By Yves Zlotowski - writing completed 18 June 2012

Will saving Spanish banks save Spain?

Spain is no Greece: The crisis gripping the monetary union's fourth largest economy is the consequence of private rather than public indebtedness. Austerity can thus not be the solution since it further depresses domestic demand currently squeezed by the process of paying down corporate and private debt. This crisis is closely connected to the bursting of the speculative property bubble. But, as reflected in Coface payment-incident tracking records, construction has not been the only sector affected by insolvency with payment defaults up sharply in agro-food, electrical equipment, distribution, and textiles. The core problem is centred on the banks, heirs to the very heavy private sector debt. All eyes are thus focused on the ultimate — doubtless high — cost of the bank reform with the creation of a *bad bank* and the restructuring of private sector debt constituting the two pivotal steps. Such radical approach augurs well for a modicum of growth albeit likely to be far below the levels reached during the heady days of the *Movida*. This alone will make it possible to halt the dangerous deflationary spiral now gripping Spain.

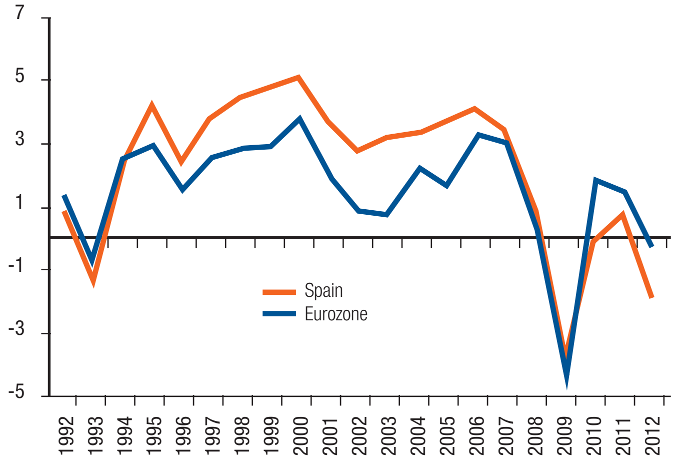
After the Greek crisis, the rapid deterioration of the Spanish economy has become the new challenge the monetary Union has to meet. But Spain is no Greece: the country collects taxes reasonably well and successive national governments have achieved respectable performance in conducting economic policy and reducing public debt. But the management of local government finances has nonetheless deteriorated: they have seen their debt double in size since 2007 and in 2012 they represent half of the public deficit and their debt an estimated 20% of public sector debt. Bear in mind, however, that the gross nation debt will level off at 79% of GDP in 2012 and remain 11 points of GDP below the eurozone average.

It is nonetheless entirely clear that the solvency of the Spanish government has been deteriorating with the spreads on the country's sovereign bonds moreover reaching alarming levels at mid-June. But excessively drastic austerity in terms of the impact on severely weakened domestic demand will not resolve the Spanish crisis. The public sector has inherited two closely tied burdens: the deterioration of the quality of banks assets and the overindebtedness of private actors with companies and households — and, by ricochet, banks — manifestly bogged down by excessive debt. The Spanish disease is serious but it is not fatal. The point being made here is that Spain's real economy could break out of the recession (even if hoping for a return to the levels of activity achieved during the Movida boom years would certainly be unrealistic) provided the measures taken to transform the banking system meet two requirements: radicalness and speed. Spain and more precisely its banks will have to get out from under the private debt burden that has been sinking this major actor in the euro zone into a disastrous deflationary spiral.

The Spanish economic *double dip*

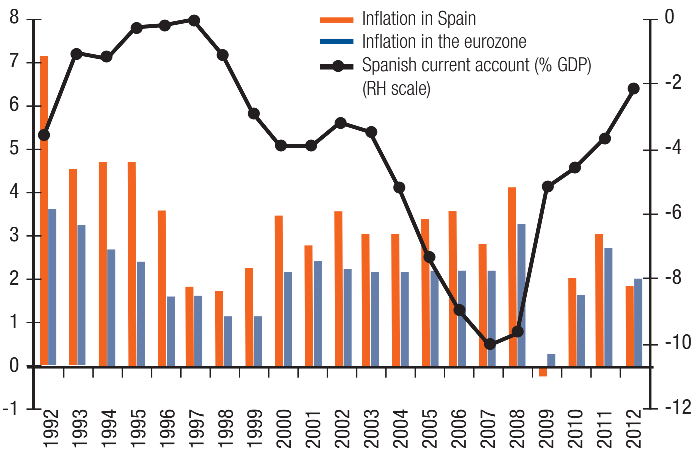
From 2007 through 2012, Spain's GDP is expected to shrink 5% in volume terms. The economy underwent an initial contraction between the third quarter 2008 and the fourth quarter 2009. The country then slipped into recession again with GDP declining in the fourth quarter 2011 and the first quarter this year. Subsequent events may reveal that Spain has yet to hit bottom. But if the country's economic adjustment has proven so painful, it is because it is the result of a speculative property bubble and the paydown of private sector debt. According to a recent IMF study the conjunction of those two trends is particularly costly in terms of growth, much more so than any other kind of financial crisis (balance of payments, banking). A posteriori, the dynamism of the 1990s was a characteristic overheating pattern marked by inflation higher than the euro zone average for the period and a spectacular deterioration of the current account. From 1991 through 2007, Spain thus posted average growth of 3.2% compared to 2.1% for the entire eurozone. But inflation during that same period was 3.5% against 2.2% for the monetary union. The current account, meanwhile, after being virtually in balance in 1997, showed a deficit representing 10% of GDP 10 years later.

