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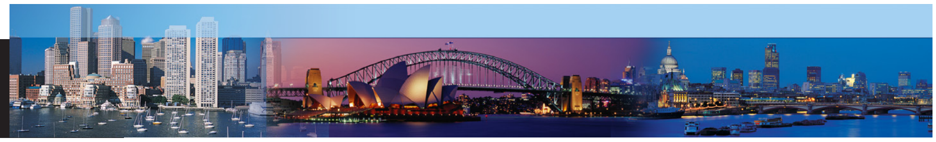

July 2012

The Pain in Spain

Is There Time for Hope and Change?

Richard P. Mattione

The intertwined problems of sovereign debt, European banking systems, and the euro itself will continue to be debated despite the measures that came out of June's meetings in Europe. Yet it is the economic and financial situation in Spain that is driving policy now. The precedents being set because of Spain are in a sense more important than discussions about the euro, for decisions about the euro can be delayed, whereas the pain in Spain is acute and the time for decisions is now.

What are Spain's key problems? First, there is too much debt, not just for the sovereign but also for banks, for numerous private companies, and for many homeowners. Second, the sovereign debt continues to rise due to budget deficits, in part because of measures needed to fix Spain's banks and corporates, just when the world's private sectors seem less interested in providing new funding. Third, and most importantly, measures to improve debt and deficits have brought on an economic contraction that some fear will turn into a free fall.

Adjustment in Spain will continue to be severe. Yet I would reiterate the sentiments of last year's paper on sovereign debt, classifying Spain as a country whose sovereign debt problem is daunting, but not quite insuperable.[1] The bank problems also appear solvable, though the outcome will not be pleasant; an earlier paper had already identified the Spanish banking system as among the neediest in Europe.[2]

So, what would it take for Spain to succeed, to keep daunting from becoming insuperable? The following sections will show that there has been some progress on the big problems that Spain faces, and that the sums under discussion are in the right ball park to get the situation under control – enough that the daunting may stay superable. The process will take years to prove itself, and in the interim Spain will endure more drama. In Churchillian terms, Spain is at best at the end of the beginning of solving its economic problems.

Fiscal policy on the edge in Spain

Spain seemed a success story for much of the 2000s. Deficits were small – the government even ran surpluses in 2006 and 2007 (see Exhibit 1) – and general government debt fell to a low of 36% of GDP in 2007 while the ratios for Italy and Greece danced around 100% from 2000 to 2008 (see Exhibit 2). Unfortunately, this seeming success largely reflected an economy fueled by a construction boom and ever-rising real estate prices. This left the economy seriously out of kilter when the real estate boom ended.

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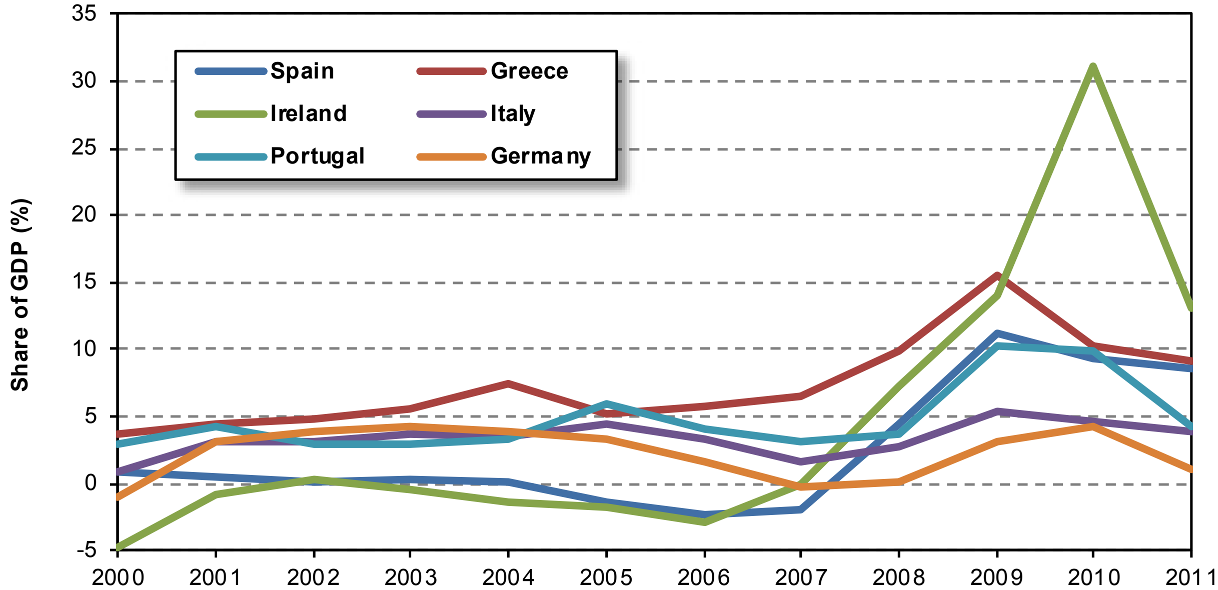
1 Richard P Mattione, "Et tu, Berlusconi? The daunting (but not always insuperable) arithmetic of sovereign debt," October 2011.

