



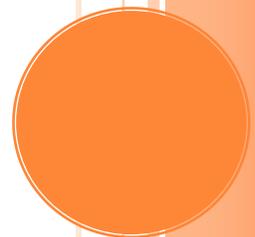
MACROECONOMIC  
Analysis & Policy Studies

**The Perils of Forsaking One's Monetary Sovereignty:  
The Case of Spain**

Student Research Internship Report

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## The Perils of Forsaking One's Monetary Sovereignty- The Case of Spain

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The Spanish economy has come a long way since its Golden Decade that lasted from the mid-1990s to the mid-2000s. Having navigated a relentlessly undulating terrain since then, Spain finds itself staring at another major challenge in the 2020s in the context of the COVID-19 pandemic.

Countries like Spain received a mixed bag of goods upon their entry into the European Monetary Union. While the nation thrived on the low short- and long-term interest rates, it ended up with an overvalued currency, a fixed exchange rate and minimal to no control over the operations of the central bank. In other words, the nation had given up nearly all of its monetary sovereignty. Furthermore, the Excessive Deficit Procedure (EDP) of the Stability and Growth Pact (SGP) of the Union discouraged the country from exceeding the arbitrary 3 percent fiscal deficit mark, apart from which there seems to be limited coordination among the fiscal policies of the member states.

A rapidly growing economy, a small fiscal deficit, at times, even a fiscal surplus and falling rates of unemployment painted a pretty picture of the Spanish economy in the early 2000s. In 2007, the per capita real GDP stood at [\\$32,301](#), unemployment at [8.2 percent](#) of the labour force, and public debt at [35.6 percent](#), the lowest in the last two decades. However, brewing beneath this calm exterior was a real estate bubble. While this was not evident on the surface, the Sectoral Financial Balances Model proposed by the heterodox economist Wynne Godley, gave a clear picture of leveraging by the private sector and its possible longer-term implications on the economy.

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The SFB model, based on an accounting identity, states that at any given point of time, the accumulation of liabilities in any one of the three sectors of an economy – the domestic private sector, the government sector and the external sector – must get reflected in the accumulation of assets of an equal sum in at least one of the other two sectors. Simply put, the net asset accumulations in the three sectors of the economy must sum up to zero as in the equation below:

$$(S - I) + (T - G) + (M - X) = 0$$

Or

$$(S - I) = (G - T) + (X - M)$$

The external sector is accumulating net asset (liabilities) when the country is running a current account deficit (surplus) as there is an inflow (outflow) of financial resources; the government sector accumulates net asset (liabilities) when it runs a fiscal surplus (deficit) and the private domestic sector accumulates net asset (liabilities) when the amount of saving exceeds (falls short of) the amount of investment. While it is not sustainable for the private sector to continually accumulate net financial liabilities, the government can do so if it enjoys monetary sovereignty although it could pose the threat of inflation.

### **Global Financial Crisis**

A look at the sectoral financial balances from Table 1 shows us that while the Spanish economy grew at a rapid pace, in the early 2000s, it did so with a burgeoning current account deficit that was reflected in the incessant leveraging of the private domestic sector through bank lending for investment in the housing market. The Global Financial Crisis of 2007 led to the explosion of the housing bubble. The banks that had been generously lending to the

construction and housing sector found themselves in a vulnerable position with the projects that they had invested in, going bust and in need of rescue. However, the ability of the Spanish government to bail these banks out through fiscal measures was limited, owing to the institutional constraints that the European Monetary Union imposed. As the private sector began deleveraging, investment collapsed and the economy was dragged into a recession. In order to combat the negative rates of GDP growth and unemployment rates of nearly 18 percent, the Spanish government had to undertake a fiscal deficit of over 11 percent in 2009. This is also apparent from the equation above; a positive  $(S - I)$  necessitates a positive  $(G - T)$  as long as the country runs a current account deficit.

