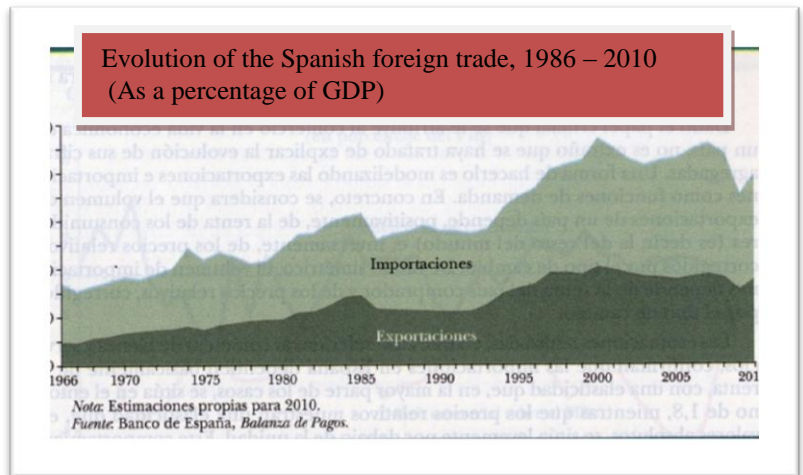
¹³⁶ Lectures in *Spanish Economy.*

expenditure due to that interest rates had increased and attracted external investments. As a result, there were three devaluations of the peseta between 1992 and 1993.¹³⁷

3.1.6.2 External Trade

The world economy has become increasingly interconnected. Since 1966 Spain has always laid a higher percentage of its GDP on imports than on exports. Besides, after 1995, both the percentage of exports and imports increased but after the international crisis there was a small decline. Spain has lately experienced an increase in export by around 10 per cent.¹³⁸

In 2009, EU stood for 58.3 per cent of Spain's imports and 68.9 per cent of Spain's exports. France and Germany have become Spain's most important trading partners. Among Spain's major exports you can find wine, machinery, motor vehicles and foodstuffs. Major imports are machinery and equipment, fuels, chemicals, foodstuffs and consumer goods.¹³⁹



3.1.6.3 Foreign Direct Investment

Last year, Spain increased its revenue of foreign direct investment by 18.4 per cent, which was equal to 28 415 million euros. Investment in productive partnerships accounted for 79.1 per cent, instead of for 59.4 per cent as in 2010.¹⁴⁰

United Kingdom, France and the Netherlands are the three top investors in Spain while Madrid and Catalonia are the two regions, which received most of the inflows of foreign investment. Besides, telecommunications, passenger's air transport and other monetary intermediaries-banking were among those main sectors receiving inflows of foreign investment.

In 2011, Spain's investment abroad, mostly in productive partnerships, accounted for 30 611 million euros, a decrease of 21.9 per cent since 2010. "Investments in companies holding foreign securities fell by 49.6%." Turkey, Poland, United Kingdom, Brazil and the United States amounted for 73.6 per cent of the investments among the receiving countries.¹⁴¹

¹³⁷ Lectures in *Spanish Economy*.

¹³⁸ SvD, *Bankproblem hotar fölla Spanien*.

¹³⁹ Trading Economics, *Spain Current Account*.

¹⁴⁰ Lectures in *Spanish Economy*.

¹⁴¹ Kyero, *Foreign Direct Investment in Spain Up 18.4 % in 2011*.

4 Capitalism 4.0

The main purpose of *Capitalism 4.0* is to develop an economic model that will be better-off than the last one due to new technology, globalization and social changes opportunities. An important task will be to understand “*that governments and markets can both be wrong and that sometimes their errors can be near-fatal*” as well as that the world we are living in “*is too unpredictable and complex to be managed by any immutable institutional structure*”. That fact implies that business and politics can collaborate and “*it creates scope for leadership, creativity and experimentation*” in both areas.¹⁴² “*If markets and political institutions are both recognized as fallible, the rational response must be a willingness to experiment and a preference for reversible policies and business decisions, initially conducted at a modest scale and in a decentralized way.*”¹⁴³

Furthermore, *Capitalism 4.0* is taking the private economy and the government into a closer relationship. It is known that governments and markets make mistakes due to complexness and unpredictability. “*The ability to operate by trial and error, to correct mistakes before they do too much social harm, is the greatest virtue of the market system.*” Banking crisis and financial cycles are likely and returning features of any market system. In the future, “*governments and central banks will have to take greater responsibility for managing growth and employment*”. Additionally, they will have to focus on preserving financial stability.

