Spain risks falling into same trap as Greece

MADRID

Reluctance to cut deficits leaves it vulnerable to forces outside its control

BY RAPHAEL MINDER

For months, politicians and banking executives in Galicia, in northwestern Spain, have been talking about a merger between the region’s two savings banks, which are in trouble because of loan losses from the collapsed construction industry.

But the planned deal between Caixanova and Caixa Galicia — banks known here as cajas — has stalled because of squabbling over who would dominate the combined institution. Desperate to break the deadlock, Alberto Núñez Feijóo, president of the Galician regional government, warned last week that “internal competition” between power brokers from Vigo and La Coruña, the cities where the savings banks are headquartered, risked leading to “self-destruction.”

The problems of Spain’s struggling cajas — often controlled by politicians obsessed with developing their own cities — are emblematic of a larger issue: the Spanish government’s similarly hesitant efforts to deal with the country’s crushing fiscal deficits resulting from its rising unemployment and persistent economic recession.

As a result, investors and analysts say, Spain risks falling into the same trap as Greece, unable to raise money on the private markets at acceptable interest rates — even though its government debt burden, as a share of the overall economy, is only half what Greece carries.

“Any further wavering could lead to a much more critical situation,” said Xavier Vives, economics and finance professor at the IESE business school of the University of Navarra. “A year ago the government didn’t even want to think about reforms. Now, under pressure from financial markets, they are at least talking about reforms. But the government really needs to get going, which would also help Spain recover its international credibility.”

So far, the federal government’s approach to the broader economic problems has been to delay most of the fiscal tightening and the efforts to free up the labor market that have been recommended by economists and increasingly demanded by creditors. It fears that doing so would spark a political backlash, par-
Spanish hesitation could hurt

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icularly in regions where elections are coming soon, while also choking off any hopes of a long-awaited economic recovery. José Luis Rodríguez Zapatero, the center-left prime minister, presented an austerity plan this year based mostly on now-obscured that would not kick in until next year at the earliest. Those include spending cuts amounting to a modest 2.5 percent of gross domestic product. But Mr. Zapatero may no longer be able to afford to wait. His failure to knock heads, like his inability to force the savings banks to consolidate before the situation deteriorates further, has left Spain increasingly vulnerable to forces beyond its control. Last week, Spain joined Greece and Portugal in being downgraded by Standard & Poor’s, the credit rating agency. While Spain’s credit level remains well above the junk level S&P. gave to Greece, and ahead of Portugal’s A- rating, its fall from AA+ to AA clearly was a blow. At best, it will mean modestly higher borrowing costs; at worst it could open Spain to attacks by speculators sensing an opportunity to make quick profits in the bond market. Among the reasons for its decision, S&P. highlighted Spain’s private sector indebtedness of 178 percent of G.D.P. and an inflexible labor market that was likely to leave Spain with a jobless rate of 21 percent this year.

To date, Mr. Zapatero’s policies have rested on the hope that the economy would begin to recover soon and that the jobless rate would average no more than 19 percent this year. Yet the jobless rate has already reached 20 percent, according to government statistics for the first quarter released Friday, almost double the level when Spain’s recession started in 2008.

To be sure, the bleak economic outlook makes it difficult to come up with any coherent policy. But Mr. