

How costly is for Spain to be in the EURO?

Are members of a monetary Union fatally handicapped to recover from recessions and solve financial crisis?

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Countries with a long history of low growth and high inflation enter into a monetary union expecting to speed up economic growth at the same time that their inflation converges to the rate targeted by the union's monetary authority. The decision makers in those countries are normally conscious that they have to implement institutional reforms and to commit to some basic disciplines imposed by the union.

The crisis that affects several Euro Area members is giving support to the view that those decision makers were not totally aware of the price their countries would end up paying by resigning independent monetary policy as a tool to cope with financial crisis and to renew growth after the recession.

Nowadays, outside Europe many economists sustain the idea that Greece, Ireland, Portugal and Spain would have been better off not entering into the Euro. The United Kingdom is mentioned as the best example of a country that, by preserving its national currency, has nowadays better tools to fight the effects of the deep recession and financial crisis that emerged from the burst of the various real state bubbles that plagued several nations during the initial years of the new century.

The comparison of economic performance of Spain and the UK should be useful to shed some light on this subject. Their economies share many common characteristics, but differ precisely in the availability of monetary policy as a sovereign tool. Spain has resigned it by entering into the Euro, while the UK preserves the Sterling as a national currency and the Bank of England is empowered to conduct an independent monetary policy.

It is clear from the spot that real state bubbles cannot be blamed on belonging to a monetary union. The real state bubble in the UK was not very different from that of Spain, and looking more broadly, the biggest recent bubble developed in the US, a country that owns the most powerful monetary policy in the world.

But, it is argued, once the bubble burst and a recession and financial crisis develops, the country that can conduct an independent monetary policy can use it to soften the negative effects of the crisis, to find a sustainable solution to the financial crisis and to renew growth.

The purpose of this note is to examine this argument in light of the course of the crisis that started in the US in 2007 and spread to the world during 2008. In particular, the focus is on the crisis in Europe, inside and outside the Euro area, taking Spain and the UK as two country cases to compare.

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The main conclusion is that the advantages to fight against recession and solve financial crisis that availability of a sovereign monetary policy gives to a country like the UK is not that important as to induce a country like Spain, which gets valuable long term benefits for belonging to the Euro Area, to abandon the Euro and to reassume monetary sovereignty.

The lack of exchange rate flexibility in the case of Spain can be compensated with labor market and tax reforms that will produce the same effect on comparative unit labor costs as currency depreciation, without losing the advantages of belonging to the Euro monetary union.

Long term growth performance

In 1980 Spain's Gross Domestic Product (GDP²) represented 54 % of UK's and by 2010 this ratio had increase to 68%. The biggest jump took place since the launching of the Euro. In 1998 Spain still represented only 55 % of UK's GDP. So, in 12 years Spain's GDP escalated 13 percentage points in relation to the GDP of the UK, while during the previous 18 years had only escalated 1 percentage point.

Relationship between Spain's GDP and UK's GDP

	1980	1998	2010
GDP	In millions of US Dollars		
Spain	256	792	1503
United Kingdom	470	1423	2214
	In %		
Spain/United Kingdom	54	55	68

An alternative way to see the same phenomena is to compare growth rates of GDP. While between 1980 and 2010 Spain grew 6.1 % per annum, the UK grew 5.3 %. The biggest difference in growth performance happened between 1998 and 2010, when Spain grew 6 % per annum while the UK grew only 4.1 %. Before Spain joined the Euro Area both countries grew at quite similar annual rates: 6.2 % Spain and 6.1 % the UK.

GDP growth in Spain and the United Kingdom

	1980	1998	2010	1980-1998	1998-2010
GDP	In millions of US Dollars			In annual change	
Spain	256	792	1503	6.1%	6.0%
United Kingdom	470	1423	2214	5.3%	4.1%

² All GDPs figures are measured in purchasing power parity (ppp) terms

From the point of view of GDP growth, since the creation of the Euro, Spain outperformed the UK.

GDP Growth since the beginning of the crisis

Since the first quarter of 2008 until the first quarter of 2011 GDP³ suffered a similar decline in both countries: 4 % in Spain and 4.1 % in the UK. Looking at the data quarter by quarter, it becomes clear that the decline was initially larger in the UK and the recovery has been slower in Spain, but summing up the ups and downs the magnitude of the crisis looks very similar.

