Economics

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Global Economics View

Spain: Prospects and Risks

- We consider the drivers of sovereign default risk for Spain.
- Sovereign debt restructuring is avoidable but would require more radical fiscal and structural measures, in our view.
- The initial conditions of the public finances look worse than expected and official growth forecasts appear too optimistic.
- The government, households, non-financial corporates and banks in Spain all look overleveraged.
- Losses are likely to mount for the fragile undercapitalised Spanish banking system as a result of falling property prices.
- The Spanish authorities may not have the resources to adequately recapitalise their banking system.
- The new government has been active in structural reform but has missed an opportunity to address fiscal austerity in its first 100 days in office.
- We think the decision by the new government to limit the degree of procyclicality in its fiscal policy was right in substance. The manner in which it was taken and announced was unlikely to have been popular in Brussels and Frankfurt.
- Spain looks likely to enter some form of a troika programme this year, as a condition for further ECB support for the Spanish sovereign and/or Spanish banks.

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Spain: Prospects and Risks

It is our view that the Spanish sovereign is not bound to restructure its debt, let alone default. But we believe that the risk of a Spanish sovereign debt restructuring is higher now than it has been since the crisis started.

We warn that, although the ECB has steeped the euro area banks and markets in a sea of liquidity through the two LTROs, the underlying problems of the Spanish sovereign, the Spanish banks and rest of the Spanish private sector have not yet been addressed, in our view. Banks and markets are liquidity junkies, and the ECB's action has triggered a brief flare of euphoria. This should buy time for the fundamental imbalances to be addressed, specifically the excessive debt and the required deleveraging of the Spanish sovereign, banks, non-financial corporates and households. Whether this multi-sector deleveraging can occur without debt restructuring, especially in the government and banking sectors remains to be seen.

1. The initial conditions for sovereign debt and deficits are significantly worse than we thought until recently. In a short span of time, the general government financial deficit forecast for GDP in 2011 was revised from 6.0% to 8.0% and the actual deficit figure for 2011 was revised from 8.0% to 8.5%. The euro area average (as of Q3, 2011) was 4.1%. The official data at the end of 2011 give general government gross debt as 67.8% of GDP. Edward Hugh (2012) argues the true figure (allowing for arrears, insolvent SOE debt, general government debt held by the social security funds, and a few other odds and ends) is likely to be close to 90% of GDP.[1] Although one can quibble with some of the specific amendments proposed by Hugh, it is likely that the official debt data represent a significant understatement of the true figure. The euro area average was 86.8% at the end of Q3, 2011.

   a) Some of the revisions have a ‘Greek flavour’ – resulting from the failure to implement agreed fiscal austerity measures rather than from a weakening of economic activity beyond the authorities’ control.

   b) The debt and deficit overshoots are not just for the usual suspects – autonomous regions (1.6% of GDP overshoot relative to the earlier deficit forecast), municipalities and social security funds (0.6% of GDP overshoot), but also for the central government (0.3% of GDP overshoot). Spain’s deficit targets for 2011 and 2012 of 6.0% of GDP and 4.4% of GDP, respectively, were based on growth assumptions of 1.3% for 2011 and 2.3% in 2012. The outcome for 2011 was real GDP growth of 0.7% and our forecast for 2012 is -2.7%.

2. The financial condition of the Spanish non-financial private sector appears among the most vulnerable in the euro area, with elevated financial debt for both households and non-financial corporates. The current account of the balance of payments still shows a deficit of just under 4% of GDP for 2011, despite import compression due to fiscal austerity and despite rather vigorous growth in exports. Admittedly, compared to Greece and Portugal, two other troubled EA countries, Spain’s current account deficit is not very large and Spain had a rather substantial reduction in its current account deficit from close to 10% of GDP in 2007/8 to below 4% in 2011. Ireland has transformed its current account deficit into a sizeable surplus over the same period. Spain’s net international investment position at the end of Q3 2011 stood at -€995bn, just under 100% of annual GDP. Here Spain is in the same league as Greece, Portugal and Ireland, but more deeply externally indebted than Italy.

