IMF: Spain to be hit hard by recession

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Spain's Socialist Workers Party (PSOE) government, after months of denying that the country would be hit hard by the worldwide banking crisis, must now face the reality of recession.

A recent forecast by the International Monetary Fund predicts Spain will enter recession next year and will be "harder-hit than other countries." Treasury Secretary Carlos Ocana admitted that the economy might not recover until 2011.

The government has drafted a $136 billion plan to aid the banks. It will guarantee up to €100 billion of new bank debt for 2008. It had already followed the rest of the euro zone economies in establishing a $41 billion fund--possibly rising to $68 billion--to buy bank assets. The plan mirrored the American rescue plan to prop up its economy. "The fundamental objective is to promote the smooth functioning of Spanish credit markets," Prime Minister José Luis Rodriguez Zapatero said before the latest legislation. He went on to say that the fund would buy "assets of the highest quality," and told reporters that the fund would be closed when market conditions return to normal.

The Spanish banking system has come under increased pressure from a massive increase in loan defaults, as a 10-year property boom comes sharply to a halt. Miguel Angel Ordonez, Spain's European Central Bank (ECB) governor, admitted in a statement to the Spanish Cortes that the world confronts a crisis of "enormous proportions." The Ibex 35, the benchmark index of the Madrid stock market, has fallen 38 percent since January.

Finance Minister Pedro Solbes told *El Mundo* that he was concerned by the rapid rate at which bad debt ratios had risen. "Non-performing loans ... have risen extremely fast and that is worrying. It's not the level of bad debt, but the rapid rise," Solbes said.

When the financial crisis broke, the ECB had already expressed concerns about the state of Spanish banks, especially savings banks. Large numbers will be affected by tighter ECB rules on lending to banks throughout the euro zone. The ECB was concerned by the growing dependence of many euro zone banks (not just in Spain) on ECB liquidity in order to survive the global credit crunch. Accordingly it issued strict new guidelines on the amount of assets banks can submit as collateral.

Saving banks account for close to 70 percent of the total growth in funds by Spanish financial companies from the ECB, according to a survey by Banco Santander. In July this year Spanish banks borrowed €49.38 billion from the ECB, three times last year's amount. Many regulators claim that the ECB is close to breaking European Union rules, which do not allow banks to be propped up by ECB funding in the long term.

Savings banks are not the only casualty of the collapse of the Spanish economy. Morgan Stanley has given the most pessimistic outlook, issuing a major alert on the health of Spanish banks. It warned that Spain could face a crisis on the magnitude of the Exchange Rate Mechanism (ERM) of the 1990s, which could wipe out completely some of the most exposed financial institutions.

"A momentous economic slowdown is now under way. We believe the deterioration in Spain is just in the beginning stages. The bulk of the pain will be suffered in 2009," said a recent report, warning that "If the ERM scenario were to become reality the main concern would not be earnings, but capital."

The report said that a non-performing loan ratio of 10-15 percent for developers' loans would fully erase earnings in 2009.

There has not been universal agreement among economists of the extent of Spanish banks' involvement in the exotic and toxic type of investments that brought about the global credit crunch. Many economists have argued that Spanish banks were not heavily involved in the creation of "structured investment vehicles" (SIVs). By aggregating large numbers of mortgages into debt packages to be sold off, SIVs were 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 remained risks nevertheless.

According to the *Financial Time*s, Guillermo Ortiz, Mexico's central bank governor, was 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.

Many heads of Spanish banks were dismissive of claims by foreign critics that there was any problem. They claimed that home equity withdrawals and "piggy back loans" are rare and mortgages in theory were mostly limited to 80 percent of house prices. But economists pointed out that they simply did not know whether the banks' claims were in any way supportable. According to Ramon Lobo, a former bank auditor, many sub-prime type deals were done through the back door, and many house valuations were inflated by as much 25 percent.

Morgan Stanley issued its report after raising concerns about Spanish banks in the wake of the €5.1 billion collapse of Martinsa-Fadesa, the country's biggest builder. Many of Spain's biggest banks are heavily involved in lending to other developers. Loans to developers make up to 26.1 percent of total bank lending by Sabadell, 21.9 percent from Banesto, and 19.4 percent from Popular.

