

# Has Austerity Worked in Spain?

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## Acknowledgements

The authors thank Dan Beeton, Alex Main, Jake Johnston, and Rebecca Watts for helpful comments and editorial assistance.

# Introduction

Since 2011 Spain has pursued a set of economic policies for recovery based on internal currency devaluation, labor market reform, fiscal consolidation, and structural and deregulatory reforms such as the Market Unity Law, which are based on the idea of boosting growth through increased efficiency. Unemployment is currently at 21.6 percent, and 47.7 percent for youth, with about 60 percent of the unemployed out of work for more than one year.<sup>1</sup> The number of people classified as at risk of poverty and social exclusion has risen with the unemployment rate, from 10.4 million people in 2007 to 13.4 million in 2014.<sup>2</sup>

The choice of internal devaluation stems from Spain's membership in the euro. The area-wide value of the euro proved too high for Spain — discouraging national financial saving. Spain's current account reached a deficit of 10 percent of GDP in 2007. The European Central Bank (ECB) determines the area-wide value of that currency, so euro membership precludes Spain from pursuing a nominal — or external — devaluation for the purposes of adjusting the country's current account deficit. Instead, the internal devaluation strategy seeks to lower wages and prices (relative to other eurozone members), thereby devaluing the euro for Spain in real terms. The main goal of the rest of the program is expressed in Spain's most recent (August 2015) Article IV consultation with the International Monetary Fund (IMF): “a clear commitment to continue structural reforms and to put the level of sovereign debt on a firmly declining path would help anchor confidence.”<sup>3</sup> In this theory, increasing the confidence of investors (foreign and domestic), consumers, and entrepreneurs, despite the negative impacts of fiscal tightening and slowing wage growth on aggregate demand, will prove to be the fastest path to recovery.

The IMF notes that the 2012 labor market reforms, which reduce the bargaining power of labor, have succeeded in reducing wage growth.<sup>4</sup> It recommends additional fiscal tightening of about 0.5 percent of GDP per year in order to reduce the public debt. The Article IV paper notes that “efficiency gains and fiscal savings” can also be found in public health and education.<sup>5</sup>

The Spanish economy began to recover in the second half of 2013, with real GDP growth for 2015 now projected at 3.1 percent. However, it is not clear how what government policy changes may

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1 Eurostat (2015b).

2 Eurostat (2015a).

3 International Monetary Fund (2015b).

4 Ibid.

5 Ibid.

have contributed to this recovery. Perhaps most importantly, the European Commission reported on December 10 that the net fiscal consolidation measures of the government for 2013–15 fell short of the target by 2.8 percentage points of GDP.<sup>6</sup> (The target is set by the Excessive Deficit Procedure of the Stability and Growth Pact.) If these estimates are accurate, then much of Spain’s economic recovery could be explained by the government’s loosening of fiscal policy — in addition to “tailwinds” noted by the IMF, including falling oil prices, a depreciating euro, and the ECB’s quantitative easing, which has lowered interest rates.<sup>7</sup> If this is true, it is possible that more fiscal tightening is in store for after the December Spanish parliamentary election — depending on the outcome — since the government has assured that it will meet the fiscal targets by 2016.

This report looks at Spain’s recent economic history, both before and after its recession, with a focus on employment, contributions to GDP growth, and the current account balance.

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<sup>6</sup> European Commission (2015).

