

# **ECONOMIC ANALYSIS OF THE 2007 CRISIS IN SPAIN**



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## **Abstract.**

In this paper we will carry out an economic analysis of the 2007 crisis in Spain. First of all we will emphasize the most relevant facts of the World economy and we will stress on the American twin deficits and the recent crisis of subprime mortgages. In second place, we will analyse the chronological evolution of the Spanish crisis, whose main trigger was the real estate bubble. In addition, we will talk about the evolution of unemployment rate, prices and Gross Domestic Product. Afterwards, we will highlight some additional issues and finally, we will summarize the most relevant conclusions we have reached to about this topic.

**JEL codes:** E24, G21, H62, H63, O11

**Keywords:** crisis, mortgage, debt, Spain, real estate bubble.

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# **ECONOMIC ANALYSIS OF THE 2007 CRISIS IN SPAIN**

## **1. INTRODUCTION.**

### **1.1. Motivation.**

During an economic crisis, important negative changes take place in the main economic variables, especially in the GDP and employment, even though at the end all macroeconomic variables end up harmed. These variables can have different severities and affect to the economy with different intensities. We talk about deceleration when growth's taxes are abruptly reduced, without reaching negative levels. The following level of severity takes place when it reaches the economic recession; this is to say when the tax of annual variation on GDP signs negative taxes of growth during, at least, two consecutive trimesters. Finally, when recession lasts during several months and growth's taxes remain too negative, we are talking about economic depression.

This economic crisis is a very recurrent topic since, after the crash of the current crisis, all economists were talking and thinking about what had happened, but very few ones knew how to prevent it as well as, knowing that the performance that was taking place within financial markets, at earth levels, and the credit movements on the construction sector were going to have deep consequences. In that sense, the objective of this project is to analyse the evolution of Spanish crisis and try to highlight the main effects over Spain's economy. We deal with chronology about the crisis and how economic variables have been changing along its.

### **1.2. Structure.**

This work is an analysis about Spanish economic crisis in 2007. First, we will explain precedents of World's economy, highlighting the most relevant facts as the sign of Bretton Woods agreements, American twin deficits and the crash of the crisis about the crap mortgage on the USA. Immediately, we will carry out a chronologic study about Spanish crisis, starting on 2000 with the crisis pertaining to the stock market and ending on the most recent information that we will find.

Once understood the crisis' evolution, we will study the main economic variables and how they have progressed along the process. Then, we highlight some additional issues as the role that tax heavens have played, how these things have affected to the pension schemes and the way bailing out the banks has influenced. To end this work, we will write the conclusions we extract after analysing all the process.

## 2. PRECEDENTS OF WORLD ECONOMY.

### 2.1. Historical context.

The end of Second World War gave the way to the creation of enormous commercial blocks and international institutions about economic cooperation, as The International Monetary Fund and The International Bank of Reconstruction and Development, known as World Bank. With the signing of the agreement of Bretton Woods (New Hampshire, EEUU) was sought to achieve stability with change's type, to avoid competitive devaluation and to promote growth's economy. Bretton Wood's objective was to obtain some fixed, but adjustable type changes, for that every coin was fixed inside a band of 1% with dollars. Dollars were fixed to gold (thirty-five dollars per ounce). Nevertheless, Vietnam War caused that the big quantity of US dollars that were abroad were left to be unsecured by its reserves. To end with this, Richard Nixon, on 15th August of 1971, put the end to convertibility from dollars to gold. With this fact, Bretton Woods' system reached to its end.

I think it is important to highlight that, two years after the end of Second World War, United States waghered to help on reconstruction of European countries and to finance Japan, through Marshall's Plan (1947). Soviet Union and East European States refused to participate on American aids and decided to take an alternative to that plan. They created the "COMECON", an organisation of economic cooperation created by socialist countries to counter international capitalism organisms.

From the date named above until 1970, United States was the financier and principal creditor of World's economy. Finally, this situation changed drastically by the response that North American economy gave to the oil crisis (1973-1979, with strong inflation and a sharp drop in production) and the emerging export capacity of Japan and Germany.

Behind the World's economic backgrounds, it is also important to analyse twin deficits that were produced on United States during the period that comprises 1981-1988. This concept makes reference to the simultaneous presence of budget deficit and current account deficit.

In United States, they were living a long process of inflation that intended to stop with the entry of president Ronald Reagan (1981-1989) with the objective of returning to prosperity of post-war period and to come back to high taxes of economic growth, since its inflation levels were situated on 13.5%. For that, in 1981 it was agreed an imposing reduction of 20% that caused a decrease of tax revenues respect to GDP, from 19.6% in 1981 to 18.1% in 1988. At the same time, spending on defence grew over the period 1981-1990 due to the fact of military invasions and several wars. This spending growth led to an increase of encumbrance. Public debt (within percentage of GDP) grew from 32% to 50% in 1988. That means, tax reduction and the consequent increase of the fiscal expenditure caused a great budgetary deficit.

In addition, United States went from being the largest creditor in the World in 1980, when it registered a 14% credit to GDP ratio, the largest debtor in 1990, with a debit position of 7% of GDP.

On that moment, United States was characterized by an economy based on an elevated consumption of foreign products, financed by dollars that ended out of their borders. This fact had their consequences on capitalist countries, since the increased imports by the hand of United States gave rise to economic growth of productive countries. Especially, Japan and Germany consolidated the bases of their exports economy, and that fact moved them to obtain an important commercial surplus.

However, this greater supplies of resources returned, for the most part (about 80%), to the United States, who used them to support their deficit levels. According to Yanis Varoufakis (2012), this is known as “Global Surplus Recycling Mechanism” and it refers to when the United States bought abroad and foreign companies earned money that was later invested in Wall Street and converted into loans. In this way, United States was able to sustain its deficit and Wall Street created toxic products that we will explain later.

To a better comprehension we will make an analytic explanation, where:

Y= Production

T= Net tax transfers

C= Private consumption

G= Public spending

XN= Net exportations

We start from the following equality of disposable income:

$$Y - T = C + S$$

In balance and with an open economy:

$$Y = C + I + G + XN$$

Replacing we have to:

$$C + I + G + XN - T = C + S$$

Operating:

$$XN = S - I + (T - G)$$

Therefore, in an open economy, net exportations depend on public and private saving.

## 2.2. Subprime crisis.

In August 1990, Iraq invaded Kuwait to seize its oil fields, which they did in a very short time, and this caused a sudden drop in confidence in the United States that led to an economic recession. In January 1991, an international coalition led by the United States forced Iraqi troops to leave Kuwait. In the same year, the new US Administration decided to make a contractive fiscal policy to reduce the US public deficit (despite the recession caused to the fall in demand), which pleased the Federal Reserve, which decided to make a monetary policy to support the Government. This, coupled with the recycling of current account deficits, led to a sharp rise in liquidity in the United States, which, together with financial deregulation, fuelled the 2000 crisis.

The period from 2000 to 2003 was characterized by a stock market crash caused, in part, by an exorbitant increase in investments in the field of Internet and telecommunications, which generated a speculative bubble that ended with a crisis that hit the United States hard and Europe (specifically, in Spain there were companies like Terra that were also harmed). These facts, along with the September 11 attacks, prompted US Federal Reserve Chairman Alan Greenspan to set his sights on preventing an economic collapse. In 2003, it applied an expansive monetary policy by increasing the monetary base, as a consequence and according to Leopoldo Abadía (2009) interest rates decreased from 6.5% to 1%, which led to lower loan costs, thereby increasing consumption and investment variables by companies. Families benefited from this monetary policy through an increase in their demand for real estate and mortgage loans. This prompted the banks to take advantage of the growing benefits of the real estate sector and acted quickly. They modified the type of loans they granted, being much riskier operations they charged a greater interest and in this way took advantage of the "real estate boom." They created credit options for people who were insolvent or had an unfavourable credit history, which was backed by the Community Reinvestment Act. As Leopoldo Abadía (2009) explains, many of these people are known as ninja (no incomes, no job, no assets), that is, people without fixed income, without fixed employment and without property.

At this time, it is important to emphasize the FICO score. The United States used this indicator to measure the creditworthiness of each person or family. This statistical model estimated the probability that an individual had to pay his debt on time or not, considering the risk and the cost of granting money to that person. The FICO Score uses a range of 300 points (with the maximum risk of default) to 850 points (the most solvent and with great capacity of return). The debtor with a score greater than 620 points is considered to have sufficient financial solvency to repay the loan. On the other hand, debtors that are below 620 points are considered "Sub-Prime", and therefore these are loans with a higher interest rate and higher commissions, given the risk involved in lending that money. In this type of credit, delinquency was a very frequent problem since most of the applicants were unemployed, sick or heavily indebted, among others.

A subprime mortgage is known as a credit modality characterized by having a high level of risk since it is based on granting mortgage loans to people with a high risk of delinquency. This type of borrower does not have a stable interest and the cancellation clauses are very demanding. Subprime mortgages were devised because they are beneficial to both parties; the client can benefit from the loan without having to fulfil any type of requirement and the credit system also obtains interest for the borrowed capital. Another feature of subprime mortgages is that the bank at issue can sell the mortgage rights to another company, thereby securing interest and repayment of the loan.

The banks, driven by enthusiasm, granted mortgages worth more than the real value of the home because, with the aforementioned "real estate boom", they were certain that these properties would increase in value and, in case of default, they could resell them at a price well above the initial price. Due to this, families became more debt-ridden and, over time, could not cope with their responsibilities with banks. Financial institutions began to lose liquidity and as a solution to this, and thanks to globalization, they were able to seek help from foreign banks and obtain liquidity for their operations.

Wall Street investors knew that no one would buy mortgages with so much risk, therefore, in the same financial package (known as MBS: Mortgage Backed Securities), they included assets with a low default risk, assets with a medium risk and assets with a very high risk (the known sub-prime mortgages). These financial packages were given different ratings by the rating agencies, so the financial asset package was more attractive to investors. These rating agencies played a very

important role because their opinion was very relevant when making a decision or another.

According to Leopoldo Abadia (2009), in order to be able to sell subprime mortgages, some investment banks managed to get rating agencies re-rating them. These reclassified MBSs were named CDO (Collateralized Debt Obligations), with a structure that contained different tranches of securities, with different maturities and different risks. Each tranche was named investment grade or senior (prime mortgages or AAA, AA and A), mezzanine (mortgages with intermediate risk, type BB and BBB) and equity (subprime mortgages or mortgages). They also created another type of derivative products such as CDS (Credit Default Swaps), in this type of packages the acquirer assumed the risk of default.

Real estate prices fell between 2006 and the end of 2007 by 25%. Thus began to become more visible the problem of unpaid mortgages and, automatically, they stopped selling MBS and CDO. All these financial packages had been bought by banks all over the World and, with the increase in unpaid mortgages, banks began to lose confidence, increased the interest rate in the interbank market, known as EURIBOR (Europe Interbank Offered Rate), and the Interbank credit fell sharply. In this way, the crisis of the known subprime mortgages had expanded across the Atlantic and had also managed to sink the European financial market. The banks stopped granting loans and mortgages, which caused the real estate sector to begin to lose autonomy and their prices fell sharply. In 2008, the construction stock index fell 40%; The companies stopped investing, the consumption of families and companies decreased, and the unemployment rate increased.

The main central banks injected liquidity to various entities in bankruptcy; In August 2007 the European Central Bank injected \$ 120 billion into the market and in December 2007 the US Federal Reserve together with the European Union's central banks injected \$ 100 billion. At the same time, investment funds created by states with sufficient resources, such as the United Arab Emirates funds and the funds of the Asian countries, bought shares in American banks.

According to Ignacio Escolar (2012), on September 15, 2008, the fall of the investment bank Lehman Brothers left terrible consequences in the world financial markets due to the great debt it had.

### 3. SPANISH CRISIS.

#### 3.1. Incorporation to the Economic and Monetary Union.

On 12 June 1985 Spain signed the Treaty of Accession to the EEC (currently known as the European Union) but officially joined on 1 January 1986.

In 1993, while the European Monetary System was going through the last great financial crisis of the 20<sup>th</sup> century, in Spain, after Olympics and Seville's Expo '92 we suffered a recession that generated a decrease in investment by companies and an increase in the unemployment rate, from 16% to 24%. In 1996 the government decided to carry out a privatization process, some companies that were affected: Endesa, Gas Natural or Repsol. This process reported to the state an income that allowed reducing its deficit to the maximum level that Treaty of Maastricht allowed for to accede to Economic and Monetary Union. On 1 January 1999 the Eurogroup was set up and it contained by European Central Bank and the central banks of the euro area. Besides, from 1 January 2002 the euro was established in 12 countries as the common European coin, including Spain. The integration into euro zone meant an expansion of the market and greater liquidity that generated an increase in the price of the stock-market and movable assets. According to José Carlos Díez (2013), since Spain became part of the Economic and Monetary Union, the lower cost of money helped to adopt greater indebtedness, benefiting from lower interest rates and lengthening repayment terms; it was easier to access capital markets around the world. As in the United States, it was very easy to access credit in Spain.

From 1994 to 2007, Spain enjoyed a period of uninterrupted economic growth based on consumption, financed by credit. Before the start of the great recession of 2007, Spain had a fiscal surplus close to 2% of the GDP and was one of the wealthiest economies in Europe. The Spanish economy was the only one of the four large Eurozone countries that fulfilled the commitment to have a public debt below 60% of GDP. It should be noted that the public debt refers to the debt that belongs to the whole country and it must be pay by all of us. This debt is the amount that has to be repaid, based on the ability to generate resources.

### 3.2. Chronological evolution of the crisis.

Below we will explain the chronological evolution of the crisis, from the prosperity years to the present, going through the bursting of the real estate bubble and detailing all the consequences we have suffered, and continue suffering. Until 2007 the Spanish economy faced very favourable conditions for investment and consumption. However, in the second half of this same year the situation became unsustainable and the possibility of the crash of real estate bubble was imminent. This was due to poor management in the financial sector and in the construction sector which led to very serious economic difficulties in that moment; in addition to the political and social problems we continue suffering in 2017.

