BlackRock Global Watch
When Spain sneezes...

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Upheaval in the Euro area has captured investor attention with deadly riots in Greece, emotional scenes elsewhere and credit markets bordering on dysfunction. In this article, we examine the particular circumstances of Spain which has been a focus of credit quality concerns. Spain provides a useful microcosm to highlight the magnitude of the difficulties currently being faced by other members of the Euro area.

Spain is caught in a vice between the dissolution of a credit-fueled property bubble, substantial leverage of its economy through a marginally capitalised banking system, a highly divided legislature, fiscal deterioration and an inflexible economic structure. With unemployment at close to 20%, social cohesion is in question. Why hasn't the announcement of the European Financial Stability Fund calmed markets more? How would a credit crisis in Spain flow offshore? We outline the situation.

On 28 April 2010, in the midst of a general deterioration in the perception of the quality of sovereign credit amongst peripheral European countries, Standard & Poors downgraded Spanish sovereign government to AA from AA+ with a negative outlook. As a cacophony of cries towards fiscal restraint rose, Prime Minister Jose Luis Rodriguez Zapatero joined the austerity bandwagon on 12 May. He proposed a painful package that called for a cut to civil service pay by 5%, freezing it in 2011. Additionally, there would be a cut in investment spending and pensions, and thirteen thousand public sector jobs were to be eliminated. Taxes on sales, income and profits were also to be raised.

The magnitude of the savings over the following two years was estimated at Euro 15 billion, or approximately 14% of 2009 GDP. Clearly, this was an extreme and emergency measure. Workers immediately rose in anger, threatening a general strike.

The austerity bill secured passage through the Spanish parliament by a single vote on 27 May. Only the 169 members of the ruling Socialist Party voted in favour of the legislation. The minority parties recorded 168 votes against and 13 abstentions. Such was the emotion surrounding the circumstance that one member of the Popular Party was even brought to the session by ambulance to record his dissenting vote.

Despite the announcement of the formation of the European Financial Stability Fund on 9 May, with a headline figure of Euro 750 bn attached when contributions from the IMF and existing EU facilities are tallied, increased liquidity measures by the European Central Bank, and a host of other measures to restore confidence in the fiscal circumstances and credit of European countries, financial markets continued to reverberate. Credibility had not been restored. Why?

In this article, we examine the situation in Spain in some detail. In doing so, we seek to highlight the thorny and manifold nature of the difficulties being addressed in the European periphery. We also consider how the problems in one country, like Spain, can be transmitted across national boundaries, potentially threatening the survival of the Euro and wider global economy.

Politics

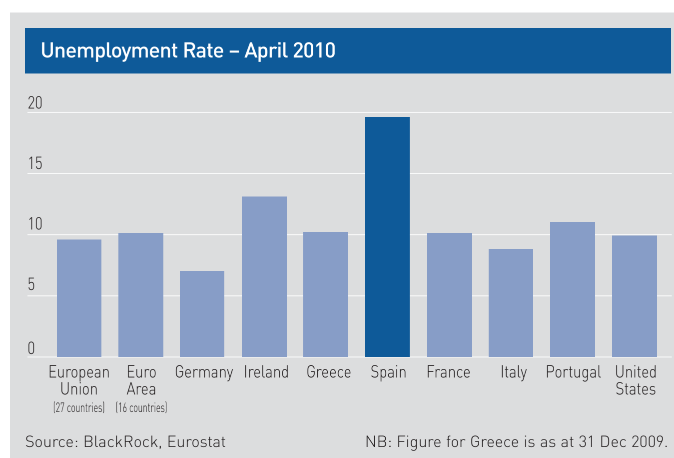
As the vote to pass the austerity package demonstrated, the Spanish parliament is finely balanced. The ruling Socialist Party relies on regional party support for an absolute majority in the legislature. The austerity package led to a widespread swing against the Socialists. A recent poll published in the "El Mundo" newspaper shows that 45.6% of the vote would now go to the Popular Party. Zapetero's Socialist Party would receive only 35.1% of the vote.