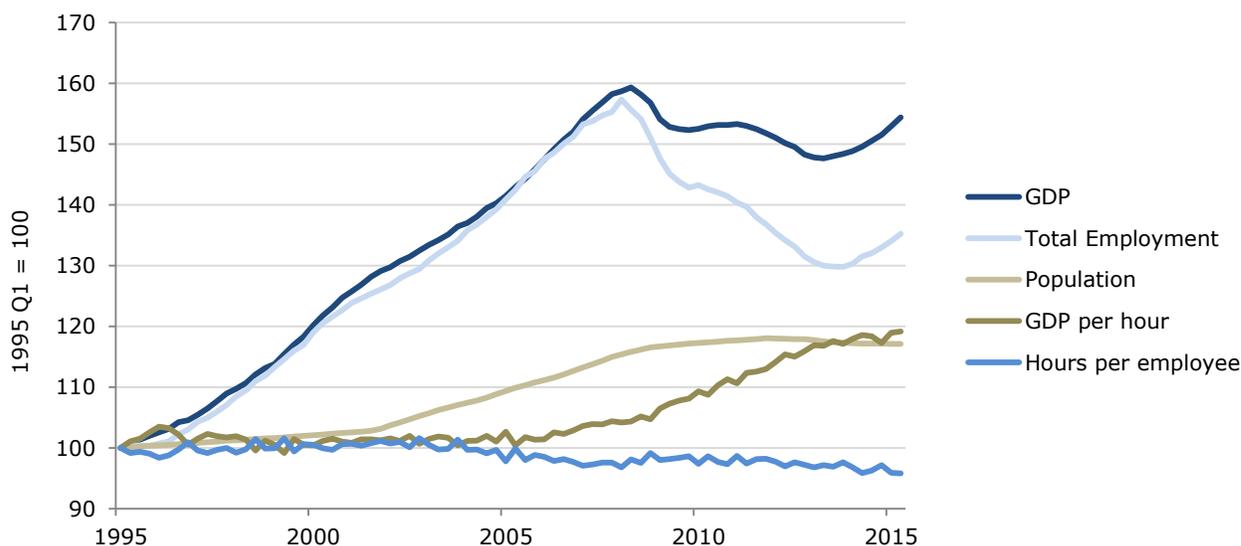
<sup>7</sup> IMF (2015b).

# Has Austerity Worked?

Since 1995, the Spanish economy has seen three distinct phases. In the pre-euro period, Spanish productivity, working hours, and population all changed little; the economy grew almost exclusively as the result of more residents finding employment. This can be seen in **Figure 1**.

**FIGURE 1**

**GDP and Components of GDP Growth in Spain**



Source: OECD Quarterly National Accounts (2015)

From 2002 to 2008, an influx of immigrants helped sustain employment growth in Spain as aggregate demand increased. Since the crisis in 2008, however, the economy has performed very differently. While population and hours remained flat, productivity growth has accelerated and employment has fallen dramatically — from 47.5 percent of the population at the start of 2008 to 38.5 percent of the population in late 2013.

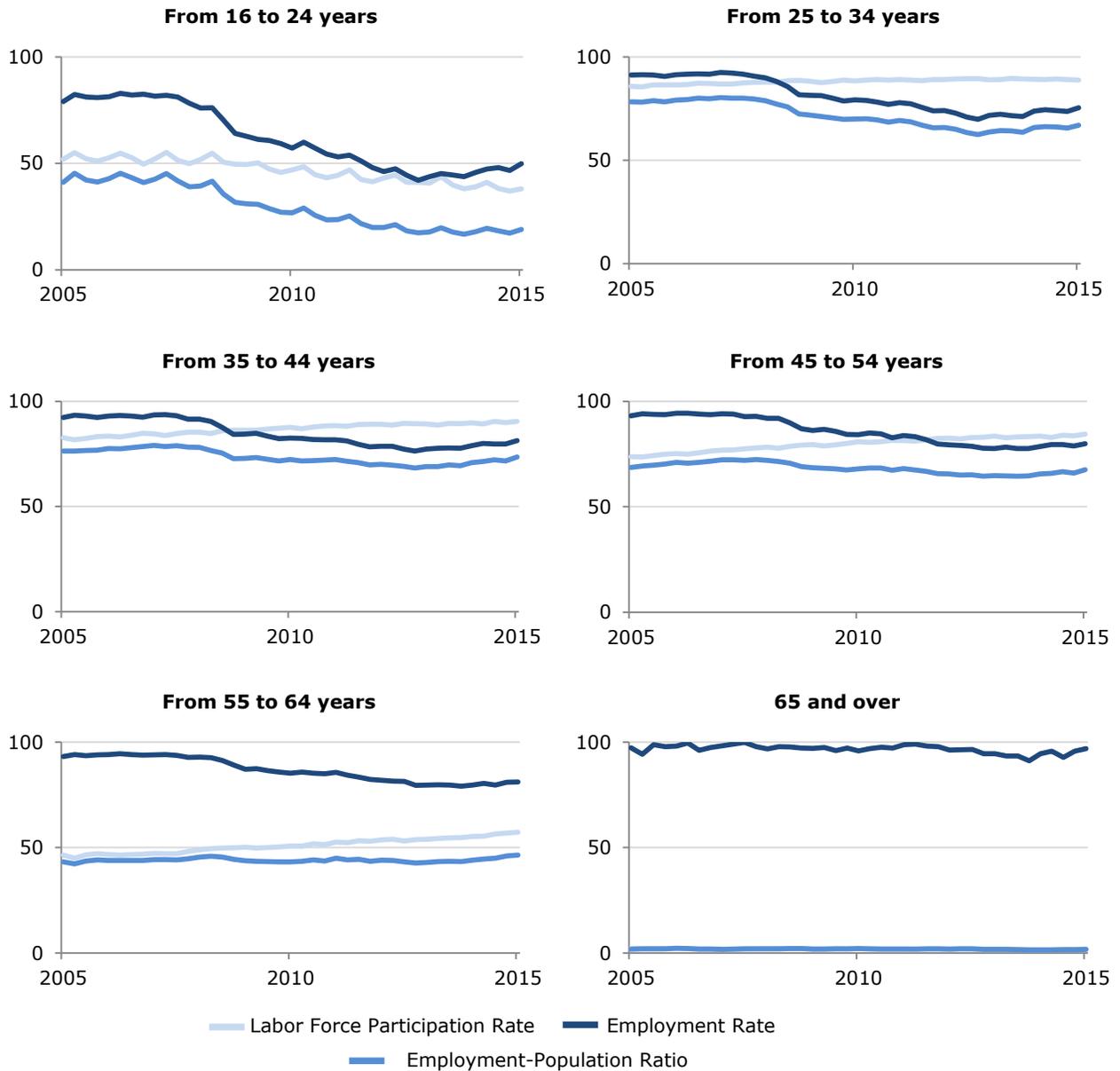
Despite recovery over the last year and a half, employment in Spain has fallen by three million in seven years. The International Monetary Fund does not expect per-capita output in Spain to return to 2007 levels until 2018. By any modern historical comparison, this is a long time to get back to pre-crisis average living standards.

