

Policy Alternatives for a Return to Full Employment in Spain

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Introduction

With Spain's official unemployment rate at 26 percent, and the economy projected to contract by 1.3 percent this year, it is difficult to make the case for continued austerity that could push a barely growing economy back into recession. Yet the government is committed to further fiscal tightening, on the grounds that it has no choice. In defending the austerity last April, Prime Minister Mariano Rajoy said:

“These are tough budgets, painful. We are doing things that nobody likes. But this is what needs to be done to correct the mistakes and failures of the past.”¹

And on numerous occasions he has added, “There is no other alternative.”²

This paper will show that there are various feasible alternatives that can restore full employment to Spain by 2018, as well as other possibilities that could accomplish this goal even sooner.

According to the International Monetary Fund (IMF), Spain's economy in 2014 will run 3.6 percent below its potential. This represents a loss of income of €1,700 (\$2,300) per person in the labor force. However, this almost certainly understates the degree to which the Spanish economy is currently underperforming. In April 2011, the IMF estimated that Spain's potential output for 2014 was €1.13 trillion while today estimating Spain's actual output to be €1.03 trillion—a shortfall of 8.6 percent. In other words, in the last two years, the IMF has erased more than half of Spain's underperformance by revising down potential output.

This matters a great deal in guiding economic policy. If output is well below potential, this means that the economy is full of qualified workers left unemployed because business does not foresee sufficient sales to make the hiring of these workers profitable. Only increasing demand for goods and services will return the unemployed to work. Generally, this means that the government itself must step up by purchasing domestic goods and hiring the unemployed.

Another source of demand is the foreign sector. Devaluing a country's currency relative to that of its trading partners makes domestic goods and services more desirable than foreign. In the case of Spain and other depressed European economies where much capital has left the country, the economy would also get a significant boost from capital inflows when a devaluation cheapens the foreign currency price of domestic assets. If, however, the country shares a common currency with its main trading partners—as is the case with Spain—then a nominal devaluation is not possible, making government spending even more important.

1 Carlos Cué and Francesco Manetto “Rajoy defiende el ajuste como único antídoto contra la intervención.” *El País*, April 2, 2012.

2 See e.g., <http://www.europapress.es/nacional/noticia-rajoy-admite-hay-ajustes-no-le-gustan-no-hay-alternativa-20120718095509.html> ; and <http://www.europapress.es/nacional/noticia-rajoy-admite-hay-ajustes-no-le-gustan-no-hay-alternativa-20120718095509.html>

On the other hand if there is considerable unemployment while output is near potential, then unemployment is considered structural. In such a case, even if businesses have opportunity to expand profitably they fail to find qualified workers among the unemployed. The solution to “structural” unemployment, as opposed to demand-driven “cyclical” unemployment, generally involves weakening workers’ bargaining position to make production more profitable.

If one kind of unemployment is wrongly identified as the other, the consequences can be disastrous. As an economy founders in a deep recession and operates below capacity, there is little incentive for businesses to expand capacity by investing. Thus, the potential of the economy to produce in the future is damaged. Likewise, the longer workers remain unemployed, the less likely they are to fulfill their own potential. In this way, untreated cyclical unemployment may turn into structural unemployment.

At first glance, IMF data suggests that the transformation from cyclical to structural is well underway in Spain, as evidenced by the downward revisions to potential output. However, recent downward revisions to potential output presented seem especially large. In comparison to the IMF’s estimate that Spain’s economy is running 3.6 percent short of potential, the Organization for Economic Co-operation and Development (OECD) estimates the 2014 output gap to be -9.4 percent.³

Furthermore, revenues naturally fall when an economy is depressed, so the fiscal stance of the government is adjusted to the business cycle. This means that if a fall in output is deemed structural rather than cyclical, the government will appear to be less austere than it would if the downturn were cyclical. Thus, it is no surprise that in the IMF’s recent Article IV consultation, the focus was on structural issues and debt reduction rather than boosting demand – since by the IMF’s analysis, the economy is not so far from its potential.