The report warns that this would leave them open to an ERM-type bust. "Such a scenario cannot be disregarded, in our view," it said, adding that developers may face an even more drastic challenge than they did in the early 1990s.

The crisis in Spanish banking is one expression of a general economic malaise. The Spanish GDP grew at just 0.1 percent in the second quarter of this year. Much of Spain's economic growth over the last decade was fuelled by cheap money from Europe and a housing boom created largely by debt. Like elsewhere, many Spanish banks lent money to the poorest and most vulnerable sections of society, making a killing in the process.

The housing sector, which is responsible for 18.5 percent of Spain's economy, was the speculative basis for much economic development. House prices continue to fall, declining 1.3 percent in the three months through September on the previous quarter. In Madrid, this figure rose to 2.8 percent on the previous quarter. One economist has predicted a decline of up to 10 percent by the end of next year. It has been estimated that some 930,000 new homes will remain unsold at the end of the year.

A downturn in this sector is having huge repercussions throughout the economy. In the first seven months of the year the government had built up a budget deficit of 9.97 billion euros. The scale of the impact of the global economic crisis is shown in the fact that Spain's budget was in surplus only last year. Some 80 percent of household assets in Spain are tied up in real estate.

Unemployment reached 11.3 percent in September, its highest level since 1997. This is a dramatic change from the days, not so long ago, when Spain was creating roughly a third of all new jobs in the euro zone. Unemployment has risen for five consecutive months, with analysts predicting that Spain will top the European region for unemployment. Rafael Pampillón of the Instituto de Empresa business school has predicted over three million unemployed by the middle of 2009, with no abatement until all of the speculatively built properties have been sold. He believes this will take "two or three years."

One sector hit particularly hard by the growing economic crisis is the airline industry. Futura, which sought bankruptcy protection last month, has now closed. Around 1,200 jobs are likely to be lost. With the auto industry also in sharp decline, General Motors and Ford have said they will cut production, shedding 2,000 jobs. Car sales in September were down more than 30 percent on the same period last year.

Joblessness is rising three times faster among immigrant workers, four million of whom arrived in Spain in the last decade to work in the construction industry and other services. Over the last four years, they have been responsible for borrowing about €172 billion--nearly a third of all lending.

With the collapse of the housing sector, the PSOE hoped that the crisis would be offset by Spain's other major industry, tourism, which accounts for ten percent of Spain's economy. The unprecedented drop in the number of people from abroad coming to Spain has dashed these hopes.

The PSOE government was thrown into turmoil by the economic crisis. It had thought it could ride out the storm by relying on budget surpluses, but these have been wiped out. Solbes told the pro-PSOE newspaper *El Pais* late last month that the economic situation is worse than predicted.

"We thought it would happen slowly but instead it has hit fast," said Solbes. He told *El Pais* that the property boom had degenerated into a "bubble", but said there was little the government could reasonably do about it. "What was the state supposed to do? Stop people building houses? That wouldn't be reasonable. Tell the banks who they can lend money too? We couldn't do that either. We warned that building 800,000 homes a year was not sustainable: and that granting mortgages for 40 years was folly, but there are certain things the government cannot prohibit," he said.

At the beginning of this year the government pumped €18 billion into the economy, which barely had an impact on the problem. Most of its measures have been attempts to shield big business from the impact of the credit crunch, such as eliminating the wealth tax, which brings around €1.4 billion a year. Banco Santander, now Europe's largest bank, has been rapaciously buying up failing British and American banks.

While the PSOE has sought to help big business, it has given next to nothing in aid to the Spanish working class. One of its first measures when the credit crunch hit was to attack the most impoverished and vulnerable sections of the working class, such as immigrants. It has all but closed the door to migrant workers, and by its actions has scapegoated them for Spain's economic woes.

Economists and bankers are calling for further drastic attacks on the wages and conditions of the working class. The International Monetary Fund has demanded deep cuts in the welfare system and an end to index linked wage increases--demands echoed by the *Financial Times*, which says other EU states should demand that "the beneficiaries end the silly policies that got them into the mess in the first place."