**1998.** In 1998 the president of the government, Jose Maria Aznar, approved the “Land Liberalization Law” with the aim of increasing urban land and be able to cope with an incipient demand. This law also managed to avoid arbitrariness among some political actors who negotiated according to their own interests. As a result, with the increase of urban land, many more houses could be built and the construction sector could obtain a high profitability of these transactions.

**2000.** The reduction in interest rates and the increase in liquidity to combat the crisis of 2000 generated a large amount of money, used to invest in the construction sector. Demand on housing began to increase, especially among the youth groups as they were trying to obtain personal independence, but the market was not ready and there were few houses available to supply this increase in demand.

**2002.** Later, in 2002, President Aznar implemented a labour reform that reduced the work rights and the wages. In this way, entrepreneurs had more resources to recruit a higher number of workers and reduce the unemployment rates. With the increasing labour demand, many young people left their studies and were employed in the brick sector, since at that time housing was fashionable and the construction sector was booming. All these young people, upon receiving their first salaries, dared to become independent and buy a house. However, the land law did not have the expected effects: as housing demand soared, the land prices increased. At that time, thousands of investors, both domestic and foreign, saw an opportunity in the Spanish brick sector. Housing prices scaled: in 1990 the average price of housing was 915€/m<sup>2</sup>, in 1998 it was 1,089€/m<sup>2</sup> and in 2002 it increased to 1,667€/m<sup>2</sup>.

**2003.** When in 2003 the interest rate was meant to reach 2%, due to the fact that convergence of Economic Monetary Union and the introduction of the euro, debt increased to 14.3% annual.

**2004.** In 2004, with an interest rate that remained at 2%, the debt increased reaching 16.4% annual.

**2005.** In 2005, with the same interest as the previous year, debt was growing at approximately 24% annual. Fear of getting into debt was lost and, during this year, Spain built in one year more houses than France, Germany and Italy together. The average price of housing increased to 2,516€/m<sup>2</sup>. On the other hand, the unemployment rate continued falling going from 22.9% in 1995 to 13.9% in 2000 and finally, to 9.2% in 2005.

In this period financial institutions started to act reducing the credit requirements which they granted. The background is the same as in the USA with subprime mortgages; the objective was to facilitate mortgage loans until a house was eventually unpaid and banks resold it at a higher price. They believed that this benefit was assured because they assumed that the housing price would continue increasing and, in this way, they recovered the initial investment and earned, additionally, a profit with the resale. In addition to having a low interest rate, banks increased the term of the mortgages. Until 1998 the mortgages were usually of a maximum of 15 years and with rates of approximately 10%. When demand for mortgage loans increased, banks decided to reduce requirements and commissions, and also extended the term of repayment of principal plus interest. In addition, the loans granted were higher than the value of the housing, in this way, workers with low and frozen wages, were living beyond their means.

This is a clear example of a speculative bubble; buy because it is believed that the price of goods will continue increasing and, what really happens is that prices increase because demand increases (in this case, this demand was financed with mortgages loans). This meant, there was no initial liquidity by part of the families; this liquidity was obtained from central and savings banks that lent the money in order to obtain back a higher remuneration, assuming that the price of housing would not cease to increase. Santiago Niño-Becerra (2012) *“debt has been the currency with which it has been possible to buy dreams”*.

**2007.** In 2007 the average house price had reached a value of 2,905 €/m<sup>2</sup> and the bursting of the real estate bubble was already imminent. At that time, the debt of companies, public administrations and families was already disproportionate and this debt was financed, mainly, by savings banks, which had obtained money from other financial institutions. Spanish families' debt had grown from 30% of the GDP in 1995 to 80% in 2007. At the end of 2007 and according to (Guillermo de la Dehesa, 2009), the total gross debt of the private sector was more than 405% of GDP; households had been indebted at 87.8% of GDP, non-financial corporations at 190.3% and financial institutions at 129.5%. Meanwhile, the public debt had been reduced to 37% of GDP and this encouraged the Zapatero's government to carry out an expansive fiscal policy, reducing the corporate tax and the personal income tax.

**2008.** At the beginning of 2008, inflation reached the highest levels known in the last decades (surpassing 4%), and this trend was due to the increase in oil prices and staple food prices. Regarding to the unemployment rate, in the first quarter of 2008 it stood at 9.6% and in the fourth quarter it reached 11.3%. The unemployment rate in Spain began to increase at an exorbitant rate and this resulted in an increase in social pressure and evictions. The price of housing was already so exorbitant that there were families who were mortgaged to 40 years in exchange for living in a flat of 10 or 12 m<sup>2</sup>.

To sum up, the declining interest rates, the ease to access to credit, the increased employment (thanks to labour reform) and the rise in housing prices, led to an increase in private consumption and investment. Spanish demand grew at much higher rate than we could bear and this made us an economy highly dependent on imports, which led to an external deficit and an external debt close to 100% of GDP. Property developers borrowed money to invest in the construction sector and they were able to build enough houses to meet the expected demand in 2020, at 2020's prices. The

banks believed it was a great opportunity to increase their profits, so they financed these operations. A third of Spanish families became indebted believing that they could later sell these houses at higher prices, but with the increase of unemployment, many mortgages were left unpaid and credit restrictions began to be much more demanding. On the other hand and according to José Carlos Díez (2013), the local governments and public administrations also believed that the income from the sale of land would be permanent and they acquired some expenses that later became unsustainable. The Autonomous Communities also counted to fixed income from taxes linked to construction – such as the formalization of mortgages or the resale of homes – these supposed benefits finally became a debt. In the same way, small companies and SMEs became indebted with the objective of obtaining a higher income according to some forecasts that were not fulfilled later.

The Government tried to compensate for the decline in consumption with an increase in public spending. However, the sharp fall in growth (due to the reduction of consumption and private investment), the huge increase in unemployment rate, the stagnation of construction sector sales, the restriction to credit, the lack of confidence, the fall in the tax collection and the increase of the public expense that supposed the establishment of the “baby cheque” in 2007, caused public accounts to close the year with a very high deficit. This multiplied almost threefold in 2009, when de Government had to finance an activation plan (Plan E and its variants) in addition to suffer a great fall in the tax collection (Santiago Niño-Becerra, 2012). During the third quarter of 2008, the growth rate of the Spanish economy began to have negative values.

With the expansion of the credit crisis that broke out in the United States, banks stopped lending money and investors stopped buying debt. With the scarce financing resources, consumption and investment declined at a high rate. In May 2008, the Euribor surpassed for the first time 5%, increasing the monthly mortgage rate.

**2009.** In January 2009 the Government presented the Spanish Plan for the Stimulation of Economy and Employment (Plan E), whose objective was to create a fund of 3,000 million euros to motivate strategic sectors such as the automotive sector, I+D and environment. In addition, a local investment fund of 8,000 million euros was created for public works. However, during this year, revenues began to be overwhelmed by the budgeted expenses; therefore an increase in the public deficit was anticipated.