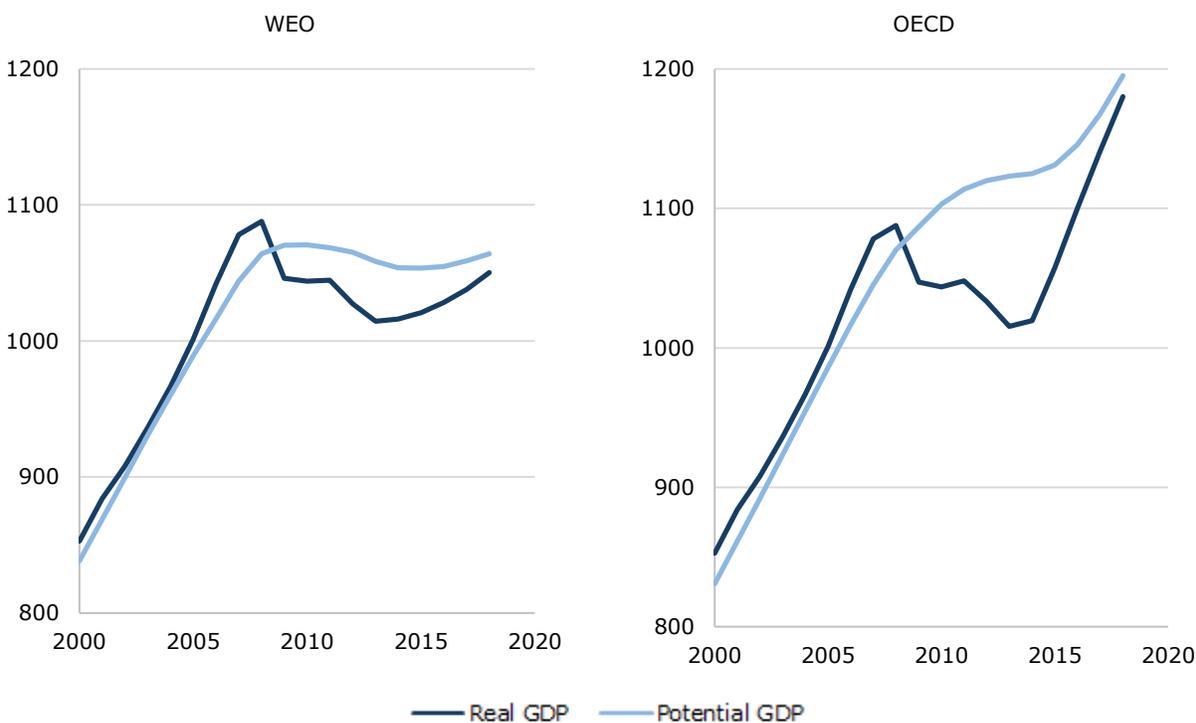
In this paper, we describe a simple economic model and – based almost entirely on IMF data – show how Spain’s economy may be improved. With some modest assistance from the European Central Bank (ECB), Spain’s debt levels may even be reduced relative to the size of the economy, even while pursuing a fiscal stimulus.

Forecasts for Spain 2014-18

Figure 1 shows the historical and projected GDP for Spain, along with estimates for potential GDP. The right panel shows projections by the OECD, while the left panel shows those made by the IMF.

³ The output gap is defined as the percent of GDP above potential, so a negative output gap means that the economy is depressed.

FIGURE 1
Real GDP and Potential Output (Billions of 2008 Euros)



Sources: IMF World Economic Outlook October 2013, OECD Economic Outlook 93, and authors' calculations

In both sets of projections, the economy is expected to recover over the next several years. The major difference between the two is that the IMF expects Spain's potential GDP to stagnate, while the OECD expects more rapid growth in potential GDP.⁴ The IMF's pessimism is so extreme that even if Spain returns to full employment in 2018, they forecast an economy that will be less productive than it was back in 2007—a truly lost decade.