Even though the government will get greater responsibilities and influence, its size will start decreasing. The economy will be in need of more private financing and “*education is likely to become more market-driven*”.¹⁴⁴ Just after the crisis, politicians and central bankers realized that they could, for instance, keep zero interest rates for long time periods, that public spending could be directed toward infrastructure and job creation and that export-led growth could be promoted by managing exchange rates. Thus, they understood they had “*powerful tools at their disposal to boost economic growth*”.¹⁴⁵ It is important to keep in mind “*that capitalism is prone to crisis, clouded by uncertainties, and dependent on government support for its survival*”.¹⁴⁶

Most likely, currency crisis, monetary inflation and rising interest rates will be easier to handle during the fourth stage of capitalism than during earlier stages.¹⁴⁷ As soon as politicians and voters understand that an interaction between every aspect of policy is unavoidable, economic objectives will be managed in a more complex way. “*The polarized dichotomies between the monetary and the real economy, between responsibilities for inflation and unemployment,*

¹⁴² Kaletsky, A, *Capitalism 4.0: The Birth of a New Economy*, page 5.

¹⁴³ Ibid., page 40.

¹⁴⁴ Ibid., page 8f.

¹⁴⁵ Ibid., page 14.

¹⁴⁶ Ibid., page 31.

¹⁴⁷ Ibid., page 190f .

between the aims of macroeconomics and microeconomics, will no longer make sense.” Central banks will be obliged to aim at numerous targets at the same time. Even governments “*will have to accept much wider responsibilities*”; growth has to be balanced internationally. Thus, under *Capitalism 4.0* more effort will be put on greater complexity, broader political responsibility and tighter constraints.¹⁴⁸

One already existing macroeconomic worry for the fourth phase “*is the outlook for inflation... in the second half of the new decade*”.¹⁴⁹ Besides, a more competitive education with private provision will be a result of the declining boundaries between the government and the market.¹⁵⁰ When dealing with goals of taxation, there must be greater distinctions between revenue raising and redistribution in the new phase. *Capitalism 4.0* will ask for an improved economic stability, which can be achieved by new financial systems, “*without sacrificing the main benefits of financial freedom and innovation*”.

To achieve with the complex trade-offs that the fourth stage of capitalism will need, reforms will have to please the following ten principles:¹⁵¹

1. “*Regulations must try to preserve financial flexibility and innovation at the same time as improving economic stability.*” Instead of as in *Capitalism 3*, *Capitalism 4.0* recognizes “*that these two desirable objectives are in conflict*”.¹⁵²

2. “*Even banks that are not "too big to fail" will sometimes be "too important to fail."* It is of importance that “*public policy should recognize this explicitly*”. Governments should, under certain conditions, support, through various insurance and dependent capital arrangements, all financial institutions and be convinced that this taxpayer support will be paid by the banks.¹⁵³

3. Since markets are recognized to be frequently wrong, policymakers “*must be willing to regulate financial institutions*”. This has to be done “*even without any evidence of particular market failures*”.¹⁵⁴

4. A clear distinction between risky and safe obligations should be required from the banks in advance. Thus, the banks' creditors and investors should know, which obligations “*are 100 per cent safe*”, thereby “*guaranteed firstly by the bank's own capital and liquidity and ultimately backed by the government*”.¹⁵⁵

5. “*Banks and financial institutions must enjoy far greater leeway in their accounting rules and disclosure requirements than other businesses. Banks must be allowed to exercise their judgment, under the supervision of regulators, in assessing the long-term value of their loans,*

¹⁴⁸ Kaletsky, A, *Capitalism 4.0: The Birth of a New Economy*, page 231f.

