FINANCIAL TIMES

March 18, 2012 7:34 pm

There is no Spanish siesta for the eurozone

By Wolfgang Münchau

The markets have concluded that the eurozone crisis has ended. Several politicians said that they, too, believed that the worst was over. Complacency is back. I recall similar utterances in the past. Whenever there is some technical progress – an umbrella, a liquidity injection, a successful debt swap – optimism returns.

If you think the European Central Bank's policies have "bought time", you should ask yourself: time for what? Greece's debt situation is as unsustainable as ever; so is Portugal's; so is the European banking sector's and so is Spain's. Even if the ECB were to provide unlimited cheap finance for the rest of the decade, it would not be enough.

In Spain, most of the toxic debt is held in the private sector. The debt level of the private sector, namely households and non-financial corporations, was 227.3 per cent of gross domestic product at the end of 2010, according to Eurostat. Last year's data are not out yet, but the number will be down only a little. One of the areas where adjustment is happening is in the housing market. The best index for Spain is the new series by the National Institute of Statistics, which shows the overall index for house prices fell by 11.2 per cent last year alone, but was only down 21.7 per cent from the peak in the third quarter of 2007. We should remember the Spanish bubble was much more extreme than others, but prices have only come down by around a fifth. In the Madrid region the movements have been more vigorous, with a peak-to-trough fall of 29.5 per cent.

On my estimates, Spain's house price adjustment is still less than halfway complete. In real terms, the US housing boom has been almost completely cancelled out. The graphs of historic bubbles, if expressed in real prices, have nice bell-shaped curves. This makes sense, since domestic property is an unproductive real asset. In Spain, as elsewhere, it would be reasonable to assume real prices will eventually fall to where they were in the mid-to-late 1990s.

The Spanish government has forced the savings banks to write down €50bn in their property portfolios this year. This will only be a small part of what will ultimately be needed if the housing market falls as I expect it will. Official estimates assume mild price falls and a quick rebound in the economy. Both assumptions are delusional. How can the

Spanish economy rebound if the private and the public sectors are deleveraging at the same time, and are likely to do so for many years?

The deleveraging of the public sector will be vicious. The deficit was 8.5 per cent of GDP last year. This was a big overshoot, but the reason was not fiscal indiscipline. It was necessary to avoid a bigger slump. The recently-revised target is 5.3 per cent for this year and 3 per cent next year. So the total public sector adjustment needed under the European deficit rules is an incredible 5.5 per cent over two years – this, in the middle of a recession. If you look at the extent of total deleveraging that lies ahead, in both private and public sectors, the question is not whether the Spanish economy rebounds in 2012 or 2013, but whether it can rebound at all before the end of this decade.

The typical European response to the last statement would be to say that economic reforms will increase confidence and produce growth. The optimists point to Italy, where the appointment of Mario Monti as prime minister has led to a seemingly virtuous circle of reforms and lower market interest rates. The main reform in both countries has been a moderate relaxing in labour laws. While that is probably necessary, I would be surprised if this has a material impact on long-term growth rates. Large parts of the labour market literature would have to be rewritten if it were the case.

For Spain, the right adjustment policy would be a programme to force the private sector to deleverage, over three to five years, supported by consistently robust public sector deficits, and yes, accompanied by economic reforms as well. The moment to address the public sector deficit is after the private sector deleveraging is complete. Such a policy would not only smooth the adjustment. It would accelerate it.

But a combination of ultra-lax monetary policies and fiscal retrenchment will delay the unavoidable adjustment. Spain remains stuck in a worsening debt trap, out of which default will be the only escape. If it pursued the agreed policies, it would end up where Greece, Portugal and Ireland are – under a rescue umbrella. This is the most likely scenario for Spain.

In November, I said European leaders had only 10 days to save the euro. My diagnosis then and now is that they have flunked it. The ECB's policies have not bought time. They have slowed down the political processes and the economic adjustment needed to resolve the crisis. The worst, I fear, still lies ahead.

munchau@eurointelligence.com

Printed from: http://www.ft.com/cms/s/0/28a4cfdc-6f6b-11e1-9c57-00144feab49a.html