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Overview

Debtocracy

Once the US elections are over, attention should rapidly swing back to Spain with the approach of the 12 November meeting of Eurozone finance ministers.

Federal power

Every four years, the US presidential election focuses the world's attention on America. This year, economists are also keeping a close eye on the US, where public finances have eroded rapidly following the crisis. President Obama was elected in the aftermath of the Lehman Brothers collapse at the height of the financial crisis. The US economy plunged, pulled under by the weight of household debt following the bursting of the housing market bubble. Between year-end 2007 and mid 2009, GDP contracted 4.7% and did not return to pre-crisis levels until the end of 2011. About 8 million jobs were destroyed over that period, and since then, only a little over half that number have been created again. The unemployment rate peaked at 10% in late 2009, from 4.6% in 2006-2007, and has not fallen much since. Currently at 7.8%, the downturn in unemployment is due less to dynamic job creations than to the decline in the labour participation ratio: employment as a share of the American civilian population is currently at its lowest since 1983.

Under automatic stabilisers and a series of economic stimulus plans, government finances have deteriorated. The federal government alone has seen its deficit swell from USD161bn in fiscal year 2007 (1.2% of GDP) to USD1,413bn in 2009 (10.1% of GDP). Since then, deficits have not narrowed much. Federal debt held by the public, the public debt indicator most commonly used in the US, rose from 36% in 2007 to 72% at the end of September 2012. Using the consolidated figure for all government entities, the US public debt ratio can be estimated at about 103%, about 35 points higher than for Spain.

The next government will face the daunting task of correcting swelling budget deficits, which will be particularly hard because it means managing the short, medium and long term all at once. Reducing the federal deficit is a priority, but it must not be adjusted too abruptly because the US economy is not strong enough yet to absorb the shock. Long-term fiscal prospects are also alarming: so-called "mandatory" spending, i.e. Social Security (public pensions), Medicare (healthcare coverage for the elderly) and Medicaid (healthcare coverage for low-income families), are swelling under the effect of an aging population.

Once the Republicans regained control of the House of Representatives in the mid-term elections of 2010, the dialogue between the two parties has been extremely tense (the Democrats held on to their Senate majority). And the solutions they managed to come up with are far from ideal. It was these agreements that created the so-called fiscal cliff. Easing payroll taxes in exchange for extending tax cuts combined with the draconian terms adopted when agreeing to raise the debt ceiling ended up creating an enormous fiscal adjustment of a scope rarely seen before. If nothing is done, the federal deficit will be slashed by about 5 points of GDP between calendar years 2012 and 2013. Tax cuts dating back to President George W. Bush's first term would expire along with the reduced rate for payrolls taxes and very long-term unemployment benefits. At the same time, automatic spending cuts or "sequestration" that were part of the law allowing the debt ceiling to be raised in August 2011 would kick in.

We do not doubt that an agreement will be reached to limit the budget adjustment to between 1% and 1.5% of GDP. This scenario would rescue growth in 2013. Or would it? The lack of visibility over fiscal matters is one of the main reasons why American companies are refraining from investing and hiring. Postponing the fiscal cliff for another year would do nothing to clear up the horizon. Resolving the impasse of the fiscal cliff is essential, but it must be done intelligently, by finding an agreement that gives households and companies a clear picture of federal revenue and spending trends in the years ahead.

In this respect, the name of the next President is less important than the composition of Congress. Granted, President Obama's economic priorities are very different from those of Governor Romney. Even so, they still manage to find some common ground, like the need to simplify corporate taxes. Yet as the second half of President Obama's first term demonstrates, a President without a majority in both chambers of Congress cannot push through his policies without compromise. Less than a week before Election Day, the two parties are neck and neck, and the outcome might not be known until late into the night, or even for several days concerning the composition of Congress. Unfortunately, the latest surveys seem to suggest that there will be little change in the division of power: the Democrats could lose a few seats in the Senate but will hold onto a majority, while the Republicans will continue to control the House of Representatives, albeit with a smaller majority. Whether the next president is Barack Obama or Mitt Romney, one thing is certain: he will face a difficult task.