GDP growth
(%)



Source : IMF

(1) International Monetary Fund (2012), Dealing with household debt, Chapter 3, pp 89-124, World Economic Outlook, Growth Resuming, Dangers Remain, April

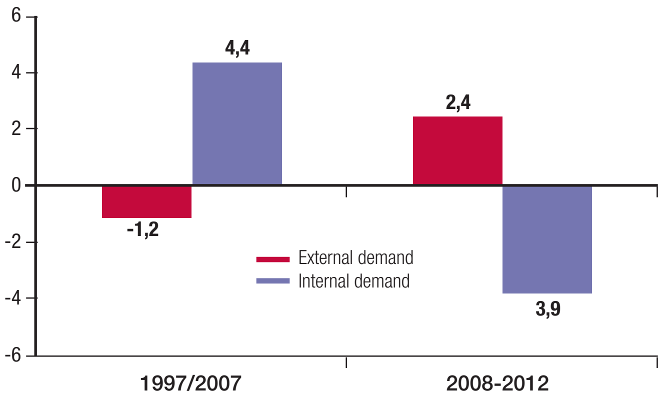


Source : IMF

A current account deficit representing 10% of GDP is a level that emerging countries rarely have the opportunity to reach. An exchange rate crisis generally occurs at a much earlier stage. The euro zone had been operating as though there was no external constraint. But the consequent postponement of necessary adjustments had the inevitable perverse effect of transforming the ultimate «moment of correction» into an excessively painful shock. And this is especially true since it cannot be accomplished via a sharp external devaluation. The current contraction of investment and consumption (the *internal devaluation*) has been responsible for Spain's brutal *double dip* recession. This leads nonetheless to a correction of Spain's external imbalances via both the reduction of demand and the beginning of a correction of competitiveness (the *internal devaluation*).

Since 2008, Spain's growth engines have thus made a complete switch around. During the speculative bubble years, foreign trade put drastic downward pressure on economic growth, making a negative annual contribution to GDP of 1.2 points on average over a ten year period while consumption and investment contributed a solid 4.4 points. Since 2009, foreign trade has made a large positive contribution to GDP, attributable to both the decline in imports and the growth of exports. But Spain cannot reasonably count on exports to drive growth considering the economy's shortcomings in terms of specialisation (see boxed text *Spanish exports: A pleasant surprise in the short-term, vulnerability in the medium-term*).

Average contribution to GDP growth
(% points of GDP)



Source : Economist Intelligence Unit

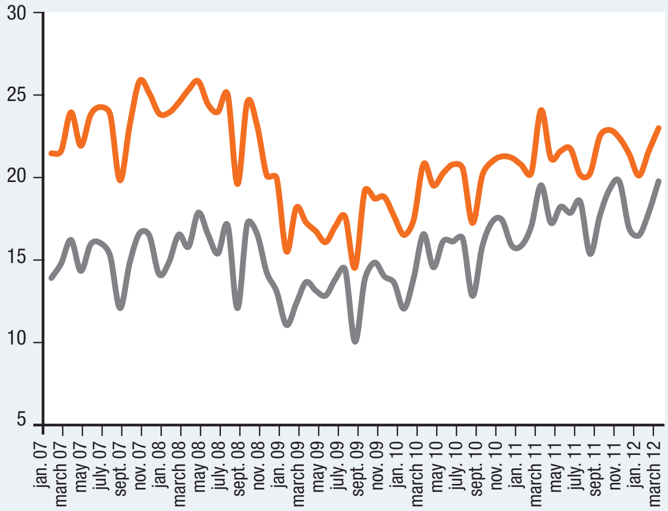
Spanish exports
A pleasant surprise in the short-term, vulnerability in the medium term

By Thomas Gillet,
Country Risk & Economic Research Department, Coface

In value terms in 2011 Spain's exports grew 15.4% and its imports 9.6%, making it possible to reduce the current account deficit by nearly half (from 3.9% to 2% of GDP in 2012). Exports surpassed their pre-crisis level and the trend initiated last year seems to be continuing in 2012. In the first quarter, exports were up 3.2% in value compared to the same period last year while imports were down 0.6%. But does this export dynamism demonstrated by Spain rest on solid foundations?