A vote on the 2011 budget is due later in the year and it is unclear if the bill will secure passage. Some of the parties which abstained in the vote for the austerity package have openly called for an early election. Currently, elections are not scheduled until 2012.

The widespread unpopularity of the revised budget and the likelihood that the Socialist Party will not remain in power long enough to see the measures through, raises doubts about the credibility of the measures which have been announced.

Unemployment

Spain had an unemployment rate of 19.7% as at April 2010 which is far higher than the European Union and Euro area average. Youth unemployment is at approximately 40%. These are levels of unemployment consistent with the lack of social cohesion and widespread dissatisfaction with domestic institutions.



Source: BlackRock, Eurostat NB: Figure for Greece is as at 31 Dec 2009.

By adding an economic burden on the populace via the austerity package, unemployment is expected to climb even further. Within an active democratic state, it does not seem credible to believe that the Socialist Party will remain in power in the midst of such deterioration. It would seem more likely that some arrangement which is more tolerable to the populace will ultimately be sought to restore finances.

Labour market inflexibility

Spain is noted for its rigid labour laws. Employment is highly regulated with a view to protection of employee's rights. Jobs are grouped into categories and each category has a different set of regulations. These regulate, for example, the salary range for each job, hours of work, vacations and several other matters.

Termination of individual workers requires notification in writing and a 30 day notice period and the provision of generous severance payments (approximately 1 month pay per year of service with a maximum of 12 months). In the event of a larger scale retrenchment program, a series of steps requiring legal representation, documentation and consultation between the enterprise and worker representatives is legislated. Larger companies must consult with representatives of the workers in this manner for not less than 30 calendar days. In the event the period of consultation ends without agreement, a competent labour authority is consulted who will hand down a decision. This decision is subject to appeal.

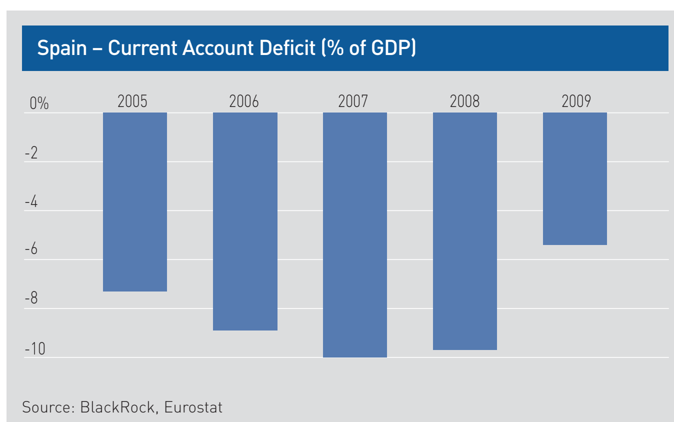
These factors limit Spain's ability to innovate and update its productive capacity for the challenges it faces. Further, they discourage investment into the country.

International competitiveness

Spain's workforce rigidity and economic structure limit its ability to adapt its productive capacity to external developments. Spain's participation in the Euro, which implies loss of domestic control over its monetary policy or use of currency deflation to absorb imbalances, implies that the associated loss of international competitiveness becomes visible through its current account.

Spain has the second largest current account deficit in the world in nominal terms, behind the United States – a position it has held since 2003. This is particularly extraordinary for a country with a population of 45 million.

Spain – Current Account Deficit (% of GDP)



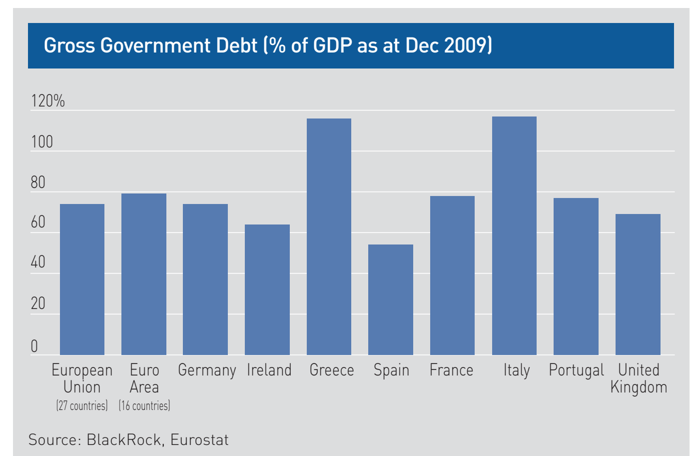
Source: BlackRock, Eurostat

The lack of international competitiveness makes it very difficult for Spain to alleviate its problems through the mechanism of export demand.

