Macro Comment 12/37

Tim Legierse

Bad news from Spain, default still unlikely

A lot of bad news has emanated from Spain over the past couple of weeks. This is likely to keep the pressure on the Spanish government bond market. But we still maintain the view that a sovereign default in Spain is unlikely.

We have seen nothing but bad news coming from Spain over the past few weeks. The economy is back in recession with unemployment continuing to rise from already elevated levels. The government budget deficit for 2011 was revised up due to previously unreported unpaid bills by regional governments. As a result, the budget overshoot from a target of 6%-GDP to 8.5% now stands at 8.9%. Catalonia (the biggest region by GDP) meanwhile has asked the central government for financial assistance. Bankia, a bank that was formed by the merger of 7 regional savings banks in 2010 will need an additional EUR 19bn in capital from the government on top of the EUR 4.5bn already received in state aid. Some relative calm in the government bond market in the first months of this year, facilitated by ECB's 3-year Longer Term Refinancing Operations (LTROs), has been replaced by renewed tensions resulting in upward pressure on yields. Interest rates have remained above 6% for 10-year paper since May 9 (figure 1). The yield on 2-year bonds rose even faster than 10-year yields.

To us, there are two important questions that arise. First, does the news change our view that Spain should be able to restore order to its public finances, by which we mean stabilize its government debt ratio at a sustainable level? Second, can it do so without official assistance? Our answers would be yes and no.

The economy

As for the recession, the 0.3% q-o-q contractions seen in 11Q4 and 12Q1 were rather modest. And although the recession will likely deepen in the current quarter, the economic outcome for 2012 is unlikely to be worse than the 1.7% contraction currently anticipated by the government. On the other hand, the government's average unemployment forecast of 24.3% for 2012 seems too optimistic given that it already reached 24.1% in March of this year. In all though, macro-economic developments up until now are not such that they will completely undermine the government's budget adjustment effort for the year. Do note that we have never assumed that the 5.3% of GDP budget deficit target for this year or the 3% for next year will actually be met.

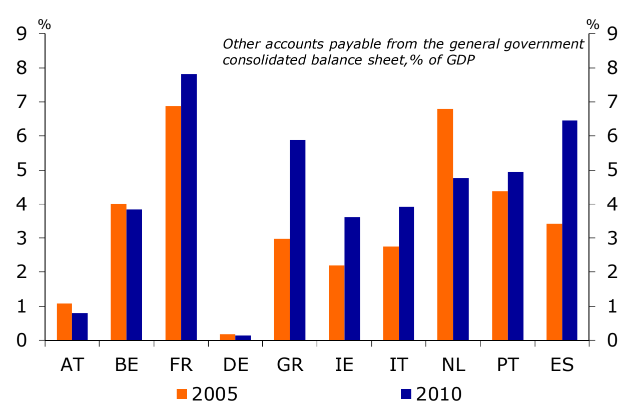
The regions

The upward deficit adjustment for 2011, and specifically the fact that the regions were responsible for it, is worrying. Getting a firmer grip on regional finances should be a main objective for the Rajoy administration.

Figure 1: Government bond yields rising

Source: Reuters EcoWin

Figure 2: Unpaid bills in perspective



Source: Reuters EcoWin, Rabobank

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Catalonia's request for financial assistance underlines the financial troubles in the regions. The regional deficits and debt figures are included in the general government accounts. As such, Catalonia's problems do not point to unreported debt and deficits but rather to the issues that the regional governments face in (re)financing themselves. A positive aspect of the regions asking for assistance from the central government is that it may enable the central government to exert much more influence in their finances. Apart from that, to us the fact that in most regions new governments were formed only a year ago is reason to believe that budgetary discipline will improve this year relative to last year. Clearly, tough choices will have been postponed prior to the elections. The central government has set up new rules to be able to approve the regional budgets. Besides, the Partido Popular, which boasts an absolute majority in the national parliament, also governs in most of the regions. That party alignment should help in pushing the regions towards fiscal responsibility. Of course, the proof of the pudding will be in the eating. As such, we will have to see whether the regions will stick to the agreed budget targets this year and, in case of failure, whether the new fiscal rules will be effective in allowing the central government to take corrective action.

The unpaid bills

Apart from pushing up last year's deficit, the trouble with unpaid bills of the regional and central governments is that they are largely not counted in the most reported measure of general government gross debt. Over the past few years, the category "other accounts payable" of the government balance sheet has increased from an average 3.6% of GDP in the period 1996-2005 to 6.5% of GDP in 2010. Having a sizeable amount of these unpaid bills in total government liabilities is by no means exclusive to Spain (figure 2). But the central government last year set up a financial facility to enable the regions to pay down their bills. This is of course good news for the suppliers and with that the wider economy. But it will push up reported gross government debt even if total government liabilities do not increase.