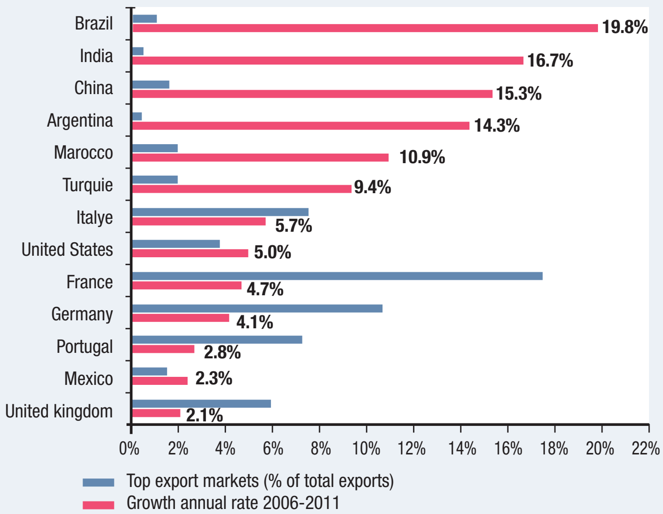
Spain has benefited from diversification of its exports to new emerging economies and from its specialisation in production segments where global demand has been booming: iron steel, machinery, and transport equipment. While its share of exports

Spanish exports to historic levels
(Million EUR)



Source : Bank of Spain, Ministry of the Economy & Competitiveness, and Datastream to the eurozone declined from 62% in 2005 to 52% early this year, sales to the Middle East (2.6% of total exports), Asia (5.4%), Latin America (5.7%), and Africa (6.1%) have increased [(1)]. In the first quarter of the year, exports to Italy and Portugal declined sharply (down 8.4% and 7.9% respectively) while sales to China, Mexico, and Morocco increased by 10.4%, 12.3% and 22.4%.

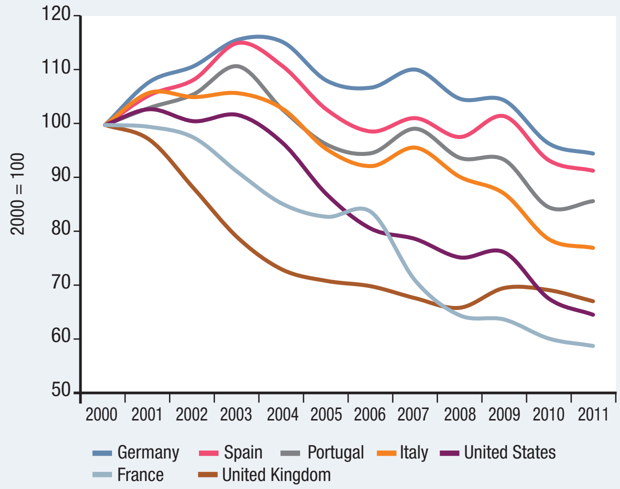
Diversification of Spanish exports



Source : Bank of Spain, Ministry of the Economy & Competitiveness, and Datastream

The competitiveness of export companies has improved (Juan *Carlos Martínez Lázaro, 2012*). Spain is currently benefiting from a negative inflation differential with the eurozone. Although the real effective exchange rate (REER) [(2)] appreciated 29% for Spain between 2000 and 2008, compared to 21% for Italy for the period, its 10% decline since 2008 with the REER for Italy remaining stable (*European Commission, 2012*) reflects an improvement in price competitiveness thanks especially to wage moderation: the unit labour cost comes to 20.6 euros in Spain against 26.7 euros in Italy and 27.6 euros four the eurozone (*Eurostat, 2012*). Two-thirds of Spain's sales abroad are moreover made by 1% of local companies, mainly large industrial groups benefiting from privileged access to sophisticated production technologies and unit labour costs below the national average. The loss of export market share has thus been smaller for Spain than it has been for the main developed countries except for Germany: While market share for Spain eased from 1.7% in 2000 to 1.6% in 2011, the shares of France and Italy fell respectively from 3.7% to 2.7% and from 5% to 3.3% for the period (*WTO, 2012*).

