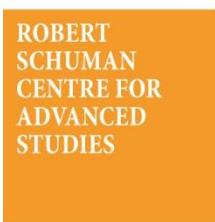




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Determinants of Spain's decision to leave the European
Monetary Union

Antonio Estella

European University Institute
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Abstract

Spain is the Member State of the European Union whose public opinion is most in favour to exit the Eurozone. In this context, there is a growing social and political debate on this issue in this Member State. This paper analyses at a theoretical level the main economic and socio political determinants that Spain would face if it were considering to take a decision to leave the EMU.

Keywords

JEL Class: K10; K19; K33; K40; K49

1. Introduction*

According to a recent opinion poll that covered seven members of the Eurozone¹, Spain would be the Member State of the European Union most in favour of leaving the euro. In this public opinion context, and above all since the summer of 2012, debate has been growing in this country about the prospects of its exiting the European Monetary Union². In this paper I argue that there are good reasons for taking this debate seriously. I therefore analyse in this paper what the determinants of this decision could be. In particular, I analyse the economic and the socio-political determinants that could condition a decision in this direction. I conclude that in the current situation, Spain's decision to leave the euro is conditioned, in economic terms, by time and fairness. Therefore, Spain would leave the euro if this decision prompted a faster adjustment and if this decision implied a more fair distribution of the costs of the adjustment. From a socio-political perspective, I also argue that the role of intellectual elites is the key to understanding the dynamics that could determine Spain's decision to leave the euro.

I therefore organize the discussion around the following horns. The first horn tries to answer the question of the causes of the current economic depression in Spain. I will try to show that a very poorly designed institutional setting for European Union monetary governance is part and parcel of the reasons why Spain is experiencing such economic downturn. Secondly, I will argue that the best possible solution would be to try to fix what is broken at the European Union level. However, as the positions of fixers and creditors coincide in the European Union setting, no-one can expect that what should be done will be done. Thirdly, I will argue that, given those circumstances, it makes sense to ask about what the economic determinants are for a country like Spain to leave the euro. Finally, I analyse the socio-political dynamics in Spain that could prompt a decision to leave the euro. The probability of these dynamics being set in motion is the best predictor of whether Spain will finally leave or not leave the euro.

2. The European Union institutional death-triangle and the current Spanish economic downturn

To better grasp the causes of why Spain is experiencing the current economic situation, it is necessary to take into account three important EU institutional features. Two of them are contingent, the third is more structural. The two contingent features have to do, first, with the powers of the European Central

* I am indebted to Pilar Lovelle Moraleda for her extremely helpful research assistance for the preparation of this article. I also thank the participants of the talk *Will Spain leave the euro?*, that I gave in the University of Princeton, on 28th of November, 2012, for their comments and priceless insights, which have all contributed to ameliorate this paper. I also thank Jonás Fernández and David Ramos for their comments on earlier versions of this article. The usual disclaimer applies.

¹ See Marshall Fund, *Transatlantic Trends*, 2012. According to this survey, a majority of Spanish respondents (58%) continued to think that their country's membership in the EU has been good for their country; however, that majority has declined significantly from last year's (68%). Secondly, a majority (57%) said that membership in the eurozone had been bad for Spain, and one-in-four respondents (27%) said that Spain should leave the eurozone. Of the Member States surveyed, Spain would be the country most in favour of leaving the eurozone, followed by Germany (26%), Italy (21%) and Portugal (20%). The other Member States surveyed were France, Italy, the Netherlands and Slovakia.

² The debate was launched after the Spanish media informed that the Director of the Economic Office of the Spanish Prime Minister, Mr. Alvaro Nadal, was considering strategies for Spain exiting the euro (see for instance Jesús Rivasés, "Un gran negocio llamado España", *Tiempo*, 22 June 2012). The debate was further fired up when three Spanish economists published an article in the Spanish newspaper *El País* in which the authors argued that leaving the euro would be equivalent to going back to the "Spain of the 50s" (see Fernández-Villaverde, Garicano, Santos: "No queremos volver a la España de los 50" *El País*, 1 June 2012). The whole story is recounted in www.escolar.net (1 June 2012), an influential Spanish blog.

Bank, and second, with the no-bailout clause. The third is, as I said, more structural. It has to do with the EU decision making process.

I will not expand on any of these features, since they are all well-known. The European Central Bank's powers are basically limited to the control of prices³. It is true that the ECB must also be concerned with the "general economic policies in the Union". But even if we afforded this a generous reading, as the ECB has probably done recently, there is consensus in the sense that the ECB lacks powers to prompt economic growth and fight at least against unemployment –tasks that the Federal Reserve unquestionably does have in the United States⁴. Things going well, as they were basically going until 2007-2008, then the debate about the exact contours of the ECB powers would not have gone beyond the realm of academia. But now that things are not going so well, we have at last started to understand why it would have been more prudent to have had a deeper discussion about this issue when the ECB was set up.

The second feature of EU economic governance that I mentioned before was the no-bailout clause. According to this clause, if a Member State faces economic difficulties, and it cannot pay its debts, then there is neither an obligation from the rest of the Member States nor from the EU as a whole to help it. The idea behind this was that Member States should understand that there would be no safety net from the European Union (or from the rest of the Member States) in case they should run amok⁵.

The no-bailout clause was complemented with a number of provisions regarding the proper functioning of the euro. In particular, the Functioning Treaty gave powers to the EU institutions to reinforce its stakes vis-à-vis Member States doing the wrong thing⁷. This constituted the "constitutional" basis of the Stability and Growth Pact: a number of measures (both preventive and reactive) that the EU institutions might adopt in the case in which a Member State overshoot its public deficit and debt red lines. The idea behind it was that the bad members of the European Monetary Union should be castigated for it, and no provision was established in order to "help" Member States in difficulties. If anything, Article 136 of the Functioning Treaty seemed to open up the door for measures different from sanctions, although it did so in a rather ambiguous and diffuse manner⁸.

³ See Article 127.1° of the Functioning Treaty of the European Union; Article 140.1° (first indent) of the FTEU; Article 1 of Protocol n° 13, "On Convergence Criteria"; Article 282.2° of the FTEU and Article 127.2° of the FTEU. See also Protocol n° 4 "On the Statute of the European System of Central Banks and of the European Central Bank".

⁴ See Section 2A of the Federal Reserve Act: "Monetary Policy Objectives: The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to **increase production**, so as to promote effectively the goals of **maximum employment, stable prices, and moderate long-term interest rates**" (my underlining).

⁵ See Article 125.1° of the FTEU.

⁶ Henning and Kessler (2012) reconstruct the historical process through which the United States of America introduced in the XIX century the no-bailout clause. Before 1840 the States of the Union were on a general basis bailed out. However, after that date, Congress started to reject bailouts. The main reason for this is that at that time, fiscal federal powers were already important enough to ensure that other federal programmes could compensate for the prohibition of bailouts. According to the authors (2012:28), "the US experience suggests that the particular path through which rules are enforced is likely to be critical to their implementation, and that introducing such rules for euro-area Member States should be accompanied by a federal system of fiscal powers and a common fund for rescuing and recapitalizing banks". In other words, one cannot have one thing (no-bailout clause) without the other (strong fiscal federal or central powers). To have the first without the second is therefore to have the worst of both worlds. "Fiscal Federalism: US history for architects of Europe's fiscal Union" by Henning and Kessler (2012).

⁷ See Article 126 of the FTEU. See also Protocol n° 12 "on the excessive deficit procedure".

⁸ In fact, Article 136 FTEU has been amended in order to introduce a third paragraph. The third paragraph establishes the European Stability Mechanism. According to the information provided by the European Council, the amendment has not yet entered in force, since the Czech Republic has not notified its ratification of the amendment, and it needs to be ratified by all 27 Member States, as De Witte recalls (De Witte, 2011). See <http://www.consilium.europa.eu/policies/agreements/search-the-agreements-database.aspx?command=details&id=&lang=en&aid=2011030&doclang=EN%22>.

It is important to recall at this point that those Member States that had fought hard to get a stringent SGP, basically France and above all Germany, were the ones that from 2003 onwards disruptively forced its reform in order to give it more flexibility, something that they achieved with the first reform of the SGP in 2005. This story is well-known and does not have to be repeated here in detail⁹. Suffice to say that in 2003 these two countries ran public deficits and debts that went beyond their respective limits as set by the SGP. Both Member States united in order to provoke its reform. Of course, this was not a story of victims on the one hand and villains on the other. Both the role of victims and villains were mixed: France and Germany had the support of other countries, specifically of the countries that could be doing worse under a more stringent SGP¹⁰. These Member States saw in this an opportunity to advance their own particular interests. But this is probably not the point: after all, one cannot blame the worse off for being rational and therefore jumping onto the bandwagon of modulating the SGP old rigors. The point is, rather, that it created a pervasive impression that the European Union economic governance rules, and above all, its monetary rules, were hand-tailored for the principal beneficiaries of the monetary Union. This, it is submitted, had profound consequences for the way in which, later on, markets viewed the capacity of the EU to solve the current economic crisis –a point I shall return to later on¹¹.

The last element that closes this institutional death-triangle is the European Union decision-making process. I have said before that this element is more structural, whereas the other two are more contingent. With this I mean that though it would be conceivable to have an ECB with enlarged powers, and also a different EU economic and above all monetary governance setting, it is instead very hard to imagine how the EU decision-making process could be made less cumbersome and less complex. It is not only that size matters here (28 Member States, and still growing). It is also that real convergence among Member States (political, economic and social) is far from evident¹². Therefore, complex decision making is probably an idiosyncratic feature of the European Union such as it is now. And it is also probable that the complexity of the EU decision-making process negatively impacts on the reform prospects of the other two elements mentioned above. Stated in different words, if one had to establish a sort of hierarchy as regards the three explanatory variables we are commenting on, the EU complex and cumbersome decision-making process would preside over the other two.

The fact of the matter is that it takes a lot of time for the Union to take decisions, and this is increasingly so¹³. This is the case in ordinary circumstances. But it is the case in extraordinary circumstances as well. Decision-taking lags are problematic under the first; they are utterly fatal under the second. It makes it simply impossible to quickly react to the changes brought about by very volatile contexts –such as the current one. The example of the timespan that has elapsed since the EU first started to talk about establishing a Permanent Bailout Mechanism (the European Stability Mechanism, or ESM) to help Member States in difficulties until it has definitively adopted one is very illustrative of this trend. As we have said before, the no-bailout clause was a first obstacle. Therefore

⁹ For a summary, see Schuknecht, Moutot, Rotherand and Stark (2011:10).

¹⁰ Spain, in particular, supported French and German attempts to reform the SGP. See Serrano and Montoro (2007:7). According to the authors “España mantuvo, a lo largo de toda la negociación sobre la reforma del PEC una postura flexible, mostrando una especial sensibilidad y comprensión ante los problemas de Francia y Alemania” (“Spain adopted a flexible stance throughout the re-negotiation of the SGP, showing particular sensitivity towards France and Germany’s problems”) (my translation).

¹¹ An impression probably not mitigated by the fact that the SGP was reformed again in 2011. Also under French and above all German pressure, this time the aim was to re-introduce more discipline and rigor to European monetary governance. See again Schuknecht et al (2011: 15).

¹² This argument is further developed in Estella (2008).

¹³ According to König (2007), the EU decision-making process has on average slowed down in recent years. While the median proposal time lag was about 100 days until the end of the 80s, it increased in the early 90s to 140 days. In general, König gives flesh to the intuitive argument that as the EU augments divergence through enlargement to new Member States with different interests, the decision-making process slows down.

the EU Treaties needed to be amended to establish an assistance mechanism. Member States had to negotiate such modification. Then Member States had to bargain about the exact contours of the new financial vehicle. The third step was to take a decision about the best way to fund the new mechanism. Further, the ESM had to enter into force. The total time that elapsed since the beginning of this operation was two years, and the ESM is not yet part of the European Union law framework¹⁴. The *lourdeur* of the EU decision-making process, its difficulty to take decisions even under pressing extraordinary circumstances, has even been echoed in the political sphere: for instance, Spanish Prime Minister Mariano Rajoy, has repeated on different occasions that the EU is “desperately slow”¹⁵.

It is against this institutional context that one has to project the events that unfolded after the bursting of the subprime crisis and the subsequent collapse of Lehman Brothers in the United States. As the general story is already known¹⁶, I will only refer to the Spanish specifics¹⁷. It is by now very clear that the Euro helped to create a credit bubble in Spain. This credit bubble was mainly channelled to the housing market in Spain. Fishman (2012:71) attributes this precisely to the lack of a powerful and dynamic industrial sector in the vast majority of the country¹⁸. Therefore the credit bubble prompted a real estate bubble. Money being cheap, virtually everyone had access to real estate ownership. However, as this was happening, a mirroring process of increasing prices came about. Real estate prices were increasingly high but people could afford them due to the substantial capital inflows that were coming to Spain, basically, from northern EU countries. Both bubbles were reinforcing each other. The more the credit bubble grew, the more the real estate one did. In turn, as the real estate bubble grew, there was an increasing demand for cheap money, and so on and so forth. The result was an impressive increase in real exchange rates and therefore a loss in the competitiveness of the Spanish economy (Fernández-Albertos, 2012:51) (See Graphs 1 and 2, Annex).

This is not to suggest that this process was automatic. It was simply rational for economic actors to want to access real estate in general and housing in particular since money was cheap and housing rental prices were high. It was also rational for Spanish creditors to keep pumping money into the Spanish economy since there was a demand for it and, as the real estate market was expanding, the solvency of debtors was never put into question. If the subprime crisis and in particular Lehman Brothers collapse had not happened, it is very probable that Spain would not be today in such a harsh economic situation. But Lehman did collapse and overnight capital inflows to Spain started decreasing. Therefore credit was less available than before in Spain and, in a question of months, it almost came to a halt. With no credit, the real estate and housing markets bubbles burst.

Spanish economic operators, above all real estate market agents, turned their eyes to the Spanish government. The Spanish government came, of course, to the rescue. The first step was a typical, neo-Keynesian, reaction. If, due to the lack of credit, the housing demand had stopped, then it should be stirred again. Therefore Spain spent in just a couple of years around 100 billion euro in trying to re-activate the housing and public works sectors again¹⁹. It worked for a while, and the hope was that the

¹⁴ First high-level conversations about the issue can be traced back to the Deauville Summit (October 2010) that was held between Russia, Germany and France. At this summit, Angela Merkel and Nicolas Sarkozy issued a joint statement in which they called the EU to draw proposals to establish a Permanent Financial Assistance Mechanism. The ESM (European Stability Mechanism) has been established as a Public International Law Treaty. This Treaty entered into force on 27 September, 2012 (except for Estonia, for which it entered into force on 4 October, 2012) and was inaugurated on 8 October, 2012. Unless new Article 136 is ratified by all Member States, the ESM cannot be part of EU Law.

¹⁵ See El País, October 31, 2012 http://politica.elpais.com/politica/2012/10/31/actualidad/1351673513_108674.html

¹⁶ See Stiglitz (2010); Krugman (2012); Reinhart and Rogoff (2009).

¹⁷ See, for a general account, Ortega and Peñalosa (2012).

¹⁸ The exception being the Basque country, where the coordinated efforts of industry and policy makers made it possible to channel credit to small and medium enterprises rather than to the housing and real estate sectors. See Fishman (2012:71).

¹⁹ Spain implemented the “Plan para el Estímulo de la Economía y el Empleo” (Stimulus Plan for the Economy and Employment) popularly known as Plan “E” from November 2008 onwards. The duration of the plan was until 2010.

crisis would not be as profound as it afterwards proved to be. Spain had accumulated a budgetary surplus during the previous years (see Graph 3, Annex). It used it. But the crisis worsened and the surplus was over. Spain started running up public deficits. More than the actual numbers, what was worrisome was the downward trend. In 2009, it had not only spent its surplus, but also overshot the public deficit and debt limits established by the Stability and Growth Pact.

It is at this point that our three institutional elements enter the scene. In the same way that economic operators had turned their eyes to the Spanish government, now it was the turn of the Spanish government to ask the European Union institutions for assistance. But the answer from Europe was three-fold. First, the ECB was there to keep inflation rates under control –not to rescue States that had run amok. Second, there was no financial assistance mechanism with enough firepower as to contain Spanish haemorrhaging. And third, decisions could be taken, but this would need the support of most if not all Member States and therefore would take time. In other words, Spain had suddenly discovered that it was trapped in the European Union institutional death-triangle.

The next notch to turn up was that financial markets soon realized that Spain was trapped in the institutional death-triangle just described and that an exit from it would be very hard to find. This is how what basically was a “private” debt problem became a “public” debt one. Without the help of the European Union, markets were less willing to lend money to the country. It was increasingly unclear to them whether Spain would be able to repay. Spreads between Spanish bonds and German bonds started skyrocketing²⁰. And the situation got more complicated when markets, probably to their delight, observed that as cumbersome as it might be, the only answer from Europe was in the form of austerity. What initially was a liquidity problem, turned into a real solvency one, since the outcome of austerity was stagnation (when not economic deflation) (see Graph 4) and high unemployment (see Graph 5).

3. The alternative: leaving the euro?

If the previous reading of things is correct, then Spain should undertake a profound path of reforms addressed to dramatically modify its economic model of growth and re-distribution of wealth. However, structural reforms of the Spanish economy alone will not be enough. Besides them, the European Union should modify its institutional model of economic and above all monetary governance. Endogenous economic reforms in Spain will be undermined if the exogenous institutional architecture of the Union's economic governance remains the same.

In this respect, the EU should, at the very least, modify the current statute of the ECB, so that a more effective quantitative easing policy could be made possible not only for the sake of price stability, but also for the purpose of feeding growth and employment in the euro-zone. Statements on the part of the President of the ECB saying that this institution will do “whatever it takes” to save the euro, though better than nothing, do not fully eliminate the uncertainties that legitimately arise as to what will actually be the behaviour of the ECB taking into account the powers that it currently has

²⁰ Spanish risk premium started its escalating trend on April 14, 2010. A month later (May 12, 2010), the Spanish government took the first budget cuts, which had almost no effect on making the Spanish risk premium decrease. The Spanish spread with German bonds reached its historical highest point on July 20, 2012 (610 basis points). Days later (July 26, 2012) Mario Draghi made a statement saying that the ECB would be ready to do “whatever it takes” to save the euro (see his speech here <http://www.ecb.int/press/key/date/2012/html/sp120726.en.html>). After that statement, the spread between Spanish 10-year bonds and German ones has decreased to 351 basis points (January 18, 2013). It is important to recall that when the Spanish government adopted the first budget cuts, Spain's risk premium was placed at around 100 basis points. The current spread is considered by many analysts as financially unsustainable in the mid-term for Spain. For the evolution of Spanish risk premium, see the following interactive chart <http://www.datosmacro.com/en/risk-premium/spain>.

according to the FTEU and its own statute²¹. Secondly, the European Union should either eliminate the no-bailout clause -and make it clear that it will assist Member States with financial problems-, or it should keep it, but at the same time give strong fiscal powers to Brussels. The current situation, in which the no-bailout clause cohabitates with the European Stability Mechanism, does not definitively clear up doubts about whether and how Member States will at the end of the day be finally bailed out²². And thirdly, the European Union should modify its decision-making rules, but, as has been argued before, this is almost a congenital feature the European Union is probably deemed to live with. If these institutional reforms were adopted, then a different set of more finely-tuned economic policies, in particular the blend of austerity and economic reactivation that, for example, the IMF is now advocating for²³, could be attempted on a European-wide scale. However, under the current institutional structure, the European Union is almost fatally oriented towards austerity policies.

Even in the longer term (Moravcsik, 2012) it is hard to forecast if the sort of institutional reforms that are proposed here for the Union will ever see the light of day. There are a number of reasons for this. First and foremost, the Eurozone is not an optimal currency area (Bornhorst, Mody, and Ohnsorge, 2012:20)²⁴. Therefore while some Member States, like Spain and others, maybe interested in having the Union implement the institutional and policy reforms I have mentioned before, other Member States may be less pressed to work in that direction. For the latter, the divergences of the Eurozone are currently paying off. Besides, the dividing line between debtors and creditors in the Eurozone is very clear. Creditors are interested in being repaid, while debtors are interested in gaining more time to be able to repay. To start a process of institutional reforms at the European Union level would serve more the interests of the second than the interests of the first at this precise moment, since it would give the former more time. But the main reason for the creditor countries not engaging in a process of institutional reforms is that these would imply –in their eyes- that they would have to further fund the European Union (the so-called “Transfers Union”). This is something, however, that some Member States public opinions are not willing to do (Bechtel, Hainmueller and Margalit, 2012).

Therefore, taking into account that the current EU economic governance institutional setting is probably here to stay, it is important to attempt to discern what other alternatives there would be

²¹ See ECB Press Release of September 6, 2012 (http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html). According to this, the ECB launches a new Outright Monetary Transactions (OMT) programme, but the other side of the coin is that it subjects this programme to a “strict and effective” conditionality on those Member States that would apply for it. This is the reason why Spain has decided so far not to apply to this new OMT programme. As is known, Article 123 of the FTEU and 21 of the Statute of the ECB (Protocol n° 4) expressly prohibits this institution to directly buy Member States public debt -and therefore, one can question the “outrightness” of the new ECB programme-; it can, however, do so in secondary markets. In sharp contrast to the ECB, the FED, for example, is legally allowed –or at least not impeded- to do so directly, as it in fact does. This ECB limitation, together with the primacy of inflation control over other policy objectives for the ECB, creates doubts as to the latter’s capabilities to work as an effective “lender of last resort” for the Eurozone, as De Grauwe remarks (De Grauwe, 2011:11).

²² The Judgment of the Court of Justice of 27 November 2012 (C-370/12) is interesting in this regard. According to the Court, both the ESM and article 125 of the FTEU are compatible since “Article 125 TFEU does not prohibit the granting of financial assistance by one or more Member States to a Member State which remains responsible for its commitments to its creditors provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy”. However, the intricate wording that the ECJ uses is telling of the difficulties that the Court finds in accommodating the ESM within the no bail-out clause. It is hard to see how Member States that remain “responsible for its commitments to its creditors” will be applying to the ESM; rather the opposite will be true, only Member States that are unable to honor their debts are the ones that will ask for the ESM help, and therefore will violate the condition set forth by the Court for respecting article 125 FTEU.

²³ See “The Good, the Bad and the Ugly: 100 years of Dealing with Public debt Overhangs”, Chapter 3, World Economic Outlook, October 2012. The IMF recommends for the EU a blend of fiscal adjustment policies over time, structural reforms and supportive monetary policies. My point is that irrespective of its soundness, implementing this specific policy mix would be unfeasible under the current EU institutional framework.

²⁴ Who in turn draw their analysis on the classical texts of Mundell (1961) and Meade (1955) on optimal currency areas and a system of variable exchange rates.

available for countries like Spain. In this section, I shall explore one of them: the withdrawal of Spain from the European Monetary Union.

In particular, my objective is not primarily to discern whether Spain would or should leave the euro, but rather, what the main determinants of this decision would be, what variables a country has to take into account if it is considering to take a decision in this direction. A first point in this sense is to try to understand when countries have more propensity to leave currency unions. A cursory look at the history of currency unions is needed here. A second point also has to do with history, since being more inclined to leave currency unions does not say anything about the positive prospects or negative consequences derived from this event. There are countries that after leaving a currency union (or a similar arrangement) have been successful while others have been less successful. It is important to understand what made some successful and others not. Finally, it is also important to try to identify what variables are of greater relevance to try to anticipate what could happen in the event that Spain left the euro.

a) Pre-conditions for leaving a currency union

In a path-breaking study on currency unions, Rose (2007) analyzes the preconditions for exit from currency unions after the Second World War. He compares 69 cases of exit, of countries that left currency unions, with 61 cases in which countries belonging to currency unions did not leave. His findings are of great interest for our discussion²⁵. According to the author, “exiters tend to be larger, richer and more democratic than stayers”. However, Rose also warns against overshooting these differences, since they tend to be “persistent” but “sluggish”. In my opinion, this warning should be understood in the sense that it is important to be very specific and detailed about the mechanisms that are at play in this domain. Rose’s findings are the following:

“When one considers all the variables simultaneously, only five show through with sizable effects. The size and income of the country are both strongly positively associated with monetary independence, consistent with Alesina and Barro (2002). More democratic countries and those with larger government sectors are systematically more likely to have their own currencies. Finally, inflation is higher with currency union exiters than stayers, though the causality here is ambiguous. High inflation countries may find it more difficult to remain with currency unions, as their competitiveness cannot be regained through a nominal devaluation; but countries with their own money may simply have systematically less disciplined monetary institutions and accordingly higher inflation”.

Rose’s article relates the three main conditions that he finds to be the best predictors of exit (size, wealth and democracy) with the following measures. First, size and wealth are understood in terms of population, real GDP per capita, openness (exports plus imports)²⁶ direct government spending and investment. Other measures that he includes are inflation, budget balance, money growth and the

²⁵ Bootle et al (2012:18) point out the following as regards Rose’s analysis: “the countries included in the study have little in common with the euro-zone” since “they are mostly small, post-colonial economies which used the currency of a larger neighbor or a colonial power. Many used currency boards which continued to issue their own currency but pegged it firmly to an “anchor” currency. What’s more, few if any of these countries had large external or public debts and few, if any, had uncompetitive currencies. But it is these issues of debt and competitiveness which are the key problems faced by the euro-zone”. However, as the same authors recognize later on in the same study, the problem is that there is no case in history similar to the one of the Euro-zone. There are cases in which a whole monetary union collapsed; but there are no cases in which one of the members of a monetary zone left. Even if probably incomplete, Rose’s analysis is therefore a good point of departure to answer the question of what states have more tendency to leave currency unions.

²⁶ Rose argues that trade is negatively correlated with exiting currency areas. Therefore, countries with large trade percentages to their GDP are less likely to leave monetary unions. According to OECD data, the average (2004-2011) weight of Spain’s exports on its GDP was of 26,5%, and the average weight of its imports on its GDP for the same period was 30,7%. See http://www.oecd-ilibrary.org/trade/exports-of-goods-and-services_exp-gds-serv-table-en; See http://www.oecd-ilibrary.org/trade/imports-of-goods-and-services_imp-gds-serv-table-en

national accounts. Rose uses a number of different sources for calculating these measures²⁷. However, he uses the Penn World Tables as a default source of information, which he complements with the others when some specific information is missing. Clearly, some of these measures are more related to size, some others are more related to richness, and others again are arguably related to both. For example, population and GDP per capita are related to size and richness, respectively. Government spending is related to size rather than richness. But openness and investment maybe related to both. In any event, I will proceed in the same way Rose does to understand the position of Spain in terms of size and wealth, but will use only some of the measures he uses to account for each of these variables. Therefore I will use population, GDP and government spending as a proxy of “size” and GDP per capita (PPP) as a proxy of income, and therefore, wealth²⁸.

As regards democracy, Rose uses the Polity series of the University of Maryland’s Center for International Development and Conflict. The Polity Series codifies countries according to a number of characteristics of governing institutions. This allows Polity to offer an index of 164 countries. In this index, countries are codified as either “autocracies”, “anocracies” or “fully institutionalized democracies”. Further, within each of these categories, countries are given a specific score, which allows for comparison within each group and also to account for changes in single countries. For example, the lowest score that countries belonging to the third category (democracies) can obtain is +6, and the highest, +10.

Starting with the latter aspect, and irrespective of the criticisms that the Polity Score has received (see Munck and Verkuilen, 2002), and of the fact that the Index can be more useful to measure transitions between different political regimes than evolution within fully institutionalized democracies, the fact of the matter is that it comes as no surprise that Spain belongs to the category of countries that, within the group of “democracies”, obtains the highest score (+10) (see Picture 1, in Annex).

Further, as regards size, if measured by population, Spain occupies position 27 in the CIA World Fact Book ranking (out of 239 countries that appear in this index)²⁹; if measured by GDP, Spain’s place in the world is number 14, according to the same source³⁰. Finally, as regards government spending, and according to data based, again, on the CIA World Factbook, Spain occupies position number 18, out of 207 countries surveyed³¹.

However, as regards income per capita (a measure of a country’s wealth), Spain occupies position number 43 in the world (out of 227 countries that are included in this ranking). The severe Spanish economic downturn that started in 2007 explains the position that Spain occupies today. However, even with the figures of 2011, it is still possible to argue that Spain belongs to the medium-to-high countries in the world in terms of wealth³².

In conclusion, this data are a first indication that in terms of size, government spending and democracy, Spain would probably belong to those countries that are more susceptible to leaving currency unions. In terms of wealth (if measured as GDP per capita) the analysis is less conclusive, if

²⁷ The Penn World Tables, World Bank Indicators and IMF International Financial Statistics.

²⁸ We leave aside inflation for the moment.

²⁹ As of July 2012. See <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2119rank.html>

³⁰ As of 2011. See <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html?countryName=Tokelau&countryCode=tl®ionCode=aus&rank=226>. I do not use here Rose’s source (the Penn World Tables) since it does not establish rankings, just data.

³¹ See CIA WorldFactbook <https://www.cia.gov/library/publications/the-world-factbook/fields/2056.html>. 2011 estimates.

³² See, for example, the Global Financial Ranking of “The Richest and Poorest Countries in the World” at <http://www.gfmag.com/tools/global-database/economic-data/11934-richest-poorest-countries.html#axzz2BeSQFnC5>. According to this ranking (2012 estimates) Qatar is the richest country in the world (106,000 US dollars, GDP per capita, PPP) and Congo the poorest (364 US dollars). It is to be noted that in this ranking Spain occupies position number 29.

taking into account the current economic downturn which Spain is in at this moment. However, if the effect of the crisis could be controlled for, then Spain would also be placed as regards this variable in a good position to leave currency unions. Finally, it is also important to note that, according to Rose, who follows on this Alesina and Barro (2002), macroeconomic events do not tend to influence the probabilities of a country leaving or staying in a currency union. More specifically, as regards income fluctuations, he points out that “it is also striking that there are no important cyclic fluctuations of real income around the time of currency union exit”.

b) Countries outcomes after leaving currency areas or devaluating: Argentina and Korea compared

We have seen in the previous section what the profile is of those countries that in the past have more often left currency unions. I also showed that Spain fits that profile, given the qualifications that have been mentioned therein. However, the previous analysis does not tell us anything –as it is not its main purpose- about whether those countries that left currency unions were successful or not, and if so, to what extent. I undertake that analysis in this section.

The problem of comparing the situation in which Spain is now with other historical cases is that it is quite unprecedented. As I have already mentioned, there is no similar case in history. This is the point that Bootle et al. make (2012). According to these authors, the major historical cases of a currency break up are the Austro-Hungarian Empire after 1918, the rubble zone after the USSR was dissolved in 1991 and the Czech-Slovak monetary union of 1993. However, Bootle et al. also indicate that we are speaking here of cases in which the break-ups occurred for political rather than for economic reasons. Further, it could be added that they were also cases in which the economic conditions in which some of them happened were probably very different to those of today, in which international financial markets have experienced an unprecedented expansion. A final aspect would be to point out that in all of these cases, we are speaking of the whole currency union break-up, and not of cases in which one of the members of those currency unions left. Bootle et al. sensibly recommend focussing on more recent cases, in which the countries in question had high levels of external debt (be it public, private, or both). They also recommend focussing not on currency break-ups (very rare in history as I have said) but rather on cases in which the countries in question largely devaluated their currency and partially defaulted. These authors focus, in particular, on the following cases: Argentina in 2001-2002, Russia in 1998, and East Asia in 1997. There is no single account, to my knowledge, that includes, analyzes and compares all historical cases in which countries have devalued and defaulted (but see Bordo and Jonung, 1999).

In this section, I will compare two of the cases suggested by Bootle et al. that could be useful for this discussion. These cases are Argentina (2001-2002) and Korea (1997). Argentina is a clear case in which a country left a currency board. In turn, the Korean case is a case of a country breaking not a currency board, but a peg with the dollar. Currency boards and pegs are, of course, not monetary unions, but, taking into account that there are no cases of countries leaving monetary unions, they can be used as useful proxies of them.

b.1) Argentina 2001-2002

Argentina experienced an unprecedented economic boom during the 90s, more in particular, from 1992 to 1998. However, for many observers, at the same time the boom was taking place, Argentina was planting the seeds of a serious economic downturn in the late 90s. The Argentinian economy was hit by the 98 recession with a number of structural vulnerabilities, such as, notably, increasing public debt, low share and high concentration of exports, the economy's reliance on external savings and a very rigid labour market. The “currency board” is also cited among the vulnerabilities of the Argentinian economy of the time, but how this affected the unfolding of the crisis in that country is however less clear.

In this context, the East Asian crisis exploded in 1997. It spread to a number of countries, in particular, to Brazil, which devalued its currency (the *real*) in 1999. Exports went down, interest rates up, and internal demand contracted in Argentina. Due to the labour market rigidity, inflation overshot, and the spreads of the Argentinian bonds started to grow, as compared to the spreads of other economies of the region. The economy entered into depression in 1999-2000, and Argentina seemed to be trapped in a downward spiral of high prices, low growth, high public debt, etc. As the economy was very marginally export-oriented, exit through that door was not possible in the short run. The only alternative was to leave the currency board.

It is however very interesting to see how the main international institutions resisted the option of leaving the currency board. For example, in its “Lessons from the Argentinian Crisis” of 2003, the IMF stated the following:

“Exiting the currency board via dollarization would not have solved this dilemma, while a float — which could have helped, in principle, to jumpstart the economy through a large depreciation— would have had major adverse repercussions via domestic balance sheets (including the public sector’s large dollar denominated liabilities)”. (IMF, 2003:58)

As a matter of fact, IMF help was initially oriented towards supporting the currency board until the Argentinian government realized that this was a daunting task. Therefore President Duhalde (the fifth president Argentina had had in three weeks) confirmed in January 2002 the debt moratorium that had been declared by President Rodriguez Saá on December 23, 2001 and, more importantly for our purposes, under the leadership of Roberto Lavagna (who would be appointed Minister of Economy after the break-up with the dollar), decided to leave the currency board. The IMF opposed these decisions, since in its opinion “they complicated any eventual resolution of the crisis”. And as a matter of fact, the immediate consequences of these decisions were harsh for the Argentinian economy: in 2002, real GDP fell about 11%, unemployment rose to above 20% and the inflation rate peaked its highest rate in the last 20 years.

That was in 2002. However, in 2003, Argentina had come out of the crisis. Due to the devaluation, exports started growing in this country. This had an immediate effect on GDP, which soared an average of 7.78% from 2003 to 2011. As regards unemployment, in 2003 it was already below 18%, and it stabilized at around 8% as of 2006. Finally, regarding inflation, in 2003 it was 13% (therefore 28% less than the year before) and from 2004 until 2009 it was on average 8.36%. However in 2011 inflation had again soared to 21%. Clearly, high inflation, besides unemployment, is the main battlefield in this country after the crisis of 2001-2002 (see Table 2, Annex).

b.2) Korea 1997

The Korean crisis that started in 1997 offers another interesting example of the effects of devaluation on a depressed economy. It is however important to mention that the situation in Korea and Argentina differ in one important aspect: where in Argentina there was a currency board, Korea only had its national currency, the won, more or less pegged to the dollar before the crisis exploded in 1997. This is the point that Stanley makes. In his account of the different approaches to the Argentinian and Korean crisis (1997-2002), he indicates that “until 1995, Korea remained pegged (...) to the dollar. After that date, exchange rate flexibility went up considerably” (Stanley, 2011:17). Therefore, whereas the Argentinian economy was dollarized before the crisis started in that country, the Korean economy was not. It follows that withdrawing from the currency board had a very different meaning for Argentina than devaluating for Korea.

Korea is another case in which the crisis was preceded by a large period of intense economic growth. As happened in Argentina, this extraordinary growth probably masked the main vulnerabilities of the Korean economy (when they did not reinforce them). According to the literature on the Korean crisis, these vulnerabilities were, basically, of two kinds: first, Korea had a feeble financial system, and second, it also had a very weak corporate management system. As often

happens, both trends were mutually reinforcing. In practice, capital inflows to Korea were “directed” by the government to finance big family conglomerates, the so-called “chaebols”. The system was so corrupt that authors such as Kang have constructed the concept of “crony capitalism” (Kang, 2002) on its basis. As financial management was very weak, the government could decide what conglomerates deserved to be financed and what firms did not. The “chaebols” received financial assistance, in many cases, irrespective of their performance. They were also an instrument for political financing.

In any case, the Korean private sector was already very leveraged in the mid-90s. This is also one of the main differences between the Argentinian case and the Korean one. While in Argentina public debt was soaring before the crisis, in Korea the problem was rather one of private debt. Korean banks were very indebted in the short run, whereas Korean big conglomerates were leveraged in the long run. On top of that, the government issued a number of signals in the 90s assuring that it would not let the conglomerates fall. This implicit guarantee allowed the conglomerates to finance themselves at low costs and artificially expand beyond market constraints.

This was the economic situation in Korea when the currency crisis of the East Asian countries unfolded. The devaluation of the Thai baht in July 1997 rapidly infected the rest of the countries in the area. At first it seemed that Korea would be sheltered from the crisis. But as inter-bank credit shrunk, Korean banks started suffering. The credit-crunch affected the big Korean conglomerates, and some of them in fact went bankrupt. This harmed the good health of the Korean economy and reduced the overall credibility of the country. After all it seemed that Korean firms could in fact go bankrupt.

In turn, the Korean won started a free fall in September and October of 1997. According to the IMF account of the Korean crisis, the depreciation was initially very gradual, but already in December one dollar was exchanged for 2,000 wons (where in September of the same year it was traded at 910 wons per US dollar). In fact the first action taken by the IMF (when it was called in to assist the country) and the Korean government was aimed at stabilizing the currency. In the words of the IMF, the rescue package was oriented to avoid the devaluation *cum* inflation spiral that had been experienced in past cases. In this respect, the IMF recommended implementing very tight monetary and fiscal policies. Therefore interest rates increased and the currency was stabilized (and even appreciated in the following months). However the literature on the Korean crisis is divided on the question of the causes that prompted the stabilization of the won. For the IMF, this was an immediate effect of the austerity fiscal and monetary policies. It even finds correlation between the increase in interest rates and the stabilization of the won. Instead, Furman and Stiglitz (1998:121) find that the connection between both variables is unclear. For these authors “a range of other factors helped to stabilize these Asian currencies, including the appreciation of the yen, changes in the governments of all three countries, disbursements of official foreign financial support (...), the restructuring of IMF programs away from overly strict fiscal policies and immediate bank recapitalization, and the restructuring of Korea's commercial bank debt. Again, high interest rates may have helped support the stronger currencies, but the magnitude of the effect was probably not that large”.

Be it as it may, Stanley remarks that the effects of the depreciation of the Korean won were soon to be noticed. According to him, this generated an important export recovery, which created a surplus of 41.7 billion dollars. This in turn allowed the building of an important buffer of foreign exchange reserves. In the aftermath of the crisis, in 1998, Korea's GDP decreased to an unprecedented -6.65%. However, already in 1999, it experienced an impressive growth of 10.5% in GDP. As regards unemployment, it peaked to an historical 8.6% at the beginning of 1999. However, Korea closed that year with a 6.3% level. Since then it has remained stable between 3% and 4%. As per inflation, it is important to mention that Korea entered the 1997 crisis with a more flexible labour market than the one Argentina had. Therefore, devaluation was not translated into a rise in labour costs and therefore inflation was kept under control. Thus in 1998, the inflation rate (CPI) was 7.53%. Since then it has stabilized between 2% and 4%, with the exception of 1999 (1.36%). It is also important to mention, in this regard, that one of the conditions required by the IMF financial package was to establish CPI inflation targeting, which Korea has done since 1998 (Hoffmaister, 1999).

b.3) Parallelisms and differences

The conclusions we may extract from the comparison between the Argentinian and the Korean cases are complementary. For one, it is clear, as Stanley suggests, that the depreciation of the Korean won from September to December 1997 had an important effect in boosting exports. However, the effects of devaluation were less clear in the Korean case than in the Argentinian case since the currency had recuperated part of its exchange value already in 1998. Furthermore, in the Korean case, there was no default (not even partial default). In some aspects the Korean case differs from and equals the Spanish case. It differs in the sense that Korea did not have a public debt problem when the crisis started, nor as the crisis unravelled. Spain did not have a public debt problem when the crisis started, but it did with time. Argentina did have a public debt problem at the beginning of its crisis. But the Korean case is similar in the sense that when the crisis started, Korea had a private debt problem (as Spain did at the beginning of the crisis). In any case the devaluation of the Korean won played a role but it is unclear the extent to which it did since it was short-lived. In other words, currency instability during the last part of 1997 was in Korea more an effect of the crisis and not so much a cause of it, whereas in the Argentinian case it is clear that the currency board was to an important extent a catalyzer of the ensuing crisis. The IMF tried both in the Argentinian case and in the Korean case to stabilize the currency: however, in the latter case it was successful whereas in the former it was not. Accordingly, the Argentinian government broke up the currency board, and this proved to be crucial for the ulterior recovery of the country, whereas in the Korean case a depreciated but stabilized won was a starter for economic recovery.

The Argentinian and the Korean cases also differ in another important aspect, that is, in structural reforms. Korea adopted structural reforms. They were oriented at breaking and eliminating the “chaebols” system. And they were successful in reforming its corporate and banking systems. However, unlike Korea, Argentina did not embark on a sustained path of structural reforms. Sound and sustainable structural reforms may be at the heart of the differences in performance of each of these economies some years after the crisis and even today. Currently, where Korea is still a promising economy, one that does not present serious macro-economic challenges, Argentina may be instead on the verge of a new economic downturn. The lesson from this is rather clear: devaluing, breaking a peg, leaving a currency board or even a monetary union would be useless in the absence of more in-depth, structural reforms. At the same time, in some circumstances, keeping a peg, or remaining in a monetary union, may be the only real trigger to make the necessary structural reforms. Further, what is still open to debate is what exact blend of reforms is the appropriate one for a given country.

c) Economic adjustment and fairness

The third important economic determinant that a country that is in the middle of an economic depression has to take into consideration when thinking about exit from a currency union is whether leaving will help to weather the economic situation, or, on the contrary, if exit will further complicate things. If Spain were to leave the Eurozone, would this event place this country in a better position to overcome its current economic difficulties?

Asking about the economic effects of leaving a monetary union for a country, like Spain, that is experiencing a severe economic downturn, also implies asking a complementary question: for whom? In effect, staying in a monetary union when a country is experiencing difficulties is not neutral for all the agents in society. For the same reason, the counterfactual, leaving the currency or monetary union, will not have the same consequences for all. Therefore, asking about the economic effects of leaving a currency union directly implies asking about how these effects will be distributed across society. It is not possible to answer the first question without answering the second.

Let us first consider the first, more general question. When analyzing the Argentinian crisis of 2001-2002, Hausmann and Velasco (2002) underline the importance that the real exchange rate, the

financial stress of the country and its export prospects had in accounting for the crisis. According to these authors,

“To make sense of what went wrong, one has to focus on the interaction of two factors: real exchange rates (...) and the country's capacity to borrow abroad (...). In our framework, export prospects determine the access of financially constrained countries to external resources” (Haussmann and Velasco, 2002:5)

The point is that this very much resembles the current situation in Spain. Thus, for example in 2011, Spain's real effective exchange rate was around 8 percentage points over the German one; in general terms, at least since 2000, Spain suffers from an endemic appreciation of its real effective exchange rate if compared with that of the EU as a whole. This explains to a large extent the competitiveness deficit that Spain currently exhibits. Furthermore, once the economic turbulences started in 2007-2008, Spanish spreads started to grow from the “huge to the obscene”, to use the same expression that Hausmann and Velasco use for the Argentinian case. Thus, as has already been shown, the Spanish risk premium was in April 2010 of around 70 basis points; however, in just two months, in June 2010, it had escalated to 221 basis points, and even reached more than 600 basis points in July 2012. After the now famous Draghi declaration of August 2012 (“the ECB will do whatever it takes to save the euro”) the spreads have decreased, stabilizing at around 300 basis points. It is to be remembered that, although the Greek and the Spanish economies are not comparable in many respects, when Greece first asked for financial assistance on April 23, 2010, its risk premium was at 560 basis points.

What about Spanish export prospects? Since the crisis started in 2007, Spain has experienced an important diminution in its current account deficit. In 2007, the Spanish current account deficit was of 145 billion dollars, while in 2011 it was of 55 billion dollars. IMF (2012: 3) estimates indicate that in 2014 Spain could even witness the first current account superavit since it joined the euro. All this seems to point in the right direction.