Government finance

In general, the difficulties in the Euro region with the level of government debt can be seen in the following chart. The debt levels compare unfavourably with the convergence criteria outlined in the Maastricht treaty which called for a ratio of gross government debt to GDP not to exceed 60%. Notwithstanding this, Spain's government debt position did not raise alarm within this context.

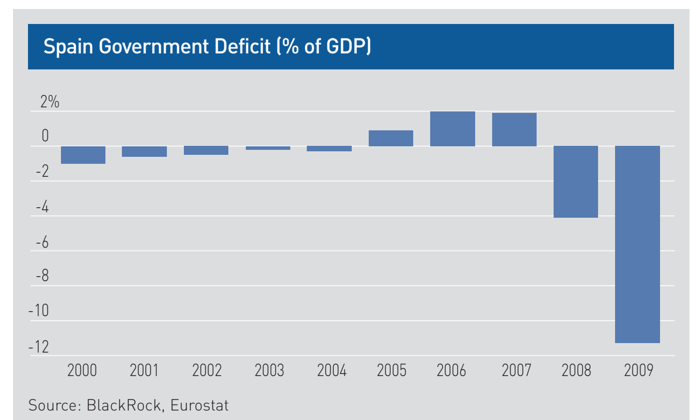
Gross Government Debt (% of GDP as at Dec 2009)



Source: BlackRock, Eurostat

However, a very sharp deterioration in its budget position has drawn attention and portends a sharp rise in indebtedness and deterioration in credit quality of sovereign debt.

Spain Government Deficit (% of GDP)



Source: BlackRock, Eurostat

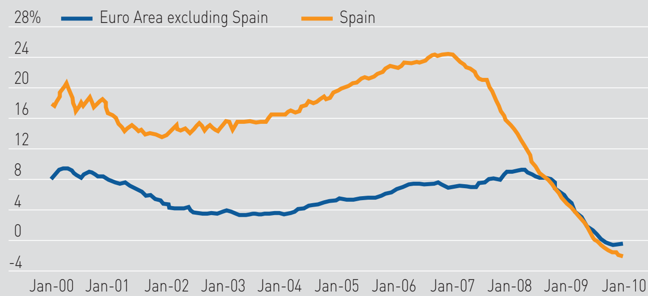
Spain has actively increased the average maturity of its central government debt profile. As at April 2010, the average maturity sat at 6.8 years. Nonetheless, there is approximately Euro 70bn of debt maturing in each of 2010 and 2011 which need to be refinanced. Thus far, market demand remains in place for these securities.

The fiscal austerity plan aims to restore confidence in the government finances by bringing the budget deficit from 11.2% of GDP in 2009 to 3% in 2013.

Credit crunch

Whilst restoring confidence to the Spanish fiscal position would be considered a positive move, the financial difficulties extend to deeper levels. Spain has been party to a very large credit-fueled property bubble. As the following chart illustrates, credit growth far exceeded the Euro area average until 2008, when the global financial system met with considerable stress. More recently, credit outstanding in households and non-financial firms has declined with a weakening of credit quality and rising lending standards.