¹⁴⁹ Ibid., page 259.

¹⁵⁰ Ibid., page 274f.

¹⁵¹ Ibid., page 291.

¹⁵² Ibid., page 291f.

¹⁵³ Ibid., page 294.

¹⁵⁴ Ibid., page 294f.

¹⁵⁵ Ibid., page 295f.

mortgages and other assets and they must be allowed to smooth out their profits over long periods.”¹⁵⁶

6. Judgments about the quality of bank assets and lending must be done by regulators and politicians since the risk management of banks is too essential to be outsourced.¹⁵⁷

7. *“A new division of labor is essential between private and public mortgage operations.”*¹⁵⁸

8. Taxpayers should be given interests *“represented alongside the interests of shareholders”*, as long as they *“are effectively partners in the banks”*.¹⁵⁹

9. Regulators will continue taking *“an interest in bankers' bonuses and earnings”* as long as it will be a legitimate reason to protect taxpayers in banking businesses.¹⁶⁰

10. Great profits for the banks do not always come along with highly rewarded financial geniuses.¹⁶¹

¹⁵⁶ Kaletsky, A, *Capitalism 4.0: The Birth of a New Economy*, page 296f.

¹⁵⁷ *Ibid.*, page 297.

¹⁵⁸ *Ibid.*

¹⁵⁹ *Ibid.*, page 299.

¹⁶⁰ *Ibid.*

¹⁶¹ *Ibid.*, page 300.

5 A Theoretical Analysis

5.1 Spain during the Different Phases

5.1.1 Capitalism 1

The late 19th and early 20th centuries' political instability in Spain proves that Spain was part of the social and economic upheaval that defines the first phase of capitalism. The mentioned upheaval resulted in a dictatorship where the dictator's leadership was unrestricted by law, constitutions and other social and political factors within the state. This shows further evidence of compliance with *Capitalism 1*.

5.1.2 Capitalism 2

General Franco influenced Spain during the second phase of capitalism, with, as mentioned, his extreme form of isolationism and self-sufficiency, which Spain was forced into. After the Spanish Civil War and by the end of World War II, Spain got diplomatically and politically isolated. The first period of the second phase, with poverty and strictly limited imports, was harder for Spain than for most other European countries. The isolation toward the rest of Western Europe largely existed until Franco's death but was less strict after 1960 when Spain experienced a delayed fast economic growth due to its many structural changes. Due to that Spain was a dictatorship, the country stood out from Kaletsky's theories. The Spanish government was strictly controlled and could not govern for the population's best and manage the economy, and was therefore inefficient. Thus, Spain was not typical for the second phase of capitalism regarding the positive attitude towards governments. Besides, due to Franco's regime and the blockade during the 1950s Spain had no chance to trust the markets.

At the end of *Capitalism 2*, Spain, as most European countries, suffered from high inflation and an increasing unemployment rate, thus stagflation, due to among other things a new blockade. Additionally, the economic crisis and divergence with Europe affected Spain negatively. It is important to stress that the reasons why just Spain was so badly affected were the country's low activity rates, deficient legislation and the bad matching of educational level and job characteristics.

5.1.3 Capitalism 3

After General Franco's death in 1975, Spain became a democracy. Thereafter, *Capitalism 3* started with an economic boom, especially with growth in labour productivity and thus a rapidly reduced unemployment rate. The lack of flexibility in the capital and labour market had before given Spain one of Europe's highest unemployment rates. Besides, openness in the economy was a fact. The openness in the economy as well as the fall of the dictatorship led to that Spain could start trusting the markets more. In contrast to Kaletsky's theories, the trust for the government started rising at the same time. The closer the end of the third stage, the more distrust for the government arose.

