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S&P Puts Spanish Sovereign Debt on Negative Ratings Watch 2 comments

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Spain yesterday became the third euro zone country within a week to be warned by rating agency Standard & Poor's that its credit rating (currently the highest - AAA) is under threat from the deterioration in public finances being produced by the government's attempt to support the banking system and put a brake on the dramatic decline in the domestic economy. As in the case of Ireland and Greece last Friday, S&P said Spain faces a painful process of rebalancing of its economy and a consequent marked deterioration in its public finances.

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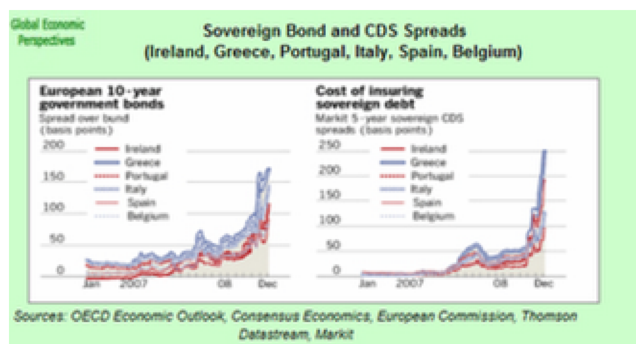


The gap in bond yields between the benchmark German bunds and the sovereign debt of Spain, Greece, Ireland, Italy and Portugal has risen fourfold since July (see charts above to get some idea) to levels not seen since the launch of the euro in January 1999, and this despite the fact that bond yields have fallen for all countries since last year's peaks in July as interest rates have steadily fallen.

One year ago the financing of Spanish government debt was barely more expensive than it was in Germany, but yesterday the 10-year bond spread between the two reached an unprecedented 92.6 basis points (or nearly a full percentage point) before settling at 92.3 basis points. The spread, or additional interest, between Spanish 10-year bonds and similar German debt rose 9 basis points, or nine hundredths of a percentage point on the day.

Credit-default swaps linked to Spanish government debt also rose 11 basis points to 106, according to CMA Datavision, in the biggest one-day move since 23 October 2008. Credit-default swaps, which are used to hedge against losses or to speculate on the ability of companies to repay debt, typically rise as investor confidence deteriorates and fall as it improves.

The Euro was also affected by the news, and is this morning (Tuesday) still trading at a one-month low of around 1.328 to the dollar, as the negative news from Spain simply added to trader sentiment that the European Central Bank will reduce interest rates, and thus reduce the present yield differential with USD instruments.

> "Everyone knew that Spain was in trouble, but this is one of the triggers that investors were waiting for," said Ivan Comerma, head of treasury and capital markets at Banc Internacional-Banca Mora in Andorra. "This is the worst timing as Spain is about to start with its funding plan for this year and the country'slenders are about to start selling government- backed bonds."

In a climate where governments across the OECD are preparing to significantly increase their bond issues in 2009 , Spain, Ireland and Greece could find themselves paying significantly more to borrow money if their ratings do in fact fall. Spain is set to increase 2009 debt issuance by around 51 percent to 104.5 billion euros to cover the growing fiscal deficit. This borrowing requirement follows government announcements of something in the region of 90 billion euros in various packages of stimulus measures, in addition to measures to support banks, while at the same time tax revenue is falling due to the contraction in the economy. And we may yet see considerable overshoot on

this borrowing estimate, since the government had a one percent GDP expansion (much to the chargin of central bank governor Miguel Fermamdez Ordoñez) incorporated in the original budget, and of course what we are likely to see is a contraction of several percentage points in GDP.

In addition the Spanish government has offered to guarantee 100 billion euros of new bank debt this year as well as promising to buy up to a further 50 billion euros in bank assets intended to boost liquidity as banks are forced to seek news sources of refinance for their steadily expiring existing cedulas hipotecarias. The first financial institution to take advantage of such guarantees may well be savings bank La Caixa, who have indicated they plan to issue a 3-year bond next week, a bond which it seems may well be backed by a government guarantee. La Caixa's decision to move ahead with a government guaranteed bond (and ride out the stigma which could be attached) may well be influenced by the outcome of last Friday's sale by Spain's second-largest bank, BBVA, who placed 1 billion euros in 5-year unsecured senior debt on offer, without a government guarantee - the first such operation by a Spanish bank in over a year and a half. The bank set guidance on the bonds at mid-swaps plus 180 basis points, but it is far from clear that the operation was a spectacular success.

> "The Creditwatch placement reflects our view of the significant challenges facing the Spanish economy as it traverses a period of very weak growth...We expect public finances to deteriorate markedly with the general deficit rising," Standard & Poor's analysts led by Trevor Cullinan said. The analysts also said they expected the general government deficit to rise well above 3 percent of gross domestic product until 2011, peaking at more than 6 percent this year."