Gross domestic product in Spain and the UK since 2008

	2008				2009				2010				2011	Growth during the whole period (%)
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	
	Growth rate compared to the same quarter of previous year													
Spain	2.7	1.9	0.3	-1.4	-3.5	-4.4	-3.9	-3.0	-1.4	0.0	0.2	0.6	0.8	4.1
United Kingdom	1.9	1.0	-0.4	-2.7	-5.4	-5.9	-5.3	-2.8	-0.4	1.5	2.5	1.5	1.8	4.0

There are some surprising differences in the expenditure composition of the decline and recovery of GDP. In spite of the fact that Spain could not devalue its currency to promote export and discourage imports, the increase in exports and the decline in imports were both larger in Spain than in the UK. Between the first quarter of 2008 and the first quarter of 2011 exports increased 1.5 % in Spain and very close to zero in the UK. Imports declined 16 % in Spain and only 6 % in the UK.

The quarterly movements show some differences in timing, but the overall picture is the one described by the behavior of exports and imports along the three years of the current crisis.

Exports of goods and services in Spain and the UK

	2008				2009				2010				2011	Growth during the whole period (%)
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	
	Growth rate compared to the same quarter of previous year, seasonally adjusted													
Spain	4.2	2.6	-3.4	-7.8	-16.5	-15.8	-11.0	-2.1	9.4	11.9	9.4	10.5	11.2	1.5
United Kingdom	3.7	2.7	0.5	-2.7	-10.9	-12.9	-11.8	-4.6	1.7	6.6	7.4	5.4	10.4	0.1

³ Quarterly figures of GDP are measured at constant prices, not at ppp.

In the first quarter of the crisis the fall in exports was greater in Spain than in the UK, but Imports fell even much more in Spain than in the UK, so the adjustment in the current account was, from the very beginning, stronger in the country that could not depreciate its currency.

Imports of goods and services in Spain and the UK

	2008				2009				2010				2011	Growth during the whole period (%)
	Q1	Q2	Q3	Q6	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	
	Growth rate compared to the same quarter of previous year													
Spain	3.4	-0.2	-8.2	-15.6	-21.5	-22.2	-17.2	-9.2	2.0	9.6	5.0	5.3	5.2	-15.8
United Kingdom	3.1	3.1	-2.5	-8.4	-14.3	-15.3	-13.3	-4.5	4.8	9.5	10.4	9.4	4.9	-5.7

The contraction and subsequent recovery in final private consumption was quite similar in Spain and in the UK.

Private Consumption Growth in Spain and the UK

	2008				2009				2010				2011	
	Q1	Q2	Q3	Q6	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	
	Growth rate compared to the same quarter of previous year, seasonally adjusted													
Spain	2.2	0.8	-1.5	-3.9	-4.9	-5.4	-4.1	-2.6	-0.3	2.1	1.5	1.6	0.7	
United Kingdom	2.8	1.3	0.0	-2.3	-4.1	-4.0	-3.4	-1.0	0.0	1.2	1.1	-0.1	-0.5	

Spain could expand fiscal policy to soften the first impact of the global crisis more than the UK, but since the fourth quarter of 2009 public consumption turned slightly contractive while in the UK was slightly expansive. Overall, the UK did not use more fiscal expansion than Spain.

Government final consumption in Spain and the UK

	2008				2009				2010				2011
	Q1	Q2	Q3	Q6	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
	Growth rate compared to the same quarter of previous year(%)												
Spain	5.2	5.7	6.0	6.4	5.9	4.3	2.7	0.1	-1.1	-0.1	-0.7	-0.87	1.06
United Kingdom	0.8	1.9	1.2	2.5	2.6	1.0	0.7	-0.4	0.9	0.9	0.6	0.56	1.06

Differences in the behavior of Investment between Spain and the UK showed up only in the last four quarters. Investment in Spain has continued contracting at a rapid pace while on average, investment started to expand in the UK since the second quarter of 2010.

Investment in Spain and the UK

	2008				2009				2010				2011
	Q1	Q2	Q3	Q6	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
	Growth rate compared to the same quarter of previous year												
Spain	1.4	-1.6	-6.5	-12.1	-15.3	-18.0	-16.4	-14.0	-10.5	-6.7	-6.7	-6.1	-5.8
United Kingdom	-1.9	-1.4	-6.0	-10.5	-14.3	-18.3	-14.6	-14.2	-2.1	2.6	6.2	5.8	-2.7

Inflation

Since 1980 until recently Inflation was higher in Spain than in the UK. During the period 1980-2010 annual inflation measured by CPI was 5.3 % in Spain and 3.6 % in the UK. The difference was much higher in the period 1980-1998 than since the creation of the Euro Area. Between 1980 and 1998 annual inflation was 7 % in Spain and 4.7 % in the UK. Between 1998 and 2010 annual inflation was 2.8 % in Spain and 1.9 % in the UK. So entering the Euro helped Spain to reduce the inflation gap with the UK.