However, a closer look gives ground for a more nuanced and less optimistic analysis (see Table 3, in Annex). As the IMF points out, although the Spanish export sector is behaving well (exports were higher than its pre-crisis level at 30%), imports fell even more in 2011, for example, than internal demand, which was already very depressed. Further, the net investor position of the country is stable, but “at very high levels”. In other words, internal demand and imports are crushed by the crisis, Spain's public and private debts are still very high, and foreign investment is very low. Therefore, *ceteris paribus*, it is at least arguable whether the growth of Spanish exports could by itself be sufficiently high as to be able to absorb the real exchange rate deficit that Spain currently exhibits. If, on top of the previous analysis, austerity policies are added, then it comes as no surprise that all international institutions forecasts of Spanish growth are again very sombre. Thus according to IMF estimates, Spain would barely start to grow again in 2014 (1.1%) but the growth rate would be anorexic as far as its projections go (in 2017: 1.6%).

It is important to remember in this regard that there is a consensus among experts on the Spanish labour market that Spain is able to create net employment once it is growing at a rate of around 2% GDP (Dolado, 2012). If the prospects of the international economic institutions proved to be correct, then Spain might well be facing its lost decade in terms of growth, but also in terms of employment.

This last remark smoothly brings us to the second point I want to make in this section –the redistribution of the costs of economic adjustment. Currently, Spain has become the second most unequal country of the eurozone, and the fourth most unequal Member State of the European Union, after Portugal, Bulgaria and Latvia. Thus if we take a classical reference in this regard, the Gini coefficient, Spain scored 34.0 in 2011, where the European Union average was 30.7. It is important to note that after a period of consistent reduction of inequalities in the country, at least as measured by the Gini index, the beginning of the crisis in 2007 precisely marked the reversal of the previous trend (see Graph 6, in Annex).

Furthermore, as regards not just plain inequality, but how income is distributed in Spain, the results are also alarming. If we take for example another classical reference in this regard, the so-called S80/S20 index, it shows that Spain is the most unequal country in terms of income distribution, this time not only of the eurozone, but also of the whole European Union (see Graph 7). Thus the Spanish coefficient in 2011 was 6.8 points, whereas the European Union average was 5.1 points. It is interesting to note that the analysis of both indexes show a more surprising outcome, which is that although inequality has dramatically increased in Spain since the crisis started, the European Union average has remained almost unchanged over the years. So in 2005, the first year in which Eurostat has data for the whole EU, the Gini score was 30.6, where in 2011, it was of 30.7.

The same happens with the S80/S20 index. In 2005 the coefficient was 5.0, where in 2011 it was 5.1. Therefore it seems that the crisis does not inexorably mean that equality has to be negatively affected. In this respect, it is interesting to take the example of Portugal: Portugal, a country severely hit by the crisis (and one that has been bailed out), not only fares much better than Spain as regards the S80/S20 index (not however as regards Gini), but its position has even ameliorated since the crisis started, except for the last year of the series, 2011, in which this country shows a minor deterioration in their respective coefficients. Thus, for example, as regards Gini, Portugal had a score of 36.8 when the crisis started in 2007; in 2011, its score was 34.2. And as regards the S80/S20 index, the results are similar: in 2007, this Member State had a score of 6.5, whereas in 2011 it had a score of 5.7. To be sure, unemployment plays a role here, the unemployment rate in Spain being much higher than that of Portugal since the crisis started. However, Portugal is again interesting in this regard, since unemployment has not ceased to grow in there (granted, to a lesser degree than in Spain) once the crisis exploded. However, even under growing unemployment, Portugal has decreased its income distribution inequalities, save for the last year of the series (2011) as has been mentioned before. In sum, the crisis does not have to be translated into more inequality, but in Spain it does.

The fact that inequality is growing in Spain is illustrative of another point; that the crisis is having winners and losers in this country. It is therefore important to identify which groups belong to each of these categories and how the counterfactual, Spain exiting the euro, could impact upon them. Though much research still needs to be done in this area (see Salido, 2012), at least in theory, it is possible to say that savers, those groups whose income comes basically from capital (either financial or real), and finally international investors (Spanish residents who have invested abroad) are the groups that are doing better in the middle of the crisis. However, those groups whose income depends on their labour, save for top executives (to which we should add top sportsmen and women), are the ones that are bearing the main costs of the crisis.

Therefore, leaving the euro would imply a devaluation of the new Spanish currency, and therefore, the purchasing power of all these groups would be affected across the board. Only those Spanish residents who have invested in the euro or in other currencies abroad would be less impacted by the change (and may even benefit from it). So if Spain left the euro, more groups would be affected by the adjustment derived from this event, and therefore it is possible to argue that there would be gains in terms of equality. This is, for example, what happened in the Argentinian case. Once this country left the currency board, it started to score better in terms, for example, of the Gini coefficient. As is shown in Table 2, in 2003 its Gini coefficient was 54.7, whereas seven years later, in 2010, it was 44, an improvement of more than ten points. To be sure, it is true that economic growth and equality are directly correlated, and the growth ratio that this country experimented in the years after it left the currency board was impressive. So growth would have to take place in the Spanish case as well³³. However, as the Portuguese case, commented before, seems to point at, equality is not only affected by economic growth; it is also affected by how the costs of the crisis are distributed across the society

³³ Spain's most recent experiences with devaluation seem to suggest a positive relationship between devaluations and the growth of exports and GDP, and therefore with the decrease of unemployment (see Graph 8, in Annex).

—something that Spain, diverging here from other countries that are very affected by the crisis as well, is not doing evenly.

4. The socio-political dynamics of exit in Spain

The connection between financial crises and the socio-political dynamics that occur in a given setting is an undisputable element that is invariably analyzed in the literature on financial crises. However, this literature, that has its remote origin in Krugman (1979), tends to treat the socio-political dimension of a financial crisis simply as a consequence of exogenous forces. Therefore, the fragile economic and above all financial situation of a country would be the main cause underlying the probabilities of political survival of a given incumbent, for example. However, there is growing concern in the academic literature about the endogenous socio-political aspects connected to financial crises (Vaugirard, 2006; Chang, 2007). According to this new and different strand of literature, the political dimension of a financial crisis would not only be an outcome of the crisis, but rather, an element that should be paid attention to when trying to understand what the evolution of a given economic situation could be.

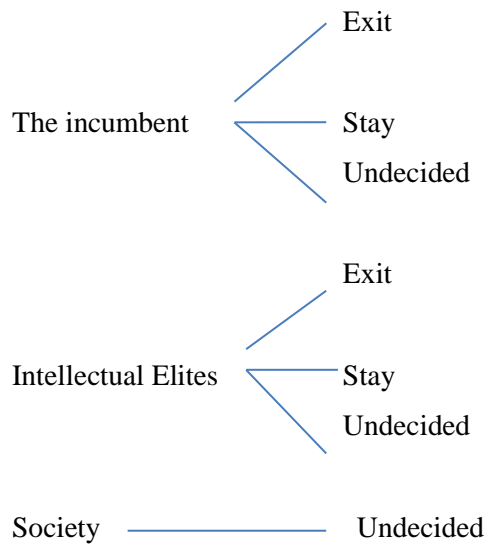
I rely on that new strand of literature that “endogenizes” the socio-political dimension of financial crises, to try to understand what the socio-political determinants of the Spanish decision to exit the monetary union could be; but differently from that literature, which basically adopts a “representative agent” model, I understand that there are different social and political actors that need to be distinguished from each other. In turn, these different actors may have, or may not have, similar preferences, on the issue of exit from the euro. In the Spanish case, this approach seems to me to be much more realistic in trying to understand the socio-political determinants of this country's decision to leave the euro.

More in particular, I set up a model in which there are three main actors:

- the incumbent (I)
- the society (S)
- the intellectual elites (IE)

In my understanding, whether Spain will or will not leave the euro is to a large extent a function of the interplay between the positions, or preferences, that these actors could adopt as regards this event. So we need now to understand the different initial preferences that they may hold as regards this issue. Basically, they may differ for both the political actors (the incumbent) and the Spanish intellectual elites, but I keep them constant for the society. So as regards the incumbent and the Spanish intellectual elites, they could be either in favour of Spain leaving the euro, or against it, or undecided about it. As regards the society, I assume it would hold a unique position on this issue, which would be to be undecided. The reason why I understand that the society would be initially undecided about this issue is because it is a very complex and technical matter about which it is very difficult that the society has a very clear-cut position. Its preferences would depend on the interplay of the incumbent and the intellectual elites preferences on this issue. Here I present a summarized version of each actor's position.

INITIAL PREFERENCES OF I, IE AND S AS REGARDS SPAIN LEAVING THE EURO



Therefore, the model would take, in a preliminary form, this shape:

$$Exit Euro = (Ip, IEp, Sp)$$

where the decision to exit would be a function of the interplay between:

- “Ip”, the incumbent’s preferences;
- “IEp”, the intellectual elites preferences;
- and “Sp”, the society at large preferences.

Of the three variables, I privilege, for reasons I will explain later on, the second, intellectual elites preferences. In my view, this is a key aspect to understanding the dynamics that could precipitate the decision of Spain to exit the Euro. It is important to note that for the sake of clarity, I do not introduce the preferences of economic elites in the model, since I understand that they would be always constant (against exit). I treat economic elites preferences as a constriction or as a cost that has to be taken into account if the decision were to exit.

Let us now turn to the analysis of the dynamics that could unfold when one combines the different preferences that all these actors may have. To start with, the preferences of both the I and of the IE could coincide. Both could be either in favour or against Spain’s exit. If this were the case, then society would follow the other actors’ preferences, and the outcome would be either to stay or to leave. This case (in which I and IE preferences coincided) would only be problematic if the decision were to leave the currency union, since as I have said before, I hold stable the economic elites preferences against exit. If this were the case, exit would come about, but at a higher cost (due to the resistance of economic elites, henceforth EE) than if it were otherwise.

A second and interesting situation would be the one in which the preferences of both the I and the IE coincided in being undecided. Here it is possible to think that society would also remain undecided, and that exit would not come about due to the fierce opposition of the EE. This is clearly the position that is closer to the current reality in Spain: despite the debate in recent months on this issue, all actors

are relatively undecided. Thus, for example, although the society seems to blame the euro for the current economic downturn, this does not go as far as to configure a clear social preference in favour of leaving the common currency. However, it is also true that this position is gaining adepts time and again; in fact, as has been mentioned in the introduction of this article, it is important to recall in this sense that Spain would be the Member State of the European Union most in favour of leaving the Eurozone³⁴.

A third possibility would be the case in which the preferences of both the I and the IE did not coincide. For example, the I could be in favour of Spain staying, since it would be captured by the Spanish EE, and independently of whether this would be even more costly than leaving the currency union for the general interest. And, the intellectual elites could be in favour of Spain leaving. There are reasons to think that, in this case of heterogeneity of preferences between the incumbent and the intellectual elites, society would be more susceptible to follow the preferences of the IE that it would be to follow the preferences of the I.

The reason for this is that the crisis has somehow crystallized what was already a very hostile Spanish public opinion climate against politicians and politics. Spaniards blame Spanish politicians for the Spanish economic downturn. And they are therefore less open, or more distrustful, of what they have to tell them³⁵.