2 Richard P Mattione, "You can bank on it: European banks need tons of money," December 2011.

Exhibit 1: Government deficits in Europe, selected nations

General government deficit as a share of GDP (%)

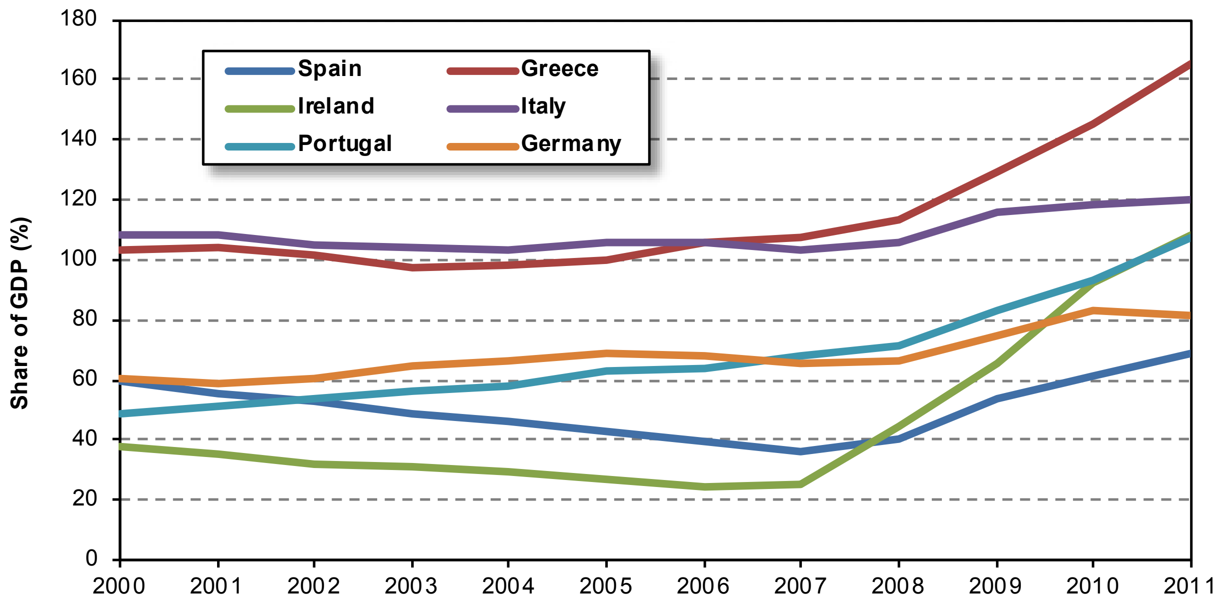


Note: Negative share of GDP indicates a surplus

Source: Eurostat

Exhibit 2: European sovereign debt, selected nations

Share of GDP (%)



Source: Eurostat

The property boom bolstered the economy and government revenues, which facilitated more spending by governments at all levels, particularly by regional governments. Regional governments are an important element in any resolution of Spain's pain, for a fair portion of central government tax collections are automatically allocated to them and until recently there was little control or even proper accounting of local expenditures. The deficit ballooned once the global economic crisis started and the property bubble came to an end: by 2009 a small government surplus had turned into a deficit exceeding 11% of GDP.

Shortly after its inauguration in December 2011, the government of Mariano Rajoy put forward a plan to bring deficits down from the 8.5% of GDP attained in 2011. The plan targets a deficit that shrinks to 5.3% of GDP this year, 3% of GDP in 2013, and 1.1% of GDP in 2015.[3] The plan foresees a tiny but growing primary surplus (a surplus excluding interest payments) from 2013, and a debt-to-GDP ratio that starts to fall in 2014, having peaked around 82%.

As expected, the Europeans have acknowledged that attaining the 2012 deficit target will be extremely difficult. Admittedly the central government appears to have imposed some discipline on regional and municipal entities.[4] However, that rationalization did not come soon enough for those entities to avoid financial difficulties, as seen in Catalonia's plea for central government help.[5]