Spain's world market share decline has been less pronounced than in the case of other advanced countries
(% of world market shares)

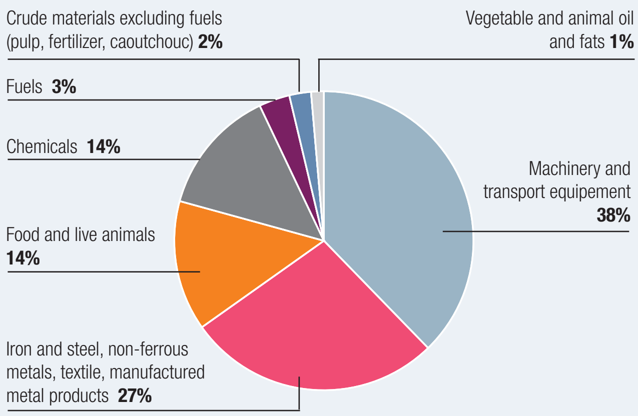


Source : WTO 2012

But several factors suggest that Spain's exports cannot be a solid growth driver.

- **Exports mainly involve low value-added products.** Relatively low-tech manufactured articles represent over 20% of Spain's exports compared to 13.5% for Germany (European Commission, 2012). Conversely, technology intensive products represent about 5% of total exports compared to 20% for Germany.

Sector breakdown of Spanish exports
(% of total exports)



Source : UNCTAD, 2010

(1) In 2006 exports to the Middle East, Asia, Latin America, and Africa represented respectively 2%, 3.7%, 4.9%, and 4.1% of Spain's total sales abroad.

(2) The real effective exchange rate (REER) is an indicator of competitiveness that takes into account not only a country's exchange rate but also the trend in the ratio of prices for its exports with those of its various trading partners. A rise in the REER reflects deterioration of price-competitiveness.

- **The import-content of exports constrains the trade balance.** The import-content of exports has increase, rising from 27.6% in 1995 to 39% in 2007. And it is higher for Spain than it is in other eurozone countries like Germany (31.6%), France (29.5%), and Italy (29.1%) (*A. Cabrero and M. Tiana, 2012*). That is mainly attributable to the economy's limited vertical integration, the lack of competitiveness of Spanish producers, and the high proportion of small companies among exporters.

- **The products exported are energy intensive.** While the contribution of intermediate and capital goods to the trade deficit has declined since 2009, it has increased for energy goods (*European Commission 2012*). Despite the recent steadiness of the oil market, the continuing high price of oil and Spain's dependence on hydrocarbon imports – 14% of total imports (*UNCTAD, 2010*) has delayed the adjustment of the trade balance.

- **Productivity improvement is constrained by the size of Spanish companies:** over 90% are micro companies characterised by low average productivity. If industry in Spain was structured as it is in Germany, its productivity would increase by 30% *(McKinsey & Company — FEDEA, 2010)* and its exports by 25% *(Altomonte et al. 2011)*.

Thanks to a highly skilled labour pool, Spain nonetheless enjoys high growth potential in high-technology intensive sectors like renewable energy, pharmaceuticals *(ILO, 2011)*, and business-to-business services *(McKinsey & Company — FEDEA, 2010)*. And the increase in the import content of exports has strengthened the Spanish economy's integration into the global value-added chain. Spain now benefits from privileged access to a broad range of inputs and could specialise in the future in various high value-added production segments, source of future competitiveness gains.

International Labour Office, 2011, *Spain: Quality jobs for a new economy*, Study on growth with equity

A. Cabrero and M. Tiana, febrero 2012, *El contenido importador de las ramas de actividad en España*, Bank of Spain, Boletín Económico, pp. 45-57

European Commission, May 2012, *Commission staff working document in-Depth Review for Spain*

Juan Carlos Martínez Lázaro, May 2012, Economics Professor IE Business School, *Crisis de la deuda soberana*, Contribution to the Coface Country Risk Conference in Barcelona, 23 May 2012

McKinsey & Company – FEDEA, 2010, *A Growth Agenda for Spain*

Ministerio de economia y competitividad, Marzo 2012, *Informe mensual de comercio exterior*

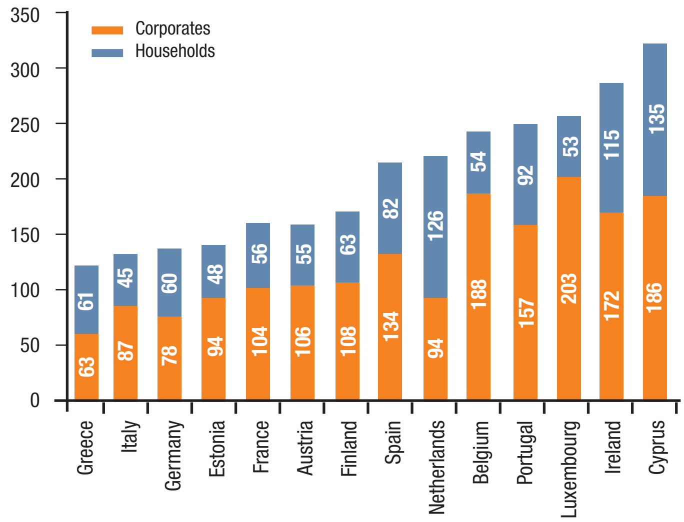
A debt-ridden private sector… and not just in property