In February 2009 and according to Ignacio Escolar (2012), although no banks had been rescued in Spain from bankruptcy, during the first quarter of 2009 the Spanish economy went into recession and the errors that Spain had been committing began to become evident: were allowed to pay suppliers in the medium or long term, and this showed that our business network was much more sensitive to credit than in other countries. Besides, many jobs depended on the SMEs, the majority financed by credit. In 2009, there were over 3 million Spaniards unemployed.

According to Ignacio Escolar (2012), by the end of 2009 it was estimated that 3.8 million flats were empty while the rich were getting richer; Spanish fortunes increased their volume by 27%. We have clear examples such as Amancio Ortega who grew 37%, Emilio Botín 71% and Esther Koplowitz 24%. However, the stark reality was that the deficit had multiplied by five, GDP had lost 3.6% and unemployment was increasing, reaching at that time 18% of unemployment. At that time, the Government announced a tax increase for the middle class, while Spain's biggest fortunes continued to pay 1% through the SICAV (Variable Capital Investment Companies).

**2010.** In 2010 we were already the European Union's country with the highest unemployment rate and we needed an economic recovery to help us reduce unemployment. Marking down dismissal was not a great solution to create job and the underground economy was also a disadvantage for economic growth. Spain was one of the countries with the lowest tax burden in the European Union; at the end of 2010, our public debt amounted to 85% of GDP and the public deficit was close to 10%, the largest in the Eurozone.

According to Santiago Niño-Becerra (2012), in 2010 Spain was already one of the most indebted countries in the World; Spanish total debt reached a volume equivalent to 410% of GDP, that is, we would need the production value of more than four years to repair that debt. The main problem of Spanish debt was private debt, companies had 120%, financial institutions 110% and families and households 90%. This was a serious problem because companies and financial entities are the drivers of generating GDP and creating jobs. In addition, half of all this debt was in foreign hands and which made Spain very dependent on the abroad, unlike Japan, whose public debt exceeded 200% of GDP but practically all this debt was financed with domestic savings.

Spain had a serious over-indebtedness problem, mostly private and related to the brick sector. Deflation of housing-related assets made debt unsustainable. On the other hand, foreign investors feared that we would not be able to offset our debts and were reluctant to invest in bonds. As the Spanish banks could not issue bonds, they did not give credit, and then the families that wanted to buy a house, due to lower prices, could not obtain a mortgage. As a result, with the decline in demand, prices continued to fall and investors feared default. It should be noted that, families could not access mortgages loans because the interest rates and conditions that were imposed were unaffordable for this type of population. Above all, SMEs were very affected because their banking dependence was greater than that of large companies. The high risk premium also contributed to increase financing costs and made it difficult to refinance our debt. José Carlos Díez (2013) states that “hasta que Europa no salga de la recesión, España no tiene solución”.

It was in May of this year when the adjustment began, both in Spain and throughout Europe. They carried out a salary reduction of public employees, increased the VAT (Value Added Tax), increased tobacco taxation and reduced public spending. Regarding to the unemployment rate, the year finally closed with 20.5% unemployed.

On the other hand, at this year the euro crisis happened. During this period the states of the Eurozone, 16 member countries, were suffering a crisis of confidence, with speculative attacks on public bonds of some their members and turbulence in the financial and stock markets that triggered a fall in the exchange value of the single currency. For years, the Greek government had assumed large levels of indebtedness, contrary to the demands of the Eurozone. With the global financial crisis, deficit widened and investors began to demand much higher rates to lend money to Greece.

The impact of the crisis on the common European currency caused a readjustment of weak economies such as Portugal, Spain or Italy. And as of March 2010, the Eurozone and the International Monetary Fund decided to negotiate to try to rescue the Greek economy, but no agreement was reached. Distrust increased the euro suffered a decline in its value. Finally, on 2 May, the European Union and the International Monetary Fund agreed on a rescue plan of 750,000 million euros in order to curb the spread of the crisis throughout the Eurozone.

2011. The budgets of 2011 showed a version with more loss-making than the previous year; the budgeted revenue was 255,910 million euros and the expenses of 297,425 million euros. Imbalances in the realization of budgets lead to justify the amount of public debt between 2008 and 2011: from 507,361 million euros to 863,826 million euros, amounted to 356,465 million euros. Meaning that the deficit accumulated in these four years, 356,142 million euros, is what increases our public debt. The amount of our debt was growing all the time.

In February 2011, Spain was the country with the highest unemployment rate in Europe, 20.2% of the working population was unemployed, twice the European average.

During his manual, Ignacio Escolar (2012), showed that in March 2011 Spain overcame four records. The first was the 4.3 million unemployed, the largest number of unemployment in the history of Spain. The second referred to the benefits of large companies, as one of the Ibex-35 earned 49,881 million euros, 24.5% more than the previous year. The third one refers to the senior executives' salaries, since 2010 the salaries of the top managers of the companies of Ibex-35 increased an average of 20%. Finally, the fourth record corresponded to Telefonica, which earned 30.8% more than the previous year.

In June 2011 the Spanish autonomous debt was approximately 2,500€ per capita. The most affected communities were Cataluña (4,329€), Baleares (3,788€) and the Comunidad Valenciana (3,500€). In July, the Comunidad Valenciana was the most indebted autonomy with 17.2% of GDP, approximately 17.6 million euros.

According José Carlos Díez (2013), until this year, the Chinese sovereign fund was one of the largest investors in Spanish public debt, owned approximately 10% of the total of public debt emitted by Spain. On the other side, the Norwegian sovereign fund also played a very important role in our country as it is considered the largest investor in fixed income in euros in the World. The Norwegian sovereign fund was the main investor in mortgage bond and bonds of our banking system until 2008, and then, until 2011, in public debt. Unfortunately, as of 2011, these important funds greatly reduced their investments in Spanish bonds.

On the 29<sup>th</sup> of July 2001, the President of the Government, José Luis Rodríguez Zapatero, announced an electoral advanced for November of this same year and on the 21<sup>st</sup> of December Mariano Rajoy became the sixth President of the government of Spanish democracy. Unfortunately, President Rajoy made the same mistakes as President Zapatero: he did not prioritize the sanitation of our banking system as soon as he came up into power. This error, coupled with a bad negotiation with Brussels regarding the delay of the deficit objective, neutralized the legitimacy and margin of manoeuvre that supposed the absolute majority of Partido Popular. Then, the government opted to request the bank rescue to our European partners.

In that moment Spain was already a heavily indebted country with a very slow economic activity, with more than 5 million people without employment, with thousands of companies in bankruptcy, with more than 22,000 million euros delayed in tax settlements with Treasury and with a youth unemployment rate of approximately 50% (José María Gay de Liébana, 2012).

**2012.** During this year the Spanish debt was growing all the time and the deficit was about 10% of GDP. So, Spain was already poorer than the previous decade. It has to be emphasised that the Spanish deficit has been a result of the mainly lack of incomes; this problem lies in our fiscal model as our public administrations collect less than the EU-27 average. The problem of our taxes is not on the payroll or the PIT (Personal Income Tax), the problem lies in fraud, underground economy and the fiscal model designed to collect as much as possible during the real estate bubble. Public spending has to be efficient and can be financed, the main source of financing is taxes and Spain has a serious problem of collection capacity.