Further, this is the main reason why, taking into account that the issue at stake is a very technical one, the role of the intellectual elites is so important. Society needs signals in order to make up its mind on this issue. Therefore, if the intellectual elites did not agree with the incumbent, then the outcome would probably be a more intense preference on the part of the Spanish society in one or the other direction (in the direction "signalled" by the intellectual elites), which could, in the end, provoke a change in the original position of the incumbent.

The reasons why the incumbent would in the end change its preferences (above all in the most plausible case in which society wanted to exit and the incumbent did not) could be the fear of revolt or the fear of being dismissed by the people (Chang, 2007). In fact, there is evidence to show that this may be the case. For example, in the case of Indonesia in 1998 and Argentina in 2001, popular revolts, due to the decisions that the incumbents were taking in these respective countries to try to weather the crisis, ultimately toppled the incumbent governments.

In any case, heterogeneity of preferences as to whether to stay or leave between the incumbent and the intellectual elites would be the most problematic case. Society would follow, for the reasons mentioned before, the intellectual elites. Therefore, if the incumbent wanted to stay and the intellectual elites to leave, the society would also put pressure on the incumbent to leave. The opposite situation, in which the government wanted to leave and the society to stay, would probably yield to an exit outcome, although it is important to take into account that, different from the previous situation (in which the incumbent wanted to stay and the society to leave) in this case the government would face resistance not only from society but also from the economic elites. It is possible to think that in this case exit would happen, but it would take longer to be the case.

A fourth possibility could be the case that both the I and the IE preferences did not coincide because the former were undecided and the latter for or against exit. The I could be undecided because, for example, of the political party supporting the incumbent's split on the issue, one part following the EE preferences to stay, the other following the intellectual elites preferences to leave. Be it as it may, this situation is one in which the role of the intellectual elites would be even more

³⁴ See footnote n° 1 in this paper, *supra*.

³⁵ Spaniards consider that the "political class" and "the political parties" are the third most important problem of the country (29.8%). The first problem would be unemployment (77%) and the second would be the economy (39.5%). See CIS (Centro de Investigaciones Sociológicas), Barometro Diciembre 2012, on page 4.

important than in the previous cases, above all if their position was that Spain should leave the euro. First, they would channel public debate on this issue, the I probably being absent from this debate (since they would not have a clear position or would not be willing to express it). And secondly, and more importantly, the resistance of the incumbent would be less strong than if they had a clear-cut position on this issue. Society would follow the intellectual elites for the same reasons mentioned above.

The other way around could be also the case –and this is probably the most interesting of all cases. Thus, the I could have a very clear preference about this issue and the IE could be undecided. In this case, if the I preference were to stay, then it is possible to think that no major social debate would unfold, and therefore the outcome would be that Spain would stay. However, if the I preference were that Spain should leave, then this would prompt a social debate on the issue, taking into account the IE indecision. Here, the generalized social distrust of political forces that Spain is currently experiencing would certainly play a role against exit, but undoubtedly a minor one compared to the case where the IE were against leaving. The probable outcome would be that Spain would leave but it would take the Spanish I longer to break social resistance or indecision on this. It is also important to remember that the I would also face the resistance of the EE in this case.

Therefore, the conclusion (see Table 4, Annex) is that in this interplay between the incumbent, the society, and the intellectual elites, the latter's preferences play a crucial role in trying to understand (or predict) what the final outcome will be. If the intellectual elites had a clear position on whether Spain should leave or not leave the euro, this would in turn influence society along the same lines, which would determine the position that the incumbent would finally adopt on this issue. If, on the contrary, the IE were undecided on this issue, then the society would remain undecided as well, and in this case it would take the I longer to convince the society to leave if this were its preferred course of action. The causality of our initial model would therefore go in the following direction:

$$\text{Exit Spain} = \text{IEpl} \rightarrow \text{Sp} \rightarrow \text{Ip}$$

where the probability of Spain leaving the euro is mainly a function of the preferences that intellectual elites have in favour of Spain leaving the euro (IEpl). Having a strong preference for leaving the euro, society (which would be undecided on this issue) would probably follow the signals sent by the intellectual elites in this direction, therefore putting pressure on the incumbent to take the decision to abandon the European currency Union.

5. Conclusions

Whether Spain will leave or not leave the eurozone is something that only time will tell. However, what we can say is that Spain fits the profile of countries that have traditionally had more propensity to leave currency unions; which have been sufficiently large, rich and democratic states. Secondly, it is impossible to know in advance what the outcome of such an event would be for the Spanish economy. However, what we do know is that states that have left settings similar to currency unions, such as currency boards or pegs, have had positive results after they left such monetary arrangements. However, here it is also important to account for the differences in these results. While some states have undertaken an enduring path of economic growth, others have had, with time, similar difficulties to the ones they once had before they left their respective currency arrangements. Leaving a currency union can be a starter for economic recovery, but the evidence of the Korean and Argentinian cases seem to show that in the absence of further structural reforms, economic recovery will not be self-sustaining. A third economic determinant that a country has to take into account when considering leaving a currency arrangement has to do with its real exchange rate, its capacity to borrow in the international financial markets, and its export capacity. If the currency is overvalued, the country is under financial stress and its exports are low, then it may seem advisable to leave a currency union if

and when the time is ripe for taking that decision. Spain currently has a problem in at least two of these three areas, its real exchange rate being largely off equilibrium and its capacity to borrow in the international financial markets curtailed by the high levels of its risk premium. As regards exports, Spain is exhibiting better numbers. However, it is very questionable whether and the extent to which the expansion of its export sector could be so strong, if nothing else changes, as to outweigh the competitiveness deficit that Spain is showing, to a large extent due to its real exchange rate imbalances. Another crucial element in this equation is fairness, that is, the extent to which exit from the currency union could provide for a more egalitarian distribution of the costs of the economic adjustment, as compared to the current situation. The fact that exiting a currency union, and in particular devaluation of the new currency, produces an across-the-board impact on the society is something that also has to be taken into account in this respect, above all in a country like Spain, in which the economic adjustment is producing clear winners and losers.

Whether Spain will finally leave the euro is a question that at the end of the day has as much to do with politics as it has to do with economics. We therefore endogenized the socio-political dimension of the crisis and questioned not only the economic determinants but also the socio-political determinants of a decision in this direction. In our model, we conjecture that the role of the intellectual elites will be the key to understanding the dynamics that could unfold towards the decision to leave the European monetary union. Due to the large discredit that the political class is currently suffering in Spain, it is sensible to think that people will be more ready to pay attention to the signals that come from the intellectual elites than from the political realm. At present, however, intellectual elites seem to be at least as undecided as the people are as regards this fundamental issue for the economic future of Spain.

All this is taking place in a context, the European context, which in theory has at least part of the solution for the malaise that some Member States such as Spain are experiencing but that, due to the current constellation of interests that is present therein, will not take steps towards the direction of dramatically modifying its current institutional setting. In the absence of this, coordinated solutions for countries that may take the decision to re-arrange their European monetary commitments would be a second-best. However, not even this is foreseeable, since also a coordinated exit solution would have different consequences for different Member States. In these circumstances, a unilateral withdrawal from the euro can emerge as the only optimal solution for countries that are suffering from the consequences of a sub-optimal monetary arrangement.

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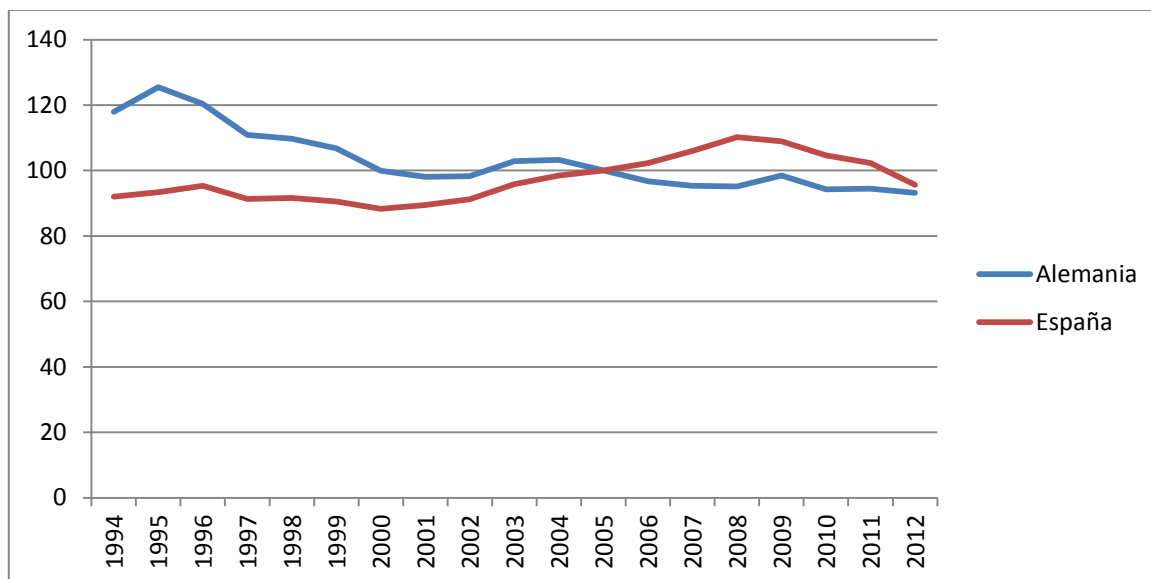
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Annex