What can be hoped for today from household consumption and corporate investment in the short and medium term? For the full current year GDP is expected to contract 2% with the contractions in consumption and investment exceeding respectively 1% and 8%. Real estate has been hit hardest by the recession with prices falling 30% from their peak level of December 2007 through April 2012, and investment in construction contracting 2% in twelve months through March. This albeit necessary shrinking of the sector weighs heavily in the balance: in 2007, it represented 16% of GDP and 12% of total employment.

The downsizing process tends to choke off any spending capacity, especially with incomes also contracting. The stock of private debt in Spain is one of the highest among eurozone economies. According to data made available by the ECB, the only countries worse off on this score include Cyprus, Ireland, Belgium, Portugal, and the Netherlands. In Spain, between 1999 and 2011, private debt more than doubled in size in proportion the GDP.

The diagnosis of private sector indebtedness calls for some comments. The household debt component has been very high (82% of GDP in 2011), well above its level in comparable large euro zone countries: France (56%) and Italy (45%). The mortgage loan burden represents 80% of total private debt. The household borrowing spree is thus closely associated with the

Private debt
(% of GDP 2011)

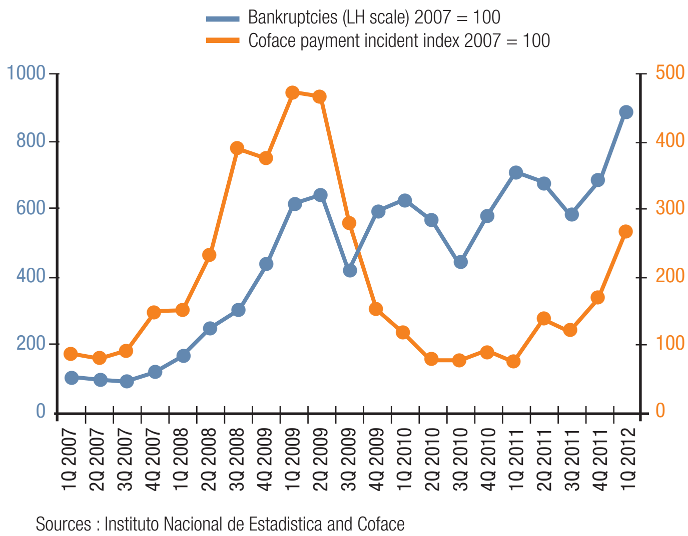


Source : European Central Bank

speculative property bubble. According to an IMF analysis [2] focused specifically on private over-indebtedness in Spain, the proportion of households holding mortgage loans is no higher there than in France or Germany. But the Spanish mortgages include a higher proportion of low-income and young households. Meanwhile, the labour market has particularly suffered in Spain and the outlook is very gloomy: unemployment has been trending sharply up from a low of 8.2% in 2007 with the IMF expecting joblessness to reach 24.2% this year, 24% in 2013, and 23% in 2014. The resulting devastated state of the labour market will of course affect household debt-repayment capacity.

Corporate indebtedness is comparably severe with the cumulative debt of Spanish companies reaching 134% of GDP in 2011, a level of financial distress exceeded in the eurozone only by Ireland, Cyprus, Portugal, Belgium, and Luxembourg. The IMF has shown that the growth of corporate indebtedness in Spain was closely allied with the construction boom. Construction and property alone thus account for 50% of the boom in credit extended to companies in the years of strong economic growth. But other economic sectors are also ridden with debt. The IMF has pointed out that outside property and construction, the debt burden of Spanish companies was, in 2010, substantially higher than the European average. In consequence, even with the downsizing underway in property, the overindebtedness question will not be resolved.

Coface payment history records show that Spanish companies have been in a particularly difficult situation in Europe. They not only have to cope with the severe deterioration of their domestic environment (economic contraction, banking crisis, fiscal austerity), but their capacity to withstand external shocks has also been severely undermined as a result their overextended debt positions. Whether based on Coface payment incident tracking records or official statistics on bankruptcies, the conclusion is inescapable: the rate of deterioration has been very steep.