If the Spanish economy does continue to stagnate, the IMF's assumptions for potential growth will become a self-fulfilling prophecy, due to low rates of investment and low participation in the labor force.

Furthermore, it may be noted that the OECD also projects larger government deficits than does the IMF. In each year from 2013-18, every dollar of additional borrowing in the OECD forecast relative to the IMF forecast is associated with 1.5-2.9 dollars of additional GDP. This suggests a relatively large effective fiscal multiplier. In this paper, we will use more conservative estimates. A recent paper summarizing more than 100 studies of fiscal multipliers suggests that tax and transfer multipliers are somewhat less than 1.0, with larger

⁴ It is inevitable that the IMF will show little growth in potential GDP as Spain's economy continues to stagnate, as its estimates are based on filtering actual GDP to remove cyclical effects. By contrast, the OECD projects capital stocks and effective labor to estimate potential output. For this reason, we will use OECD estimates for potential output rather than those produced by the IMF.

multiplier effects for direct government spending on consumption and investment—the latter about 1.0 percentage point greater than the tax multiplier.⁵

The Model

Suppose that every dollar of taxes reduces GDP by 50 cents. Suppose further that every dollar of primary (non-interest⁶) transfers from the government to the public increases GDP by 50 cents, but every dollar of direct expenditures increases GDP by \$1.50. Given baseline GDP (Y), an increase in direct expenditures (dG), primary transfers (dT) and revenues (dR), results in an alternative path for GDP (Y') where $Y' = Y + (3dG + dT - dR)/2$. As the World Economic Outlook (WEO) does not distinguish between direct expenditures and transfers, we may distinguish an increase in direct spending from an increase in transfers by adjusting the multiplier accordingly.⁷

Figure 2 shows the effect of raising direct expenditures by 1 percent of *potential* GDP, and alternatively, the effect of cutting taxes by 1 percentage point of GDP.⁸ By construction, each alternative lowers the cyclically-adjusted primary budget balance⁹ by 1 percent of potential GDP.

As seen in Figure 2, the baseline cyclically-adjusted primary fiscal balance is expected to move into surplus this year. Officially, the IMF reports a structural fiscal deficit amounting to 4.9 percent of potential GDP, but this figure relies on their very low estimates of potential GDP. Regardless, an increase in government expenditures has a much larger effect on output than does a tax cut of (cyclically-adjusted) equivalent size.¹⁰

5 Table 5, http://www.boeckler.de/pdf/p_imk_wp_117_2013

6 Interest payment recipients are assumed here to be all foreigners. Thus, any increase in interest payments has no effect on output. In practice, some interest payments are domestic, and therefore likely to be recycled in part into the economy. This assumption makes larger deficits appear less beneficial than would otherwise be the case.

