Creation of “bad bank” heightens prospect of Spanish bailout

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Reports that the Bank of Spain is considering the creation of a national “bad bank” to buy up the huge toxic debts of the country’s banks has heightened the prospect of a bailout by European Union and the International Monetary Fund.

The move occurred days after Portugal applied for a €78 billion bailout from the EU and the IMF. Last Friday a secret meeting of EU finance ministers was held to discuss the threat that Greece will be forced to default and withdraw from the euro.

Official figures show that the bad loans held by Spanish banks are around €112.5 billion. Closer examination could reveal further losses, as loans to the stricken construction and real estate sector stood at €440 billion at the end of 2010. Nearly one million properties stand vacant, and the number of new builds has fallen by 90 percent from its peak in 2006.

Particularly hard hit have been the 45 regional savings banks, or *cajas*, which now hold roughly half the country’s bad debt arising from the collapse of Spain’s housing bubble. Any interest rate rise by the European Central Bank (ECB) will increase the risk of people defaulting on mortgages, especially as homes are now worth a fraction of what they paid for them.

The Bank of Spain had begun merging most of the *cajas* into a handful of new institutions. However, the debt remains, and attempts to seek more capital from the private sector have failed. In March, the Bank of Spain revealed that eight *cajas* were unable to attract sufficient private investors.

Investors are unwilling to take on bad debt without state guarantees. Last month, Spain’s big banks, including Santander and BBVA, ignored government appeals to take over the Alicante-based *Caja de Ahorros del Mediterráneo* (CAM) when its merger with three other *cajas* broke down.

At first, the idea of a bad bank was mooted for just one *caja*, Banco Financiero y de Ahorros, which had a substantial portion of its €320 billion assets tied up in toxic debts. But now it appears discussions involve CAM, Banca Cívica, Banco Mare Nostrum and possibly others. The bad bank is supposed to get help from the divested “good” banks and long-term loans from the Bank of Spain’s Fund for Orderly Bank Restructuring. But this raises the question of where the money comes from to do this.

Spain is following in the footsteps of Ireland. The Irish government set up a bad bank—the National Asset Management Agency—in 2009 as a state-funded repository for loans, estimated to be as much as €90 billion. Many of these loans, handed out by the Irish banks to property developers, had little chance of being repaid and far outstripped the banks’ declining cash deposits. But by buying real estate assets at knock-down prices, NAMA only exacerbated the crisis, causing the whole sector to slump and increasing further the indebtedness of other banks holding real estate assets.

Ultimately, liability for these bad debts was forced on the Irish working class, which has seen its living standards slashed. Many jobs have been lost, sending unemployment soaring to 14.7 percent; it would be much higher had it not been for increased emigration from the country.

Some commentators also argue that the very existence of NAMA encouraged speculators to suspect that a state default was possible. It increased doubt about the Irish government’s ability to repay bonds to cover the debt and led to the €85 billion emergency EU/IMF organised bailout last year. The interest rate of 6 percent that these institutions imposed, compared to the 3 percent enjoyed by Germany and other EU countries, has made it virtually impossible for the Irish government to reduce its budget deficit and national debt. It signalled to the money markets that a significant risk of Ireland defaulting exists.

At every turn in the global financial crisis, Prime Minister José Luis Zapatero and his Spanish Socialist Workers Party (PSOE) government has sought to convince the finance markets that Spain should not be lumped together with Greece, Ireland and Portugal, which have been forced to seek bailouts.

The Bank of Spain recently declared that Spain had now successfully “decoupled from the group of countries most affected by the tensions on sovereign debt markets”, due to various measures, including “structural reform” of labour rights.

According to National Bank Financial analysts Angelo Katsoras and Pierre Fournier, however, this claim “underestimates the risks facing the country.… Historically, the number of countries that have been able to overcome debt and competitiveness-related problems without resorting to currency devaluation and/or debt restructuring is exceedingly low”, they said.

As Spain is part of the euro monetary union, the first option suggested by Katsoras and Fournier, which has seen the UK pound devalued by 25 percent compared to the euro over the last two years, is impossible. Spain cannot devalue its currency to make its exports cheaper; it cannot compel the European Central Bank to print money (the UK’s quantitative easing) or buy its bonds. When the global crisis first erupted in 2008, the Spanish government attempted to stimulate the economy with massive deficit spending, estimated at 11.2 percent of GDP in 2009 and 9.24 percent last year.

The high levels of external debt (over 100 percent of GDP compared to 35 percent five years ago) are hard to service on the international financial markets. At present, the cost of 10-year borrowing for Spain is around 5.2 percent, modest compared to Greece’s 15.5 percent, Ireland’s 10.4 percent and Portugal’s 9.5 percent, but almost double that of other EU countries such as Germany. The higher borrowing costs are still costly to Spain, whose banks, central and regional governments, which account for 36 percent of public spending, need to raise about €290 billion euros in debt, including rollovers, in 2011.

Also, there is no guarantee that investors will continue to buy Spanish bonds without the prospect of growth. If they stop, interest rates will rise, deepening the cash crunch. Should Spain lose its ability to borrow from the international markets at affordable rates, it would need a loan package worth about €350 billion, dwarfing the €275 billion total for the Greek, Irish and Portuguese bailouts.

The latest figures on the prospect for growth make for grim reading. The Bank of Spain and IMF predict the economy will grow by 0.8 percent in 2011 and 1.5 percent in 2012, well below the government’s forecasts of 1.3 percent and 2.3 percent respectively. Industrial production fell 0.9 percent, retail sales slumped 8.6 percent in March from a year earlier, and despite government attempts to talk up rising exports, the total trade deficit has risen.

Credit to businesses has virtually dried up. The president of the Federation of Castile and Leon, Javier Cepedano, described the rejection of 42 percent of applications for credit in the last 12 months compared to 10.7 percent in the previous period as a “terrifying…bleak picture”. A record 1803 bankruptcies were declared last month—up nearly 6 percent for the same period of 2010, and way above the 250 recorded before the outbreak of the economic crisis.

According to IE Business School Professor Ignacio de la Torre, “Spain needs to raise 3-4 percent of its GDP to finance its current account deficit—or €30-€40 billion a year; this implies selling Spanish assets to foreigners, as the other way would be to cut consumption or investment by the same amount, and [that] would produce a new recession”.

To that end, Public Works, Transport and Housing Minister José Blanco and Housing Minister Beatriz Corredor toured European capitals in an attempt to persuade leading real estate investors that “Spain remains an attractive destination” for investment.

Most of the PSOE’s energies, however, have been directed at implementing austerity measures to drive down the living standards of the working class, though Spain already has high levels of poverty and is among the most socially unequal countries in Europe. The government introduced a €15 billion package, cutting civil servants’ pay and pensions by 5 percent and raising the retirement age from 65 to 67 years. Reform of the pension system and labour protection laws are underway.

Unemployment has soared to 21.3 percent, the highest in the industrialised world, with the jobless rate for youth under the age of 25 reaching 43.5 percent. Recent reports show an unprecedented growth in unemployed household breadwinners to almost one million and a similar number of families that have no income whatsoever.

Demands are rising for further austerity measures in a situation where real wages, after discounting inflation, have risen only 6.2 percent since 2000, just €8 on average per year, from €1,335 a month to €1,417.

Santander recently defended a two-year wage freeze, while at the same time announcing a €330 million bonus plan for its top 250 executives.

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