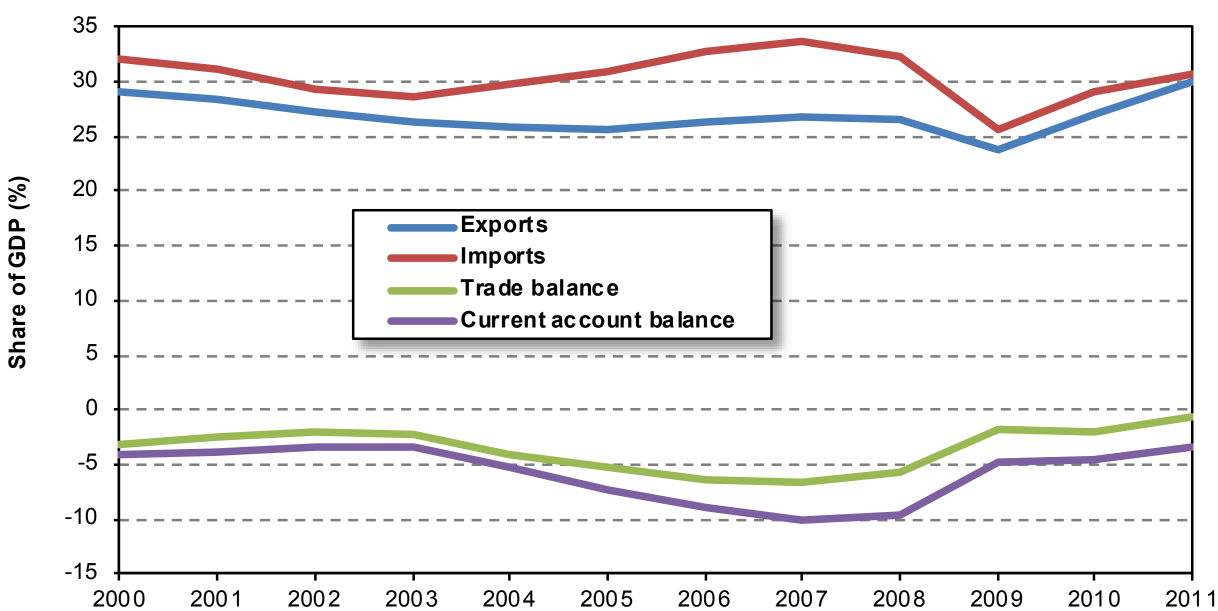
Other aspects are less favorable. The Rajoy government has made progress on a long list of labor and social policy measures that it believes will re-invigorate the Spanish economy, producing real economic growth in 2014 and beyond so as to shrink both the deficit and the debt-to-GDP ratio. It has measures to reduce the arrears piled up by regional governments. Yet these policies will be slow to implement. This implies that Spain will continue to make sizable new requests for debt financing at a time when markets are not that happy with rolling over old debt.

A quick look at the nonfinancial private economy

Spain had run a small but growing trade deficit in the first half of the 2000s. The trade deficit soared from 2006 to 2008 (see Exhibit 3) as construction activity displaced exports while drawing in imports. The last three years have seen a sharp correction. Imports in 2011 were 7% below pre-crisis levels while exports were 12% above pre-crisis levels, leaving the trade account near balance in 2011. Yes, a good chunk of the correction can be attributed to the

Exhibit 3: Spanish balance of payments

Share of GDP (%)



Note: Negative share of GDP indicates a surplus

Source: OECD

3 Tesoro Publico, "The Kingdom of Spain's path towards stability and growth," May 2012.

4 "Madrid hails moves by regions to cut spending," *Wall Street Journal,* May 18, 2012.

5 "Catalonia needs a bailout from government," *Bloomberg News,* May 25, 2012.

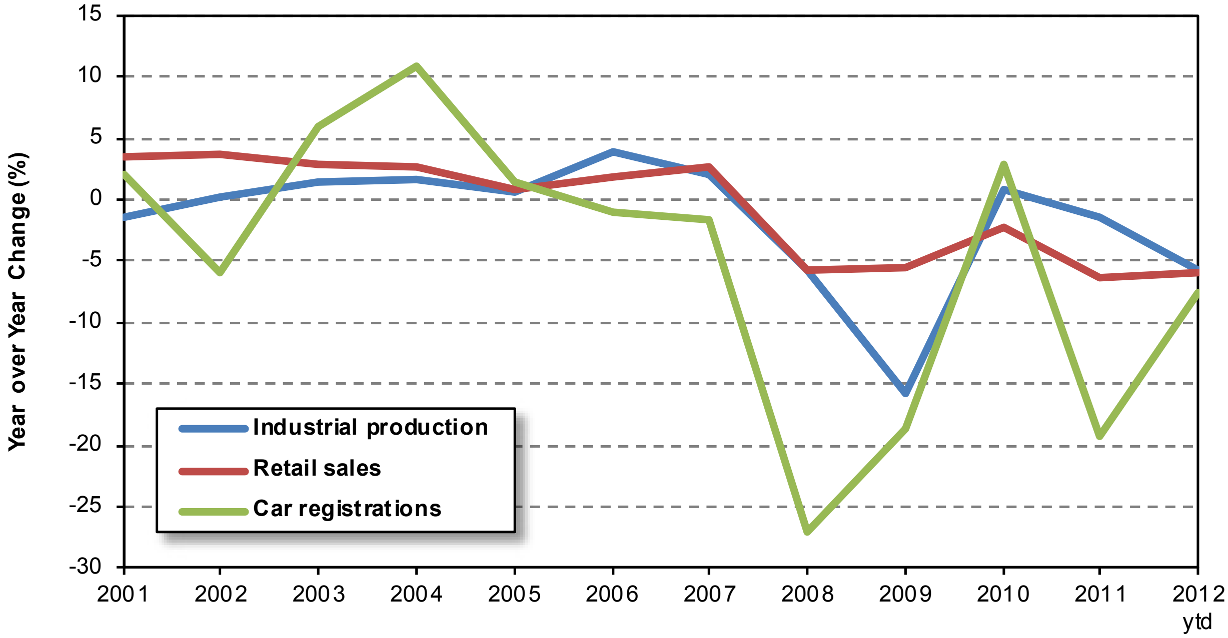
sharp fall in demand. Yet these data show that the received wisdom on European adjustment – that Italy can export its way out of the crisis but Spain cannot – may well underestimate Spain.

The current account, on the other hand, still has a way to go to achieve balance. The awful deficits of 10% of GDP in 2007 and 2008 shrank to 3.5% in 2011, but Spain now makes larger interest payments than before. Spain's problems are unlikely to be solved until the current account, too, is at or very close to surplus. After all, a current account deficit indicates that Spain remains a net drawer of new funds from the rest of the world, and today the private sector is unwilling to provide funds.

Domestic adjustment remains painful. Retail sales in April were 10% below year-earlier levels, and 6% below for the first 4 months of the year; industrial production has dropped 6% so far this year (Exhibit 4). The scramble to stay close to current on mortgages may be contributing to the drop in retail sales, especially as unemployment insurance starts to run out. Deleveraging in the banking sector may be constraining industrial production even if demand is there.

Exhibit 4: Domestic economy activity in Spain

Share of GDP (%)



Source: OECD Statistics

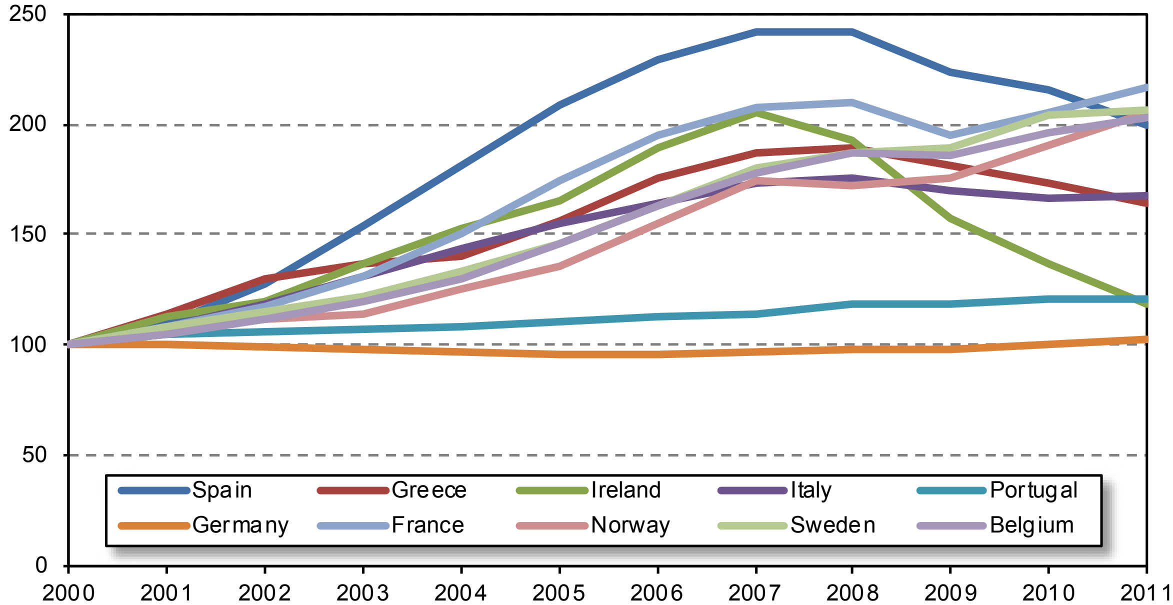
Thus it is imperative to look at the intertwined issues of the Spanish real estate bust and fixing the Spanish banking system to gauge Spain's eventual course.

The real estate bubble: anything that goes up that much must surely come down, but how far?

Housing prices in Spain rose 142% from 2000 to their peak in 2008 (see Exhibit 5). This bubble surpassed that of any other European market in the run-up to the global economic crisis of 2008-09, although three others – France, the United Kingdom, and Ireland – also saw prices more than double. Spain's prices in 2011 were still double what they were in 2000 even with the correction, whereas the next sharpest run-up among the PIIGS countries (Portugal, Ireland, Italy, Greece, Spain) at the center of the sovereign debt crisis is the 67% cumulative rise in Italy. Irish prices have run most of the way back down, and Portuguese prices never went up very much.