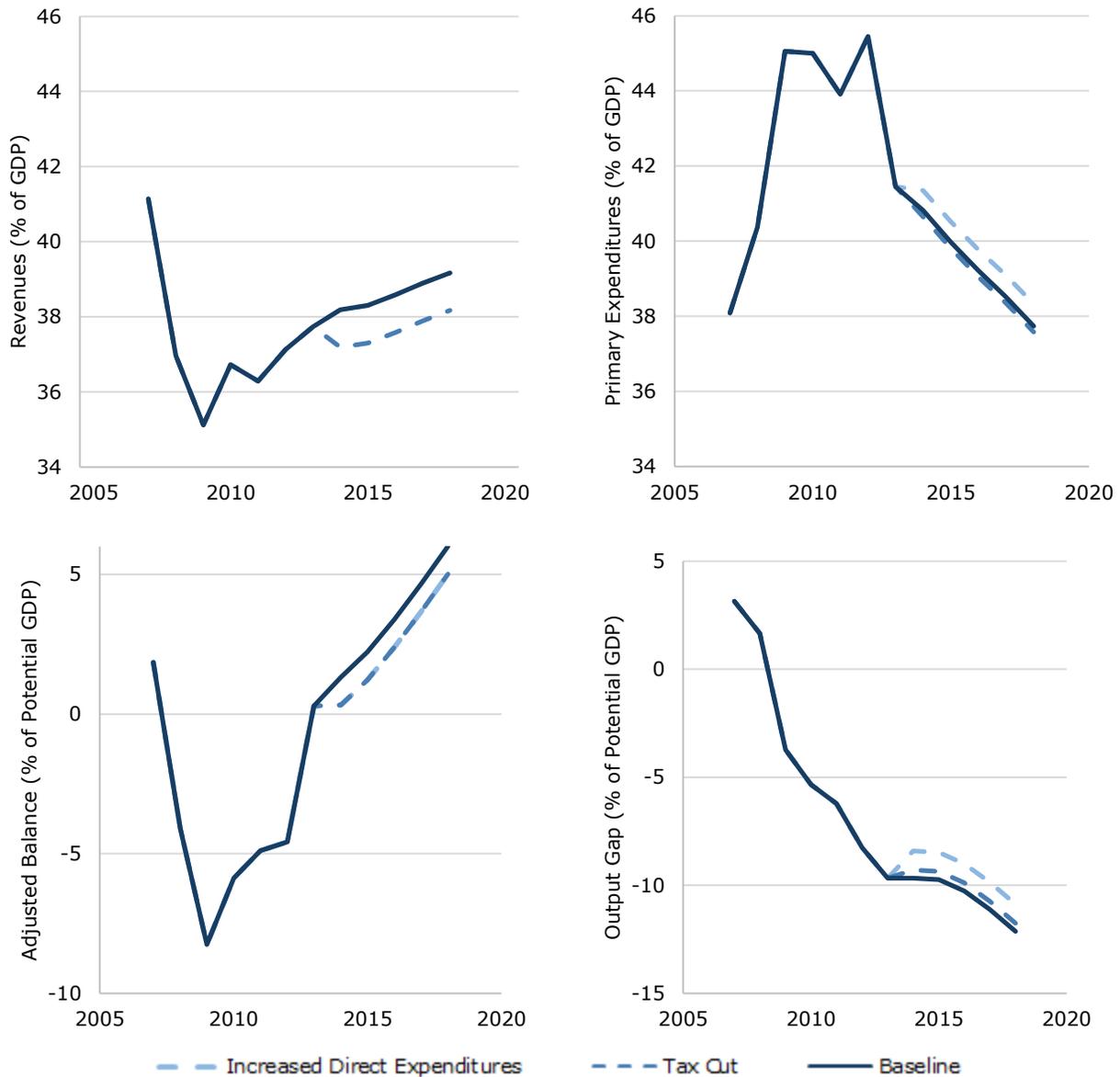
7 That is, an increase in spending which consists entirely of transfers will have a multiplier of 0.5, while an increase in spending which consists entirely of direct expenditures will have a multiplier of 1.5. A 50-50 mix of transfers and direct expenditures will have a multiplier of 1.0.

8 Note that because the increase in spending (tax cut) raises GDP, the amount of the increase (tax cut) in euros is more than 1 percent of baseline GDP. If baseline revenues and spending are 40 percent of GDP, raising it to 41 percent would require an increase in government expenditures equal to about 2 percent of baseline GDP, thereby raising GDP by nearly 2.5 percent.

9 Here, we define the cyclically-adjusted primary balance as potential GDP times the revenue share of GDP, less primary expenditures, as described in <http://www.imf.org/external/pubs/ft/tnm/2009/tnm0905.pdf>. The cyclically-adjusted primary balance as a share of potential GDP is therefore given by the revenue share of GDP, less the primary expenditure share of potential GDP.