Over the past decade, people aged 25–64 have consistently increased their labor force participation, despite plummeting levels of employment from 2009–14 (as shown in **Figure 2**).

**FIGURE 2**

**Employment Status in Spain By Age**

(percent of the age group)



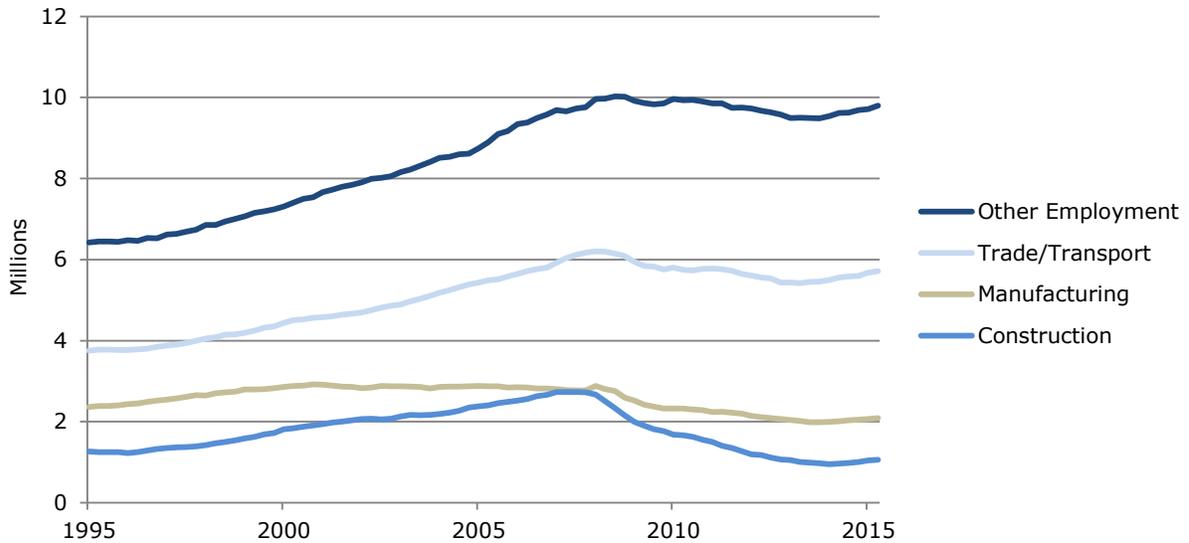
Source: INE Statistics on the Flows of the Economically Active Population (2015)

The employment losses have not been equally shared. Trade and transportation lost 787,000 jobs between 2008 and 2013, and another 894,000 jobs were lost in manufacturing. However, from 2007 to 2014, the number of people working in construction fell by 1,786,000. Construction alone accounted for 55 percent of all job losses over this period, despite representing less than 13 percent of total jobs in mid-2007. Consequently, 2 percent of the Spanish population worked construction in early 2014, compared to more than 6 percent in 2007.