Spain was part of the currency crisis during the beginning of the 1990s but since Spain was not one among those countries, which adopted the free-market most willingly, Spain was not that badly affected. The development toward the EMU helped Spain move forward in the mid-1990s.

Also, the period between mid-1990s and 2007 is characterized by macroeconomic stability, reduced unemployment rates, decreased interest rates as well as increased housing prices and investment.

5.2 Questions to Be Answered

5.2.1 Has the Spanish Economy Been Typical for Each Phase of Capitalism?

Despite that *Capitalism 1* only has been dealt with shortly, I would say that Spain more or less has followed Kaletsky's theories regarding that phase.

When analysing *Capitalism 2*, Spain has partially followed Kaletsky's theories. The markets were distrusted but, at the same time, no faith in the government existed due to the regime and the periodic isolation.

During the phase *Capitalism 3*, Spain deviated from Kaletsky's ideas in the beginning of the phase, due to the regime change, but as the years passed, Spain's situation became more and more in line with Kaletsky's theories.

5.2.2 Would Spain Have Succeeded Better if Keynes' and Friedman's Theories Would Have Been Applied during the Last Decade/Decades?

Spain did not fully take part of the Golden Age of Keynesian economics. During some time living standards were low, technological progress not as fast as in competing countries and there have been periods with lack of financial stability.

Due to Franco's regime and the long-lasting isolation, the Spanish government has not been able to follow Keynes guidelines regarding how to act like a well-functioning government. The Spanish government has, for example, not had the power to boost spending when necessary and to create an active employment policy in time. This was possible first after becoming a democracy. Fiscal and monetary measures are, as mentioned, essential in order to ease adverse effects of economic recessions and depressions.

When studying the figures showing the public deficit/surplus in Spain during the last decade/decades you can more or less say that Spain has followed Keynes' strategy and shifted policy in boom and recession. For example, in the boom of the 1960s as well as of the early 21st century, Spain created a budget surplus and in compliances with the recession of the beginning of the 1990s, Spain experienced a budget deficit.

Also, for example, after 1960, when Spain experienced better living conditions, faster growth and lower unemployment rates, the country made a mistake according to Keynes. Spain should have invested more since high rates of investment during a period of optimism increase the amount of capital in the economy. Furthermore, an increase in investment lowers the number of job losses and increases incomes as well as consumption.

Moreover, the lack of efficiency and flexibility as well as the delay in growth in productivity have led to an insufficient aggregated demand, which according to Keynes can be one explanation for a high unemployment rate and lead to a financial crisis.

Keynes' statement that "*governments should spend money they don't have may have saved capitalism.*"¹⁶² If Spain would have taken a greater part of the Golden Age of Keynesian economics, there is a chance Spain's situation would not have been as severe as it is today. The delay that the Franco era and the isolation contributed to has set its marks on Spain's development.

In connection with the beginning of the global financial crisis in 2008, policy makers and academics in the world's industrialized economies sought "*a resurgence of interest in Keynesian economics*". "*Discussions and implementations of economic policies in accordance with recommendations*", made by Keynes, "*in response to the Great Depression, such as fiscal stimulus and expansionary monetary policy*" have become of interest again.¹⁶³

Thus, it is possible that Spain would have succeeded better¹⁶⁴ if Spain would have applied more of Keynes' theories during the last decade/decades.

Spain applied Friedman's theories more willingly than Keynes'. To limit the high inflation, which occurred in the beginning of the 1980s, and to bring it under control, economic activity was reduced, which is a pattern in Friedman's theories. In 2008 though, this pattern was not applied, as growth in the money supply was not restricted.

When examining Spain in a monetarist perspective, the inflation has not in all times been stable, see, for example, the beginning of the 21st century and in compliance with the crisis. If the Spanish government would have kept the amount of money in circulation under control, the inflation may have followed a more smooth evolution. In addition, the fact that Spain has a high natural/structural unemployment rate is natural according to monetarists like Friedman. In the long-run, the government cannot affect it but in the short-run, it is dependent on expectations.