10 Note that these results are built in to the model, and do not serve as independent evidence of large fiscal multipliers.

FIGURE 2
Effects of Alternative Types of Fiscal Stimulus

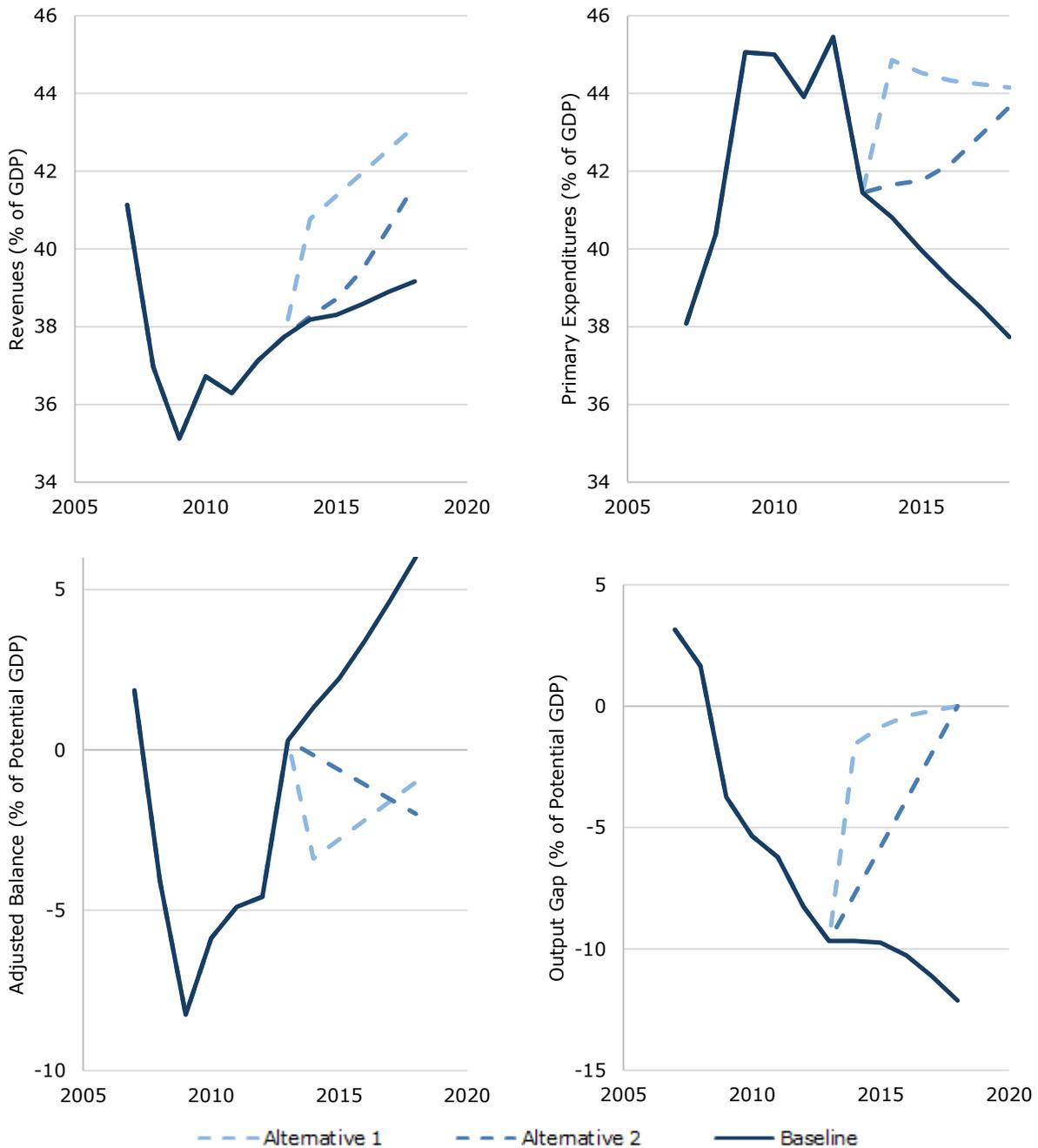


Sources: IMF World Economic Outlook October 2013, OECD Economic Outlook 93, and authors' calculations