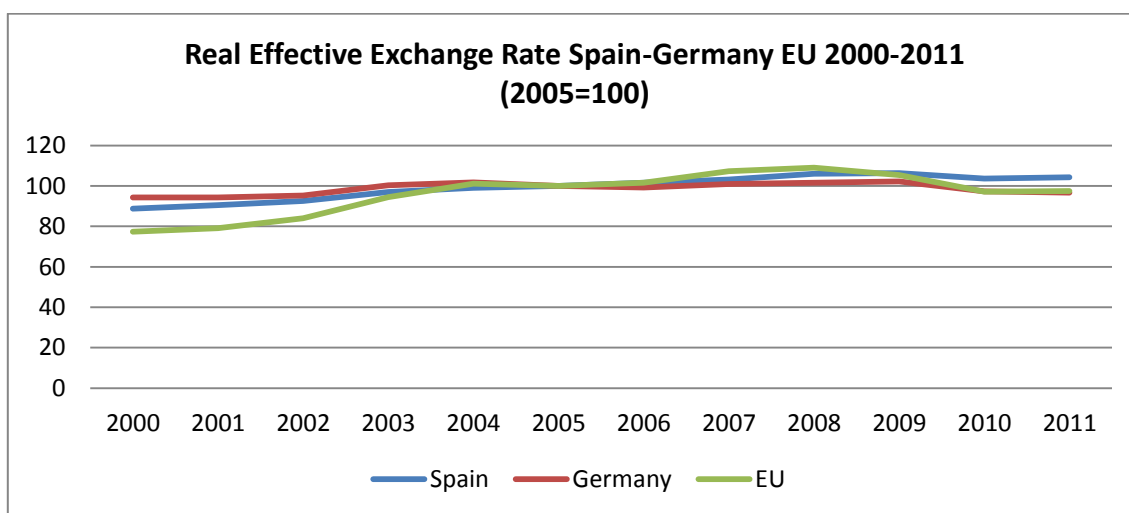
I. Graphs

Graph 1: Real Effective Exchange Rate, Spain and Germany



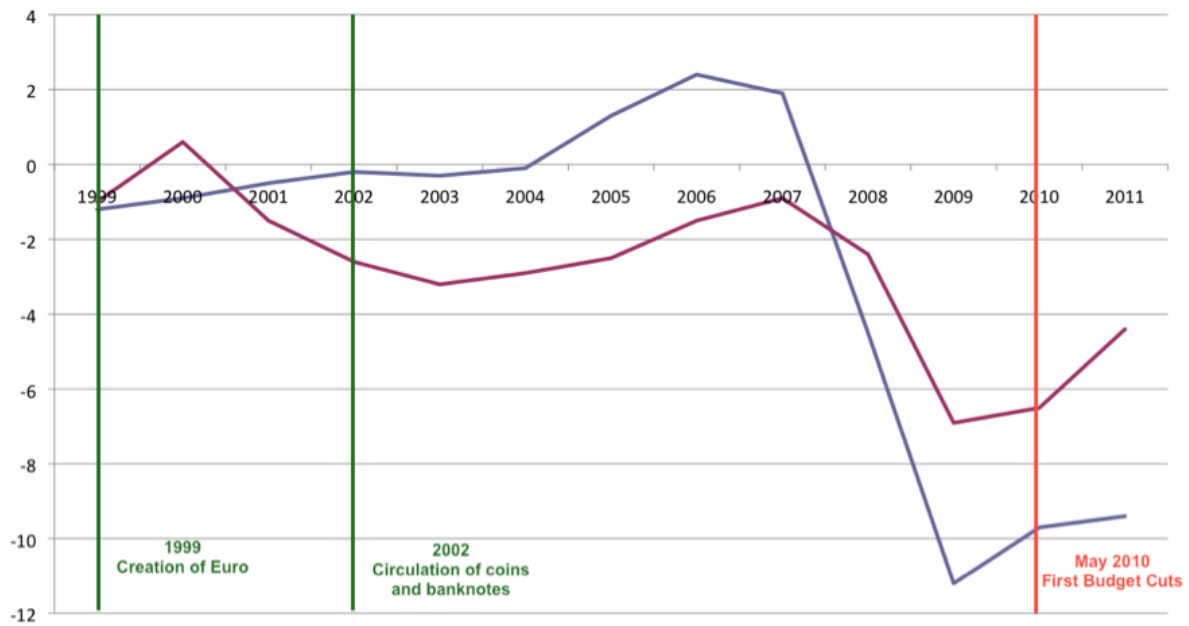
Source: Eurostat

Graph 2: Real Effective Exchange Rate, Spain, Germany, EU



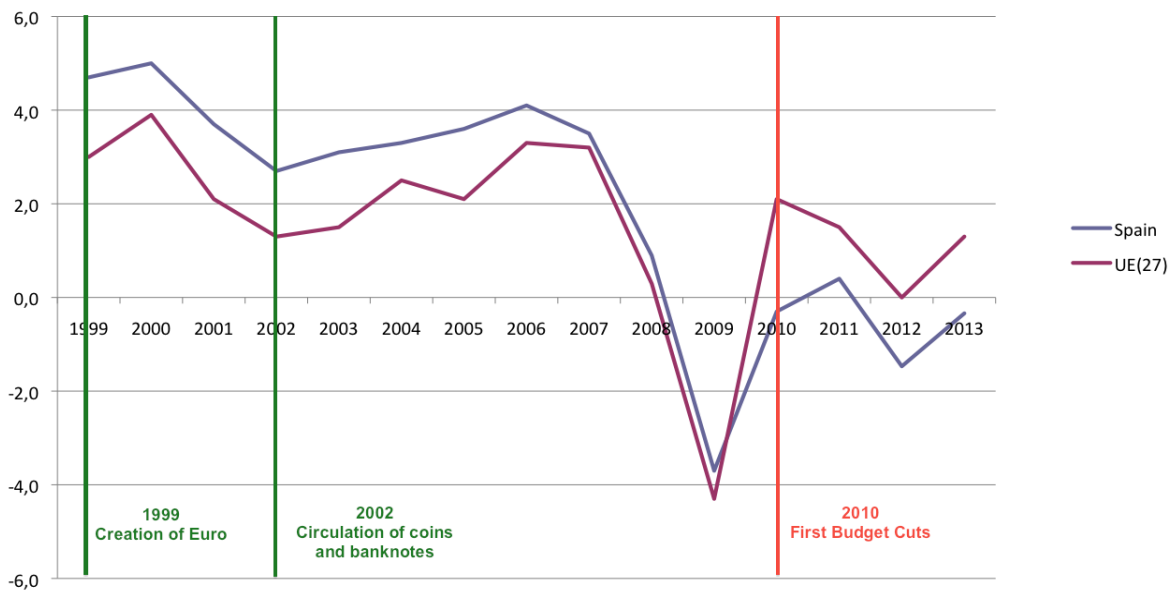
Source: Eurostat

Graph 3: Spain's Government Deficit (-) and Surplus (+) 1999-2013



Units: Annual Percentage
Source: EUROSTAT

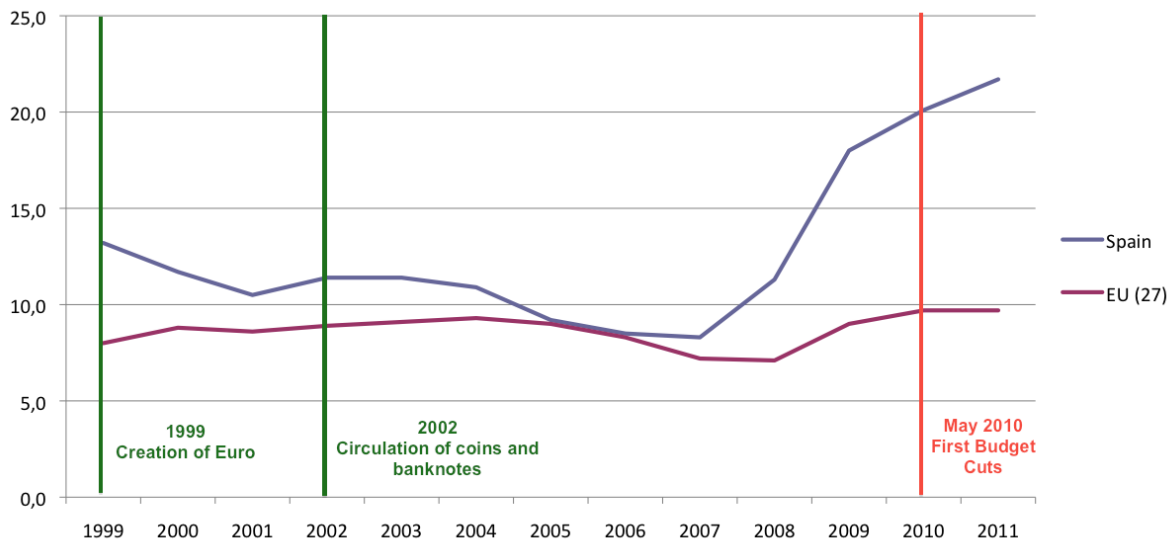
Graph 4: Spain's GDP growth as annual percentage 1999-2013



Source: EUROSTAT

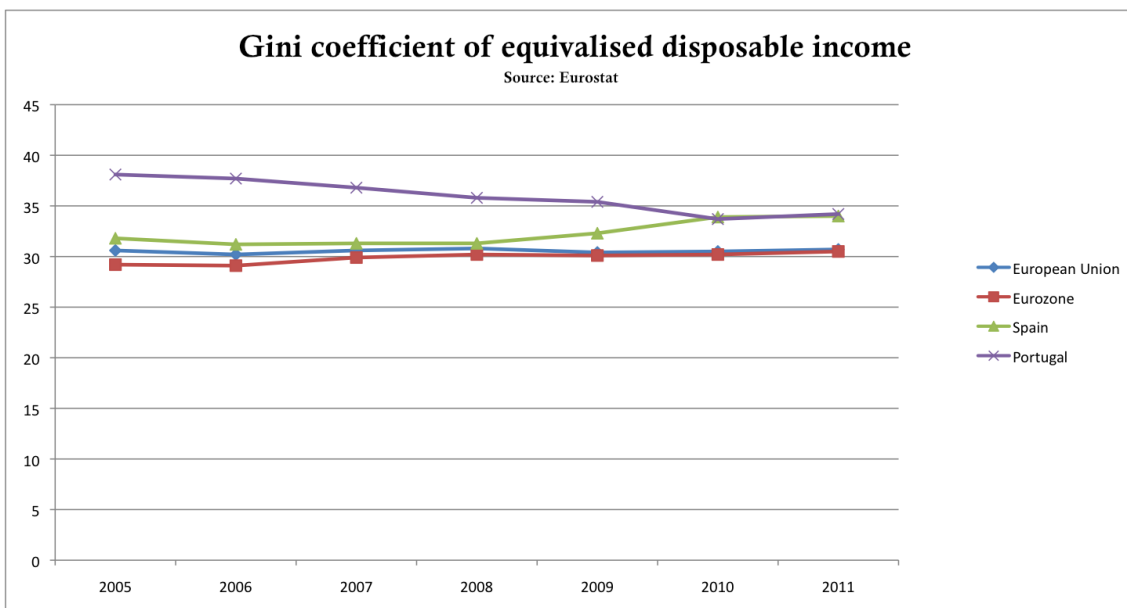
Predictions for 2012 and 2013: Spanish Government Predictions for Spanish GDP Growth of 2012 and 2013 are -1.2% and 1.2% respectively. IMF estimations are -1.538 and -1.316, UE calculations are -1.8 and -0.3, and OCDE estimations are -1.1 and 0.6 respectively. The average of IMF, UE and OCDE estimations (in the graph) are -1.47 for 2012, and -0.339 for 2013.

Graph 5: Spain's unemployment rate as a percentage of labour force 1999-2011



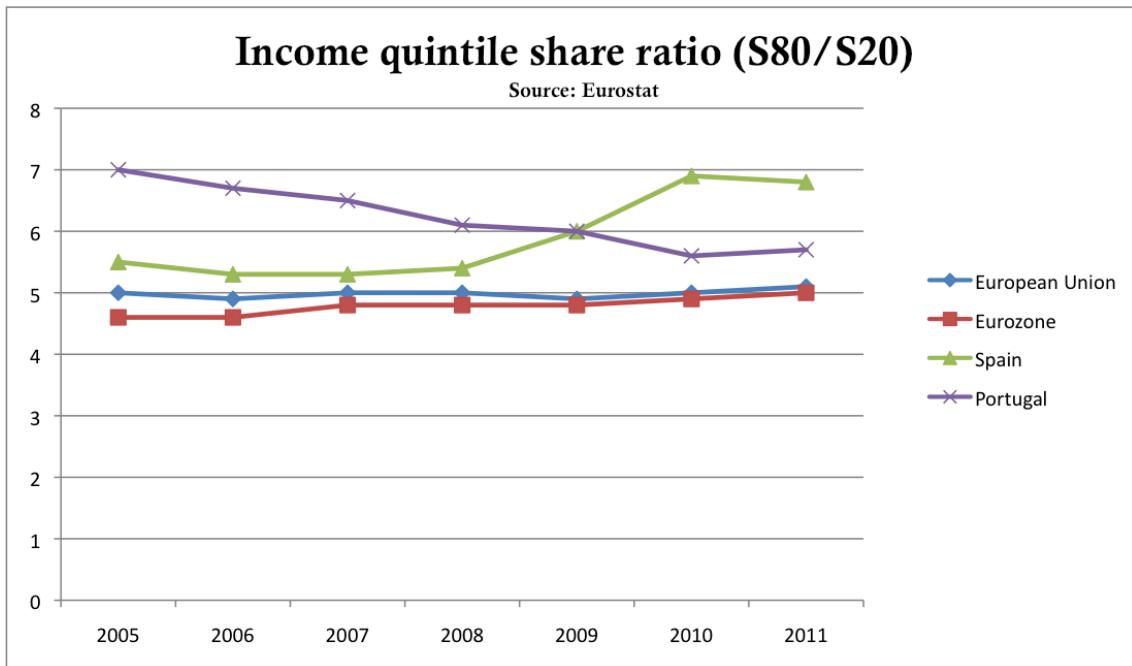
Source: EUROSTAT

Graph 6: Gini (Spain, Portugal, Eurozone, EU)



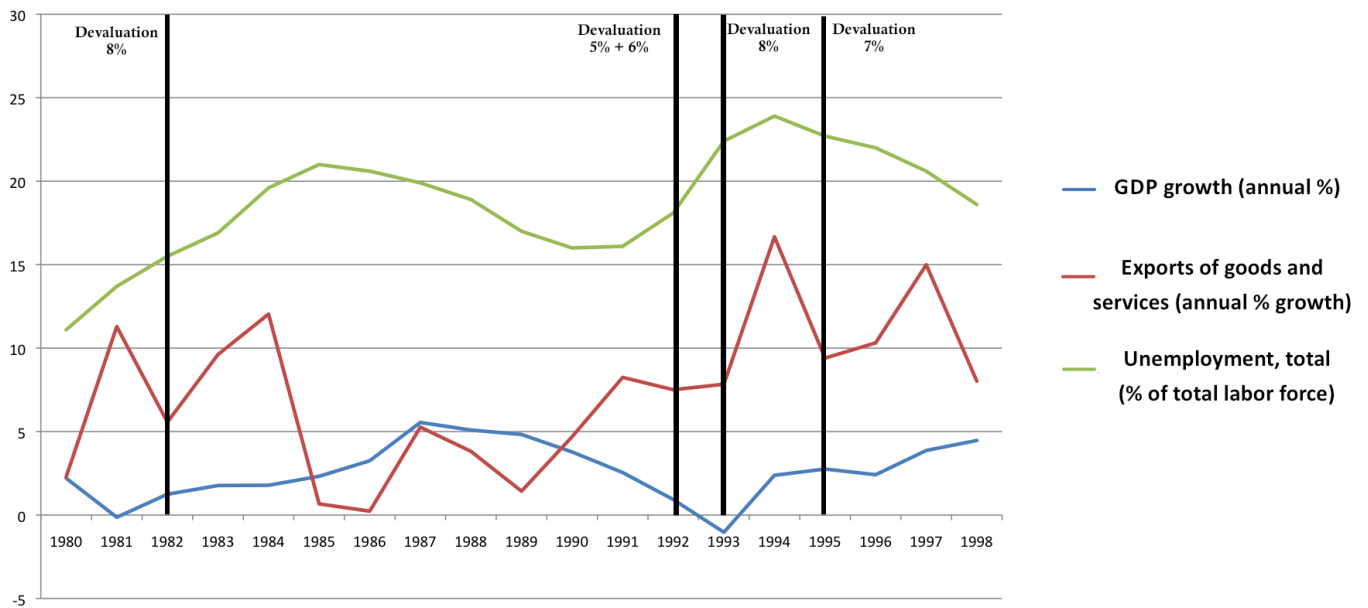
Source: Eurostat

Graph 7: S80/S20



Source: Eurostat

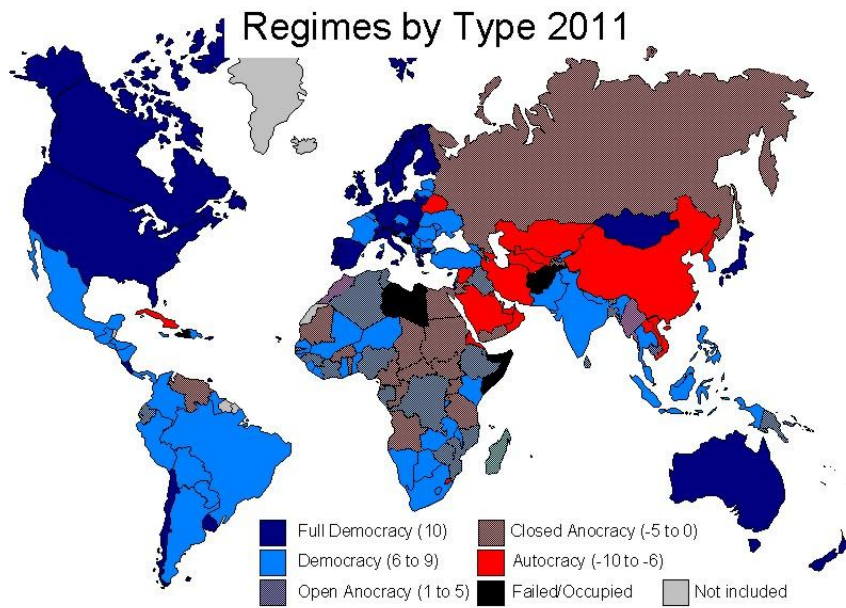
Graph 8: Devaluations and Exports, GDP and Unemployment in Spain (1980-1998)



Source: World Bank

II. Pictures

Picture 1: Regimes by Type, 2011



Source: Polity IV Individual Country Regime Trends, 1946-2010

III. Tables

Table 1: Spain’s position in the world as regards: Population, GDP, Government Budget, GDP per capita and Democracy

Variables	Spain’s Position in Ranking
Size (Population)	27
Size (GDP)	14
Size Government Budget	18
Income (GDP per capita, PPP)	43 (29, Global Financial Ranking)
Democracy	Highest

Sources: CIA World Factbook, 2012 and Global Financial Ranking, 2012

Table 2: Argentina and Korea compared: before, during, and after crises

	Argentina	Korea
Before the crisis	<ul style="list-style-type: none"> - Economic Boom: GDP (1991-98): average annual growth: 6.3% - But structural vulnerabilities: <ul style="list-style-type: none"> - Public Debt: 80% GDP (2000) - Low exports - Reliance on external savings - Rigid Labour market - Private debt as % of total external debt (1991-1998): 31% - Currency Board: 1 peso/1 dollar 	<ul style="list-style-type: none"> - Economic boom: GDP (1987-97): average annual growth: 8% - Public debt: 1997: 12.9% GDP - But structural Vulnerabilities: <ul style="list-style-type: none"> - Financial management - Corporate management (<i>chaebols</i>) - Private debt as % of total external debt (1994-1997): 92.79% - No currency board but Pegged with dollar (though more flexible when crisis started)
During the crisis	<ul style="list-style-type: none"> - At first IMF tried to support dollarization - But Duhalde/Lavagna (January 2002) took two measures: <ul style="list-style-type: none"> - Left the CB - Partially defaulted - Restrictions on capital outflows (corralito/corralón) 	<ul style="list-style-type: none"> - IMF and government first movements aimed to stabilize won (very heavily depreciated from Sept. 1997 to Dec. 1997). Increased interest rates. - In 1998 the currency was stabilized and then structural reforms
After the crisis	<ul style="list-style-type: none"> - GDP (2003-2011): 7.78% GDP - Unemployment (2003-2012): 9,84% (but in 2001, 18.3%) - Inflation 2011: 21% - "Fairness": <ul style="list-style-type: none"> - Gini in 2003: 54.7 - Gini in 2010: 44 (-10.7) 	<ul style="list-style-type: none"> - GDP (1999-2011): 5.16% - Unemployment (1999-2011): 3.8% (in 1998, 7%) - Inflation 2011: 4% - "Fairness": <ul style="list-style-type: none"> - Gini in 1998: 31.6 - Gini in 2010: 31 (-0.6)

Sources: World Bank; CIA World Factbook.; Damill, Frenkel, Rapetti "The Argentinean Debt: History, Default and Restructuring (Revista Economía, December 2005); Basualdo, Nahony & Nochteff "La deuda externa privada en la Argentina (1991-2005): trayectoria, naturaleza y protagonistas". *Desarrollo Económico*, Vol. 47, n° 186 (Julio-Septiembre 2007); Koo "Fiscal Performance, Public Debt, and Fiscal Consolidation in Korea" Nimeo, Paper presented to the Korea and World Economy Conference, December 10-11 (2005) University of Washington; Bank of Korea.

Table 3: Spain's macro-economic indicators (2005-2017)

	2005	06	07	08	09	10	11	12	13	14	15	16	17
Total domestic demand	5.0	5.2	4.1	-0.5	-6.2	-1.0	-1.7	-3.9	-1.4	0.4	0.7	0.9	1.0
Net exports (contr. to growth)	-1.7	-1.4	-0.8	1.5	2.8	0.9	2.5	2.4	0.7	0.7	0.7	0.7	0.6
Exports of goods and services	2.5	6.7	6.7	-1.0	-10.4	13.5	9.0	1.7	4.6	4.5	4.9	4.9	4.9
Imports of goods and services	7.7	10.2	8.0	-5.2	-17.2	8.9	-0.1	-6.2	2.4	2.8	3.0	3.4	3.7
Gross fixed invest.	7.1	7.1	4.5	-4.7	-16.6	-6.3	-5.1	-7.5	-1.1	0.6	1.0	1.4	1.8
Constructi on invest.	6.7	6.7	2.4	-5.8	-15.4	-10.1	-8.1	-9.4	-1.9	0.3	0.9	1.2	1.6
Other Invest.	7.8	7.0	10.5	-0.8	-15.2	1.0	0.8	-1.9	0.1	1.0	1.2	1.6	2.1
Private sector debt (% GDP)	245	273	286	286	289	294	273	267	263	258	254	250	247
General governme nt debt (% DGP)	43.2	39.7	36.3	40.2	53.9	61.2	68.5	90.3	96.5	100.2	102.7	104.4	105.9
CDS (spread in basis points) (senior 5 year in euro)		2.7	12.7	90.8	103.8	284.3	466.3						
Spread over German 10-year bond yield		0.03	0.09	0.8	0.516	2.47	3.43	4.01					

Source: IMF: Spain, Staff Report, July 20, 2012 and Bank of Spain, Boletín económico 9/2012 and ESPAÑA. INDICADORES FINANCIEROS. SERIES DIARIAS, 11 Feb 2013

Table 4: Exit dynamics in Spain

INCUMBENT

	STAY	EXIT	UNDECIDED
ELITES	STAY	EXIT	UNDECIDED
	Stay (Stay)	Stay (Exit, more costly)	Stay (Stay)
	Exit (Exit)	Exit (Exit)	Exit (Exit)
	Undecided (Stay)	Undecided (Exit)	Undecided (Stay)

In red, position of society on the issue of “exit”

In green, outcome

Author contacts:

Antonio Estella

Jean Monnet Professor of European Union Law, and Professor of Administrative Law

University Carlos III of Madrid

C/ Madrid, 126 (28903) Getafe

Madrid

Email: Antonio Estella UC3M < > antonio.estella@uc3m.es