Spain: Government admits economic crisis far worse than previously acknowledged

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Deputy Prime Minister and Economy Minister Elena Salgado has been forced to admit that the economic situation in Spain is far worse than previously acknowledged. Until last month the Socialist Workers Party (PSOE) government remained publicly optimistic about the recession, with ministers talking about "green shoots" of recovery.

Following their poor showing in the European elections, when they fell four percent behind the right wing opposition Popular Party (PP), the PSOE has started to speak more frankly. The government has admitted for the first time that the economy will continue to shrink next year, as well as this. The European Commission has said that it expects Spain to be the last European Union economy to emerge from recession, probably in 2011.

A report from the Organisation for Economic Cooperation and Development (OECD) has painted a bleak picture predicting economic contraction of 4.2 percent this year, considerably worse than the 3 percent prediction of the Bank of Spain.

The scale of the Spanish economic crisis is indicated by the continued downward revisions of forecasts by the International Monetary Fund (IMF). In January the IMF predicted a contraction of 1.7 percent; in April it was revised to 3 percent and this week, in line with the OECD's assessment, the figure stands at 4 percent.

The speed of the recession has been striking. In 2007 Spain was running a record public sector budget surplus of 2.2 percent of GDP, but this year it will have a deficit of nearly 10 percent. Within the Euro-zone, only Ireland's public spending deficit has risen faster. The governor of the Bank of Spain has warned that government debt could exceed 60 percent of GDP next year, up from less than 40 percent at the end of last year.

Further evidence of the economic crisis can be seen in recent figures on house sales, which fell a record 47.6 percent in April compared to the same month last year. House sales have been falling for 16 months, but this was the sharpest year-on-year decline to date. The National Confederation of Construction has estimated that around 600,000 homes around Spain remain unsold and predicted a decline in the construction sector of 12.8 percent this year.

One economic analyst has suggested that the housing market will "take at least five years to be resolved." Spain's second biggest bank, BBVA, last month predicted that home prices would fall around 10 percent this year and a further 12 percent in 2010. Overall, BBVA predict a 30 percent fall from peak prices.

Much of the growth in the Spanish economy was based on a housing bubble that has now burst. Between 2001 and 2007 Spain accounted for around a third of new-build properties in the European Union. The property crash had a huge impact on the major banks and the regional savings banks, which rested on mortgages and loans to property developers. Bad loans have quadrupled in the last year and there has been a rapid rise in defaults.

The housing bubble was fed by a chain of finance based on the sale of bonds. This was swept away by the credit crunch. At its peak the Spanish current account deficit was nominally the world's second highest, behind only the United States. This was in spite of the fact that Spain has a population of only 45 million.

This unsustainable deficit has been slashed by recession. In April imports fell by 35 percent, bringing the current account deficit down from €6.55 billion in March to €3.49 billion. This is two-thirds the €9.14 billion deficit in April 2008.

Tourism, which accounts for 11 percent of Spanish GDP, has also been hard hit. Foreign visitors fell by 2 million in 2008.

Salgado has warned that employment will recover more slowly than the economy generally. Unemployment currently stands at 18 percent, just under 4 million people, almost double the Euro-zone average. Most analysts predict that it will reach 20 percent next year.

Spain has the highest level of unemployment of any OECD country. In the first quarter of 2009 Spain accounted for nearly 55 percent of total job losses across the Euro-zone, and around 35 percent of job losses in the European Union.

Salgado still defends the notion of "green shoots." Discussing the government's current fiscal stimulus measures, which are worth more than 2 percent of GDP this year, she insisted that there had been "signs of an inflection point" in June. She went on to warn that Spain cannot continue to run large budget deficits for any length of time.

Last month the government approved a bank restructuring fund, which could reach €90 billion to accelerate mergers and cut costs in savings banks. It has also agreed a €20 billion sustainable economy plan to fuel recovery, with Salgado calling on banks to put up half of the money. She called on banks not to shy away from lending to "solvent entities" at the risk of prolonging the recession.

Salgado pledged last month to "retire" the current fiscal stimulus package when growth reaches "normal figures." This was followed by a clear statement of intent: "Of course, we are very much committed to austerity and to the sustainability of our finances."

The government has already indicated what this will mean, with a first wave of tax hikes following Salgado's statement. Shortly afterwards, Treasury Secretary Carlos Ocana announced that all taxes will be reviewed for the 2010 budget.

The government has also announced cuts in spending. Salgado has pledged to reduce the 10 percent budget deficit to the European Union's stated (and largely obsolete) limit of 3 percent over the next three years. Dominic Bryant of BNP Paribas approved the intention, saying it was impossible to run a 9-10 per cent deficit for three or four years without running into problems. He warned that the pressure to "do something about the finances ... will hinder the recovery."

Similar warnings were sounded by José Luis Malo de Molina, director-general of the Bank of Spain. He expressed concern at the speed of the crisis: "the worsening of public finances could lead to a situation in which it might be necessary to raise taxes or cut costs when the economy has not emerged from the recession."

Launching the Bank of Spain's annual report, governor Miguel Ángel Fernández Ordóñez said their task was to "stop public sector debt becoming an obstacle when the Spanish economy is in a better condition to grow."

In particular, he expressed a concern that the government has no further room for manoeuvre, as "Any chance of using fiscal policy to increase spending has now been exhausted." Emergency spending brings with it the possibility of a further downgrading of national credit rating and corresponding rises in credit risk premiums.

Ordóñez upset the PSOE government earlier this year when he insisted on the need for pension and labour market reforms. As Salgado's comments have made clear, the disagreement is a tactical one. Salgado herself was appointed earlier in the year to replace former Finance Minister Pedro Solbes who was removed following his public complaints about government overspending.

The PSOE is acutely sensitive to reactions from the working class to blunt statements about spending cuts. The government looks likely to approve a €16 billion unemployment benefit supplement for up to one million workers whose dole has run out.

Prime Minister José Luis Rodriguez Zapatero is seeking to reach a new agreement on collective bargaining between employers and unions. Although he has ruled out reducing the costs of firing workers, as demanded by business groups, he is likely to offer other concessions to employers. As a minimum, employers are calling for cuts in the social security contributions they make for workers.

Gerardo Díaz Ferrán, head of the Confederation of Spanish Business (CEOE), has insisted that the labour market must be reformed, with or without agreement. "If the government can't reach an agreement through talks," he said, "it must legislate anyway. ... That is what it was elected to do."

Jean-Claude Trichet, President of the European Central Bank (ECB), has also called for greater labour reform including an end to indexing wages to inflation.