Tullett Prebon Research, a blog by Dr Tim Morgan

Spain – in the eye of the storm
by Tim Morgan on September 28, 2012

Sometimes, markets' surprise can be surprising in itself, and this is certainly the case where events in Spain are concerned. There has long been a certain grim inevitability about the tightening of the economic, political and regional stranglehold gripping the Eurozone's fourth-largest economy.

Certainly, anyone who believed that the Draghi plan was going to fix the woes of the Eurozone was gravely mistaken. The great weakness with this plan is that it treats sovereign debt as the root cause of the Eurozone's problems. The reality is that debt is a symptom, not the disease. The disease is a sharp deterioration in economic competitiveness.

As I explained in a recent report, Spanish competitiveness deteriorated by about 18% relative to the other Eurozone countries – and by 24% in relation to Germany alone – between 2000 and 2011. Debt is only a problem to the extent that an economy can or cannot support it. At the end of 2011, Spanish public debt, at 57% of GDP, was lower than that of the UK (78%, on the same basis of calculation). Debt at this level would be perfectly supportable if the Spanish economy was growing. The real problem is that economic output, far from growing, is now crumbling very rapidly indeed.

Though exacerbated by the fall-out from the property bubble, the real cause of Spain's economic deterioration lies in a lack of competitiveness. If Spain still had the peseta, the competitiveness problem would long ago have been solved by devaluation. Conversely, if the euro were a viable economic (as opposed to political) currency, imbalances would have been tackled through redistribution, much as tax and spending flows redress regional imbalances within, say, the United States or the United Kingdom.

In absence either of currency independence or of true integration, the **only** mechanism which can restore competitiveness to the Spanish economy is internal devaluation. Spanish incomes and consumption – including, of course, consumption by the state – have to be driven downwards relentlessly, until the country's cost base has fallen sufficiently for competitiveness to be restored.

This is going to be an extraordinarily painful process. Indeed, it may prove to be more than can be accomplished, in social or political terms. Unemployment, at 25% (but over 50% for young people), is truly alarming. There is, specifically, every possibility that Catalunya will secede from Spain.

The relationship between Catalunya and the rest of Spain is widely misunderstood by outsiders. The country that we think of as Spain actually began as a Castillian empire forged by war, alliances and politics. More recently, republican-supporting Catalunya suffered under Franco, when its language was banned and books in Catala were burned. The post-Franco settlement solved this problem by granting Catalunya (and the other regions) a remarkable degree of autonomy. But Catalunya, with its distinctive language and culture, has never been wholly comfortable within Spain.

Regional autonomy, hitherto admirable, may now pull Spain apart. Regional governments have taken on very substantial debts. Local tax revenues, disproportionately linked to property, have crumbled away just as the Spanish state's ability to provide support has eroded. Catalans will tell you that the fiscal relationship with Madrid is a one-way street, with revenues flowing to the centre and precious little flowing back.

These issues seem to be little understood outside Spain. Instead, there is a tendency to attach stereotypes to Spain, and to some its fellow 'Club Med' countries. Just as there is a lot more to Spain than sun, sangria and the costas, those who regard the country as feckless and spendthrift are guilty of a ridiculously parochial leap to judgment.

Spain does indeed have whole herds of costly white elephants (like the absurdly vast, €1.1bn mothballed airport in the historic little town of Ciudad Real). Valencia alone has its disused Formula 1 circuit and its grandiose opera house.

But stereotypes disguise the fact that membership of the euro has been a disaster for Spain. The property bubble (in which Spain built roughly 30% of all new residential units in the European Union) was inflated by cheaply-available liquidity from banks in other Eurozone countries, banks which now, of course, want their money back in full.

Spaniards believe that the country is doing all that the Eurozone is asking of it in terms of austerity. Unemployment benefits have been cut, as have public sector salaries. The government of Mariano Rajoy has promised to bear down on the black economy. Dysfunctions remain, of course. Farmacias in some parts of Spain are reportedly owed an average of €100.000 because reimbursement cheques from government have simply not turned up. You can even get a discount for paying taxes in cash (because regional tax offices are starved of running costs from the centre).

If, until very recently, there has been a prevailing mood in Spain, it has been one of grim foreboding, of waiting for something to happen. Now, though, that mood is changing. Anger is increasingly supplanting resignation.

The 'something' that needs to happen is the forging of greater budgetary and banking unity in the Eurozone, since what Spain (and others) are suffering from now is the inevitable unwinding of an idiotically-idealist attempt to combine a single currency with a multiplicity of budgets.

This resolution can only come from the centre. The old description of a camel as "a horse designed by a committee" could have been coined to describe the governance of the Eurozone. Spain's ability to wait upon the cogitations of the camel that is the Eurozone is strictly.time-limited. It can sometimes seem that it would be quicker to send Don Quixote off to tilt at the windmills in Frankfurt and Brussels.

At least his home town of Ciudad Real has a shiny new airport.