Year-on-Year rate of change in credit to Household and Non-financial Corporations

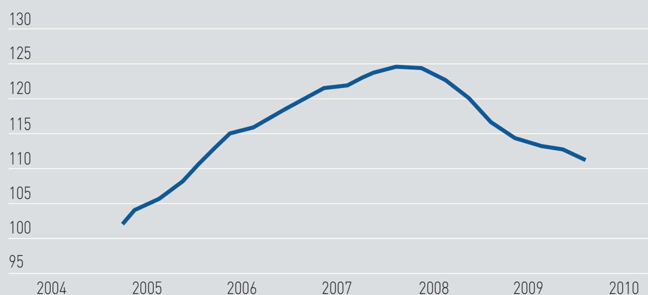


Source: ECB, Bank of Spain

Property prices rose and fell in unison with the credit cycle. This pattern has preceded many collapses in banking systems around the world in history. Financial markets are very concerned that Spain's banking system will require substantive support from the central government as insolvency threatens the financial system. Standard & Poors anticipates that the cumulative cost of this will exceed 5% of GDP. Meanwhile, property prices continue their precipitous fall.

There are now an estimated 1.6 million unsold properties in Spain, or about four year's of inventory at the current sales rate of 400,000 a year. This compares with "only" eight months of supply in the US. The Economist's latest survey of global house prices (*You can't keep 'em down, 15th April 2010*) found that housing prices in Spain are still 53.4% over-valued (against their long-run average of price-to-rents ratio), despite the property market crash.

General Price Housing Index – Spain



Source: Spanish Ministry of Housing, FactSet

Financial system

The Spanish financial system faces considerable challenges. To begin with, the major banks are thinly capitalised. Free equity represents only 5.7% of total balance sheets amongst deposit taking institutions as at December 2009. The gross balance sheet size of the banking sector relative to GDP is a multiple of 3.6x (for comparison: Australia 2.5x, United States 2.8x), highlighting the extent of leverage that the Spanish government may be exposed to indirectly.

There is an active program of encouragement to merge weaker banks. On 22 May, the Bank of Spain removed the managers of CajaSur, one of Spain's smaller banks (assets of Euro 19bn), and placed the bank under provisional liquidation. The Spanish authorities established the Fund for Orderly Bank Restructuring in June 2009 to aid in this process by providing credit support to banks requesting assistance to restore their financial quality. Access to the Fund closed on 30 June 2010.

As would be expected, refinancing of debt to Spain's banks has become more troublesome, and reliance on the Eurosystem has approximately tripled from levels prior to the onset of the global financial crisis. Further, concern on the part of depositors for the safety of their assets and competition for these scarce assets has seen a flight to quality which exacerbates the refinancing problem for weaker banks.

As if more exhibits were needed to highlight the magnitude of the problems facing the Spanish banking system, the table below highlights that 25.6% of the Euro 445 bn gross loan exposure to the construction and property development sector was already subject to specific provisions for impairment. It is worth noting, though, that general provisions have already been made for 35% of the loan book. These figures do not include general mortgages or consumer loans.

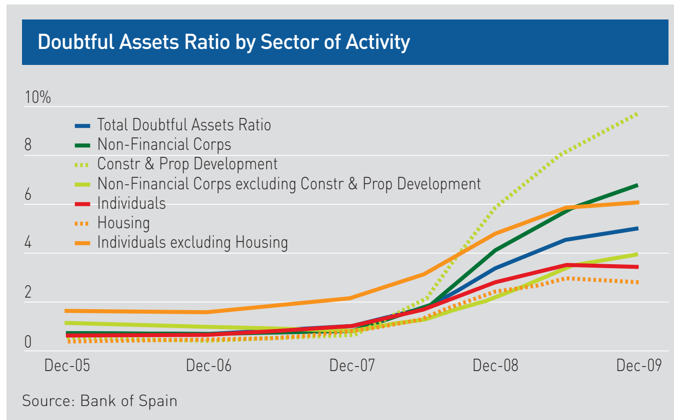
In relation to mortgages, Spain's prior experiences suggest that the quality of mortgages exceeds the general loan pool. 90% of home loans are first mortgages. Of these, 80% are for the principal residence. Approximately 80% of household mortgages for first residence had loan-to-value ratios of less than 80%.