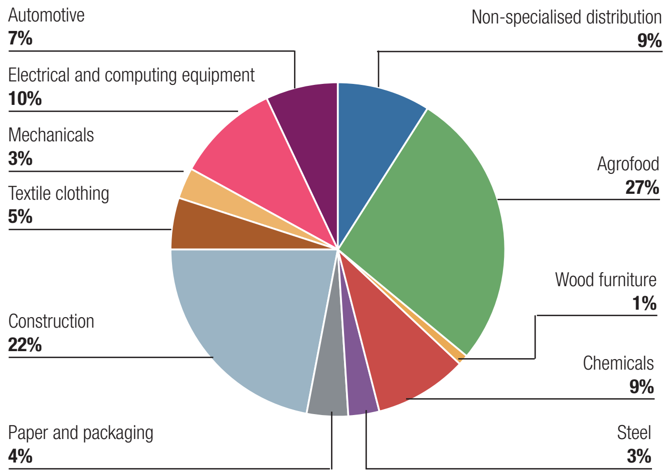
Sources : Instituto Nacional de Estadistica and Coface

(2) International Monetary Fund (2012), Spain: Vulnerabilities of Private Sector Balance Sheets and Risks to the Financial Sector, Technical Notes, IMF Country Report n°12/140, June.

The two curves trace the Spanish economy's double dip pattern: an initial peak from early 2008 to mid-2009 then an upturn by 2009 for bankruptcies, and from the 2011 second quarter for payment incidents as reflected in Coface tracking records: At the peak of the crisis — in the 2009 first quarter —Coface recorded a five-fold increase (in value terms) in payment defaults compared to early 2007. Similarly, in the first quarter this year, payment incidents were almost three times (in value terms) the level recorded in 2007.

While smaller companies suffered most in the first phase of the crisis, larger companies have been in difficulty since. A high proportion of the payment defaults recently recorded has moreover been concentrated in construction (some 22%) other sectors have also been greatly affected including agrofood (27% of total payment incidents), electrical equipment (10%),chemicals (9%), and unspecialised retail (9%). Corporate solvency is thus a problem whose scope is not limited to the construction sector alone.

Sector breakdown of the payment incidents recorded by Coface involving Spanish companies
(June 2010-Aprill 2012)



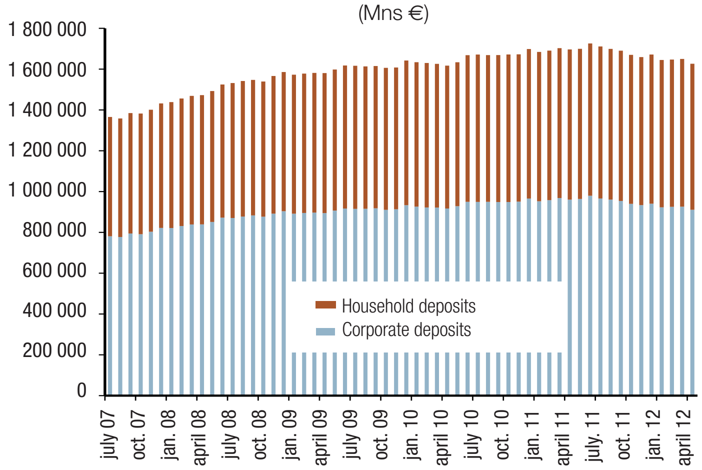
The banking sector — epicentre of the crisis in Spain

Corporate and household debt has become a major problem for the banks, which are the receptacle for the overindebtedness of economic agents whose insolvency is ultimately reflected in the assets of credit institutions. Bank weaknesses often work in the same way: internal indebtedness is not under control. The politicization of bank management — responding favourably to the appetite for spending of local authorities — has been patently obvious in Spanish savings institutions. The complicity between banking decision-making bodies and the political power structure has thwarted the practice of sound counterparty risk management in extending credit. Whether it be preferential treatment based on family ties (as was commonplace in Asia in the 1990s), loans to stakeholders (notably shareholders), or subsidies granted to *friendly* companies or sectors deemed important to the region's development: all such practices skew the governance of credit distribution. The quality of bank assets can then deteriorate sharply when the economic cycle goes into a downturn. Many countries, both emerging and advanced, have had to deal with bank crises. We can draw on their experience in analysing the very urgent Spanish bank reform from three angles: its pace, cost, and content.

The pace of reform: A crucial factor in maintaining depositor confidence

That derives from the fundamental role of banks, private entities but which are also guardians of a shared resource: deposit money, or the funds entrusted to them by depositors. A loss of depositor confidence has a devastating effect on the entire financial system and economy. For that reason a banking *disease* must be treated with all due speed and decisiveness. At this juncture in Spain and based on available data (which do not take into account the impact of the latest reports on Bankia), it cannot be readily concluded that, unlike the case of Greece, resident-depositors have indeed lost confidence. The 6% decline (in value terms) in deposits observed in the past year can be attributed not only to a loss of confidence in the banking system but also to a deleveraging process with economic agents drawing down on savings to repay their debt. The banking reform in Spain has been marked by a gradual rise in the losses announced by the banking supervisor. The president of the European central bank Mario Draghi moreover commented early June 2012 in response to journalists that quite often "the reaction of the prudential supervisor is to underestimate losses and to increase the frequency of successive estimations", adding "that is the worst way to proceed since the action ultimately taken comes at a prohibitive cost [3]. This approach entails risks associated with the threshold effects that generally follow variations in depositor confidence. The impact of an announcement of external aid provided by European institutions (solely?) to banks and in a large amount could ease depositor skittishness.