Spain's public finances are thus threatened with a marked and sharp deterioration. Debt was equivalent to a mere 36 percent of GDP in 2007, compared with a 66 percent average for the eurozone as a whole, 95 percent for Greece, and 105% for Italy. Worse, S&P's and many others (myself included) are worried not so much by the deterioration itself (in times of crisis fiscal spending is entirely legitimate) but by the level of realism in the government's approach to the problem. What we could thus well see, in my opinion, are two or three years of above expectation annual contractions, accompanied by two or three years of above expectation fiscal deficits, with the national credit rating steadily deteriorating. We could then find ourselves arriving at 2011 with one unholy mess of an economic problem still to be sorted out - a construction sector which is still in need of serious downsizing, and an export sector which is still far from competitive, for example - with all the resources in the national coffers effectively exhausted by a completely useless spending spree. So now it isn't only "Edward" who is saying this, we are getting some objective international responses to the situation too, and we are now likely to see more such moves.

In fact I have been warning about the problem posed by lax fiscal policies and mounting concern from the rating agencies in the Italian case for years (their position will be much more serious in the short term if they do get another downgrade), and I recently commented on Greece. Back in August 2007 I even pointed out what "fools" I felt Sarkozy, the EU Commission and some European MPs were being by pointing the figure directly at the ratings agencies in the wake of the sub prime scandal. As I said at the time (16 August 2007):

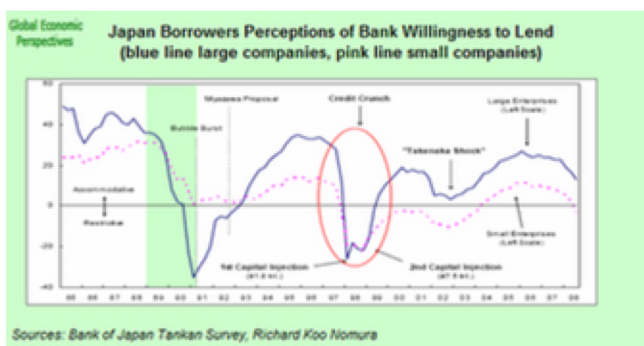
> The sub prime situation is in fact a good "case in point" example of this process at work. And after the agencies themselves admit the problems were worse than previously anticipated, then the markets, predictably, also over-react. So the question I am asking is, would we all now really like to see this situation replicated in the case of the Italian debt problem, or the Baltic overheating issue? Would we, or the EU Commission, be happy with the outcome?I think in this kind of area it is better not to tempt fate, or call on others to do what you are not prepared to do yourself.
>
> In the event that the Italian government is one day forced to default on its sovereign debt, will we be holding the European Commission itself responsible in the way that they would now try to point the finger at Standard and Poor's or Moody's? The root of the problem here is that the EU itself needs to be able to make accurate and clear assessments of the underlying issues involved on its own account, and to develop the capacity to face up to difficult decisions, take them, and then make them stick, rather than simply fudging everything in an ongoing process of political "deals" and horse trading. Nor is it a solution, when the going gets really tough, to outsource responsibility to agencies which really are neither designed for, or adequate to, the task in hand.

At the present time it isn't clear that there will be an immediate downgrade in Spain's credit rating, and at AAA there is of course quite a long road to travel before we reach the precipice of being awarded the "junk bond" status (BB+) which was attached to Romanian sovereign bonds by S&P's on October 27 last. At the same time, this is a road, however long it may be, that it would have been better never to have gotten started down in the first place. Even the activities of Spain's Instituto de Credito Oficial, a government body which issues bonds in its own right as part of the bailout programme - and which only this week sold a five-year euro-denominated benchmark bond - will see its triple-A rating lowered in the event of a downgrade, since the rating is effectively supported by the Spanish national one. The ICO - in theory - provides backing to small and medium-sized businesses, long-term loans for infrastructure projects and financial support in cases of economic or natural disaster.

The Problems Of Resolving The Credit Crunch

The difficulty I see coming in all of the above refers to the need for a large injection of funds at some point in the not so distant future to decisively unblock the credit crunch. Let's look again at my "exhibit A" from the Japan experience - the chart, [prepared by the Japanese economist Richard Koo](), which shows the evolution of lending conditions in Japan during the 1990s (those who read my "coffee deflation" post will already have seen this). The thick blue line (please click over chart if you can't see adequately) show large business perceptions of the willingness of banks to lend to them. You will note the line plunges twice, and it is the second plunge, or "credit crunch", which interests us here, since it is my conjecture that we have yet to see this part of the Spanish crunch, but that we will, when push finally comes to shover and the banks throw the towel in on the mounting pile of non-performing loans.

This was the crunch remember, the one that finally drove Japan decisively off into deflation, and produced that now famed "liquidity trap". Basically the first credit crunch was resolved via large scale government contruction spending, the guaranteeing of bank deposits, and the swallowing by the banks of a large number of non-performing loans. Does all this sound familiar? It should. But then Japan reached a point were the financial system could struggle forward no further. So the crunch broke out again, and this time the only way to resolve the problem was with two massive injections of capital into the banking system. These injections served to push the Japan government debt to GDP ratio sharply upwards, and it is this part of the story that I feel we will see repeating itself here in Spain. Maybe in 2010, maybe in 2011. It all depends how far the system can limp forward before it folds in on itself.