**FIGURE 3**

**Employment in Select Sectors in Spain**

(number of people employed per sector)



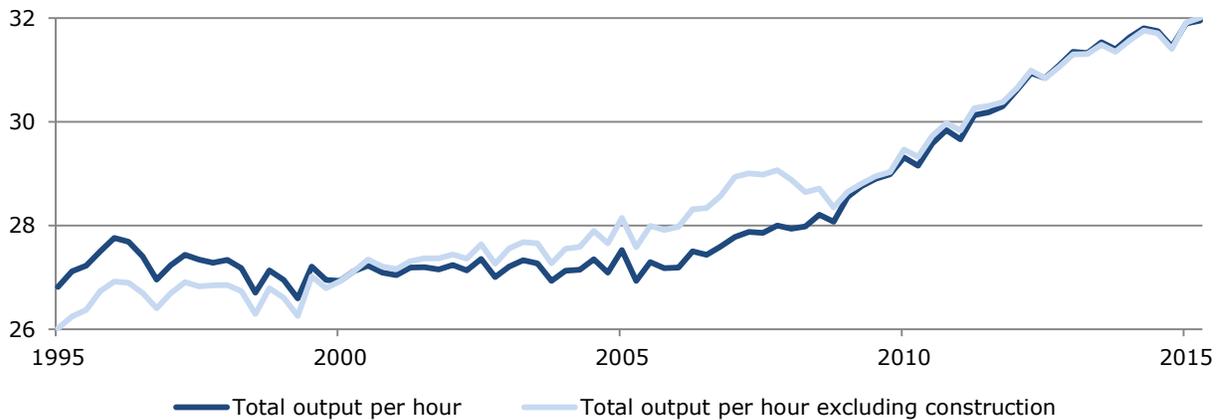
Source: OECD Quarterly National Accounts (2015)

Likewise, construction explains a large part of the acceleration in productivity growth since the crisis began. From 1995 through the start of 2007, overall productivity had been growing at an annualized 0.3 percent rate; productivity in the economy outside of construction had grown three times as fast — 0.9 percent per year. Since the start of 2007, overall productivity has grown at a 1.7 percent annualized rate, but only 1.2 percent outside construction. This can be seen in **Figure 4**.

**FIGURE 4**

**Hourly Productivity in Spain — Overall and Non-Construction**

(real output per hour)

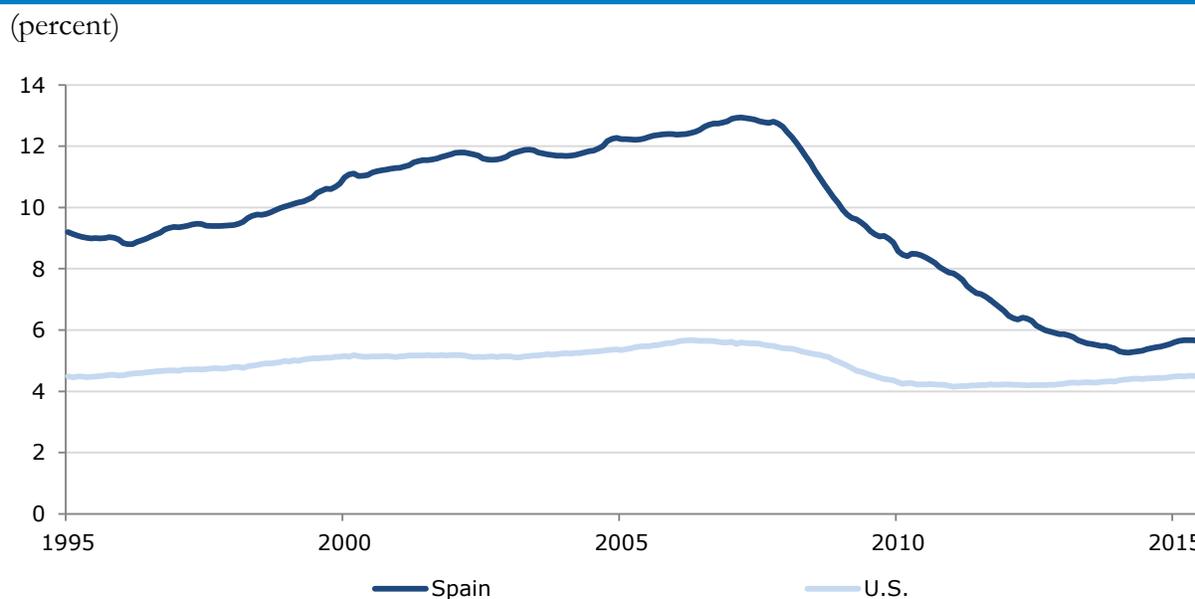


Source: OECD Quarterly National Accounts (2015)