In February 2012, the government had raised taxes, cutting the public spending and the cost of dismissals. To clean up public accounts, it was decided to cut back public spending and raise taxes to workers, this represented to harm the middle class through PIT and through their social benefits. During the fourth year of crisis, the risk premium increased, consumption fell down and the recession returned. Among the ten macroeconomic objectives required by the European Union, Spain only met four.

In April 2012 it officially returned to the recession with more reductions, more layoffs, the collapse of the stock market and the risk premium shot up. It should be noted that the more cuts, the less growth, since there will be less tax revenues and a greater deficit. In July 2012 the second labour reform came into force with the authorization of the Temporary Employment Agencies (TEA) as placement agencies and changes in recruitment. According to José María Gay de Liébana (2012), our purchasing power declined significantly and the average Spanish salary in 2012 was 22,790€, although the most common salary was 16,489€.

Interest payments on public debt increased from 1% of GDP in 2007 to almost 3% in 2012. Economic theory tells us that the interest rate on debt should be lower than nominal GDP growth, since if the interest rate is higher than growth, the debt increases without control.

From the integration of the euro, the Spanish banks lent billions of euros that they would not recover in the short term. This money provided by Spanish banks consisted of funds that the European Banking had provided to Spain, especially the French and German entities, and these funds, in general, were granted in the short term and, nevertheless, were lent in the long term. To try to fix the situation, the Government imposed severe sanitation requirements on banks and had to nationalize many financial institutions. As a result of this, Spain had to pay more for its bonds and attract investors, but by the increasing of debt costs the country was forced to seek international aid. In the middle of May, Bankia crisis hastened its own nationalization and drove the need for European financial aid. Finally and according to José Carlos Díes (2013), on June 9, the Eurogroup approved a bailout of up to 100,000 million euros to recapitalize the Spanish financial system, meaning, they rescued the banks whose capital reserves were insufficient. This rescue counted as debt but also had influence over the public deficit. State guaranteed the loan, which meant socializing 10% of GDP of private debt by public debt, thus capital flight to the outside was intensified. In this way, Spain became the fourth country in the Eurozone to receive economic assistance. The intervention of European Central Bank in August - with the announcement of the purchase of Spanish bonds – prevented our public debt market from collapse.

The bailout of the Spanish financial system did not reassure the situation; the risk premium increased to 640 points, the profitability demanded by the Spanish 10-years bond market shot up to 7.6% and the Treasury came to pay 6.7% for placing a bond to 7 years. The stock market gave no respite, in one month it fell 8.5% and this did not favour investors.

From the debtor's point of view, the consequences of a bailout are a series of spending cuts and tax increases, this is because those who rescue the country demand that they return the money lent, and for this you have to deduct a part of your income. That is, you are required to make spending cuts to pay your debt and to ensure that your tax revenues will be sufficient to take away from what it has to give back, therefore it raises taxes. No one can assure that this will be sufficient to face all the debt, but it is what works in a theoretical way.

As mentioned above, Spain is heavily dependent on external financing. With the euro, our banks accessed international markets and their debt to foreign investors amounted to one billion euros, almost 60% of our total external debt and 100% of GDP. Our main creditor was the European Central Bank; in 2012 the Spanish bank owed 350,000 million euros, 35% of GDP. Regarding to social problems, during the first 10 months of this year there were 36,232 demonstrations in Spain, double in 2011.

**2013.** During 2013 the Spanish economy faced two distinct stages; a first half still marked by uncertainty and a second half in which it seems that the crisis has bottomed out and begins to show of recovery.

The first reform was in the pension system, the retirement age was delayed from 65 to 67 years with the requirement to be contributed 37 years in order to collect 100% of the pension, although they could retire at 65 years with 100% of the pension if they have 38.5 years worked. The age of early retirement was also delayed from 61 to 63 years.

According to José Carlos Díes (2013), the SAREB, known as the “bad bank”, went live on 2 January. Capital aids were non-refundable, since if an entity is nationalized and must comply with minimum regulatory capital, it will be with taxpayer’s money and will cause an increase in the deficit and public debt. The SAREB was created mainly to finance problematic assets; this “bad bank” was an instrument that consumed many resources at the beginning, which supposed losses for the taxpayers. But later, it bought credits and real estate assets from insolvent entities.

On the other hand, the sanitation of Bankia also supposed much effort in the Spanish economy. In February, a Statutory Lay-off proceeding (ERE in Spanish) was applied to 4,500 workers to comply with the consolidation process agreed with Brussels. The FOBR valued by a penny the shares of Bankia and this supposed a collapse of its quotation in stock market to all-time low. The recapitalization process began with a capital reduction of 3,980 million to repair losses and two extensions of 15,500 million that concluded with new actions. Meanwhile, the 400,000 shareholders of the bank lost almost the total of their investments. However, currently the share prices are above the euro and the entity has been able to return to the Ibex-35.

On May 2, the European Central Bank lowered the official price of money to 0.5%, and later, on November 7, it again lowered interest rates until reach all-time low of 0.25% to stimulate recovery in the Eurozone and combat deflation.

On the other hand, during this year some corruption scandals began to be made public: the former president of Caja Mdrid, Miguel Blesa, was the first banker to enter jail and, on June 27, judge Ruz ordered unconditional imprisonment for former Partido Popular treasurer, Luis Bárcenas.

Finally, on October 23, it is known that Spain left behind recession after growing 0.1% in GDP during the third quarter of the year. Exports and tourism were essential in Spanish economy; during this year Spanish sales grew by 6.8% and the number of foreigners reached 54.3 million between January and October, an increase of 4.8% over the previous year.

It should also be noted that the house price rose in the third quarter in 10 of 17 autonomous communities, contributing an increase of 0.7% in the whole of Spain. However, within the labour market the number of unemployed attained almost 6 million, as we will detail later.

2014. During the year 2014 signs of recovery began to appear: 400,000 jobs were created, social security recovered more than 300,000 affiliates, unemployment fell to 5.4 million unemployed and new companies were set up. Spain began to create employment from the second quarter of 2014, so the economy hardly grew by 0.6% over the previous year. 2014 was the year in which the construction sector stopped destroying employment, yet it was one of the last to stop falling.

It should be emphasized that Spain did not need to grow by 2% over the previous year to create employment as in previous crisis. Nevertheless, the quality of those jobs was very poor since the labour was too cheap. We talked about precarious work because it was cheap labour with very low salaries. Temporary work and part-time work also increased again.

On the other hand, GDP grew 2.2% over 2010, this increase was due to the fact, among other things, that the increase in investment, consumer spending and exports and imports. And the 10-year Spanish bond reached minimums, came to be 1.65% interest and the risk premium around 110 basis points.

However, seven years of crisis are not healed in just a few months and this is demonstrated by several economic indicators such as the unemployment rate (which had been from 25.5% in January to 23.6% in December, but remained high), the number of long-term unemployed (approximately 3.5 million people) or families without income, which in 2014 added 729,000.