Options for Restoring Full Employment in Spain

Based on this model, we now investigate policies to help the Spanish economy return to its potential. These options fulfill the modest goal of narrowing the output gap to zero by 2018. There are innumerable paths by which this goal may be achieved, but here we consider two possibilities. The first path returns the cyclically-adjusted primary balance to a path that reaches -1 percent of potential GDP by 2018. The second path more slowly improves the output gap but more slowly increases the cyclically-adjusted primary deficit to -2 percent of potential GDP by 2018. These alternatives are illustrated in **Figure 3**.

FIGURE 3
Alternatives for Reaching Full Employment by 2018

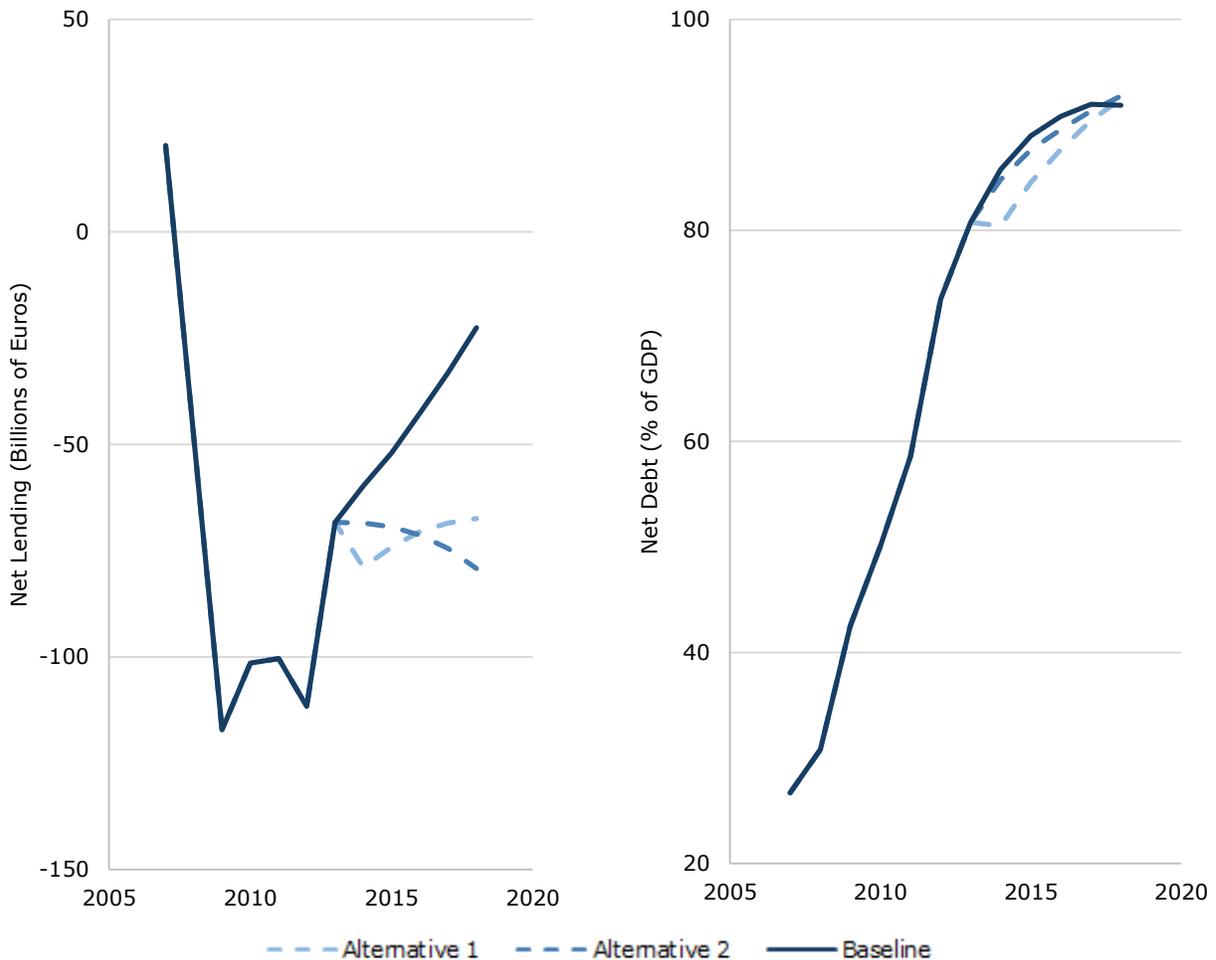


Sources: IMF World Economic Outlook October 2013, OECD Economic Outlook 93, and authors' calculations

As Figure 3 shows, both alternatives require higher revenues and expenditures than does the baseline scenario, and the first alternative employs generally higher revenues and expenditures than does the second. However, the first alternative results in higher GDP in the medium-run with generally less debt as a share of the economy than even the baseline, as seen in **Figure 4**.

The second alternative path to full employment involves higher levels of debt—both absolute and relative to the size of the economy. As we assumed this debt to be foreign, the interest payments represent a real cost to the domestic economy. In this model the cost is reflected in the need for higher revenues, which then slows growth. Spain, having a shared currency, has no ability to monetize its debt. Rather, the ECB holds that power. If the ECB bought significant amounts of debt with the intent of rebating (or forgoing) interest payments, this would in effect lower Spain’s debt levels, which would then permit an increase in primary deficits.