At the beginning of the crisis, inflation went down much more in Spain than in the UK. Actually Spain suffered deflation, a phenomena that the UK could avoid by letting the Pound to depreciate. Since the fourth quarter of 2009, inflation started to increase again much more rapidly in the UK than in Spain.

CPI inflation in Spain and the UK

	2008				2009				2010				2011
	Q1	Q2	Q3	Q6	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
	Growth rate compared to the same quarter of previous year (%)												
Spain	4.4	4.6	4.9	2.5	0.5	-0.7	-1.1	0.1	1.1	1.6	2.0	2.6	3.5
United Kingdom	2.4	3.4	4.8	3.9	3.0	2.1	1.5	2.1	3.3	3.4	3.1	3.4	4.1

In the case of Spain the variability in the rate of inflation came mainly from the behavior of foreign prices. That is not the case for the UK as reflected by the lower divergences between the rate of inflation measured by the CPI including and excluding food and energy. In Spain non-food, non-energy consumer prices reached almost zero inflation but did never experienced deflation and in the last quarter increased up to 1.3 % per annum as compared with 3.2 % in the UK. This means that the deflation in the case of Spain during the second and third quarters of 2009 originated in the fall of commodity prices in dollars whose impact could not be dampened by currency depreciation as was the case in the UK.

CPI non-food non-energy inflation in Spain and the UK

	2008				2009				2010				2011
	Q1	Q2	Q3	Q6	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
	Growth rate compared to the same quarter of previous year (%)												
Spain	2.3	2.2	2.5	2.4	1.6	1.1	0.3	0.1	0.1	0.1	1.0	1.2	1.3
United Kingdom	1.2	1.5	2.1	1.7	1.5	1.6	1.7	2.2	3.0	3.0	2.7	2.8	3.2

The comparison of the course of inflation during the crisis suggests, that not having monetary policy as an instrument to dampen the effects of the recession, does not allow to prevent imported deflation but, as a compensation, it does not risk a post-crisis inflationary hike.

Unemployment is the big difference

No doubt entering the Monetary Union helped Spain to speed up long term growth and to converge into the inflation target set by the monetary union. Since the creation of the Euro growth was higher in Spain than in the UK and inflation, even though continued to be higher in Spain than in the UK, tended to converge with the 2 % target set by the ECB, very similar to the target set by the Bank of England

So far the comparison between Spain and the UK, before and during the recent crisis, does not support the conventional view that conserving a sovereign monetary policy by not entering into a monetary union is a big help to avoid recessions and financial crisis.

But those that argue that the UK is better equipped than Spain to cope with the crisis show the much larger number of unemployed in Spain than in the UK as the irrefutable probe of their statement. In April 2011 there were 4.3 million persons unemployed in Spain and 1.5 million unemployed in the UK. The argument runs as follow: by letting the Pound to depreciate, unit labor costs (ULC) in the UK can go more rapidly down than in Spain, and, therefore, unemployment can be reduced more rapidly in the UK. The figures on exchange rate adjusted ULC do confirm this different pace of decline.

Exchange Rate Adjusted Unit labor costs in Spain and the UK⁴

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Spain	0.47	0.45	0.40	0.40	0.44	0.54	0.61	0.63	0.66	0.75	0.83	0.80	..
United Kingdom	0.53	0.53	0.51	0.50	0.54	0.60	0.68	0.70	0.72	0.80	0.75	0.68	0.69

Exchange rate adjusted ULC were lower in Spain than in the UK until 2007. Since that time, while ULC declined in the UK, in Spain ULC first increased up to 0.83 in 2008 and then it declined slowly. In 2009 exchange rate adjusted ULC were 17 % higher in Spain than in the UK. For the more recent years there are no data yet but very likely in Spain ULC continued to decline very slowly.

The figures on the number of unemployed are very eloquent on the differences between Spain and the UK. But the much higher number of unemployed in Spain is not associated necessarily with the recent crisis. Actually, between the first quarter of 2008 and the first quarter of 2011, the number of unemployed increased 87 % in Spain and 81 % in the UK, only slightly less in the UK than in Spain.

Registered Unemployment in Spain and the UK

	2008				2009				2010				2011
	Q1	Q2	Q3	Q6	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
	In millions of persons												
Spain	2.3	2.4	2.5	3.0	3.5	3.6	3.6	3.9	4.1	4.1	4.0	4.1	4.3
United Kingdom	0.8	0.8	0.9	1.1	1.4	1.6	1.6	1.6	1.6	1.5	1.4	1.4	1.5

⁴ The annual exchange rate adjusted ULC measure is obtained by converting total labor costs to a USD basis and dividing this by a real output series which is also \$US converted using the prevailing exchange rates in the OECD base year.

