Spanish economy dominates election

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12 February 2008

With the Spanish election just under two months away, the two main political parties have made the economy central to their election manifestoes.

The service sector has been especially hard hit, with retail sales falling in December for the first time in 20 months. Newspaper reports reflect the widespread feeling that the economy will worsen in 2008. Unemployment is rising faster in Spain than elsewhere in the European Union. Close to 40,000 real estate and construction workers have been laid off by firms that have no money for wages because they have no credit or customers.

The right-wing opposition Popular Party (PP) says its first priority will be to help Spanish businesses get over the credit crunch. It plans to lower corporation tax from 32.5 percent to 25 percent. One of the PP's more headline-grabbing announcements has been a zero tax level for any worker earning less than 16,000 euros, with an estimated cost of 4 billion euros. This has been met with scepticism. Juan José Merino, a construction worker from near Madrid, told the press he would "believe that when I see it. If they cut your taxes, they take it back somewhere else. If the price of bread and milk rises, you're back where you started".

The PP's concentration on the economy is understandable: it is reluctant to have public debate on international issues such as the ongoing war in Iraq. It was the PP in power that took Spain into Iraq, and the PP lost the last election on the back of the hostility this aroused.

The Spanish Socialist Workers Party (PSOE) came to power on the back of the mass anti-war movement. Popular anger was focused on the PP government's lies over the Madrid bombings. However, the PSOE has essentially continued to defend the interests of Spain's ruling elites at the expense of the working population. It has pandered to the PP, and has sought to block any movement by the Spanish working class to defend its economic and political interest. It has capitulated to any number of right-wing campaigns, most recently that of anti-abortionists.

The PSOE has also said it would lower taxes, but both parties have been warned by the European Union not to raid Spain's budget surplus to further their electioneering. Last month the PSOE changed the government housing programme to extend access to housing subsidies to families earning less than 3,300 Euros per month. Prime Minister José Luis Rodriguez Zapatero told a breakfast meeting of business executives that he had "full confidence in the economy now and in the future." What was needed, he said, was "a bit more prudence in public statements and a bit more patriotism."

In reality, under the PSOE, the economic position of the working class has grown steadily weaker. Unemployment has risen to its highest for 11 years. Bread prices have risen by 14 percent and milk prices by 25 percent. Any further drop in house prices will cause a social disaster for millions of Spanish families, as many Spaniards have 90 percent of their wealth tied up in housing. The credit crunch will have huge impact. Many Spaniards will be unable to refinance their mortgages in order to supplement their already meagre wages. A recent poll suggested that 70 percent of Spaniards are already struggling to make ends meet. Some 58 percent of the Spanish working population—around 7 million people—earn less than 16,000 euros a year.

The global credit crunch associated with the sub-prime mortgage collapse is likely to hit the Spanish economy especially hard in the coming weeks. European Commissioner Joaquin Almunia has said that Spain is vulnerable because of its extremely high overseas borrowing requirements

The Spanish economy has the second highest current account deficit in the industrialised world (after the United States). This currently stands at 9.5 percent of GDP. Its shortfall has increased four times since 2000, and now stands at 80 billion euros. The Banco de España's recent sale of 80 tonnes of gold was widely seen as an effort to finance the current account deficit. Many Spanish financial institutions are trying to borrow heavily on the international markets in order to counteract the current financial crisis.

This is a short-term response that will do little to soften the impact of the global credit crunch.

Both political parties have responded to the economic crisis by suggesting that the budget surplus be ploughed into the economy. Spain currently has a 20 billion euro budget surplus, its largest in over 30 years. While it is clear that Spain's banks are presently solvent, the country's weak spot is its dependence on foreign credit. This has produced a boom largely fuelled by consumer and construction-led growth.

Like the rest of the world markets, Spain's IBEX35 was hit heavily in recent stock market crashes, enduring its largest daily fall, 7.54 percent. This virtually wiped out overnight all of last year's gains. The banking sector was hardest hit. Santander suffered worst, losing 9 percent, but BBVA, Banco Popular (both down 6.98 percent), Bankinter (down 6.79 percent), Banesto (down 5.63 percent) and Banco Sabadell (down 4.29 percent) were badly affected. Oil giant Repsol was down 9.71 percent and telecoms company Telefónica 6.87 percent. The largest loss was by the energy company Iberdrola, which dropped 12.58 percent.

"We face a period of uncertainty and lack of clarity," Pedro Solbes, the finance minister, said. "This is always bad for the economy." His remarks were echoed by José Vinals, deputy governor of the Banco de España, in a recent speech. Vinals identified the main effect of the market turbulence as a "drying-up of market liquidity." He likened the current economic turmoil to "a reality check that can give rise to a kind of Darwinist natural selection." This would mean a survival of some financial institutions, while "those instruments, business strategies and, potentially, institutions whose *raison d'être* was exclusively the loose conditions of markets and trades experienced in recent years are bound to disappear."

Banks have already started to cut lending, and credit has started to dry up. Almunia has already expressed concern that "from the point of view of debt...the situation in the financial markets is making financial conditions more expensive," and that it makes it harder for companies to refinance their debt. The Bank of Spain's governor, Miguel Angel Ordoñez, also tried to calm things down, telling the Spanish parliament the country's financial system was "immensely solid."

Ordoñez went on to deny reports in the British newspaper *Daily Telegraph* that Spain's financial institutions had asked for "emergency liquidity" similar to that of the British bank Northern Rock. His denials have not ended speculation that Spanish financial institutions have sustained more damage than they admit.