Doubtless, then, much of the recent history of the Spanish economy is driven by construction — and by the expansion and implosion of a large real estate bubble. According to the IMF, inflation-adjusted house prices doubled in just seven years before losing 40 percent of their peak value.<sup>8</sup> While house prices moved likewise in the United States — losing more than 2.2 million construction jobs — construction accounted for 5.6 percent of total U.S. employment at its peak at the start of 2007 compared to nearly 13 percent in Spain that same quarter.

**FIGURE 5**

**Construction Share of Employment — U.S. and Spain**



Source: OECD Quarterly National Accounts (2015) and BLS Current Employment Statistics (2015)

As of mid-2015, construction in Spain accounted for 5.6 percent of total employment, compared to 4.5 percent in the United States. Thus, the real estate bust hurt Spain much more than it did the United States. One problem for Spain is how to find work for almost two million construction workers when demand for such work is low.

Total employment hit bottom at the end of 2013. Indeed, more than any other sector, employment in construction has grown more rapidly in percentage terms in the last year and a half. Over that period, construction employment has increased by 83,000 jobs, or 8.5 percent. In absolute terms, trade and transport has recovered 257,000 jobs — or about one in three jobs lost in that sector since the crisis began.

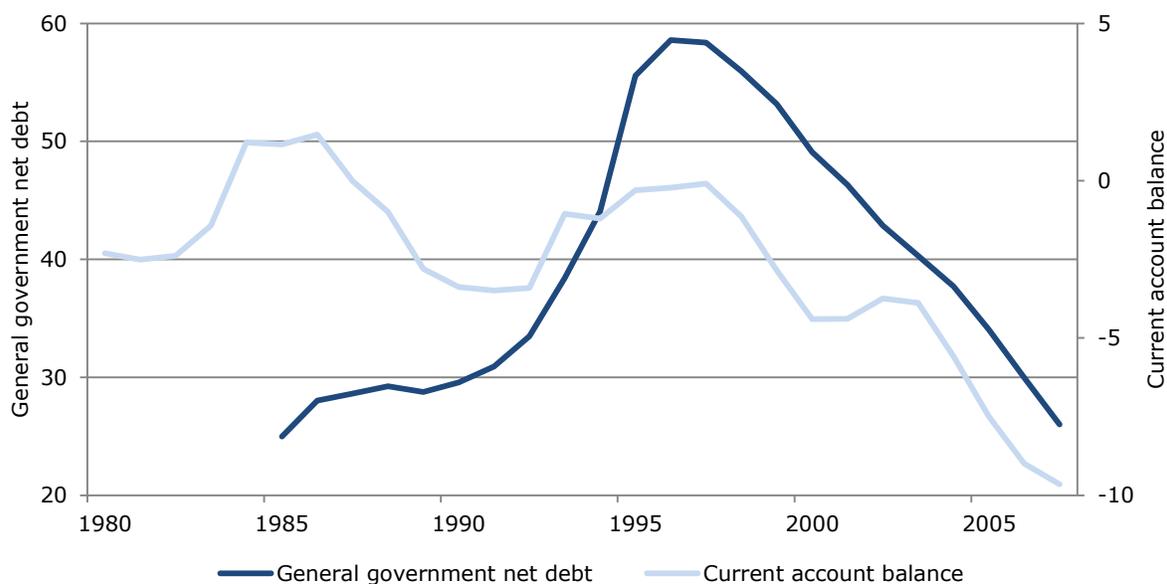
<sup>8</sup> International Monetary Fund (2015a).

Locking in a euro that, for Spain, proved overvalued may well have fueled the housing boom. In **Figure 6**, we see that, pre-Euro, generally austere Spain had an unusually high level of government debt but had been rapidly reducing its debt-to-GDP ratio from nearly 59 percent in 1996 to 26 percent in 2007.