Lending by Deposit Institutions to the Construction and Property Development Sector – Exposure and Coverage, December 2009

	Amount (€bn)	% of lending	Specific coverage (€bn)	% specific coverage
Lending	445.0			
of which:				
Doubtful	42.8	9.6	17.7	41.4
Substandard	59.0	13.3	7.6	12.9
Foreclosures	59.7	13.4	13.0	21.8
Write-offs	4.0	0.9	4.0	100.0
Potentially troubled exposure	165.5	37.2	42.3	25.6
% of coverage including general provisions				35.0
% of coverage including net operating income – December 2009				71.0

Sources: Bank of Spain

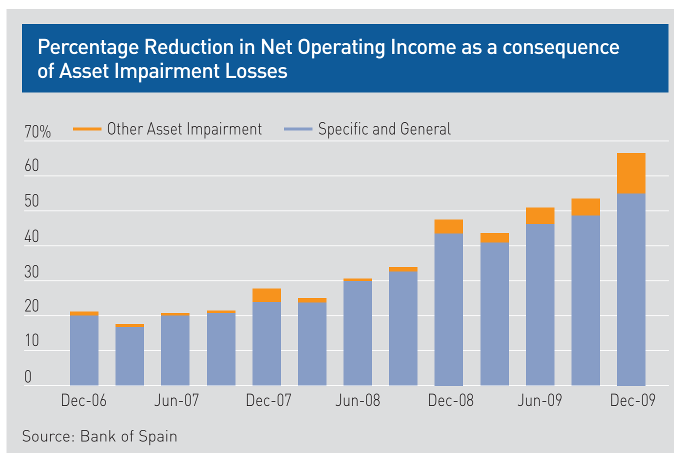
As at March 2010, total mortgage loans of Spanish credit institutions were valued at Euro 1.1 trillion. Despite historical experience suggesting that the quality of mortgages is relatively strong, credit quality has declined (as evidenced by the increasing doubtful assets ratios in the chart below). Doubt must be expressed that the relatively muted adverse experience to date will remain in place as the economy deteriorates in light of the severe austerity package in Spain and increasing fiscal conservatism now evident throughout Europe.



Doubtful Assets Ratio by Sector of Activity

Source: Bank of Spain

As credit quality deteriorates, banks are less able to develop their capital base from retained earnings (see chart below).



Percentage Reduction in Net Operating Income as a consequence of Asset Impairment Losses

Source: Bank of Spain

In Spain, the direct budgetary consequence of a deeper budget deficit than consistent with long term sustainability is further burdened by the troubling state of the banking system. Spain's banks and property market have the hallmarks of a significant property boom-bust cycle which has yet to reveal its full extent. These concerns were not salved by the European Central Bank's June 2010 Financial Stability Report which estimated that European banks had a further Euro 123 bn in loan writedowns to take in 2010.

Contagion transmission mechanism

In the integrated financial market, a difficulty in the Spainish banking sector can be spread to other countries through a variety of mechanisms. It can also be affected by developments within the government debt market.

The most direct mechanism for a credit contagion to spread is via international holdings of Spanish bank debt. As at December 2009, foreign claims on Spanish bank assets totalled USD $1.1 trillion. The distribution of these claims to countries of main interest is summarized in the following table.

Claims on Spanish Bank Assets as at December 2009 (Immediate Borrower Basis)

Country	(USD Billion)
Australia	1.601
France	219.636
Germany	237.983
Greece	0.434
Ireland	30.225
Italy	31.101
Portugal	28.075

Sources: BIS

Widespread difficulties in the Spanish financial system could further weaken financially stressed countries in the Euro, and spread to the major financial centers of France and Germany. From there, depending on the second round effects of bank failures elsewhere in the system, financial stress rapidly moves outside of Europe.

Approximately half of Spanish government debt is held by domestic investors. In general, many banks engage in the carry trade where assets are held in longer maturity securities, but financed by shorter maturity liabilities. This typically generates a positive carry (the yield from the assets exceeds that of the liabilities). However, if confidence in government debt deteriorates or inflationary expectations become unhinged, mark-to-market losses will be generated in the domestic banks, further weakening their capital base.

A general decline in confidence for the government sector also leads to increased risk buffers demanded from other domestic borrowers. Further, the global web of financial dependencies can see these margins spread offshore if subsequent consolidated exposures are concerning.

