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Fiscal consolidation in Spain: the battle goes on

Authors:
Christian Hornberg, phone +49 (0) 69 7431-3770
Dr Jörg Zeuner, phone +49 (0) 69 7431-2931, research@kfw.de

In recent years, austerity policies have significantly reduced budget deficits in the struggeling European peripheral countries. However, debt-to-GDP ratios have not yet stabilised and questions remain about whether public debt in some European countries is sustainable. Persistently low credit ratings are preventing any significant drop in interest rates, which is also a problem for private sector companies, who usually pay even higher risk premiums than the national government.

Is there any way out of this impasse? Will further austerity measures ultimately increase sustainable debt? Well yes – but far more patience is also needed. That does not have to be a problem Unlike private households and companies, national governments can take the long view. We look at the example of Spain.

Are austerity policies scoring an own goal?

Spain has succeeded in consolidating its budget (Figure 1). The cyclically-adjusted primary budget deficit will be eliminated by 2014. Spain has therefore been one of the most ambitious champions of fiscal consolidation, together with Greece and Portugal.[1] Large sections of the population have had to accept drastic cuts, with many European citizens losing their livelihoods but remaining committed to the European project.

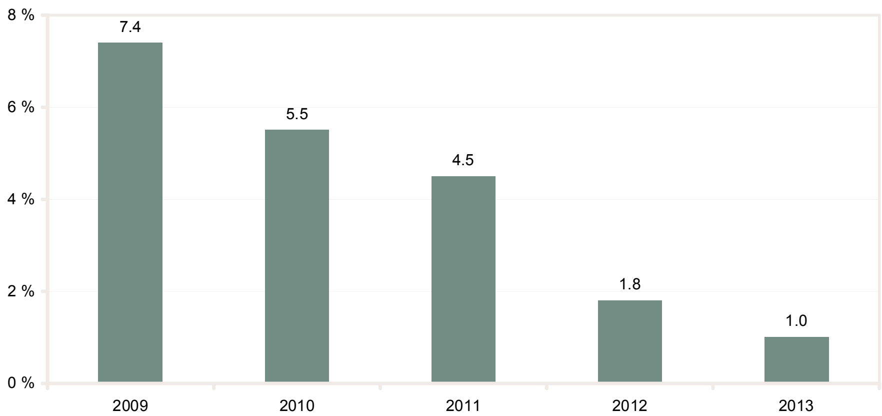
However, austerity measures have apparently not affected debt sustainability. In Spain, the ratio of public debt to gross domestic product (GDP) has continued to rise virtually unchecked during the austerity years, from a Maastricht-compliant 54 % in 2009 to an anticipated 94 % of GDP by the end of 2013.

There are four possible causes for debt-to-GDO ratio increases:

- The cyclically-adjusted primary balance deteriorates, due to higher current expenditure and / or lower current revenue from tax and social security contributions.
- Private sector liabilities – mainly from banks – are transferred to the State balance sheet.
- Rising interest rates.
- Lower GDP, due to the recession.

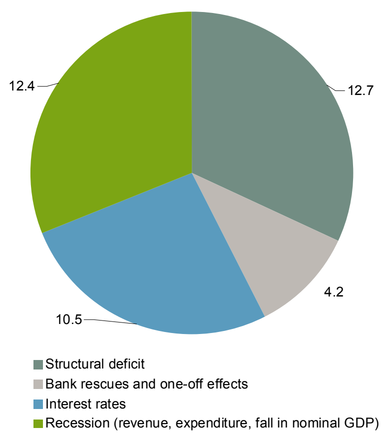
GDP in Spain has declined by around 1.5 % per annum since the onset of the crisis .The decline in GDP (including the drop in tax revenue and automatic government spending triggered by the recession, e. g. unemployment benefits)

Figure 1: Cyclically-adjusted primary deficit in Spain from 2009 to present, as a percentage of GDP, net of financial sector support



Source: IMF

Figure 2: Breakdown of the 40 percentage points increase in the debt-to-GDP ratio



Source: IMF, European Commission, own calculations account for roughly one-third of the 40 percentage point rise in the debt-to-GDP ratio since 2009 (see Figure 2). This figure far exceeds the cost of bank rescue packages and is as high as the increase in debt levels linked to the cyclically-adjusted deficit (net of interest payments). The financial crisis pushed up interest rates, which has also contributed to net new debt in Spain since 2009. Hence, efforts to combat higher debt levels through tax and spending policies *alone* were almost doomed to fail.

How does austerity create recession?

Austerity measures were necessary and yet, they are part of the problem (Figure 3). A private household can reduce spending and thereby improve its financial position, because the household's income is not dependent on expenditure. The rules are different for national governments. If the State – the largest entity in the national economy – cuts spending, economic activity falls, and subsequently so do tax revenues. This is due to the sheer size of the public sector. Similarly, if a large company goes bankrupt, there are knock-on effects in the local and regional economy that extend far beyond the initial jobs loss in the company.