¹⁶² Reich, R., *Time 100: The Most Important People of the Century*.

¹⁶³ Wikipedia, *2008-2009 Keynesian Resurgence*.

¹⁶⁴ In general economic terms such as greater economic growth, lower unemployment rate, lower inflation, lower deficit and debt etcetera.

During the years just before the financial crisis in 2008 started, Spain followed Friedman's theories about a free market economic system with as little government intervention as possible. For example, in 2006, it is suggested that Spain's *"households were far richer, even after taking into account all their borrowing, than ever before in history"*. *"Their wealth was much higher in relation to their incomes"*, thus *"they were more solvent than ever before and more capable of carrying their debts"*. In all cases, the growth of debt during the boom period was smaller than the increase in wealth.¹⁶⁵ A flourishing period like the one just mentioned cannot last forever and when the amount of money in circulation in the economy at one point became too high and the crisis started, the Spanish economy turned into an upheaval. These facts can be a result of letting the markets run "free" and if the markets would have been better controlled, the situation Spain is in today may have been less problematic.

Thus, it is possible that Spain would have succeeded better if Spain would have applied more of Friedman's theories regarding controlling the money in circulation but less of Friedman's theories regarding letting the market run "free" during the last decade/decades.

5.2.3 Is Spain in Need of Something New? Capitalism 4.0?

The last years' increase in unemployment and the weakening of government finances have been sharper for Spain than for other advanced OECD economies in terms of real GDP. The construction sector has been permanently downsized at the same time as the private sector's debt burden is still high, which in the future will decrease economic growth. For Spain to start flourishing again, a new reform of the pension system is of importance to ensure the long term sustainability of public finances and to guarantee benefits of retirement in 20 years.¹⁶⁶

During the crisis, half of the people who became unemployed in the euro area were Spanish. If the unemployed would get the possibility to start working again, Spain's economic recovery would strengthen again, social well-being would be improved and poverty would decrease. In the long-run, a lower unemployment would improve the government finances. Thanks to new labour market reforms after the crisis, the amount of permanent contracts have been reduced as well as it is now easier for companies to set their wages according to their economic conditions. Consequently, the unemployed must get better help from public employment services when looking for jobs. Particularly vulnerable are young workers, where the unemployment level is as high as 46 per cent.¹⁶⁷

To solve the crisis, *"education is the ultimate solution to prevent the intergenerational persistence of unemployment"*. Those without full secondary education are especially affected of youth unemployment. One solution can be to make more attractive and relevant courses,

¹⁶⁵ Kaletsky, A, *Capitalism 4.0: The Birth of a New Economy*, page 90.

¹⁶⁶ OECD, *Spain after the Crisis: A New Growth Model*.

¹⁶⁷ Ibid.

which can be used in local businesses and labour markets and to link higher education and businesses. Among those Spanish students between 25 and 29 years old, who graduate from university, 44 per cent have low skilled works. The OECD average is 23 per cent.¹⁶⁸

According to OECD, comprehensive structural reforms have to be carried out in education, innovation and increased competition as well as it is vital to increase employment, reduce inequalities and protect the weakest in society. Consequently, to increase growth, fiscal austerity measures have to go hand in hand with structural measures. At the same time, it is extremely important to find a balance between saving measures and revenue growth in each country's budget.¹⁶⁹

Also, the creation of firms needs to be supported as well as the innovative capacity of the economy need to be boosted. Spain has become unproductive due to lack of flexibility, innovation and focus on sectors, which only contribute with little value to the rest of the economy.¹⁷⁰ A new, better regulation, which can help strengthening competitiveness of business abroad, is vital.¹⁷¹

The foreign exchange market and the banking sector are linked together. Therefore, a crisis in the foreign exchange market often comes together with a crisis in the banking sector, in this case within the euro zone.¹⁷² *"The reason is that the lender of last resort function of the domestic central bank is very much impaired when banks expand the foreign currency components of their balance sheets."*¹⁷³ One explanation for the severe banking crisis that occurred in 2007-08 is the absence of a centralized supervision of the banking system. Therefore, political integration needs to develop further and necessary institutional changes need to be done as soon as possible within the euro zone.¹⁷⁴