The Ibex-35 experienced a 6.3% increase in the value of its companies. This situation contrasts with social problems: according to UNICEF (United Nations International Children's Emergency Fund) and OECD data, child poverty in Spain had increased by 800,000 since 2007 and 36% of Spanish children between 0 and 5 years old were at risk of social exclusion.

**2015.** During 2015 the pace of recovery intensified (begun in mid-2013) thanks to declines in the price of oil, the monetary stimulus and the restoration of the main macroeconomic indicators. It is considered that the period from 2013 to 2015 is the period in which economic recovery begins with an increase in production, job creation, consumption and exports, among others. Spanish growth rate increased from 1.4% in 2014 to 3.2% in 2015. The economic activity began to recover thanks to the increase of household consumption, business investment and exports. Thanks to this growth activity, the public deficit was reduced to 5.1% of GDP and the number of unemployed decreased by more than half a million people, the unemployment rate in Spain decreased from 24.4% in 2014 to 22.1% in 2015.

GDP per capita is the measure that reflects the citizens' welfare and it has been going down since 2008. In 2014 this trend changed and GDP per capita began to grow at rates of 1.8% in 2014 and 3.4% in 2015. On the other hand, exports, especially good ones, increased almost 17% since 2011 while imports did so by 6.9%. By contrast, during this year the investment was reduced compared to 2011 in 1,912 million euros and this was due to the fall in investment property.

In 2014 the unemployment rate was 24.4% and in 2015 it fell to 22.1%, this represented a very important advanced in the country's growth, although the rate remained high, we had managed to decreased it by more than two percentage points. The job creation favoured the reduction of poverty rate but social problems persisted since unemployment is the main cause of poverty. It is important to emphasize that unemployment has to be created in a stable and sustained manner by increasing production. An economic policy is needed that really drives production and not a policy that creates job artificially and temporally, with precarious employment and limited working conditions.

**2016.** During 2016 there have been major advances that have motivated the economic recovery: members of the social security have increased in 540.7 thousands of persons during the last quarter compared to the same period of the previous year, sectors such as tourism have grown 10.1% in the last year, almost twice as much as the previous year, exports have also experienced growth of 0.9%, however imports have fallen by 1.6%.

The year 2016 has been favourable for the labour market, according to the Labour Force Survey, 2016 closes the year with 18.63% of the citizens unemployed, that is, unemployment has fallen by 541,700 people. During this year 413,900 jobs have been created and unemployment rate has been the lowest rate over the past seven years, the number of unemployed has been reduce to 4,237,800 people. Nevertheless, temporary contracts continue to exist; one per three contracts is less than six months and each busy employee works one hour less to week.

During 2015 the price of oil affected inflation, which stands at above 1.5% in December 2016. It is estimated that the upward trend of inflation will continue and its intensity will depend on the evolution of the price of oil.

**2017.** Estimates for the year 2017 show that the rise in the price of oil will have a negative impact on the costs and the improvement of productive activity will be slowed down. On the other hand, it is expected that in 2017 the household disposable income will increase thanks to the rise in production and job creation.

## 4. EVOLUTION OF THE MAIN ECONOMIC VARIABLES.

### 4.1. Unemployment rate.

Employment has been the most harmed sector by the crisis in Spain, meaning a direct problem due to the repercussion over welfare of unemployed.

One of the traits that distinguish the Spanish labour market is the high rate of temporality. Before the crisis, Spain was the country with the highest percentage of temporary contracts within the European Union. We have always been one of the countries with more temporality and this is a problem because the entrepreneurs invest fewer on training. In addition, this kind of precarious employment encourages low added value economy (Ignacio Escolar, 2012).

The permanent employee's compensation for wrongful dismissal is higher than the European average, and seasonal worker's layoff is much cheaper. For this reason, when the economy is bad it is very easy to dismiss temporary workers instead of reducing the workday or the wage.

The real average wage is a good indicator of activity level and purchasing power. During prosperity period, the real average wage decreased, between 1995 and 2005, 4% of purchasing power was lost. However, between 1999 and 2006 the business benefit grew by 73%. The Spanish average wage in 2011 was 21,500€ gross per year, half in Germany, Holland or United Kingdom. In that moment, 6% of the Spaniards were "*mileurista*" (wages below 1,000€/month) and 20.8% of them were within the poverty line, one of the highest rates on European Union (Ignacio Escolar, 2012). Therefore, this scenario of limited growth which we were undergoing was getting us into economic problems, whose consequences directly affected society.

Until now, the model in force in labour market is based on low added value of productions, of the lacking capitalisation, intensiveness in labour factor and productions heavily oriented to domestic market. Besides, these productions are highly dependent on a credit, which shows the low productivity that exists in terms of value generated by unit of productive factor used (Santiago Niño-Becerra, 2012). The Spanish production model is intensive in labour force, not in capital, and it has been driven by sectors with low value added as the construction sector or tourism. In 2008, the brick sector supposed for 18% of GDP, auxiliary industries 21% and tourism 11%. Meaning, half of the Spanish economy depended on sectors with low added value.

When the real estate bubble crash, the construction sector destroyed employment with the same intensity and speed with which it had been created. Spain had suffered highly levels of structural unemployment; unemployment rate went from 8.3% in 2007 to 26.02% at the end of 2012, this was equivalent to 5,965,400 unemployed. Spain has gone from being a country of opportunity for immigrants, in spite of unskilled jobs, to the labour drought and to incipient emigration of young people. The maximum was reached in 2013 with a rate that almost attained 27%, more than six million unemployed. Another sector badly affected by the crisis was of the small and medium entrepreneurs due to credit's shortage and failure consumption. In 2011, 376,945 SMEs went into bankruptcy and in 2012 this number ascended to 391,270 SMEs.

Market economy grows when companies invest and families consume, therefore, the main objective of the bank system is transform savings into credit, provide for sustained growth and encourage job creation for improve social welfare. However, within a clearly adverse economic situation like the one we have gone throughout, it has not been possible to carry out all this, since private equity was scarce and recapitalisation can only be done with taxpayers' money. Therefore, it was necessary to implement reforms in active politics which create jobs for low skills persons and coming from construction sector. However, low geographical and sectorial mobility, abundance of underground economy, the problems for the creation of new companies, shortage funding, high temporality and little flexibility in labour market have been sufficient reasons that have triggered unemployment in Spain.

#### 4.2. Prices.

To analyse the state of an economy is also very important to study the increases or decreases in the general price levels; this is what is known as inflation or deflation. The evolution of price is measured by Consumer Prices Index or by deflators. Consumer Prices Index (CPI), that is the ratio between the costs at current market prices of a given basket of goods versus the cost of that basket valued at the prices of a base year. On the other hand, GDP deflator is equivalent to CPI; the difference is that the basket of goods is modified year by year to coincide with the GDP's composition, although it leaves out the imports.