Banking deposits in Spain
(Mns €)



Sources : Bloomberg - *http://www.bloomberg.com/quote/TODEREES:IND/chart*

The content of the reforms is a central question

According to Laeven and Valencia [4], earlier crises (from 1970 to 2006), including both advanced and emerging countries, have cost on average 16% of GDP and more recent crises (2007-2009) 24% of GDP. Analysis of large emerging crises (prior to the post-Lehman period) shows that the costs incurred in some large countries can reach as high as 50% of GDP. The Indonesian and Thai crises in 1997 (respectively 57% and 44% of GDP) and the Turkish crisis in 2000 (32% of GDP) [5] weighed very heavily on public sector finances. Estimations for Spain have varied widely depending on the source. It is very difficult at this juncture to estimate the Spanish banking sector's recapitalisation needs: Bank loans to the private sector represented 160% of GDP in April 2012 (including 62% of GDP for mortgage loans alone!) according to data published by the Bank of Spain.
A comparison with Asian bank crises in the 1990s affords two interesting insights.

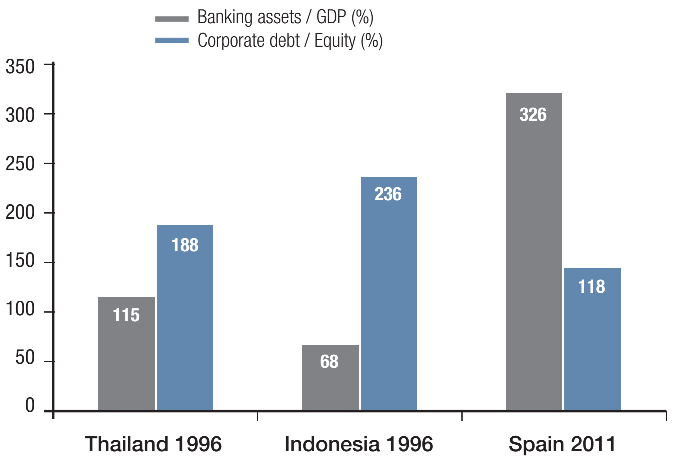
In terms of debt leveraging by companies, Spain's indebtedness seems relatively less excessive than that of Thailand or Indonesia with the debt of companies in relation to their equity capital representing 188% of GDP in Thailand and 236% in Indonesia in 1996 compared to 118% in Spain [6]. But the size of its banking system in relation to the economy is much greater than it is for either Asian country: the total assets of Spanish banks represent 320% of GDP compared to 115% for Thailand and 68% for Indonesia. As a result, cumulative losses could be much higher in relation to GDP. These quantitative elements (to be exploited with caution considering the questionable reliability of Asian statistics in the 1990s) suggest that the overall bill for the Spanish banking crisis will be at the high end of the possible range based on past experience.

(3) *Spain Acted in 'worst possible way' on Bankia Bailout, ECB's Draghi says, El Pais*, Madrid, 1 June 2012

(4) Laeven L and Valencia F. (2011), Resolution of Banking Crises: The Good, the Bad and the Ugly, IMF Working Paper, 35p

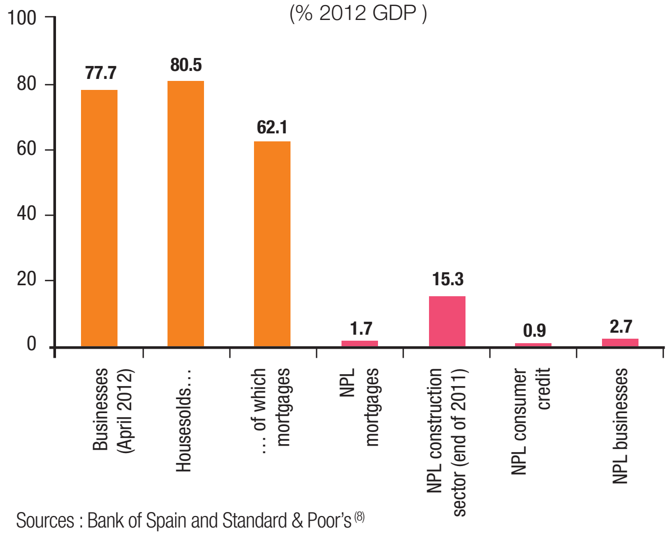
(5) Consult at *http://www.luclaeven.com* — the site of the economist Luc Laeven, assistant manager of the IMF's research department — two databases containing a wealth of information on bank crises. One describes the crises that occurred between 1970 and 2012 providing for each of the 123 crises catalogued, the cost, the peak rate of non-performing loans, and the loss of GDP growth associated with the crisis. Each crisis is accompanied by comments describing its main characteristics.