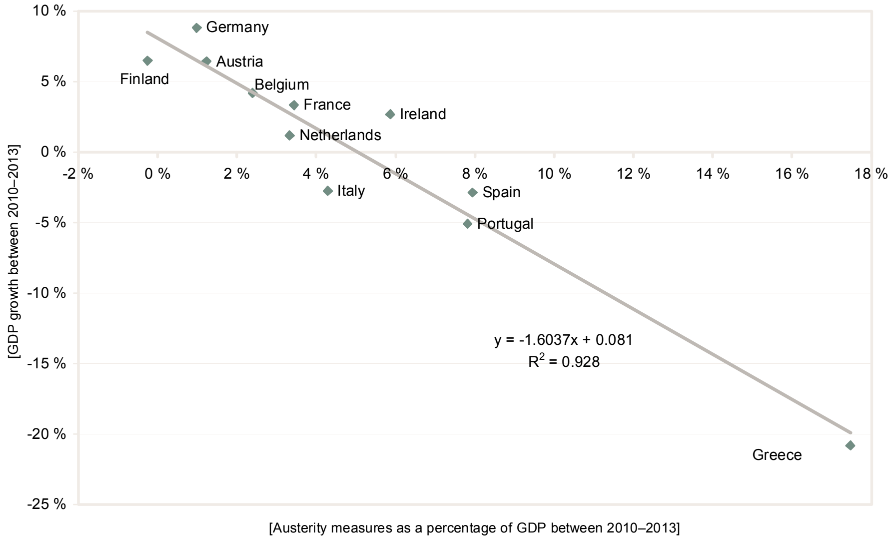
National economies form a closed circuit – if spending is reduced, then revenue declines further down the line, which in turn pushes down spending, and so on. National spending cuts ultimately result in lower tax revenue, because GDP falls.

Lower tax revenues create more pressure to cut costs and the cycle begins again. The effect of reduced spending on total current demand is currently greater than one in each cycle on this downwards spiral. The precise figure is hotly debated among economists.[2]

Of course, other factors have contributed to the recession. In Spain, as in all other struggling eurozone countries, a whole series of circumstances have exacerbated the consequences of austerity measures:

- Monetary policy has had very little impact. Spain's credit rating means higher risk premiums, which have offset the effects of base rate cuts to date.

Figure 3: Correlation between austerity measures (higher taxation and spending cuts, as a percentage of GDP) and scale of recession (GDP in 2013 as percentage of 2010 GDP)



Source: IMF, own calculations

- Weak banks have been unable to lend to the private sector. The problems in the banking sector have not yet been resolved, and it is unclear what shape Europe's future financial architecture will take.
- Debt levels are very high in the private sector now that the real estate price bubble has burst, so investment is inhibited. In a textbook recession, the negative impact of reduced state spending would be less pronounced, because private sector demand increases, effectively taking over from the State. This compensating effect has been absent in Spain due to excessive private sector debt.
- The construction sector is too big.
- Devaluing the national currency to boost exports is not an option within the single currency.
- Almost all European states are undertaking fiscal consolidation at the same time.
- In the absence of a common fiscal policy in the eurozone, the austerity packages arguably had to be draconian at the outset because capital markets essentially refused to refinance existing debt.[3] This position only changed once the ECB rolled out the OMT programme (outright monetary transactions).

Extending the term is the solution

Although sustainable fiscal consolidation is within reach for programme countries, debt sustainability appears to be more remote. Nonetheless, it is still a viable objective.

The current official fiscal policy target for eurozone countries is set out in the *European Fiscal Compact*. The economic transition countries, including Spain, are expected to return to debt ratios of 60 % of GDP, in line with the Maastricht criteria, within the next 20 years. However, this target can only be met under some very optimistic assumptions (Figure 4):

- Spain will only achieve the Maastricht target if the primary surplus increases to around 4 % of GDP and stays on that level for 15 years from 2018. That would imply GDP growth of 1.5 % per annum despite spending cuts at 5 % of GDP until 2018. International experience suggests that this is unlikely. No industrialised country has ever posted surpluses on that scale for such an extended period.
- If you take into account that austerity measures effectively slow economic growth – which would drop to an average of 0 % per annum until 2018 then – the primary surplus will even need to be almost 5 % of GDP in order to meet the Maastricht target.

Box 1: Scenarios and assumptions

In all the scenarios, we have assumed that average interest rates for the Spanish state will rise from 4 % in 2012 to 5 % from 2022 as rates in Europe gradually normalise. All scenarios comprise a transition period from 2014 to 2021, with values changing each year, then a target phase from 2022, when we have applied constant values for the future.