The higher number of unemployed in Spain is a structural problem of its economy, related to the lack of flexibility in the formal labor market, to the pace of increase of the labor force and the high social security contributions on wages and salaries that create a large gap between labor costs and pocket income of the workers.

The much higher flexibility of labor markets in the UK than in Spain is well documented. The more rapid long term growth of the labor force in Spain is clearly seen in the figures on the Labor force over time.

Labor Force in Spain and the UK

	1980	1990	2000	2010	1980-1890	1990-2000	2000-2010	1980-2010
	In millions of persons				In percentage change during the period			
Spain	13.3	15.4	17.9	23.0	16%	17%	28%	73%
United Kingdom	26.5	28.8	28.6	31.2	9%	-1%	9%	18%

Spain's Labor Force increased 73% during the period 1980-2010 while UK's grew only 18%. In number of person the difference is also striking. While in Spain during the 30 years 9.7 million persons entered into the Labor Force, in the UK the increase was only of 2.1 million people, being the UK's economy much larger than that of Spain. Both, during the decade of the 90's and that of the 2000's the increase in the labor force in Spain exceeded that of the UK in 18 and 19 percentage points respectively. During the 90's, while in Spain the Labor Force increased by 17% it declined 1% in the UK.

Te other important characteristic that explains the lower structural unemployment in the UK relates to the tax structure of its economy. While total revenue of the government is a higher proportion of GDP in UK than in Spain, the social security contributions that create a gap between labors cost for the employer and pocket income for the employee are much higher in Spain than in the UK. In Spain 35.4% of total government revenues are collected as social security contributions, while in the UK only 19.8% of total revenues are collected that way.

Payroll Taxes in Spain and the UK

	Government revenue as percentage of GDP	Social security contributions as percentage of GDP	Social security contributions as percentage of government revenue
	Figures for year 2008		
Spain	37.1	13.2	35.4
United Kingdom	42.5	8.4	19.8

Social security contributions are calculated as a proportion of the payroll of the employers that comply with labor and tax laws and create a gap between the labor costs for the employers and pocket income for the employee. When social security contributions are too high, many employers and employees decide to operate in the informal economy where labor and tax laws are just ignored. At time of crisis the shifts from the formal to the informal economy increase as it seems to be happening right now in Spain. Normally the people that after losing a formal employment continue working in the informal economy register as unemployed as to get the unemployment compensations. So it may very well happen nowadays in Spain that the large number of registered unemployed hides, to some extent, an enlargement of the informal economy rather than true unemployment.

Joaquin Cottani and I suggested some time ago that Spain could get the same effect on unit labor costs in relation to the price of tradable goods perceived by producers (which is equivalent to the exchange adjusted unit labor costs concept for fix exchange rate economies) by reducing the rate of social security contributions and increasing the rate of the VAT in compensation. If Spain introduces this tax reform it will be shifting the incidence of taxes from the payroll to consumption and, therefore, would be producing the same effect of currency devaluation, without abandoning the Euro.

The substitution of VAT for social security contributions could be of varied dimension. In a soft movement it could try to jump to the rates of the UK, which are similar to those that prevail in the US. Or it could go to the extreme of completely eliminating the social security contributions, as it is the case in Australia. Most of the countries outside the Euro Area have social security contributions not higher than 21.2 % of total government revenues.

Payroll Taxes in various countries

	Government revenue as percentage of GDP	Social security contributions as percentage of GDP	Social security contributions as percentage of government revenue
	Figures for year 2008		
Australia	33.0	0.0	0.0
Canada	39.8	4.5	11.3
Korea	33.4	6.1	18.3
Mexico	23.1	1.5	6.6
New Zealand	42.3	1.2	2.8
Norway	59.9	9.0	15.1
Switzerland	34.5	6.8	19.7
United States	32.7	6.9	21.2
Spain	37.1	13.2	35.4
United Kingdom	42.5	8.4	19.8

The prevailing high rates of social security contributions in most countries of the Euro Area suggests that not only Spain, but other economies suffering from too high unit labor costs could resort to the same solution rather than abandoning the Euro and devaluing its new currency.

Of course, such a tax reform should be only part of the more complete fiscal and regulatory reform oriented to fiscal consolidation and higher labor market flexibility.

The advantage of belonging to a monetary union reside precisely on the obligation that it imposes to look for structural and long term solutions to fiscal and regulatory problems, rather than only postponing them by letting the currency to depreciate and softening monetary discipline, something that, most frequently than not, would end up reintroducing persistent inflation into the economies.