Exhibit 5: House prices in Europe

Index, 2000 = 100

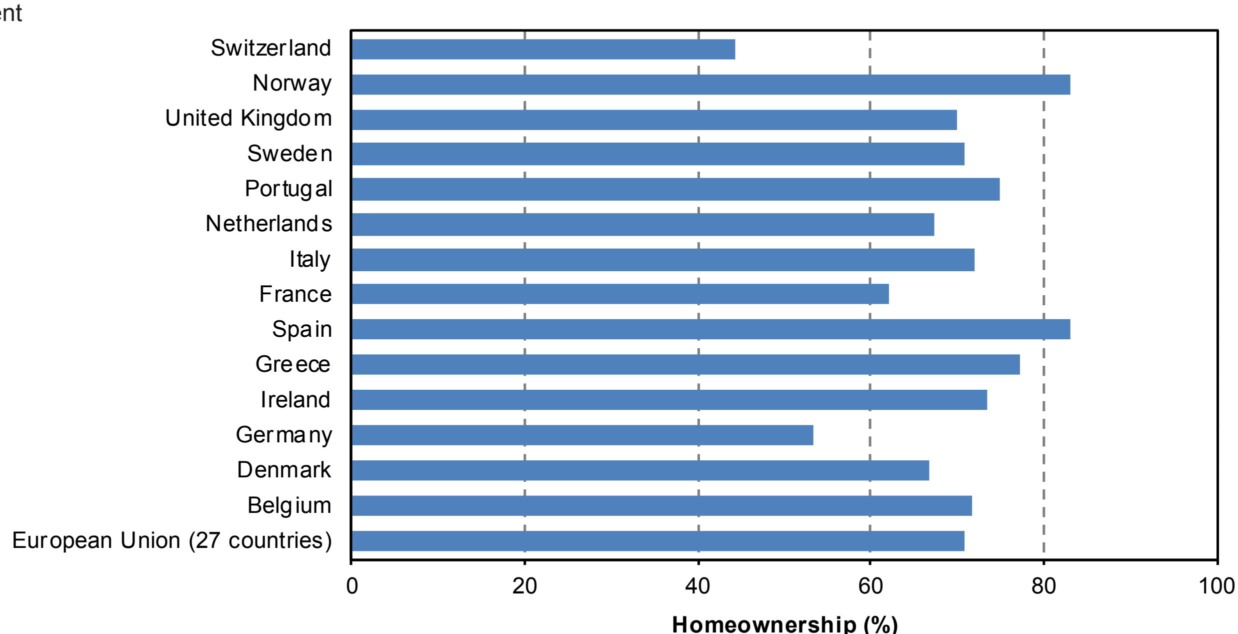


Source: OECD Economic Outlook

Some argue that the residential portion of the crisis will prove mild. The homeownership rate was 83% in 2010, noticeably above that of any other European nation except Norway (Exhibit 6). So far the default rate on home mortgages has stayed relatively modest, with a run-up from 2.3% to 2.8% over the last 6 months.[6] This seems incredibly low for a country whose unemployment rate is approaching 25%. Yet data on housing costs as a share of disposable income are actually slightly better than the European or eurozone averages: 10.9% of Spaniards in 2009 paid more than 40% of their disposable income for housing, against a eurozone average of 11.8% and a European average of 12.1%.[7] Many homes are already paid off: mortgages on the primary residence have an original life of 15

Exhibit 6: Homeownership in Europe, 2010

Percent



Source: Eurostat

[6] Banco de Espana, Economic Statistics, May 2012.

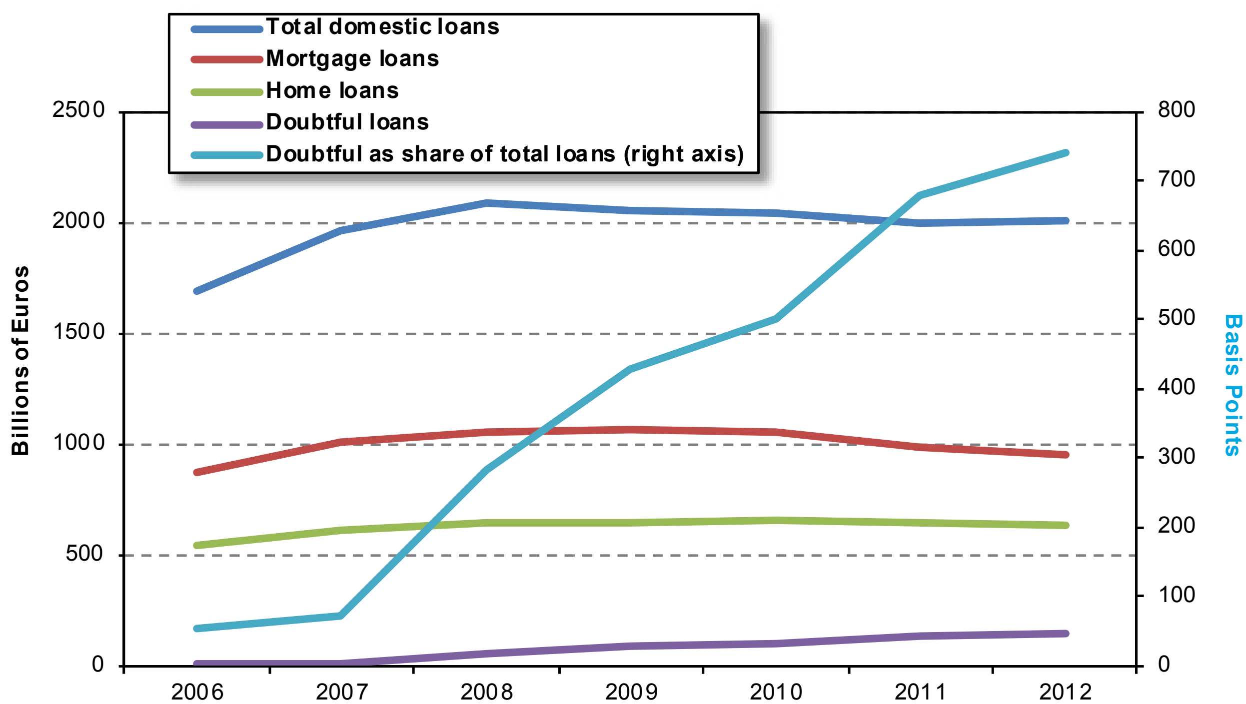
[7] European housing statistics, October 2011.