**FIGURE 6**

**Net Debt and Current Account Balance in Spain**

(percent of GDP)



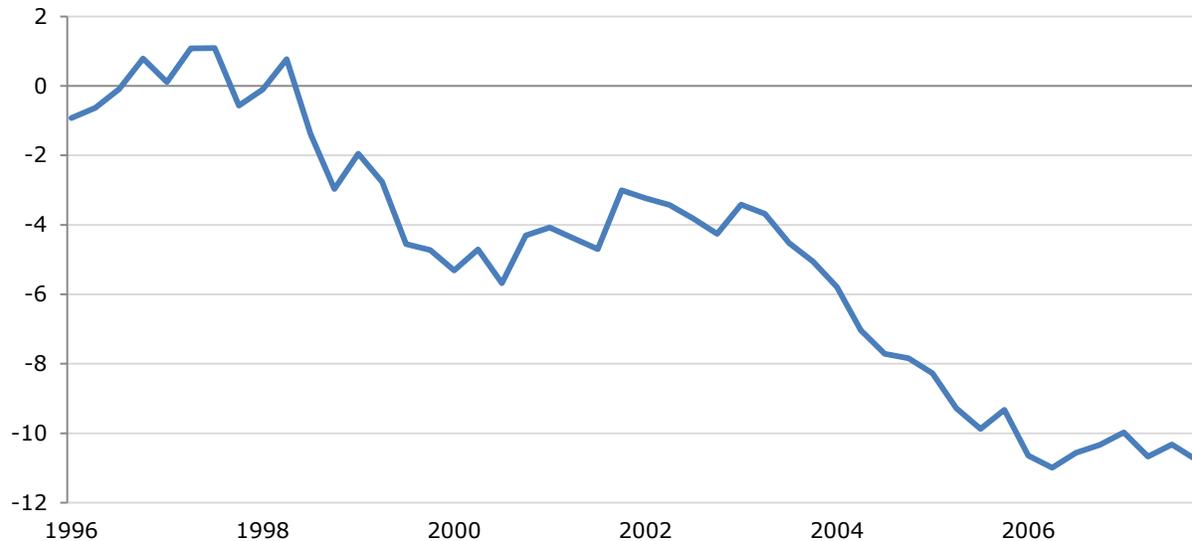
Source: IMF World Economic Outlook (2015c)

Figure 6 shows that the decline in the current account balance was not the consequence of excessive government deficit spending. In fact, government net *lending* rose from 0.7 percent of GDP in 1997 to 3.1 percent in 2007 while national financial saving (as measured by the current account balance) fell from -0.1 percent to -9.6 percent of GDP. Rather, Spain's increased private sector borrowing financed net imports of goods and services.

**FIGURE 7**

**Net Export Share of Total Trade in Spain**

(percent)



Source: OECD Economic Outlook (2015)

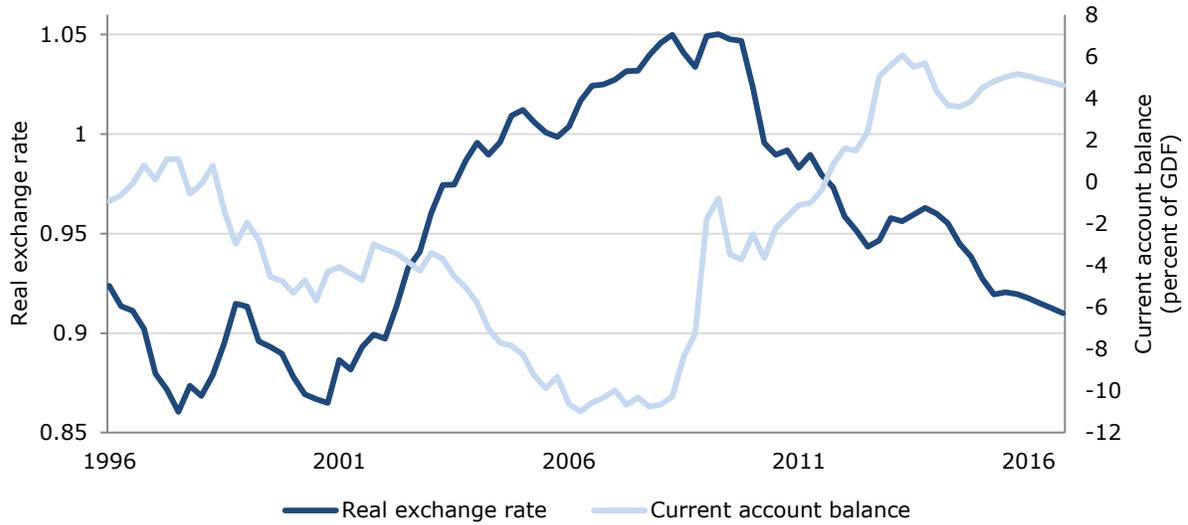
While in the United States the dollar may not be appropriately valued from state to state, it has a national fiscal authority that automatically supports those states where growth slows. The eurozone has no equivalent balancing mechanism.

