Global Counsel

Rajoy's rebellion

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Summary

- Spanish Prime Minister Mariano Rajoy went to Brussels last week to announce that Spain would not meet its deficit reduction targets for 2012. After a week of negotiation, Spain has talked its European partners into accepting a target of 5.3% instead of the previous 4.4% commitment.

- At face value, the Eurozone's new system of fiscal discipline appears to have fudged its first major test of will. But the combination of inflexibility and weak enforcement in the Eurozone's new rules is likely to ensure that this is only the first such compromise.

- Nevertheless, Rajoy has been at pains to say that Spain believes in tough European budget rules. Rajoy is still proposing the toughest austerity package of any major European economy. He is still proposing to cut more spending in a year than Mario Monti aims to cut in three in Italy.

- The most important thing about his modest rebellion may be that he did it not just in the name of economic reality, but of Spanish sovereignty. Rajoy is calculating that Spaniards will live with austerity, but not with austerity imposed from Brussels or Berlin. For advocates of closer fiscal union in the Eurozone, this is a reminder of the political problems ahead.

It was a modest rebellion, but a significant one. Spanish Prime Minister Mariano Rajoy went to Brussels last week to announce that Spain would not meet its deficit reduction targets for 2012. After a week of negotiation, Spain has talked its European partners into accepting a target of 5.3% instead of the previous 4.4% commitment. This is less than the 5.8% Rajoy had initially proposed, but the Spanish clearly went home satisfied.

It was a slightly discordant note in the week that European leaders formally signed their new Fiscal Treaty, in theory agreeing to a lot less of the kind of belt-loosening that Spain is proposing. The deficit hawks around the table in Brussels made a show of resistance, but Rajoy's argument that further tightening would be economically and politically counterproductive clearly got a hearing.

After the event, one of Rajoy's European Council peers said that Spain should not be forced into "stupid consolidation" in the face of "common sense". Yet giving politicians too much scope to define stupid is precisely what the deficit hawks in Berlin and Brussels have spent the last six months worrying about. This Global Counsel Insight note asks if European austerity politics just stumbled at the first major hurdle.

Stupid, as seen from Madrid

A number of things are shaping Rajoy's strategy and tactics. The first is simple necessity. There is growing agreement that the previous PSOE government had dramatically overstated the chances of hitting their 6% in target in 2011, let alone the 4.4% agreed with the European Commission in 2012. As we noted last year (GC Insight *The Pain in Spain*, 23 November 2011), Rajoy's commitments to meet the 2012 target looked eye wateringly tight before the election, especially with a general reluctance to really stamp on the regional spending brakes ahead of key Andalucian elections in April this year. Meeting that target now would require €45 billion in spending cuts this year – more in one year than Mario Monti has pledged in Italy over the next three years.

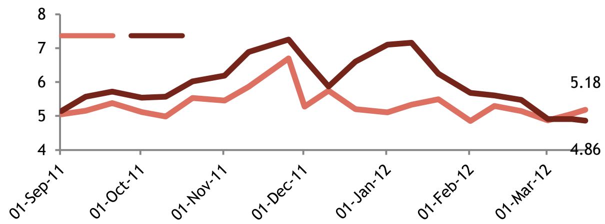

Chart 1: 10 year government bond yields, Spain and Italy (%)

Source: Bloomberg

Rajoy's government has made a serious attempt at structural change, both in the labour market and the banking sector. But further deep spending cuts in an economy with at least 23% unemployment and weak demand in its crucial European market are a different proposition. Unsurprisingly, Rajoy has concluded that his European targets are something of an abstraction. His political reality is a simmering mood of discontent that is already spilling into the street in Barcelona and Valencia.

His second calculation is that the bond markets will live with it. In part because market sentiment is probably as sensitive to sliding growth expectations as it is to hitting European deficit reduction targets. But much more importantly, the ECB's massive liquidity splurge for the European banking sector (see GC Insight *Why Frankfurt is the new frontline in the Eurozone crisis* 16 March 2012) since November 2011 has prompted a renewed appetite for Spanish debt – either as collateral for ECB loans, or carry trade – that has pushed Spanish debt costs well below the danger zone.

