Spanish debt crisis pushing global economy to the brink

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Barely four months after the European Central Bank (ECB) began its latest intervention into financial markets, making available a total of €1 trillion at ultra-cheap rates to cash-strapped banks, the European financial system is heading into a new crisis, with far-reaching global implications.

The renewed market turmoil is a product both of the ECB measures under its Longer Term Refinancing Operations (LTRO) and the austerity program being imposed across Europe at the insistence of the financial markets.

Since the near-default of Greece threatened to set off a meltdown of markets at the end of last year, the eye of the financial storm has shifted to Spain, Europe's fourth largest economy. Last week it was revealed that the Spanish unemployment rate had jumped to almost 25 percent.

The leap in the jobless rate was preceded by an announcement of a credit downgrade by the rating agency Standard and Poor's (S&P), which warned of the dangers facing Spanish banks and forecast that the economy would fall deeper into recession. The credit downgrade on Spanish debt was the third in just seven months.

"The negative outlook on the long-term rating reflects our view of the significant risks to Spain's economic growth and budgetary performance, and the impact we believe this will likely have on the sovereign's creditworthiness," the S&P statement commented. It forecast that the Spanish economy would contract by 1.5 percent this year and by 0.5 percent in 2013, after an earlier forecast of a 0.3 percent expansion in 2012 and 1 percent the following year.

Spanish Foreign Minister Jose Manuel Garcia-Margallo said the country faced a crisis of "huge proportions" amid predictions that the Spanish banking system may need a bailout of €120 billion by end of the year.

In a clear warning to the stronger European powers, especially Germany, Garcia-Margallo likened the situation to the Titanic. "If there is a sinking here, even the first-class passengers drown," he said.

There are fears that if the crisis in Spain continues, it will rapidly spread to Italy and the rest of Europe. Italy, the eurozone's third largest economy, owes around €1.9 trillion, more than double the Spanish debt of €734 billion. There are also fears that France's credit rating could be downgraded again.

The parlous state of the Spanish banks was highlighted in an International Monetary Fund (IMF) statement last week. It said that in the past four years the Spanish financial sector had experienced a crisis of "unprecedented proportion," with significant risks arising from a real estate "boom-bust cycle." This had exposed weaknesses in the policy and regulatory framework and an over-reliance on raising funds on financial markets rather than via deposits.

In an unusually blunt statement about Spain's banks, the IMF commented: "To preserve financial stability, it is critical that these banks, especially the largest one, take swift and decisive measures to strengthen their balance sheets and improve management and governance practices." The reference to "the largest" was to Bankia, a collection of seven savings banks, which are especially vulnerable because of their involvement in the collapsed real estate bubble.

However, the crisis is not merely the result of Spanish conditions. It is also the outcome of the supposed “rescue” measures put in place by the ECB through its LTRO program.

Under this policy, weak banks were provided with funds from the ECB at an interest rate of 1 percent in order to try to prevent a liquidity crisis spreading throughout the financial system. The policy was initiated last December amid warnings that Europe faced a crisis of Lehman Brothers proportions.

The ECB actions, however, did not provide a long-term solution. In fact, they have contributed to a deepening of the problems. This is because the weak banks that received funds did not use them to finance activities in the real economy but bought up sovereign debt in the hope of easy profits. As a result, the fate of the weakest banks is now ever more closely tied to the fate of governments with the biggest debt problems.

While the ECB’s actions provided a short-term boost to financial markets in the first four months of this year, the turmoil has re-emerged in an even more virulent form. Concerns grow that the banks are running out of money to buy government debt.

These fears are reflected in the recent spike in interest rates on Spanish and Italian government debt. The interest rate on Spanish debt has approached the critical level of 6 percent in recent days. The rates on Italian bonds, which fell to 4.5 percent in March after touching 7 percent in January, are now back up to 5.63 percent.

Hedge funds are reported to be betting against the Eurozone economies because they consider that the increase in liquidity does not provide any durable solution. According to a report in the *Financial Times*, a growing number of hedge funds “are directly wagering that Europe’s problems have become so entrenched that they will lead to a much more serious crisis in the coming months than the Eurozone has experienced.”

The financial uncertainty has been exacerbated by the austerity programs that are pushing the European economy deeper into recession, setting up a negative feedback loop. As economic growth declines, tax receipts fall, leading to a worsening debt situation and a further rise in the interest rates on government bonds.

Spain exemplifies this process. Tax receipts are estimated to be down by almost €1 trillion as a result of the loss of 374,300 jobs in the first three months of this year. At the same time, Spanish banks are estimated to have borrowed €316 billion from the ECB, equivalent to 11 percent of their total balance sheet. Anything over 10 percent is regarded as a “tipping point,” after which the injection of additional funds is needed.

Reflecting the fears of US financial institutions, former US Treasury Secretary Lawrence Summers, in a comment published in today’s *Financial Times*, warned that the ECB’s provision of liquidity had been little more than a palliative. “Weak banks, especially in Spain, have bought more of the debt of their weak sovereigns while foreigners have sold down their holdings. Markets see banks grow ever more nervous. Again, both Europe and the global economy approach the brink.”

The impact of the Spanish crisis will extend beyond Europe and the US. Last week, in a report on Asia, the IMF said the global economy remained “unusually vulnerable” and further “setbacks” would have “great repercussions” for Asia. “In particular, a sharp fall in exports to advanced economies and a reversal of capital flows would severely impact activity in the region.”

There are signs that the reversal of funds has already started. The Bank for International Settlements released figures showing that European banks withdrew $100 billion in lending to Asia in the last three months of 2011.