[1] Edward Hugh (2012), http://www.economonitor.com/edwardhugh/2012/03/06/homeric-similes-and-spanish-debt/

3. The new Spanish government, which took office on 21 December 2011, delayed introducing its first budget until 29 March 2012, after the regional elections in Andalusia and Asturias (on 25 March), thus missing the opportunity to address fiscal austerity in the honeymoon period. It did use this period to pass several important pieces of structural reform legislation. Among these were labour market reforms aimed at reducing severance pay in the long-term contract sector (while introducing or raising it in the flexible contract sector); reforms aimed at reducing the scope and incidence of industry-wide collective bargaining and replacing it with something closer to firm-level or establishment-level contracting; the imposition of an additional €50bn provisioning requirement on the banks; and laws aimed at strengthening central government control over the finances of the lower-tier authorities (autonomous regions and municipalities). Thus, as regards passing the legislation required for important structural reforms, Spain may well have done more than Italy since the new Spanish government took over. Passing legislation and implementing it are not the same thing, however, as we know from the Greek experience. In addition, both structural reform and a medium-term programme of fiscal austerity based on a politically acceptable formula for fiscal burden sharing look necessary to restore Spain to fiscal sustainability. The new government's decision to wait 100 days to introduce its first budget, in the pursuit of electoral gain, did little to boost Spain's standing in global markets.

4. The new PM, Mariano Rajoy, alienated some key allies in Brussels and Frankfurt when, a day after signing the Fiscal Compact, he announced that the Spanish government had decided to revise the target deficit for 2012 from 4.4% of GDP to 5.8%. Although this was, in our view, the right decision in substance (because it avoided even more intensely pro-cyclical fiscal policy), the manner in which it was taken and announced ("I did not consult other European leaders and I will inform the Commission in April…This is a sovereign decision by Spain.")[2] was unlikely to have been popular with the ECB, the European Commission and the other heads of state and government in the Eurogroup. The compromise 5.3% of GDP deficit target for 2012 and the unchanged 3.0% target for 2013 seem unlikely to be realised in our analysis.

5. The economy looks likely to decline by significantly more than foreseen in the official projections. The interim forecast of the EC in February 2012 foresaw a decline in real GDP of about 1% during 2012 (down from 0.7% growth in 2011) and a HICP inflation rate of 1.3% (down from around 3.0 in 2011). The Spanish authorities forecast a 1.7% decline for real GDP in 2012, while our own forecast is for a decline of around 2.7% in real GDP for 2012 and of 1.2% in 2013.

6. The decline in Spanish land and property prices appears far from complete (probably less than half complete).[3] The General IMIE Index, an indicator created by Tinsa, increased its year-on-year decline in February, and fell by 9.5% – returning to the levels of 2004. The cumulative decline in the General IMIE Index from the top of the market in December 2007 was 27.1%.[4] In addition to the hidden legacy losses carried by the Spanish banks, new property- and real estate-related losses are likely to come their way as a result of further property price declines. The Spanish banks are unlikely to be able to absorb these losses. If these institutions are deemed too important to fail, these losses could migrate to the public sector, which could have severe problems carrying them.

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[2] See http://articles.businessinsider.com/2012-03-02/markets/31115657_1_eu-summit-madrid-higher-deficit

[3] Based on the 50% decline thus far in Irish real estate prices; a number we expect to increase to a peak-to-trough decline of around 60%

[4] http://prices.kyero.com/2012/03/13/spanish-house-prices-return-to-2004-levels/

7. The ability of the Spanish government to control the public finances of the larger autonomous regions, especially Andalusia and Catalonia, remains in doubt despite the new legislation that was passed. The failure of the Partido Popular to win the 25 March election in Andalusia strengthens these doubts.

8. With a 23.3% unemployment rate in March 2012 and a more than 50% youth unemployment rate, we think Spain requires far-reaching and unprecedented reforms of its labour market, service sector and professions, as well as the privatisation of state-owned industries, to restore growth and prosperity.

9. Spain is likely, in our view, to be pushed into a troika (EC, ECB, IMF) programme of some kind during 2012, possibly by losing access to market funding on affordable terms, but more likely by the ECB making a programme for the Spanish sovereign a condition for continued willingness to fund the Spanish banks, which are currently the main buyers of newly issued Spanish sovereign debt. The existing and likely near future EFSF/ESM and IMF financial facilities are unlikely to be sufficient to both fund the Spanish sovereign fully and leave enough financial ammunition in reserve to deal with possible sovereign financial emergencies in Italy or in the ‘soft-core’ of the euro area. The Spanish sovereign would therefore likely continue to fund itself at least partly in the markets even if it comes under a programme. To ensure market access by the Spanish sovereign, the same combination of cheap ECB funding for periphery banks and financial repression of periphery banks by their national authorities that has been effective in lowering sovereign yields since the first LTRO is likely to be required.

Appendix A-1

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