Scenario 1: We have calculated the primary budget surplus required to achieve the Maastricht objective by end-2033, provided that austerity measures do not slow economic growth. Most assumptions are based on the IMF forecasts. GDP growth is assumed to be 1.25 % to end-2021, then 1.5 % after that date. Average inflation (GDP deflator) is 1.3 % to 2021 and then constant at 1.75 %. With five regular increments, the required 4% primary surplus is assumed to be achieved by end-2018, based on current figures. Figure 4 shows the change in the debt-to-GDP ratio based on these figures.

Scenario 2: Here we have assumed that fiscal policy will curb economic growth and inflation. Starting from Scenario 1, we estimated the new growth rates following from that assumption and the primary surplus needed to achieve Maastricht. Average growth is lower, at 0 % to 2018 and 0.25 % to 2021. Inflation is slower, at around 0.8 % to 2021. The required primary surplus comes in at just under 5 %. The debt–to-GDP ratio rises to cvonsiderably higher levels than under Scenario 1.

Scenario 3: In contrast to Scenarios 1 and 2, here we have assumed a budget surplus of 1 % of GDP then calculated the growth needed to achieve the 60 % target.

Stabilisation scenario: Values as for Scenario 1. We have calculated the budget surplus required to stabilise the debt-to-GDP ratio over the long term.

- If, however, Spain aims to meet the Maastricht criteria with a more realistic primary deficit of 1 % of GDP from 2019, then the Spanish economy will need to achieve 6.25 % annual growth. This is unrealistic, it would constitute an economic miracle and could only be achieved through massive, almost unprecedented productivity gains.

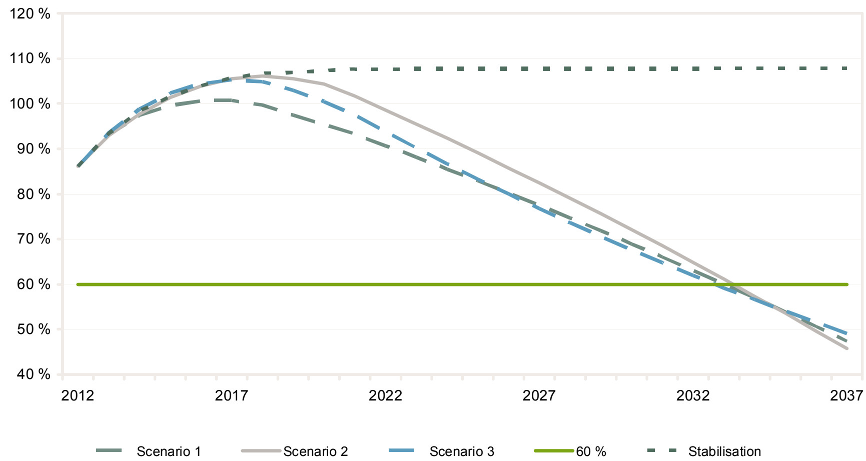
In conclusion, it seems overly ambitious to expect Spain to show a Maastricht-compliant debt level of 60 % by 2033. It will be virtually impossible to achieve that objective without a marked hike in economic growth.

In contrast, stabilising the debt ratio would be an ambitious but feasible objective. The challenge would be to achieve and maintain a primary budget surplus at 1.8 % of GDP from 2019 in conjunction with 1.5 % growth per annum. National debt would then level off at around 108 % of GDP after just five years. The necessary, annual expenditure cuts or tax increases would have to be at 0.75 % of GDP until 2019, a realistic and feasible number. In this scenario, solid growth in the United States and emerging countries combined with euro-zone stability could then help to end the recession in Spain.

Moreover, in a few years time, this scenario could be used as the starting point for reducing debt to lower levels. There is no hurry. Nation states have a long life expectancy and capital markets can easier be convinced by a plausible model than by short-term ambition.

Should growth in Spain exceed current expectations, then the debt ratio will fall almost automatically. Increased tax revenues would also boost the primary surplus and accelerate the debt reduction process. A national economy is a closed circuit and can also create a self-sustaining upwards spiral. ■

Figure 4: Spain's debt ratio as a percentage of GDP



Source: IMF, own calculations

[1] See frequency distribution of budget surpluses in industrialised countries from 1980 to 2010 in Bencek, David and Henning Klodt, Kiel Institute for the World Economy, *Five percent is too much (Fünf Prozent sind (zu) viel)*, Wirtschaftsdienst 2011, Issue 9, pp. 595–600.

[2] See in't Veld, Jan, *Fiscal consolidations and spillovers in the Euro area periphery and core*, European Commission Economic Papers 506, October 2013; International Monetary Fund, *Easy does it – the appropriate pace of fiscal consolidation*, Fiscal Monitor April 2012, Chapter 3, pp. 12–16 and International Monetary Fund, *Fiscal multipliers in expansions and contractions*, Fiscal Monitor April 2012, Appendix 1, pp. 33–39.

[3] See De Grauwe, Paul and Yue-mei Ji, *Panic-driven austerity in the Eurozone and its implications*, http://www.voxeu.org/article/panic-driven-austerity-eurozone-and-its-implications, 2012.