The banks

What *will* push up both gross government debt and total public liabilities is the cost of recapitalising the ailing banking sector. The government has already injected EUR 14.8bn into its banks through the Fund for Orderly Bank Restructuring (or FROB from the Spanish name Fondo de Reestructuración Ordena Bancaria). Last week it was announced that Bankia needs an additional EUR 19bn in capital from the government. Even though it has been widely anticipated for some time that more government funds would be needed to help the banks cope with the loan losses arising from the real estate bust, it still contributes to the already heightened market nervousness due to the 2011 budget overshoot, the renewed recession and more general risk aversion arising from the political uncertainty in Greece. The government that was elected in November of last year has taken some important steps to increase transparency concerning the financial situation of the banks, by forcing them to increase provisions for non-performing real estate loans and also to some extent for loans that may be non–performing in the future. It has, however, maintained the position that no public funds would be needed for the banks to cope with these provisions. Bankia now shows that this was an unrealistic expectation. It has been reported that, in an attempt to by-pass both the financial markets and the European rescue fund, the government plans to buy Bankia shares in exchange for government bonds. As such, they are not providing money to the bank now, but will still have to do so in the future. Bankia can pledge the government bonds at the ECB to obtain much needed liquidity. This strategy is similar to the one employed by the Irish government when they supported Anglo Irish Bank through the issuance of promissory notes. As in the Irish case, this strategy will push up gross government debt. But there will be no need to raise the money in the markets right now.

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In our view, this is very much a new attempt to push the real resolution of the problems into the future Even though the government now tries to explain that Bankia is a special case, we expect more funds to be needed. Two international consultants are currently going through the books of all the Spanish banks. If that exercise leads to the conclusion that more public funds are needed, stress in the government bond market will increase. But fully cleaning up and recapitalising the banking sector is a necessary condition to both enable the banks to support the economy and to make clear the 'total costs' of the banking sector bailout for the government. This will effectively end the vicious sovereign-bank feedback loop. We believe that the reputational damage and the continued market uncertainty resulting from continued attempts to push the resolution of the banks into the future will eventually be worse than coming clean about the costs of supporting the banks. Private sector estimates of total capital needs range from EUR 50bn to over EUR 100bn. If the government was forced to provide a total of up to €100bn to the banks, that is surely a large amount, but it would be less than 10% of GDP. As such, total general government debt would be pushed up from an anticipated 80% of GDP in 2012 to 90%. Since the budget is still in deficit, debt will keep increasing for the coming years. As a result, in an adverse scenario the general government debt ratio will rise towards 100% before it can be stabilized. That is substantial, but with a realistic macro-economic adjustment programme that includes budgetary and economic structural reforms, it should be sustainable.

Spain sliding towards default or working its way towards recovery?

Despite the negative newsflow from Spain, we view part of these developments as a necessary process that Spain has to go through before it can regain market trust. In the short term though, we will probably see bond yields continue to rise until (i) investors see and believe what the costs of the banking sector bailout will be and (ii) a clear improvement in the budget deficits of the regions is realised. As such, it may well be the case that Spain will have to turn to the European rescue fund for financial assistance. Last week's plea by Mariano Rajoy to the European leaders to do more to resolve the crisis sounded a bit strange since he keeps insisting that he does not want to request the aid that is available. The European Financial Stability Facility (EFSF) can provide loans to governments for the recapitalisation of the banking sector without the full programme of conditions demanded from Portugal and Ireland. Part of the strategy to avoid tapping the EFSF for funds right now is the hope that the permanent rescue fund ESM will be allowed to directly recapitalise banks instead of lending money to the government to do the same thing. In that case, the cost of supporting the banking sector would actually be prevented from leading to increased fiscal risk.

In all, we think it is likely that Spain will have to ask for some form of official financial assistance. We also think that it should still be possible for Spain to get its finances under control if it provides full clarity on its banking sector and gets the regional government finances under control. If they fail to convince investors in time and need a rescue package that goes beyond the recapitalisation of the banking sector, we think it is highly unlikely that this will entail a restructuring of government debt such as we have seen in Greece. Given that gross government debt would perhaps peak at 100% of GDP, the IMF and the European Commission are likely to conclude that Spanish government debt is sustainable when a realistic macro-economic adjustment programme is implemented, meaning that private sector involvement will not be a necessary condition to provide financial assistance.

To conclude: 1) financial market stress in Spain is likely to remain high for some time to come, 2) Spain may well need financial assistance from the European rescue fund and perhaps a somewhat bigger program from the EU/IMF but 3) we think a restructuring of government debt remains rather unlikely.

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