years or so but are paid down ahead of schedule for an actual life just in excess of 10 years, and refinancings are not the norm. Cultural traditions mean that the family helps out younger members who have trouble with paying their mortgage. Finally, the bank holding the mortgage has full recourse to the assets of the borrower, so that a borrower cannot simply hand over the keys and walk away.[8]

The first phase of the bank stress tests in Spain, released in June 2012, assumed further declines in housing prices. The base case scenario essentially had prices fall to around 180 on the index above, the adverse scenario to around 150, by the end of 2014 and then (implicitly) stabilize. The base case for 2012 translates into a cumulative decline from the peak of 25% in nominal terms, more than 30% in real terms – in line with previous cycles.[9] On the other hand, even the adverse case in the stress test would leave cumulative price changes since the previous trough far above Irish and Portuguese results. In that sense, the scenarios may prove optimistic despite making assumptions that things are worse than in previous cycles.

How much would a further correction in housing prices complicate Spain's efforts to conquer its banking and sovereign debt problems? Spain's banking system is heavy with loans secured by real estate. At the end of 2008, deposit taking institutions of all types had domestic loans outstanding of 2.1 trillion euros (see Exhibit 7). Of that total, 1.1 trillion euros were in the form of secured loans, with mortgages the most common form of security, encompassing 1.05 trillion euros of loans. That number held fairly steady until late 2010 before beginning to shrink, a trend that has recently accelerated. By April 2012 loans outstanding had fallen to 2 trillion euros, of which 953 billion euros were secured by mortgages and 637 billion were tied to housing.

Exhibit 7: Key portfolio metrics at deposit taking institutions



As of April 2012 Source: Bank of Spain

[8] Often offered as back-up is the hard to verify "fact" that most of the home mortgage problems have been focused on foreigners. These are presumably illegal immigrants who do not enjoy the family support network in Spain and who could leave the country and thereby escape their bank's pursuit.

[9] The 1979 housing bubble showed a peak to trough decline of 33% in real terms. See Carmen M. Reinhart and Kenneth S. Rogoff, "This Time Is Different: Eight Centuries of Financial Folly," Chapter 10, table 10.8. This seems comparable to numbers from Spanish government publications. See, for example, Jose Maria Roldan, Banco de Espana, "Spanish Banking Sector: September 2011," presentation in London.

Doubtful loans had been minimal prior to the global economic crisis of 2008-09, representing a mere 63 basis points of the total portfolio at the end of 2006 – 9.1 billion euros. But the number began to rise even before the eurozone crisis, to 59 billion euros (329 basis points) at the end of 2008, and soared to 148 billion euros (884 basis points) at the end of April 2012.

What should Spain be preparing for on residential mortgages? In the 1990's real estate bubble the nonperforming rate on residential mortgages peaked well below 10% even though unemployment was high. This time around prices are higher and the global economy worse, so a 10% ratio of nonperforming residential mortgages seems a useful reference point for adverse scenarios. With residential mortgages of around 640 billion euros, an increase in nonperforming loans from the 2.8% ratio reported in May to 10% (respectively 15%) would imply extra provisioning for the system of 23 billion euros (respectively, 39 billion euros) if 50% provisioned.[10] These numbers, while extreme compared to past experience, provide stringent notions of how much more capital might be needed for record-setting delinquencies on home mortgages. If this were Spain's only problem, 39 billion euros would probably be seen as a marvelously low number.