Regional tensions

With each day that passes, Spain moves a little closer to requesting European aid. Until recently, the main obstacle was regional elections, which were held on 21 October[1]. Mr. Rajoy's

[1] *See EcoWeek « Waiting for Rajoy », 12 October, 2012.*

Popular Party (PP) won an absolute majority in Galicia, sheltering the prime minister from the least sign of defeat, even relative, in his natal region. In the Basque Country, where Mr. Rajoy had little to win but a lot to lose, the double victory by the nationalists, notably the separatist Bildu party (25.5%), rekindled separatist fears after four years of PS-PP management.

As in the rest of Europe, the economic crisis has fuelled political tensions in Spain between the centre and the peripherals. The 17 Spanish regions control nearly half of total spending by public administrations. Since 2002, they are responsible for healthcare and education, two areas in which they must slash EUR 7 bn and EUR 3 bn in spending, respectively, to bring spending in line with smaller revenues following the bursting of the real estate bubble.

Two regions, the Basque Country and Navarra, are fiscally autonomous. Of the 15 others, Catalonia has tried in vain to obtain the same status, arguing that its budget deficit reflects a fiscally unjust redistribution system. According to Mr. Mas, the region's president, Catalonia loses EUR 16 bn in revenues each year. To counter the government's refusal, Mr. Mas has called early elections on 25 November and promises to hold a referendum on self-determination if he wins. Catalonia has the country's highest regional debt (22% of the region's GDP) and an unemployment rate of 22.5% of the labour force, so that more than ever before, his message falls on eager ears. On 11 September, a million Catalonians marched for the region's independence under the banner "Catalonia, a new European State". Yet without the financial support of the central administration, regional budget cuts would have to be even more drastic. A few weeks before launching the debate on fiscal sovereignty, Catalonia requested a €5bn loan from the €18bn rescue fund set up by Madrid. It is hard to say whether the early election and promise of a referendum on self-determination is really part of Mr. Mas' political project, or just a way to pressure the central administration when negotiating the terms of the loan So far, the regional president has yet to reveal his true intentions.

Catalonia is not the only region to request central government assistance. Seven other regions have also called on the Autonomous Liquidity Fund (ALF), which has almost depleted its resources. The ALF is obviously a management tool for Madrid, which only authorises funding for regional deficits defined in the budget, requires consolidation plans to deal with budget overruns, and can even intervene directly in the regions if the plan's conditions are not respected. Eventually, all regions could depend on the central administration for financing.

In 2013, some EUR 40 bn in financing needs for the regions could be added to those of the central administration, increasing pressure on the government to call on funds from the European Stabilisation Mechanism (ESM). The Spanish government might use the 12 November summit of Eurozone finance ministers to make its request. Spain would have to accept an Enhanced Conditions Credit Line (ECCL), which is different from the complete adjustment programmes imposed on Greece, Ireland and Portugal. It consists of a credit line of up to EUR 100 bn, which can be drawn on or not by the Spanish government, to support demand during Treasury auctions. The main political cost would be the loss of sovereignty associated with the quarterly supervision of its public accounts, rather than the implementation of additional austerity and/or structural measures. The 2013 budget that Spain revealed at the end of September was elaborated with the help of the Troika's experts, who are already present in Madrid.

In 2013, the Spanish Treasury must cover EUR 105 bn, including EUR 60 bn in central administration debt reaching maturity. Without European support, borrowing costs would probably be too high, triggering a downgrade of Spain's sovereign debt rating to speculative grade. In contrast, a request for ESM funding would pave the way for the ECB to launch its securities purchasing programme. Under this programme, Spanish debt with a residual maturity of between 1 and 3 years could be purchased on the secondary market. In 2013, about EUR 162 bn in Spanish debt would be eligible. The ECB could intervene in this segment until long-term rates declined to a sustainable level for Spain.

More than the spread with the German Bund, the level of Spanish sovereign yields are what matters to European authorities. In order to lower its debt-to-GDP ratio, a country must benefit from interest rates that are lower than its nominal rate of growth. If it is not the case, the government has to experience a primary surplus as large as the differential between yields and nominal growth. Taking into account the potential for growth of Spain, its ability to achieve a primary surplus, which is limited by the high level of unemployment (the government forecast a 3% primary deficit in 2012), the undisclosed goal of the ECB is probably to lower medium-term rates in the vicinity of 2%. If financial markets are to perceive this move as a commitment from the ECB to do whatever it takes to keep Spanish sovereign yields low on the short-end of the curve, it will lead to a downward shift and a flattening of the whole curve. This will help the Spanish government to keep going with structural reforms without choking the economy.