Thus, when a country like Spain starts running large external deficits the correction must come through product prices. As with the Federal Reserve vis-à-vis Argentina's dollar peg in the late 1990's and Greece today, the European Central Bank (ECB) has failed to sufficiently accommodate Spain's need for greater inflation among its trading partners. And as in Argentina and Greece, these combined policy failures demand "internal devaluation" — lowering the real price of the currency through relatively low inflation (or deflation), brought on by a cycle of reduced demand for goods and services and lower employment.

Note that the collapse of the Spanish economy brought a significant improvement in the balance of trade as demand for imports rapidly fell. As inflation slowed nearly to zero — the GDP deflator increased a total of 1 percent between 2008 and 2014 — the internal devaluation succeeded and the falling real exchange rate further increased net exports. In that sense, then, **Figure 8** shows progress in the Spanish economy.

**FIGURE 8**

**Real Exchange Rate and Current Account Balance in Spain**



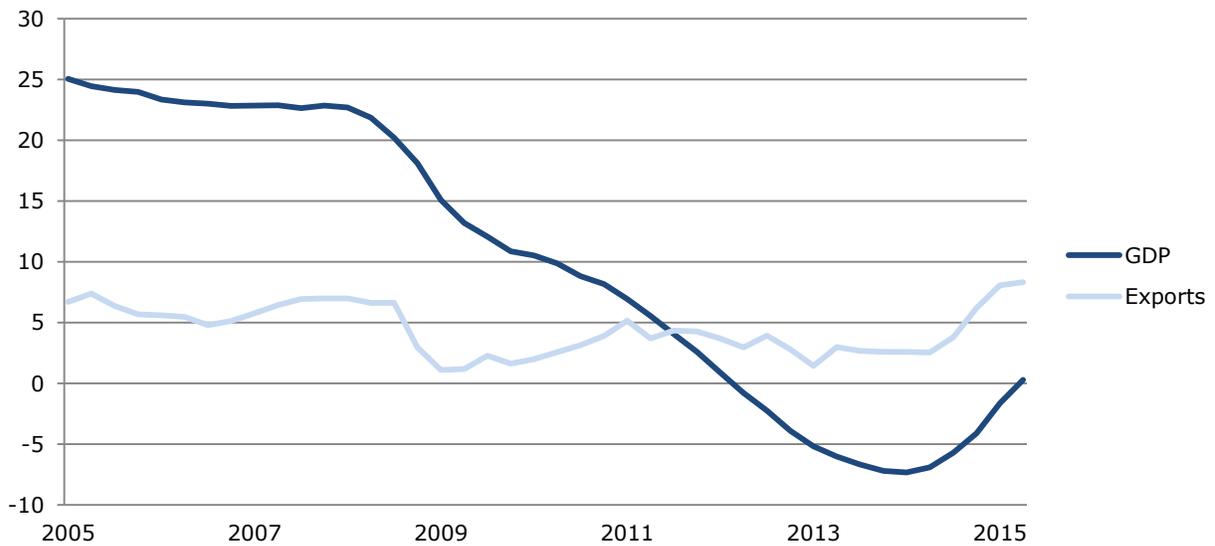
Source: OECD Economic Outlook (2015)

There has also been some recovery in export growth since the crisis, but the recent contribution to GDP growth from exports has been comparable to pre-crisis. In the last six years, export growth in both goods and services increased GDP by 8.3 percent compared to 7 percent in the six years ending in early 2008.