Commercial real estate and bank capital

Unfortunately, the commercial real estate situation is already proving far worse than that facing home mortgages. On May 8 the Spanish government took over Spain's third largest bank, Bankia, as a nascent run on bank deposits forced the government's hand. Bankia's previous financing needs had been handled as part of the restructuring of Spain's cajas and caixas (savings banks) through the Foundation for the Orderly Restructuring of Banks (FROB, using its Spanish acronym). Arithmetically, the May 8 announcement did not represent a new credit from the central government, but was handled by transforming an existing convertible bond into equity. A few days later the restatement of Bankia's results required a further 19 billion euros of new provisioning, though it promises to result in substantial coverage once completed (see Table 1).

On May 11 the government announced higher provisioning requirements at all banks on loans related to commercial property (see Table 2). This covered 323 billion euros of loans, of which 175 billion euros were ruled problematic. Problematic loans were subject to specific provisions of up to 60% and capital add-ons of up to 20%, the rest became subject to generic provisions of 7%. These changes in provisioning requirements for commercial real estate would tie up just over 60 billion euros of capital at Spanish banks compared to previous capital adequacy calculations.

Table 1: Post recapitalization loan coverage at Bankia

Coverage ratio (%)

Real estate	44.5
of which foreclosed assets	56.6
Nonperforming and substandard	53.3
Total portfolio	13.1
Non developer loans	5.1

Source: Bankia press release, May 15, 2012

Table 2: Provising changes in Royal decree of May 2012

Amount in billions of euros; others in percent

	Amount	Specific Provision		Capital Add-on	Generic Provision
		Prior	Current		
Problematic assets:					
Land	75	31	60	20	n.a.
Housing under development	13	27	50	15	n.a.
Other	87	25	35	n.a.	n.a.
Non-problematic assets	148	n.a.	n.a.	n.a.	7

Source: Bank of Spain

[10] If all houses had been bought at the high prices of 2008, 50% provisioning would mark down a house bought at 242 thousand euros to 121 thousand euros, not much above its price in 2000 using the data from Exhibit 5. Clearly, not all houses were bought in 2008 at the peak.

Finally, in late June Spain made the official request for 100 billion euros of assistance from Europe. Could that be enough to fix Spain and its banks? Phase I of the Spanish bank stress tests, announced June 21, resulted in estimates of 51 billion to 62 billion euros of new capital required relative to the situation as of the end of 2011. The 62 billion euro estimate for immediate capital needs in the adverse scenario understates the long-term need for capital, because it assumed that in adverse times capital would be restored temporarily to only a 6% ratio; a restoration to a 9% capital ratio would require perhaps 40 billion euros more. Results from Phase II of the bank evaluation, consisting of bottom-up audits of individual bank portfolios, should be released in August.[11]

Our earlier calculation on residential mortgages indicated a provision of 23 billion to 39 billion euros is believable there. This can be coupled with a low estimate of 60 billion euros for commercial real estate from various sources, probably 100 billion euros if capital is more quickly restored. Only a small portion would be covered by existing capital.

In an economy that is shrinking or stagnating for 2 more years, the outcome may well be worse. Loans not related to property, about one half of Spanish loans, could deteriorate, creating losses worse than those envisioned in Phase I of the Spanish bank stress tests. Lower loan volumes may combine with weaker spreads to reduce profits at banks, especially now that bank deposits must compete with the higher yields available on short-term Treasury securities. But Spain made its official request to Europe for 100 billion euros of support last Saturday, and three outside evaluators – the International Monetary Fund (IMF) and two private firms, Oliver Wyman and Roland Berger – have all come out with exhibits noticeably less than 100 billion euros. So 100 billion euros will be the first step, albeit a very big step.

Implications for Spanish debt

The need in Spain is to keep its daunting problems of bank capital and sovereign debt from becoming insuperable. The official projection of the government deficit for 2012 implies more than 55 billion euros of new debt, beyond rollovers, coming to the market this year, and the projection of a deficit equal to 3% of GDP in 2013 translates into 32 billion euros of further new financings next year. To this must be added the bank recapitalization, which requires 100 billion euros as of now. That assumes bond yields more in the 5% to 6% range, yet Spanish 10-year bonds traded at a yield just shy of 7% in mid-June. If such a yield were to persist until all 10-year bonds have been refinanced, with comparable rises at shorter maturities, Spain would eventually have to devote an extra 20 billion euros, or around 1.9 percentage points of GDP, each year to servicing its debt, an unwelcome addition.

Altogether this would imply a Spanish sovereign with a debt to GDP ratio between 85% and 90% at the end of 2013 if the financing is done through the sovereign, as currently planned.[12] It would also imply some further tightening of government spending to cover the extra debt servicing costs in order to stabilize the ratio in the 85% to 90% range and a market willingness to fund extra debt, compensated by the new and higher yield. That willingness to fund could be regained once the market realizes the situation has stabilized. A worsening of Spain's debt to GDP ratio to 85% would be worse than the historical experience chronicled in the oft-quoted book of Reinhart and Rogoff, which might perversely offer some comfort that the number is not an underestimate.[13]

Europe's announcement on June 29 included several concessions to make the bank recapitalization and sovereign financings easier. It was decided that the European Financial Stability Fund (EFSF) will be the initial provider of funds for Spanish banks, and that the funds will later be transferred to the European Stability Mechanism (ESM), resolving that lack of clarity. It also eliminated the previous request for seniority for the funds, which was scaring

[11] Auditors will not redo the numbers for banks at which they had previously been engaged, but essentially they will be checking each other's past work.