The European Central Bank has the responsibility to keep inflation low. Consequently, the expansion should have caused a warning for the European Central Bank of a future financial crisis. Even though the European Central Bank's *"focus on inflation prevented it from taking action aimed at checking the ballooning expansion of bank credit"*, the main responsibility of the financial crisis *"is to be found in the failure of bank supervision"* as well as in the remaining of nationally organized regulation. In addition, the euro system has to reform the supervisory authority to an European level. Other critics mean that the absence of an obligation for the European Central Bank to, in excess of controlling inflation, also control unemployment rates

¹⁶⁸ OECD, *Spain after the Crisis: A New Growth Model*.

¹⁶⁹ SvD, *OECD varnar för utvecklingen i eurozonen*.

¹⁷⁰ Ibid.

¹⁷¹ OECD, *Spain after the Crisis: A New Growth Model*.

¹⁷² De Grauwe, P, *Economics of Monetary Union*, page 134

¹⁷³ Ibid., page 142.

¹⁷⁴ Ibid., page 190.

is a further explanation for the current euro crisis. In comparison, the Federal Reserve has such an obligation.¹⁷⁵

Not to be forgotten, Spain's economy is deeply internationalized and it has leading multinational companies as well as the world's second most spoken language.¹⁷⁶ Nations with great losses in their competitiveness are the ones which got most badly affected by the crisis.¹⁷⁷

Spain is one of the countries which support "green industries" and means it is compatible with growth. Sustainable use of scarce natural resources is required for sustainable economic growth. Fresh water is a scarce resource in many of Spain's regions. "*Making sure that prices for water use reflect cost adequately can help mobilise private sector funding to upgrade water infrastructure, providing some stimulus for investment, as well as water savings.*"¹⁷⁸

Scientists, who study how ecosystems in nature work, mean that the single currency has increased the individual members' dependence on each other, at the same time, as each member is still capable of acting independently from their own financial situation. When this happens in nature, key members expose the entire network for a risk, which often leads to eradication or complete collapse. An economic network must break the interdependence, increase regulation or loose members. Problems arise when certain parts of the system are independent and others not. Systems based on both cooperation and competition are vulnerable and nature is good to learn from.¹⁷⁹

Capitalism 4.0 could be an alternative for Spain. When examining the ten principles, which are necessary for achieving the complex trade-offs that the fourth stage of capitalism will require, it will be necessary to work on all points for Spain. Especially, the part about taking the private economy and the government into a closer relationship is essential for Spain. Mistakes must be corrected before they cause too much social harm and a greater responsibility has to be taken for managing growth and employment. An accelerating private financing as well as a change in education would as already discussed also improve Spain's situation.

After studying the statistics on Spain, Spain can overall be said to, currently, facing many difficulties. For instance, since the crisis started, Spain has experienced slow growth, low productivity, a fall in housing prices and an increase in the corporate indebtedness, decreased interest rates, high unemployment rates, high national deficit and debt and so on. By applying *Capitalism 4.0* and giving both the government and the market a chance to correct today's problems, Spain can start working on improving the above mentioned struggles. It will also be

¹⁷⁵ Leiden-London Meeting.

¹⁷⁶ De Grauwe, P, *Economics of Monetary Union*, page 134.

¹⁷⁷ Ibid., page 243.

¹⁷⁸ Ibid.

¹⁷⁹ GP, *Naturlag att krisen fördjupas*.

important for Spain to divide and accept much wider responsibilities between different actors. In the future, collaborations between businesses and politics should not be something rare. Spain will have to enact more regulations as well as act more internationally. Also, international organisations must be reformed so that they can meet the new challenges of globalization at the same time as they need to be developed so that they can gain greater legitimacy.¹⁸⁰

5.2.4 Contributions from Other Theories

Spain should in the future also try to apply Bernanke's doctrine, thus preventing fraud and abusive lending and ensuring that lenders employ sound underwriting practices as well as making effective disclosures to consumers and putting more power on preserving price stability. Currently, though, Spain's high inflation in 2008 and deflation in 2009 have been replaced by inflation around the preferred level of 2 per cent.