According to Zapatero's chief economic adviser, David Taguas, talk about severe adjustments or price meltdowns is “ridiculous...unthinkable.” Spain’s “efficient” financial system is “insurance in times of turbulence.” However, the *Daily Telegraph* noted a “scathing” report on Spanish banking by Citigroup, which had a heavy impact on the Madrid stock exchange. This report allegedly downgraded Banco Popular, Banco Sabadell, Banesto and Bankinter, and warned that the credit crunch had changed the scenario for Spanish lenders reliant on the wholesale capital markets—the type of funding that caused Northern Rock to collapse. Spanish banks’ shares have fallen nearly 40 percent since April.

The article quoted David Owen, an economist at Dresdner Kleinwort, who said that Spain was in danger of a serious crisis. “House prices may fall, but what is even worse is that the corporate sector’s deficit has grown so large that it needs to find financing equivalent to 10 percent of GDP every quarter just to stand still,” he said.

Spanish banks seeking further cash injections from abroad were facing a collapse of confidence, according to Owen. “Major banks and financial institutions were refusing to lend either because they wanted to keep cash on hand in case some of their own off-balance-sheet operations started to fail or because they did not know the extent of the exposure to doubtful debt of the banks and other institutions to which they might lend.”

The creation of “structured investment vehicles” (SIVs) through the aggregation of large numbers of mortgages into debt packages to be sold off was supposed to shift risk off the balance sheets of banks and other financial institutions. But the risky debts were often purchased by off-balance-sheet organisations set up by the banks and remain risks nevertheless. Analysts disagree over the extent of Spanish banks’ involvement in the creation of SIVs. According to the *Financial Time*s, Guillermo Ortiz, Mexico’s central bank governor, had been watching Spanish banks closely. Ortiz claims that a number of high-profile banks had secretly approached the Spanish central bank, requesting that Spanish banks be allowed to do what other international banks were doing without restraint, and set up networks of SIVs.

According to the article, the central bank urged caution and made Spanish banks put an 8 percent capital charge against SIV assets. Most banks baulked at the charge. But it remains unknown how many banks went ahead with SIVs, and how this will affect the Spanish economy.

Due to the credit crunch, the Spanish government has been forced to lower its economic growth forecast for 2008 from 3.3 percent to 3.1 percent. A recent survey of 20 economists forecasts a growth of just 2.7 percent, the slowest in a decade. December also saw a rise in inflation to 4.3 percent, its highest level in over a decade. The OECD is now predicting that Spain’s GDP will decline from its current 3.8 percent to 2.5 percent.

The clearest indication of the global credit crunch’s impact in Spain is the sharp slowdown in the housing sector. According to a recent report, house prices are set to drop for the next three years. In the past, Spain’s housing bubble—as elsewhere in the world—has been driven in large part by financial speculation. With interest rates at historic lows over the past few years, and returns on investments in the stock market declining with the bursting of the dot-com bubble, large and small investors have been pouring money into the real estate market. This market was fuelled by cheap credit, low wages for migrant workers in construction, and in many cases, outright fraud and corruption. According to figures from the International Monetary Fund (IMF), house prices in Spain are overpriced by 14 percent.

A Royal Bank of Scotland report notes that the Spanish economy is particularly at risk from a weakening housing sector because of the tight profit margins for many house builders. Around a third of the Spanish property development comes from “small, non-professional developers with average gross margins of less than 15 percent.” These companies would be hit by even relatively small falls in prices. Their ensuing unprofitability would affect supply, which would have a knock-on effect for the economy as a whole, as residential construction represents around 10 percent of GDP.

The collapse of Spain’s housing bubble is being felt hardest in smaller provincial towns. Families and businesses are starting to feel financial pain. “I’ve been a bank manager for 28 years and I have never lived through a situation as dramatic as this,” said the branch manager of a regional savings bank, speaking anonymously to the *Financial Times*. “House prices in this town have fallen by 20 percent, there is no demand, and no mortgage finance. Savings banks have cut off funding. Before the credit crunch, I used to do 12 mortgages a month. Since August, my branch has approved only one new loan.”

He added that, for the first time, his clients are handing in the keys of their homes and walking away from their debt problems. “With the fall in house prices, families are giving up. They don’t see the point of struggling on with their mortgage payments.” Repossessions are on the rise, and large numbers of property developments have already been stopped. Many towns are filled with idle construction sites. Perhaps most at risk are developers with recently completed properties. As property prices are falling, buyers who have put down a deposit are withdrawing from their agreements, preferring to lose the deposit rather than get trapped in negative equity.

Fully 18.5 percent of the Spanish economy is housing related, twice as high as the rest of Europe. There would be serious implications if Spain were to fall back to the European level, as the country has one of the lowest rates of productivity growth in the European Union. Such a slump would further exacerbate the already dangerous position of Spain’s foreign balance of payments, which has steadily declined year on year.

A substantial price drop would force numerous owners into distress sales, further depressing the market. Three quarters of Spain’s 60,000 property companies may end up bankrupt, according to a real estate research firm in Madrid. There is speculation that some companies are buying their own properties to keep prices artificially high. Recent figures note that millions of Spaniards with a mortgage are now paying 55 percent of their wage on principal or secondary home repayments, double the percentage considered healthy by many banks. Spain’s household debt is at record levels of nearly 600 billion euros. The Banco de España blames this level of debt on the fact that “Spanish people are being forced to take on bigger mortgages to keep pace with the rising tide of the property boom.”