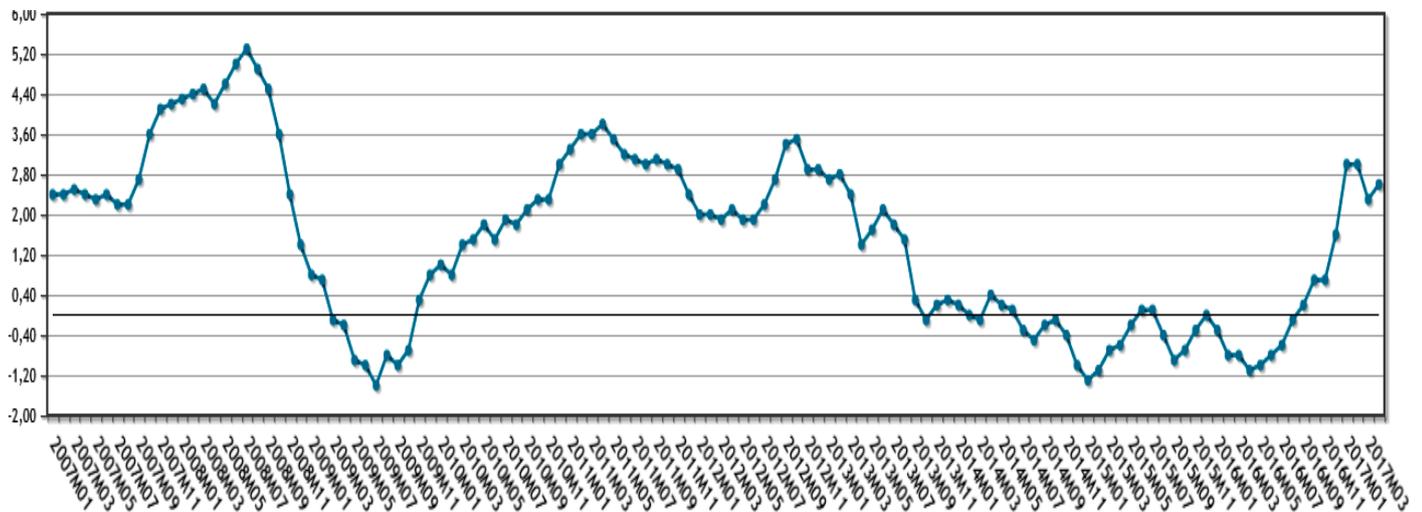
Inflation rate is the percentage of annual variation in the aggregate price level.

$$\pi_t = 100 * \frac{P_t - P_{t-1}}{P_{t-1}}$$

On the other hand, deflation is the opposite of inflation; therefore, it is produced when there is a prolonged fall in prices during several periods. Speaking about deflation when the supply of goods and services is higher than demand and entrepreneurs are forced to lower prices to sell production and not accumulate surpluses.

After the theoretical explanation, we will explain the inflation level evolution in Spain during the recent years. In the year 2000, Spain suffered constant inflation due to the main fact of importing oil, as the energy resources were scarce. As we can see on Graph 1, during the years following 2007, the inflation level had always been between 2% and 4% as maximum. In 2008, the burst of the real estate bubble was accompanied by a drop in oil prices, in that moment there was some risk of deflation, however the inflation rate throughout the year did not turn out to be negative. In 2009 it reached a minimum monthly of -1.2%, but in 2010 this figure managed to rise and inflation increased to 3%. In March 2011, prices fluctuated between 2% and 3.6%, affecting to quality of life of Spaniards through increased unemployment, purchasing power decreased significantly and wages declined. Subsequently, on the fourth quarter of 2012, the CPI began to decline until reaching the minimum in the first quarter of 2015 with a negative rate of 1.21%. It has to be emphasized the curious evolution of prices throughout the economic crisis; in the midst of the crisis, year 2009-2010, prices rose and began to decrease as of 2011, meaning, four years after the bursting of the housing bubble.

**Graph1.** Annual rate of change in CPI.

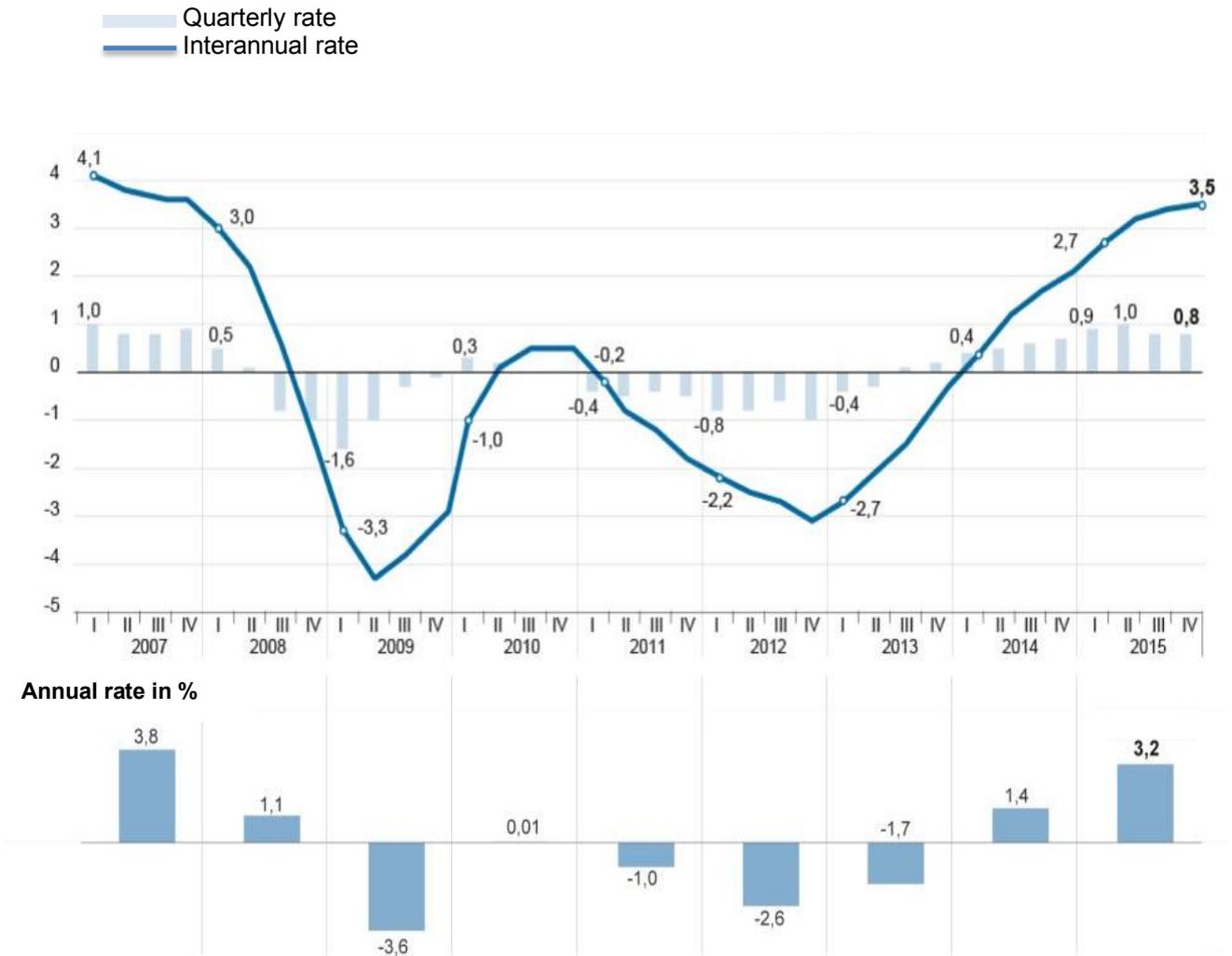


Source: Prepared by the author on the basis of data supplied by INE.