As we witnessed in 2008, financial dislocations quickly spiral out of predictive ability when they take hold. Investors far removed from the source of loan origination can become embroiled. There are many primary mechanisms through which difficulties in the Spanish government sector or banking sector can spread into a pan-European concern. This potential for contagion is part of the reason why close attention is focused on Europe and the financially weaker countries in the Euro area.

The European Financial Stabilisation Fund (EFSF) and other facilities

In the wake of continued market dislocation following the bail out package to Greece, the European authorities and IMF announced additional measures on 9 May 2010. The headline figures suggested that a facility of Euro 750bn would be created that consists of a new EFSF (Euro 440bn), IMF loans (Euro 250bn) and access to an existing Balance of Payments facility (Euro 60bn) from resources of the EU budget.

Euro area finance ministers have established a limited liability company which will raise funds and provide loans of up to Euro 440 billion to euro area member states, subject to strict conditionality. Euro area members will back the EFSF's bond issuance to fund emergency loans on a pro-rata basis, with the respective share corresponding to the paid-up capital of the ECB. The members will issue guarantees when 90% of the shareholding has completed their relevant parliamentary procedures. The EFSF is backed only by the 16 members of the EU who have adopted the monetary union.

Proportion of Euro Area Capital Subscription to ECB

Country	%
Germany	27.1
France	20.4
Italy	17.9
Spain	11.9
Netherlands	5.7
Belgium	3.5
Greece	2.8
Austria	2.8
Portugal	2.5
Finland	1.8
Ireland	1.6
Slovakia	1.0
Slovenia	0.5
Luxembourg	0.3
Cyprus	0.2
Malta	0.1
Total	100.0

Sources: BlackRock, ECB (2009)

The credit of the EFSF will be enhanced further by the provision of an excess cash buffer and over-provisioning of guarantees from Euro area members.

The Balance of Payments facility is backed by all 27 EU member states, delivering funds conditional on progress in a number of policy areas, notably tough budget cuts.

The IMF component, we believe, will be supplied via stand-by arrangements which represent the bulk of Fund assistance. This was the case for Greece. Such loans are strictly conditional and closely monitored by IMF delegates.

Why has a stabilisation package of this size failed to quiet the markets? There may be a wide range of reasons, but some of them relate to the small print:

- As the states likely to be receiving assistance from the EFSF include some of the same ones listed as the guarantee providers, the headline figure of Euro 440 bn is not credible. It is not reasonable for Spain, as an example, to be making assurances for loans to itself!
- The IMF loan facilities are based off a quota system. The large headline figure will only come into play if big countries like Italy, France or Germany were to seek assistance. For the other countries, a smaller loan facility will be provided.

What happens next?

Spain is a country experiencing significant difficulties. A recently concluded Article IV review by the IMF outlined the challenges: a dysfunctional labour market, a deflating property bubble, a large fiscal deficit, heavy private sector and external indebtedness, and a banking sector with pockets of weakness.

The key governments of the Euro area, and wider European union, have taken strong measures to retain the current shape of the monetary union. Detailed historical accounts of monetary unions suggest that political will and unity are the key determinants of whether such unions survive.

However, the steps which have been taken have been deeply unpopular amongst the populace. In Germany, voters query why they should bail out their Greek neighbors whose work hours are easier and social security nets more comfortable. In Spain, workers rail against the severity of the austerity package and the passage of the package rested on a single vote.

The key challenge for the long term survival of the Euro area has been for it to become a fiscal union as well as a monetary union. Such moves would be severely resisted at present, but will need to be moved closer to resolution once this episode passes.

The prospect of a significant dislocation of the financial system in Spain and Europe more generally is very real. The conditions are present for a very poor outcome if the situation were to pass an unknown tipping point somewhere in the financial system. Such conditions can spring up from sources which, even in retrospect, can seem incredible.

In the immediate term, there is significant political will on the part of the elected public officials to bring the situation under control. However, whilst the greater likelihood is a negotiated outcome where some sovereign or private debt may ultimately be restructured, a full blown credit contagion emanating from the PIIGS countries cannot be dismissed as fanciful. History suggests that significant banking crises are usually followed by sovereign crises. Will history rhyme this time?

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