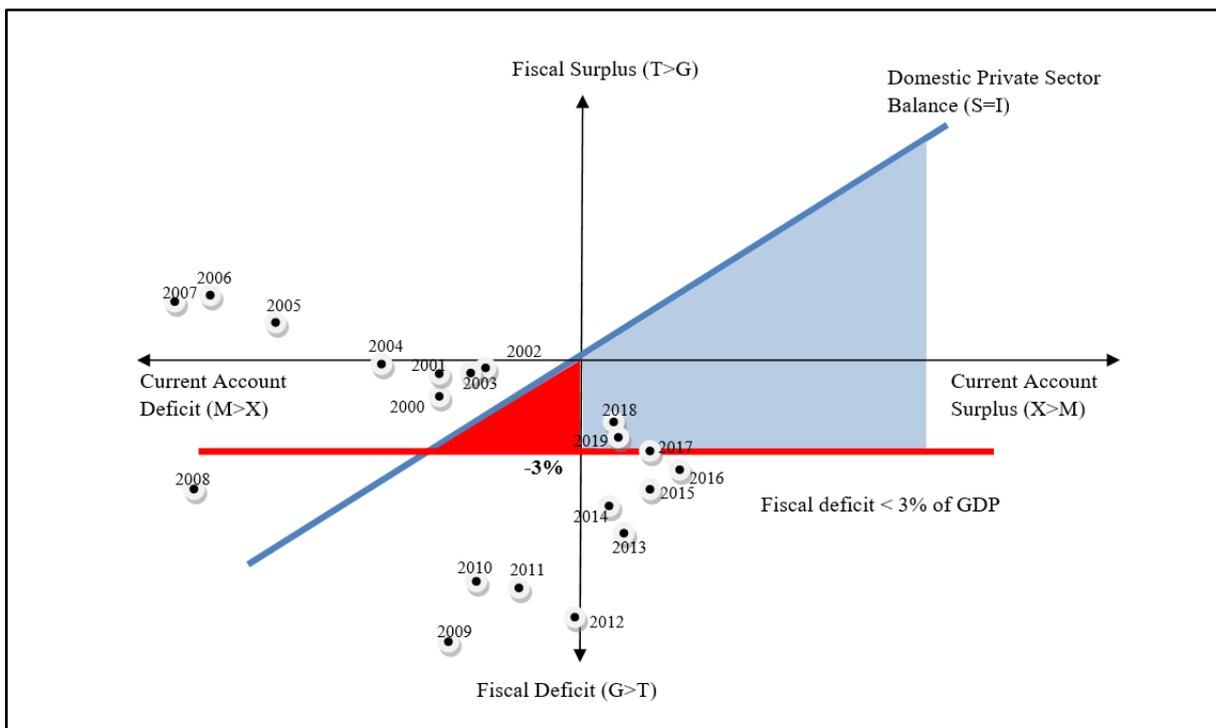
Table 1: Sectoral Financial Balances of Spain

Year	(G-T)	(X-M)	(S-I)	(S-I) + (M-X)
2000	1.2	-4.4	-3.2	1.2
2001	0.5	-4.4	-3.9	0.5
2002	0.3	-3.7	-3.4	0.3
2003	0.4	-3.9	-3.5	0.4
2004	0.1	-5.6	-5.5	0.1
2005	-1.2	-7.5	-8.7	-1.2
2006	-2.1	-9	-11.1	-2.1
2007	-1.9	-9.6	-11.5	-1.9
2008	4.6	-9.3	-4.7	4.6
2009	11.3	-4.3	7	11.3
2010	9.5	-3.9	5.6	9.5
2011	9.7	-3.2	6.5	9.7
2012	10.7	-0.2	10.5	10.7
2013	7	1.5	8.5	7

2014	5.9	1.1	7	5.9
2015	5.2	2	7.2	5.2
2016	4.3	3.2	7.5	4.3
2017	3	2.7	5.7	3
2018	2.5	1.9	4.4	2.5
2019	2.8	2	4.8	2.8

Source: Author's calculations from Eurostat data

Figure 2: Sectoral Financial Balances of Spain Mapped



Soon after, in 2010, the Spanish government was directed to curb its deficit by the European Commission. Its inability to do so rapidly and its rising public debt resulted in prominent credit rating agencies lowering Spain's ratings to near-junk status. By 2012, Spain had slipped into another recession.