And while I am here one further point on all this, since a friend of mine asked me earlier in the week some searching questions about my "back of the envelope" calculation of a 50% to 60% of GDP cash injection requirement. That conversation has lead me to see that I may have been responsible for causing some confusion here. What I want to try and make clear is that I am not saying that the extent of DEFAULT in Spain will reach the order of 50% to 60% of GDP (I mean private sector, household and bank default, we are not talking about government default here, and I hope that in the Spanish case we never will be), but that the size of the government cash injection needed to break the back of the credit crunch will be of this order.

To try to explain the distinction I am trying to make let's look at one of the most publicised recent defaults in Spain - that of Martinsa Fadesa. Now in this case the non-performing loan was something in the order of 6 billion euros. So in a way the press are right to talk about it as a 6 billion euro default. But of course not all the 6 billion euros is lost, since the administration process will recover something from the assets which are still to be disposed of. And so it will be with the rest of them. Ben Sills at Bloomberg [recently drew attention]() to an estimate by R.R. de Acuna & Asociados, a Madrid-based real estate research firm, that there are more than 1.6 million unsold homes (new and second hand I presume) in Spain, while annual demand for housing was down to 220,000 units in 2008 from a peak of 590,000 in 2004. That is we could have an inventory of some 8 to 9 years worth of unsold homes, and the question is who is going to fund holding them while we all sit back and wait.

So even while the fact the Spanish state has to fund in some way or another some 300 billion euros in non performing loans doesn't mean that net government debt needs to rise long term to pay for them (since in the end something can be recovered) some massive "bridging finance" is going to be needed.

The same thing goes for the cedulas. In my opinion the Spanish state will have to buy out all the cedulas which need refinancing over the next 5 years, and they will need to fund this. I estimate there may well be between 250 and 300 billion euros involved here. So someone has to raise this money, and I am saying the Spanish state cannot do this alone, or the yield spread will go through the roof as the credit rating goes down, as we are now starting to see.

One possibility might be [the creation of EU bonds]() which could be used to expand the ECB balance sheet in the way that the [US Treasury has done for Bernanke and the US Federal Reserve](), but this raises a structural question with important political implications, since non eurozone countries like the UK and Sweden would also be being asked to underwrite eurozone debt. Or are we talking of a "shotgun-fushion of the EU and the eurozone to created that much maligned federal state which some have been arguing we need to make the eurozone a coherent entity, but which others have resisted tooth and nail?

In times of need, you do what you can.

Basically my view is that our EU architecture is in something of a mess here, simply because not enough thought was given to the possibility that something like this might happen when the eurozone was first set up - in the same way little attention was paid to the question of how to avoid the kind of bubble Spain has been subjected to by having a single size for everyone interest rate policy thrust upon it. The problem is there is no eurozone-specific fiscal equivalent of the EU commission which could issue bonds and regulate fiscal policy.

Acknowledging, however, that all this debt doesn't need to go straight onto those widely quoted debt-to-GDP ratios, doesn't amount to saying that all those extra debt obligations don't matter, as we can see in the Japanese case. The true level of Japan debt to GDP is still a hugely controversial issue. The OECD insists on using the gross figure 182% - due to their unwillingness to put a value on assets (like land) still held by the government, and for which no one really knows the mark to market prices. Other agencies quote the much lower net debt to GDP - which is still near 100% - and until someone actually disposes of the assets the Japan government holds post the credit-crunch-bailout no one will really know what the true level of Japan sovereign debt is. In Japan's case this doesn't matter so much, since most of the people buying the debt are themselves Japanese (home bias) and Japan is a current account surplus country. This is not Spain's case, and Spain will need non Spaniards to buy some significant part of this extra debt, hence the problem.

Santander Under Investigation

Well, as we say in English, when it rains, it pours (*sempre plou sobre mullat*) - and if only to confirm the validity of the old adage I simply can't end this post without mentioning that we have learnt today that Spanish prosecutors are currently investigating Banco Santander's (STD) loss of more than 2.3 billion euros of its clients' money by investing with alleged swindler Bernard Madoff. Just what Spain and its badly mauled banking system needed at this moment in time - a crisis of confidence in the professional judgement of Emilio Botin.

According to the Wall Street Journal yesterday Spain's anticorruption prosecutor is set to examine the relationship between Santander, Fairfield Greenwich Group, and the Madoff funds. Fairfield Greenwich Group is an investment fund, whose clients stand to lose $7.5 billion in the alleged $50 billion Ponzi scheme. According to the Journal, investigators are looking into why Santander Chairman Emilio Botin sent his head of risk management operations to visit Madoff weeks before the scheme fell apart. Investigators are also reported to be looking into whether several people who managed money at Santander funds were aware of problems at the Madoff funds.