Spanish bank debts deepen eurozone crisis

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The European financial crisis has taken another turn for the worse as doubts grow over the solvency of the Spanish banking system and the prospect of a Greek withdrawal from the euro zone becomes increasingly likely.

Last Friday the Spanish government demanded that banks set aside an additional €30 billion ($39 billion) to cover massive losses in real estate loans, its fourth attempt in three years to clean up the country's banking system. But the measure was generally considered to be too little, too late by financial markets. Bank shares fell and the interest rate on Spanish bonds climbed to over 6 percent, a level considered unsustainable, amid fears that Spain would have to seek a bailout package from the European Union. The plunge in bank share values included Banco Santander, the euro zone's largest bank by value.

The Spanish government's call for additional funds to be set aside followed its decision earlier in the week to convert its €4.5 billion holding in the Bankia conglomerate into equity, effectively nationalising the lender.

The takeover signified the collapse of an earlier government-backed bank rescue plan and exposed the fraudulent claims by both the government and regulatory authorities that the property market had stabilised and Spanish banks were on to road to recovery.

Bankia, which holds 10 percent of all bank deposits, was formed in 2010 through an amalgamation of regional banks that had been rendered virtually insolvent by the collapse of the Spanish property market bubble, following the onset of the global financial crisis in 2008. The seven banks involved in the merger had accumulated €55 billion of toxic real estate loans, amounting to nearly 30 percent of their combined balance sheets.

Since Bankia's launch on the sharemarket last July, its shares have fallen by more than 45 percent as big international investors withdrew their money. Many of those who initially brought shares were small investors who responded to a government campaign to support a national revival.

The chief economist for southern Europe at Barclays Bank, Antonio Pascual, said there had been large outflows of funds from Spain in the past six months. He warned that external financial support would be needed if foreign investors continued to reduce their exposure at an "economically disruptive rate".

Overall, banks are estimated to hold about €308 billion in real estate loans, of which €184 billion are considered to be "toxic assets". These bad loans are the result of the property crash which has left repossessed housing complexes standing empty with no one to buy them. In addition, there are concerns over the banks' exposure to residential mortgages that total €656 billion. These assets are still on the books of the banks at their original value, despite the fact that house prices have dropped by about 25 percent since 2008. Last Thursday official data showed that home sales had fallen for the 13th consecutive month.

Far from alleviating the crisis, the government's latest measures may intensify it. Spain is already in the grip of an austerity program that has seen government spending cuts of €27 billion and a leap in unemployment to 25 percent. Consequently, a number of weaker banks will have difficulty in raising the additional funds required, necessitating state intervention. As the *Financial Times* commented, this sets up a vicious circle: "As government debt rises, yet more austerity measures will be required, throttling economic growth and making banks even more unlikely (and unable) to lend."

A similar process is at work as a result of the European Central Bank's longer-term refinancing operation (LTRO), under which €1 trillion has been made available to weak European banks for three years at the ultra-low interest rate of 1 percent.

Spanish banks have used the money to buy up government debt, setting up another potential vicious circle. As the position of the banks weakens and they pile more money into bonds, they become increasingly exposed to risks on sovereign debt.

The crisis is also exacerbated by the prospect of a further fall in Spanish growth. According to the latest forecast by the European Union, Spain can expect a downturn for at least the next two years. This means that government revenues will continue to decline, resulting in new demands for austerity measures as its debt to GDP ratio rises and it fails to meet its deficit targets. Further government cuts will in turn lead to more economic contraction. The European Commission has forecast a budget deficit of 6.4 percent of GDP in 2012, missing the EU target of 5.3 percent.

While there has been talk that the EU may allow Spain some leeway on its deficit targets, economic affairs commissioner Olli Rehn has warned that the debt situation "calls for very firm treatment to curb the excessive spending of regional governments".

The latest turn in the Spanish debt crisis has been accompanied by fears that the unstable political situation in Greece, where talks over the formation of a new government have all but collapsed, may result in Greece leaving the euro zone.

Next month, Greece is scheduled to set out a program of €11.5 billion in cuts under the EU-imposed austerity program, amid warnings that if it fails to do so the supply of funds will be shut off. The cuts will likely involve still further reductions in wages and pensions—the very measures that the Greek people overwhelmingly rejected in the May 6 elections.

European Central Bank (ECB) officials stepped up pressure at the weekend for the implementation of the austerity program. ECB governing council member Patrick Honohan said that while a Greek withdrawal would damage confidence in the monetary union, it could be "technically" handled.

Threatening the Greek people with further economic disaster, Jens Weidman, head of the German Bundesbank, warned that "The consequences for Greece [of a withdrawal from the euro zone] would be more serious than the rest of the euro zone."

While ECB and other officials insist the euro zone will be able to weather the storm of a Greek withdrawal, there are considerable doubts about this. The fear is that Portugal would be immediately targeted—with banks and financial institutions withdrawing their money and placing it in German banks—followed by Spain and Italy.

British business secretary Vince Cable said the UK "must hope" that measures set in place to prevent contagion prove strong enough to prevent the crisis spreading to Spain and Italy, otherwise there would be a "massive impact" on British trade. Contagion would not stop there but would set off a global crisis far exceeding that which resulted from the collapse of Lehman Brothers in September 2008.