## **Sovereign Debt Crisis**

By the time the new crisis emerged, the unemployment rates were soaring to much higher levels than those a few years back and the nation witnessed three consecutive years of negative growth in 2011-2014. The inability to accommodate a current account surplus by allowing the currency to depreciate in the Forex market led to the adoption of the internal devaluation strategy. This meant that in order to achieve global price competitiveness, the wages in the country had to be reduced and labour reforms introduced. This was coupled with severe austerity measures to curb the fiscal deficit. Spain saw a modest recovery in 2014-2017 with positive GDP growth. It began recording a current account surplus in 2013 along with a falling fiscal deficit which was reflected in a smaller net asset accumulation in the domestic private sector. The unemployment rate had also fallen to [15 percent](#) by 2019. However, it has witnessed a slower pace of output growth since 2017. With Spain being a wage-led economy<sup>2</sup> and a large section of the fall in wages being absorbed by a rise in the share of profits, the impact of the internal devaluation strategy on economic growth has been negative. In 2019, prior to the COVID-19 outbreak, the Spanish economy recorded a small fiscal deficit of [2.8 percent](#), a current account surplus of [2 percent](#) and a net asset accumulation of 4.8 percent of the GDP in the domestic private sector. The economy paints a very different picture in the post-pandemic period.

## **COVID-19 and Temporary Monetary Sovereignty**

Spain has been one of the worst hit European economies during the pandemic. The multiple lockdowns and national emergencies declared have reduced growth prospects significantly.

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<sup>2</sup> An economy where the negative impact on consumption from a fall in the wage share is greater than its positive impact on investment and exports

Q1 2020 and Q2 2020 saw massive falls in GDP of over -5 percent and over -17percent respectively. Q3 2020 saw a quarterly rise in GDP of nearly 17 percent which is expected to slow down in Q4. The ECB forecasts that the real GDP of the Spanish economy would have shrunk by -11.1 percent in the baseline scenario, by -10.7 percent in the mild scenario and by -11.6 percent in the severe scenario in 2020. All three scenarios project the unemployment rates to have risen to approximately 16 percent in 2020 and project it to rise further in 2021. The only silver lining has been the response of the ECB, European Commission and the Spanish government. The 3 percent fiscal deficit target has been suspended for the time being and the ECB has launched several large temporary asset purchase programs to refinance banks and has voiced its willingness to participate directly in the government bonds market. The European Commission also launched the Multiannual Financial Framework for the period of 2021-2027 that is closely linked to the measures introduced in the NextGenerationEU (NGEU) programme to aid in the post-pandemic recovery that together amount to a stimulus of €1.8 trillion. Nearly half the corpus of the NGEU has been designed as grants and the other half as loans that mature in 2058. The Spanish government has adopted immediate fiscal measures worth €46 billion that stand at 4.1 percent-4.3 percent of the 2019 GDP. The fiscal deficit for 2020 is estimated to be upwards of 10 percent of the GDP. Spain is also expected to see a small current account surplus. This implies that the private domestic sector is expected to deleverage greatly. Despite the steep deficit, inflation is not worrying as the Harmonised Index of Consumer Prices is expected to remain moderately positive with the threat of imported inflation being eliminated through low oil prices and no foreseeable depreciation of the Euro. Furthermore, the high rates of unemployment in the country create room for deficit spending without risking higher inflation. In fact, the Tourism sector that contributes to over 12 percent of the GDP poses a threat of deflation.

Spain has witnessed very low interest rates these last few years, and several loan guarantee programmes and moratoriums have been put in place. Credit to the sectors most affected by the pandemic such as manufacturing, wholesale and retail trade, motor vehicle repairs, transport-storage, accommodation, food and recreation has grown at twice the pace of that to other sectors. While these affected sectors have also seen a rise in Non-Performing Loans, they aren't a cause of immediate concern to the economy. However, the fear remains that the end of the moratorium period could result in a pile up of NPLs, should the economy not recover as expected. The [yield on the 10-year government bonds](#) of Spain rose up in March and April 2020 in response to the spread of the virus but has been falling since then.

Therefore, the markets don't seem to have reacted very adversely to the stimulus and have in fact, welcomed it. The ECB also projects the long-term bond yields to fall in the next three years. While the Spanish government has expanded the unemployment benefit to include many sections of the society and proposed a means-tested Minimum Income Scheme set at half the minimum wage, the current and forecasted unemployment rates demand a Universal Job Guarantee programme. Due to the lack of certainty over the revival of external trade, the recovery of the economy will be driven by domestic demand. However, domestic demand can only be revived if there is adequate support from the government sector.

The fact remains that Spain is not monetarily sovereign. The generosity of the loans from the ECB that mature in 2058 is well-timed. However, they will show up in the public debt to GDP ratio that is expected to rise to levels above 110 percent in the next few years. It is only a matter of time before Spain's lack of monetary sovereignty catches up, unless measures are taken to wholly integrate the fiscal and monetary policy action in the Union.

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