### 4.3. Gross Domestic Product.

GDP (Gross Domestic Product) is an indicator that refers to the goods and services production within a specific territory in a certain period of time. Although inflation and unemployment rate are considered good indicators of economy, GDP has traditionally been used to express the wealth of a country in terms of welfare, without considering social or environmental problems such as inequality, education or health quality. We have referred to GDP on numerous occasions during the crisis' explanation, but to improve understanding, we append an image on the evolution of GDP in the period from 2007 to 2015 where we can see all the data we are referring to on Graph 2.

**Graph 2. Spanish GDP's Evolution (GDP growth rates in %)**



Source: Prepared by the author on the basis of data supplied by INE.

## 5. ADDITIONAL ISSUES.

### 5.1. Tax haven.

The concept of tax haven started to be known in 2009. Tax haven refers to territories where tax systems are very favourable for non-residents, therefore, many companies or citizens earn their money in these countries. Although they don't reside there, they are exempt for pay taxation (partly or completely). In tax havens there are other advantages, for example, in these countries there is little openness, and in fact there are regulation and laws that restrict the exchange of information regarding capital. These countries take benefits because they get to strengthen their currency thanks to foreign exchange reception. Ignacio Escolar (2012) states that "*in a word, globalized as the present, limits exist for people but not for money*". According to OECD, in tax havens there are hidden between five and seven trillion dollars, this information is equivalent to 13% of world GDP.

According to Ignacio Escolar (2012), in 2011 Spain was the country with more banknotes of 500€ from all over Europe; 65% of the money that moved around Spain was in banknotes of 500. Since the bursting of the real estate bubble, the figures have barely fallen and still represent 52,000 million euros. The problem is that a high percentage of that money is not declared and represents a tax fraud of 16,000 million in a year. That is, the Spanish underground economy is one of the highest in Europe, with 20% of GDP, only exceeded by Italy and Greece. In 2011, Spanish underground economy represented more than 260.000 million euros, 23.7% of GDP.

On the other hand, according to Ignacio Escolar (2012), Spanish senior managers are the best paid in Europe, during the worst year of the crisis, their wages grew by 15% and entrepreneurs of Spanish Ibex-35 companies earned a million euros on average. For example, Telefonica's manager earns as much as the total wage of 103.5 of his workers, all together.

## 5.2. Pensions.

Pensions are an important issue to address because they affect barely all of population. According to Ignacio Escolar (2012), Spanish population's pyramid is unusual because we went through the baby boom until seventies and, after, the birth rate sank drastically. When those born during the baby boom grow older and retire, workers will be lacking in proportion to the retired population and this will be an important problem because the worker's contributions are used to pay the pensions. In comparison to other countries, Spain spends little proportion of money on pensions: Spain spends 8.4% of GDP and European average is 10.1%. Ignacio Escolar writes about this topic and suggests two solutions: reduce pensions and reduce the time of enjoyment, or that the difference is paid by means of taxes.

According to José María Gay de Liébana (2012), in 2012, a critical moment for the Spanish economy, almost 113 million euros were spent on pensions. With the increase of the quality of life increases the life expectancy, we are increasingly long-lived and this is a burden for the State.

A pension reform was made in 2013: the retirement age was delayed from 65 to 67 years, with the requirement to be based on having contributed 37 years in order to collect 100% of the pension, although they could retire at 65 years with 100% of the pension if they had 38.5 years worked. The age of early retirement was also delayed from 61 to 63 years old.

### 5.3. Savings banks.

Most citizens had deposit their money in savings accounts before the crisis. These financial institutions were established non-profit and characterized by supporting the local productive sector and dedicating their incomes on reserves to improve their solvency or social works. However, during the economic crisis, the savings banks were the financial entities that were more involved; in 2007 they were the entity that most granted credit to the construction sector, during the real estate bubble they financed a lot of urban designs. In 2007 there were 349,540 million euros in loans to buy housings and, with the bursting of the real estate bubble, came the problem of delay in payments: the average default in Spanish financial system obtained a maximum of 13.62% in December 2013.

Between 2000 and 2007, 8,829 new offices were opened, in total there were 8,000 more savings banks' offices than banks. In addition, most of these offices were located in the Spanish cities which were most involved in real estate speculation: Madrid, Barcelona and Valencia. Savings banks dedicated the greater part of their ways to investing in by-products with a high risk and one of consequences was that thousands of savers were defrauded. When this situation was unsustainable, more than 31% of savings banks' branch offices were closed.

Afterwards, Fund for Orderly Bank Restructuring (FOBR) was founded with the main objective of savings banks were restructured and recapitalized throughout get the fusion of a saving bank 'acquitted' with another with financial losses, in this situation, the FOBR would assist with economic resources.

Between January and March 2009, Spanish savings banks earned 2,028 million euros, of which, 1,637 million euros was allocated for socials projects. This amount meant a fall equivalent to 16% regarding to the previous year. During the first decade of the XXI century, in Spain, 45 savings banks were operating but, in 2010, only two of these entities were survived. All of this showed the financial character of the savings banks.

## 6. CONCLUSIONS.

Finally, it has to be emphasized that one of the mistakes that led us to this difficult situation was to buy housing rather than rent them. In Spain, we have a cultural problem in which we associate that to rent is to waste our money, and this ideology has contributed to forge the bubble. Since the bursting of real estate bubble in 2007, housing supply has been incalculable. As of 2007, the average price of a new dwelling started to fall because housing demand was steadily decreasing. However, the price average housing has already started to grow up.

This period with serious economic difficulties has generated the impoverishment of society. The situation has been so severe that, ten years later, we are suffering still its consequences. It has been difficult for us to recover the growth levels, before the crisis, although we have already recovered the GDP levels before 2007.

Now there is a greater fear of go into debt, the credit demands more restrictive conditions and the financial institutions are more careful in processes of lending money. From my point of view, it was no necessary to go through such a serious situation in order to know how to organize the financial market and to select, under strict guidelines, the people who can cope with a loan and those who do not.

Currently, we are in an economic recuperation process: GDP grows quarter over quarter and Spanish unemployment rate reached 18.63% in the fourth quarter of 2016, 4% less than the average rate of the previous year. On the other hand, production is one of the main forces of growth, therefore, a good choice would be to trust young entrepreneurs and offer them some financial instruments so, in this way, they may carry out their project. In the same way, consumer confidence needs to increase and, for this, we must show recovering signs and greater stability.

All datum provided during the work is objective datum. A big part of the information detailed here, has not been shown in the media since, sometimes, the information we have accessed to can be subject to political interests. Therefore, doing this work has helped me to have a whole global vision of what has happened in Spain, also to know some precedents of the World's economy and some details of the Eurozone.

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