(6) The figures for Asian economies are drawn from a work of reference on emerging financial crises in the 1990s: Sgard J. (2002), The economy of panic, confronting financial crises *L'économie de la panique, faire face aux crises financières, Éditions la Découverte*, page 34. For data on Spain consult the International Monetary Fund (2012), Spain: Financial Stability Assessment, IMF Country report n° 12/137, June.



Of course, not all loans included in the assets of the banks are of doubtful quality. But non-performing loans in the property sector nonetheless represented end 2011, according to Standard & Poor's, over 15% of GDP. However, the question of the valuation of property assets held by the banks has not been resolved since a high proportion has not been put on the market, which means that their value is not really known at this stage. The proportion of mortgage loans considered non-performing moreover represents, based once again on S&P estimations, under 2% of GDP while non-performing consumer loans represent under 1% of GDP. These data tend to tone down the extent of the difficulties associated with the deterioration of economic conditions and the fact that some restructured loans have not been booked as non-performing [7].

Credits et non-performing loans
(% 2012 GDP)



Sources : Bank of Spain and Standard & Poor's [8]

The content of bank reform constitutes the decisive element in determining its ultimate effectiveness. Spanish authorities have given priority to the merger of banking entities (Bankia is thus the result of the merger of seven cajas), the tightening of loan provisioning rules, and the segregation of non-performing loans off balance sheet, but on a case by case basis. It is urgent, however, to determine the extent of the losses. And it seems essential in a phase associated with the necessary recapitalisation to transfer problem assets to a *bad bank*. Removing non-performing loans from bank balance sheets makes it possible to buoy depositor confidence. Avoiding the *socialisation* of losses naturally constitutes a key objective. A *bad bank* structure ultimately recovers some — but only some — of the value of its assets. It amounts de facto to reducing the stock of private debt.

Alternative courses of action seem more risky. Pursuing a slow adjustment — the Japanese approach — entails major deflationary risks in the long term: maintaining high private debt weighs, in an unbearable manner, on growth in the context of an economy where the population has already suffered greatly. Keeping the loans in the banks via more or less transparent methods of refinancing (as is currently done by Chinese authorities in managing the debt of local communities) is not a viable solution since it maintains systemic crisis risk at high levels. The current context of depositor skittishness simply excludes letting banks continue to bear the full burden of private debt.

European aid — confirmed the weekend of 10 June 2012 — intended to bail out Spain's banking sector, is clearly welcome and it may be supplemented. But we can well understand the reticence of the Spanish administration regarding conditionality intended to focus on public finances: That would probably be the wrong target. The core of Spain's problem is located in the private sector rather than the public sector. It is true that Spain will hardly be able to avoid the institution of stricter controls on spending at the regional level. But such politically delicate reform can only be instituted over the long haul. In the short term, excessively strict austerity would only weaken already shaky domestic demand. The urgency is located elsewhere. The setting up of a *bad bank* structure to segregate non-performing loans accumulated by the banks is inevitable and amounts de facto to restructuring and writing off some of the private debt.
As radical as it may be, that solution has the merit of allowing hope for some growth. Restructuring public debt (as in the case of Greece) or private debt (as can be hoped for in Spain's case) makes it possible to ease the debt repayment constraint and break the disastrous spiral of demand contraction and economic deflation. Dealing with the stock of debt is not a solution that makes it possible to avoid the formation of new speculative bubbles.

This solution would entail a *socialisation* of the losses with the cost borne by the entire European community. That would make it possible to wipe the slate clean. At this juncture Spain desperately needs growth. A radical solution for the banking system — a *bad bank* with a restructuring of private debt — will not bring back the unbridled growth of the 1990s. But it would at least make it possible to halt the downward spiral currently gripping the monetary union's fourth largest economy.

(7) See in particular the analyses of Delphine Cavalier, the latest being Cavalier D. (2012), Espagne : l'Etat accroît son soutien aux banques, ECO Week, BNP Paribas, 11 May, 12-19. According the previously cited IMF report on private debt some banks have implemented programmes to facilitate mortgage loan repayment and use various refinancing techniques that enable them to avoid classifying the refinanced loans as non-performing.

(8) Standard & Poor's (2012), The Timing of recognition Of Mounting Loan Losses Could Push Spanish Banks Over the Edge, Global Credit Portal, RatingsDirect, June 7.