FIGURE 4
Deficits and Debt Under Alternative Policies

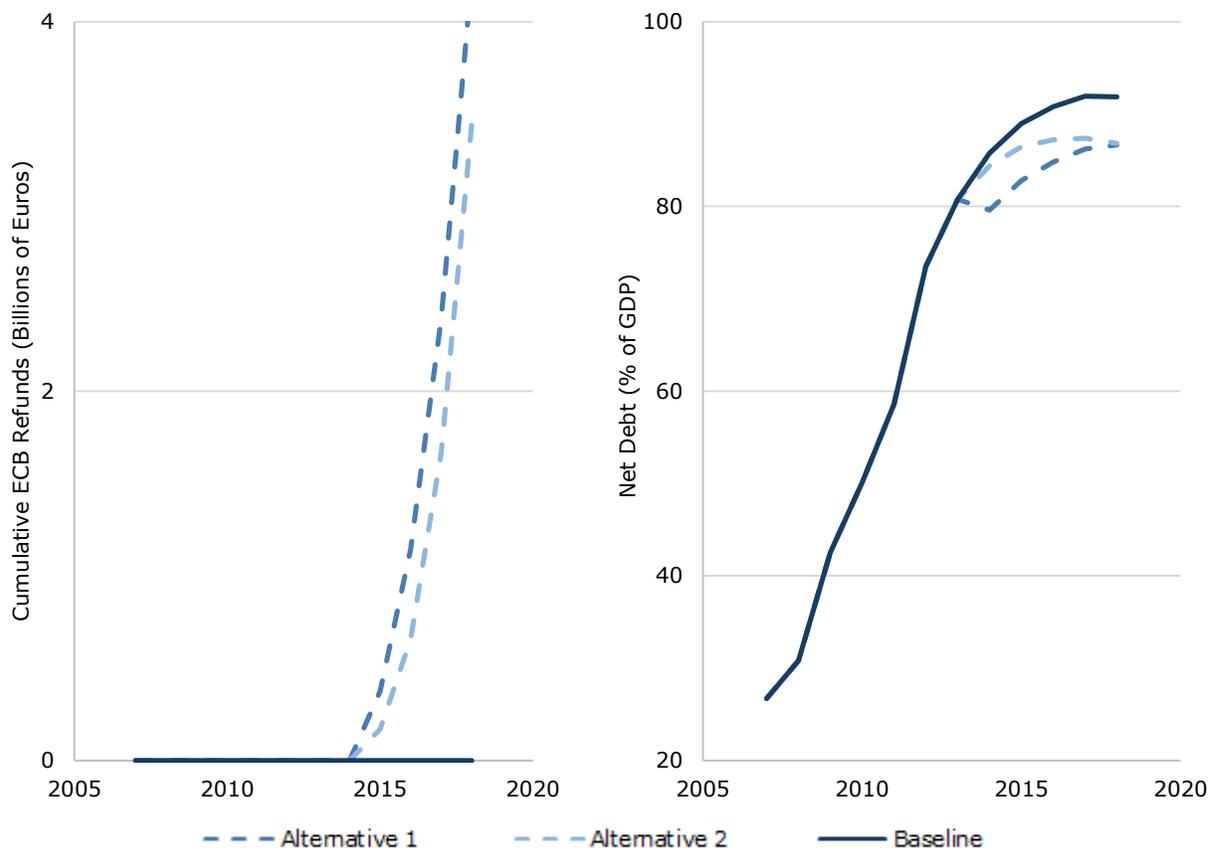


Sources: IMF World Economic Outlook October 2013, OECD Economic Outlook 93, and authors’ calculations

Suppose that the ECB committed to financing half of any proposed stimulus—that is, purchasing Spanish debt of value equivalent to 50 percent of primary net lending in excess of baseline. As a money-creating central bank, there is no true cost to the ECB to make this commitment. Nevertheless, the size of the commitment may be described by the cumulative interest payments that the ECB would forgo. In the first alternative path, the ECB would forgo about 1 billion euros per year—less than 0.1 percent of Spain’s GDP.

As seen in **Figure 5**, such a commitment by the ECB would leave Spain's net debt as a share of GDP below that of the baseline path.

FIGURE 5
Debt Path net of ECB Purchases and Refunds



Sources: IMF World Economic Outlook October 2013, OECD Economic Outlook 93, and authors' calculations

To be sure, the model used in these forecasts is a simple one, and the timing of any stimulus is unlikely to be so immediate. However, these examples suggest that if the goal is economic recovery, then Spain's options are wider than generally recognized. This is true even while maintaining a preoccupation with debt levels, and particularly true if the ECB is willing to provide very modest assistance to the government. A goal of reaching full employment by 2018 appears to be in reach, even without the IMF's pessimistic forecast for potential output. Indeed, a much faster economic recovery than is currently forecast will be necessary to prevent a self-fulfilling prophecy of depressed capacity.

Conclusion

Contrary to the common assertions that Spain has no alternative to its current policies of austerity and prolonged high unemployment, this paper shows that full employment can be achieved by 2018 without accumulating an unsustainable debt burden. However, the

scenarios illustrated here are modest proposals with either limited or no co-operation at all from the European Central Bank (ECB). In reality, Spain's economy is depressed, and there is no threat of excessive increases in inflation; it is currently running at negative 0.1 percent over the past year. In this situation, if Spain had its own its own currency and central bank, it could replace some or all of the tax increases with money borrowed from the central bank – created through quantitative easing, as in the U.S. or Japan. Of course it cannot do this while it is part of the eurozone, but it is worth emphasizing that the ECB, if it wanted to play the role that the U.S. or Japanese central banks have done for their own economies, could make Spain's return to full employment vastly easier politically. It could also make the recovery much faster than the scenarios described in this paper, and lower the country's net debt burden.

Nonetheless, these scenarios also illustrate that Spain has feasible options to return to full employment, even without co-operation from the ECB.

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