According to Fisher's theories, the Spanish economy has become short-circuited in conjunction with crisis over time. When prices have started falling, real debt has started increasing.

When applying Mishkin's five lessons on Spain, you can among other things draw the following conclusions. Today's economic situation in Spain has become more acute than anyone could ever imagine. The statistics on Spain have varied wildly during the last decades and it is impossible to see a linear trend. Regarding the different types of costs, Spain has experienced all of them. For example, after the crisis aggregate output has declined, growth has slowed down and the government's budgets have deteriorated drastically. Besides, the confidence in the European Central Bank has been reduced. The fact that Spain, for instance, experienced budget surpluses three years in a row just before the economic crisis started in 2007 did not ensure a future financial stability for Spain. What is more, as mentioned, some rethinking is necessary regarding the basic framework for monetary policy strategy and more effort has to be put on monetary policy.

The theories of Reinhart, Rogoff and Kaminsky give an overall understanding of economic crisis but their theories are not fully applicable on Spain. One essential contribution to why the economic situation in Spain has become so severe has to do with the fact that Spain is facing more than one crisis at the same time, both a currency and a banking crisis. Besides, the real estate bubble in Spain became a deeply problematic one. One reason, as explained, is the fact that Spain imported capital from abroad, which boomed the economy and led to that Spain could not keep track of realistic values.

Wihlborg talks more generally about the euro area and an optimal currency area than about Spain in particular during his lesson but his talk gives a deeper insight into the EMU matter. When a country has its own currency, the need to keep pace with other countries in terms of

¹⁸⁰ Hansson, H., *Internationell ekonomi*, page 290.

productivity is not as big as when countries have a common currency. When the euro was introduced in Spain, the labour costs per unit increased and production in Spain has become one third more expensive. The gap between high and low performing countries is increasing year by year.¹⁸¹ One important argument Wihlborg mentions has to do with insolvent banks. By closing insolvent banks, Spain can more easily get out from the current credit crunch situation but to make this happen there is a need of new regimes.

¹⁸¹ SvD, *Slutar EMU i haveri?*.

6 Conclusion

To understand the situation Spain is facing today, it is important to take into consideration the delay in the Spanish economic development caused by Franco's regime and the isolation Spain was exposed to decades ago. Besides, the regional autonomy and the regional differences have caused and cause problems for Spain. The last decades' climate changes have affected Spain more drastically than most other European countries. Low productivity, low efficiency, low flexibility and low skills of the workforce as well as lack of competitiveness in foreign trade are other weaknesses with historical backgrounds.

Since the beginning of the 1970, Spain has undergone a higher number of social changes than any other Western European country. Not only today but also historically has Spain had one of the highest unemployment and natural unemployment rates in Europe. The delay in the economic development and the fact that Spain has spent less on R&D and innovation than other European Union countries have caused and cause difficulties for Spain.

In 2007, the national debt in relation to domestic product was as low as 36.30 per cent and far from the 60 per cent roof. From 2005 to 2007 the national deficit was positive. At this time, Spain did not only face a house price boom but also a construction boom. When these booms stopped abruptly in 2008, major building projects remained half-finished and housing prices started falling drastically. This is the main reason for the economic crisis in Spain and explains to a big extent the extremely fast increase of the unemployment rate in Spain, the huge corporate sector indebtedness and the severe banking crisis. For instance, the national debt in 2012 is expected to reach the level of 79.04 per cent and the national deficit 5.3 per cent.