**FIGURE 9**

**Cumulative Six-year GDP Growth and Export Contribution to GDP Growth in Spain**

(percent)



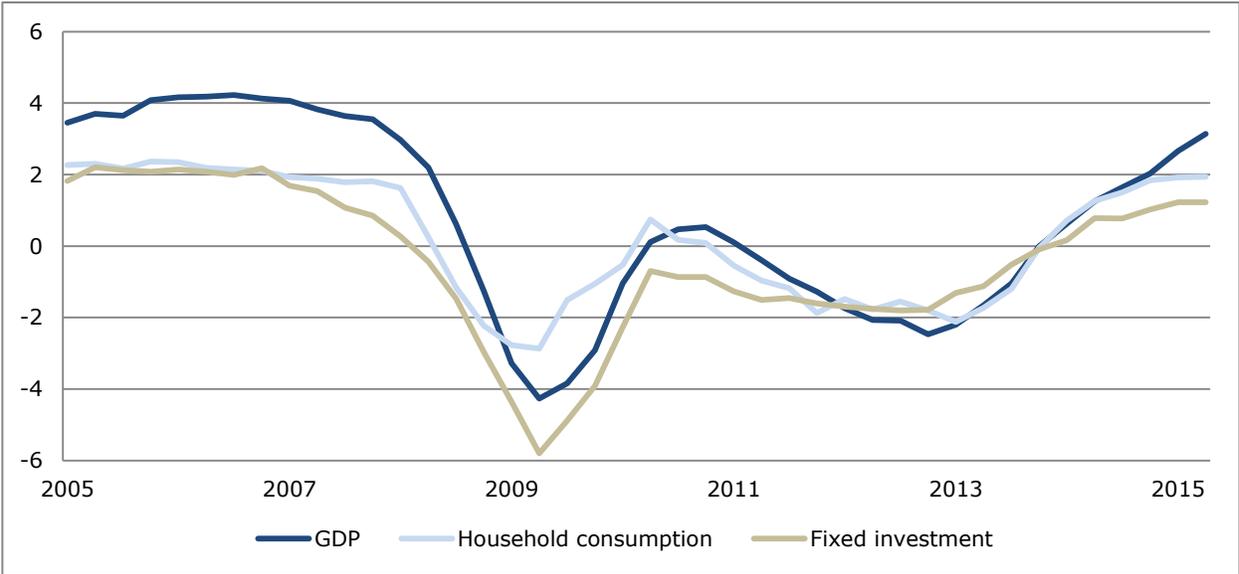
Source: OECD Quarterly National Accounts (2015)

However, the return to overall GDP growth in the last several quarters is due to acceleration in growth of consumption and fixed investment. Household consumption has added 1.9 percent to GDP in the last four quarters — comparable to its contribution to growth in 2006. Fixed investment contributed another 1.2 percent to GDP — its first positive contribution since the bursting of the construction bubble.

**FIGURE 10**

**Four-quarter GDP Growth and Contributions from Household Consumption and Fixed Investment in Spain**

(percent)



Source: OECD Quarterly National Accounts (2015)

Specifically, the increase in fixed investment has come not in construction of new homes but in transportation equipment and machinery.

## Conclusion

The data examined in this paper indicate that Spain's current economic recovery is unlikely to resolve the problem of mass unemployment in the foreseeable future. Indeed, the IMF estimates that Spain will have an unemployment rate of about 16.5 percent when it reaches potential output,<sup>9</sup> i.e., that will be its full employment level unless there are structural changes in the economy that significantly increase potential output. However, there is little evidence that the kind of structural changes being proposed, such as making it easier for employers to fire workers, will greatly increase potential output.

The data here also do not support the thesis that the current economic recovery is the result of a return of market, consumer, and investor confidence due to fiscal consolidation. A more likely explanation is a slowdown and possibly even end of fiscal consolidation, combined with the favorable external factors mentioned above. IMF estimates of Spain's general government structural balance for the years 2011 to 2015 are shown in **Table 1**, below, as percentage of GDP:

**TABLE 1**

**General Government Structural Balance in Spain**

Year	2011	2012	2013	2014	2015
Percent of GDP	-7.0	-3.7	-3.0	-2.5	-2.3

Source: IMF World Economic Outlook (2015d)

As noted above, the European Commission estimates that Spain's government missed its net fiscal consolidation targets by 2.8 percent of GDP for the years 2013–2015 indicate that the government's fiscal consolidation may have been significantly less than reported.

Relying on continued “growth-friendly fiscal consolidation”<sup>10</sup> — as the IMF recommends — as well as efficiency gains from further labor market or other reforms, is unlikely to move the economy toward reasonable levels of employment in the foreseeable future. A strategy of fiscal stimulus and public investment, combined with revenue increases that maintain a sustainable debt burden, present a much more effective alternative.<sup>11</sup>

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9 IMF (2015b).

10 Ibid.

11 Rosnick and Weisbrot (2013).

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