[12] The June 29 announcement from Europe envisages direct capital injections in the future from Europe to individual banks. But Spain's banks will almost surely be recapitalized before those details on direct injections are resolved. Thus FROB would probably stand between Europe and the banks initially, and FROB is an entity consolidated into the government's accounts.

[13] Carmen M. Reinhart and Kenneth S. Rogoff, "This Time Is Different: Eight Centuries of Financial Folly," Chapter 10, various pages and tables. They found that real government debt rose by 86% over the course of resolving a housing-induced bank crisis, based on an experience that includes five developed markets (Japan, Spain in the 1980s, Norway, Sweden, and Finland); the number for Spain's previous crisis was just over 100%. These results are reported as real debt, not debt to GDP. Remember that Spain entered the crisis with a ratio of 36% of GDP.

private investors away from Spanish sovereign debt because it appeared that Europe would have priority in payoffs. Another part of the announcements made it easier for the European authorities to buy Spanish (and other sovereign) debt in primary and secondary markets. Though Finland and the Netherlands have already expressed disapproval of this measure, even together they cannot block it.

The question remains open as to whether ratings agencies might yet feel the need to treat this as so substantial an increase in Spain's sovereign exposure as to require a downgrade of the Spanish sovereign. A downgrade would matter because it could trigger sales of bonds already held, either by investors that are scared or merely because investment agreements do not permit the holding of low-rated bonds, adding to the difficulties when Spain still requires new money from the markets. But, as mentioned earlier, there is now more room for direct European support of bond markets. And if worse comes to worse, as unpalatable as it is to Spain, it would also be possible to call in the IMF to work with Europe in covering Spain's interim funding needs for the bank bailout and for the deficits of 2012 and 2013. The arithmetic suggests that Spanish debt would peak as a share of GDP at less than 100% of GDP, far less than in Italy. This could encourage the private sector to supply just enough to make the issues of sovereign debt and the Spanish banking system daunting, but not insuperable.

Final thoughts: that "hopey-changey" thing

The markets have long since tired of strategies for muddling through Europe's problems. Some desire fiscal union, some suggest a banking union.[14] Some believe the euro must disappear, in the hope that new (and drastically depreciated) currencies would fix any competitiveness problems of the periphery.[15]

Yet it is unlikely that anything better than a strategy of kicking the can down the road will be on offer over the next several years. In that case it might be better to make sure that the can is kicked a suitable distance down the right road. European governments chose last week to follow a road headed toward solving Spain's bank capitalization and sovereign debt problems, the most pressing problem they faced.

European governments seem to have chosen wisely with their decisions, even if not everything is resolved. They have established precedents and suggested mechanisms that can work should an even bigger country become the next target of the markets. They have started the work toward a unified regulatory framework that might lead to banking union, and at the least has the potential to address any further capitalization issues that will arise in coming years. I do worry that they should move faster, especially on the bank recapitalization.

Whatever the ultimate solution, Germany and a few other rich European countries, perhaps the IMF and its main funders, will provide the bulk of the money. Germany seems willing to help those who take actions to improve their own situation, but also wants to keep the help limited and conditional so as to "hold the feet of the PIIGS countries to the fire." The PIIGS countries, and any others that continue to need net new money (especially any money beyond debt servicing costs), will have strong incentives to behave. It is not an inappropriate method of monitoring behavior.

True, Europe has not identified all of the mechanisms and funds to solve all future problems, but resolving everything would truly have been a surprise. One should assume that questions of collateral or liquidity that are holding up the resolution of future financing needs will also be resolved, much as long-term refinancing operations helped carry European banks through a crisis this past winter. More difficult questions of fiscal union and the euro have been set aside because they were nowhere near so pressing as settling Spain's problems.

[14] "A union to bank on," *Financial Times*, June 19, 2012.

[15] Lower relative wage rates between the periphery countries and their global competitors, including Germany, would theoretically be enough to solve Europe's problems once and for all. The market seems in a hurry to get that reset through the demise of the euro. Yet the demise of the euro creates many other complications, so one can understand the reluctance to give up the euro today. There is also a long record of research showing that devaluations alone are not very effective in restoring competitiveness over the long term.

For some this is too much hope, too little change, bringing to mind that U.S. bumper sticker, "How's that hopey-changey thing working for ya?" But working on Spanish bank capitalization and sovereign funding is the best ticket for Europe now. Other committees can take the years, not months, necessary to put in place a stronger banking and fiscal structure for the continent (perhaps stretching to banking and fiscal union) and determine the long-term role of the euro.

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