A high unemployment rate has been a returning problem for Spain and still is. The unemployment situation in Spain is getting worse and worse. The main reason for the fast increase in unemployment is that as many as fully 20 per cent of the Spanish labour force were engaged in the construction sector when the crisis in that sector started. The regional differences in Spain are another explanation but also among other things the high indebtedness, a weak demand, lower capital inflows from abroad, low activity rates and the worse correlation between its educational level and job characteristics explain the current situation. The estimated unemployment rate for 2012 is as high as 24.2 per cent. The unemployment rate for young workers is as high as 46 per cent.

Spain's need of capital is huge, as mentioned, Bankia will need 19 billion euros to repay its current debts but also the rest of the Spanish banking system has similar problems caused by the housing recession. Spain's estimated national debt in relation to GDP was 79.04 per cent, 839.95 billion euros, this year and Spain's external debt 1 779 973 million euros. EU's grants and support to Spain are mostly used for solving the banking crisis.

New structural reforms in the areas of education, innovation, increased competition and pension systems have to be enacted. Besides, Spain needs to review its decreasing employment, inequalities and create a link between higher education and businesses. The number of sectors, which contribute with much value to the rest of the economy, has to be developed. Besides, restrictions on natural resources are of main importance for a future economic growth to exist.

To what extent Spain has followed the different phases of capitalism varies but Spain has to some extent followed each phase. Spain's development during Kaletsky's *Capitalism 2* is what differs the most due to the distrust of the Franco government and the periodic isolation. The same result occurs when examining the Spanish economy in comparison with Keynes' and Friedman's theories. More similarities can be found between Spain's development and Friedman's theories than between Spain's development and Keynes' theories. The fact that Spain did not take greater part of the Golden Age of Keynesian economics is of importance to be able to understand the severe situation Spain is facing today. The opinions about whether Friedman has influenced Spain positively or negatively are dual. Fisher's debt-deflation theory, Reinhart's and Rogoff's study of the varieties of financial crisis, Kaminsky's and Reinhart's study of the links between banking and currency crisis and Wihlborg's lecture about the *Crisis in the Euro-zone and in Banks – "too Big to Fail" and "too Big to Save"* give an overall understanding for economic crisis but cannot be applied on Spain in the same way as, for example, Keynes', Friedman's and Kaletsky's theories. For a deeper understanding of the above mentioned economic theories I refer to the theoretical analysis in chapter 5.2.

The current difficulties Spain is facing can partially be solved by both already existing economic theories as well as by new ones. Keynes' theories, for example, regarding fiscal stimulus and expansionary monetary policy, could to a degree help Spain out of its current situation but some new ideas are necessary. Kaletsky's *Capitalism 4.0* can most likely diminish today's problems by giving both the government and the market a chance to improve the growth, productivity, housing prices, the corporate indebtedness, interest rates and unemployment rates as well as national deficit and debt to some extent. The Bernanke doctrine about preserving price stability should be applied by Spain in the future. Further, Mishkin's lessons should be considered during future decision makings. The basic framework for monetary policy strategy needs to be reviewed and the financial sector's activities have to be regulated more thoroughly.

Without any academic qualities, I would like to add some personal remarks. I am convinced that the new phase of capitalism with strict rules to control the short term greed - with the short term profit as the main goal – with other relevant actions will lead to a better future

situation for Spain in general economic terms such as greater economic growth, lower unemployment rate, lower inflation, lower deficit and debt etcetera.

What is more important is that we have to act to handle the lack of natural resources, the growing world population and the effects of the climate change, which consequences, in my opinion, will be more severe than according to the common opinion. Scientists state that it will not be possible for an increasing amount of people to live in big cities. Instead people will have to move in the other direction due to among other things lack of energy. Agriculture has to change from big scale to a more intensive farming involving a bigger part of the world's population. If the world can agree on this, I am convinced that we will be able to create a world with higher life quality than in today's world. Personal initiatives and small scale activities will be more important than multinational greed both for Spain and the rest of the world. Thus, self-sufficiency will be of bigger importance, but this time due to actual need and not due to political isolation, as during the Franco era.

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