Spanish ten year debt is now trading at 32bps above Italian (Chart 1), but Madrid has not particularly spooked the market. Those German Bundesbank observers worried that the ECB's liquidity measures may be taking the pressure off leaders in the Eurozone periphery to prioritise deficit reduction will no doubt see Rajoy as a symptom of the problem.

The first failure of austerity politics?

What does this all imply for the Fiscal Treaty that European leaders signed in Brussels just days before the Rajoy government's minor insurrection? The treaty was of course sold as ushering in a new era of fiscal discipline for the Eurozone. States would set fiscal targets and be held to them. Yet the first serious test of that commitment resulted in a familiar fudge. The revised targets agreed in Brussels remove the prospect of the European institutions rejecting Spain's revised budget when it is submitted in Brussels in April.

When France admits that it will not meet its own deficit reduction targets this Spring – as it probably will – the odds are on a similar compromise. Critics of the Stability and Growth Pact – of which the Fiscal Treaty is essentially a souped-up version - have always pointed to the weakness in a system that relies on politicians to agree on imposing discipline on politicians. Germany, France and the UK all supported Spain in arguing for revised targets, leaving only the European Commission insisting on sticking to what had been agreed.

Nevertheless, Rajoy can hardly be argued to be reneging on a serious commitment to balance Spain's budget. Speaking to fellow European Conservative leaders in Majorca on March 8, he focused on Spain's reform commitments. He is still proposing €30bn of cuts in 2012 and to meet Spain's Fiscal Pact 3% target in 2013, goals that he is unlikely to meet and which will almost certainly require a further compromise with Brussels next year. If he even comes close to meeting his targets his will be the sharpest retrenchment in any major European economy in decades.

But by insisting on balancing growth and austerity Rajoy is part of a growing pushback against a single minded commitment to reaching 3% EU deficit targets on the shortest possible timeframes. French Presidential hopeful Francois Hollande, who has pledged to try and renegotiate the Fiscal Treaty if he is elected in May, will have watched Rajoy's trip to Brussels with interest. It is exceptionally unlikely that Rajoy sees himself as making any kind of common cause with Hollande – in Majorca he stressed his support for the rules - but both ultimately reflect the same political unease with inflexible fiscal consolidation targets imposed from Brussels.

And significantly, Rajoy did not just go to Brussels and invoke economic necessity. He argued that greater latitude for Spain was a question of sovereignty, calling his revised plan "a sovereign decision". While this is partly a smart politician speaking to a domestic audience weary of the idea that Brussels is dictating its economic destiny, it is a reminder how tenuous the idea of committing to greater centralised oversight of domestic spending is in the Eurozone. Even for a relatively committed European like Rajoy, in a relatively pro-European state like Spain.

From the start of the Eurozone crisis, greater fiscal discipline has always been the price that the ECB and Germany have required for rescuing the Eurozone periphery and the basic ingredient in Berlin's recipe for economic government in the Eurozone. Up to this point, both elites and their voters in these states have broadly accepted this. However it is likely that if economic conditions in Europe deteriorate, populations in Spain, Italy, Greece, Portugal and Ireland will increasingly find the Brussels straightjacket they have just pulled on to both economically impractical and politically impossible.

Economic pragmatists like Rajoy and outright revisionists like Hollande may increasingly find themselves on the same side of an argument against a system that is inflexible in principle and unenforceable in practice. For external economic confidence in the Eurozone this is an unfortunate combination. It is also a stark reminder that the real barrier to a closer fiscal union in the Eurozone is not technical but political. Rajoy is calculating that his voters will accept fiscal discipline. But fiscal discipline imposed from Brussels or Berlin is a different story. This basic political reality may be the most important lesson from Rajoy's modest rebellion. For advocates of closer fiscal union in the Eurozone it certainly leaves something to think about.

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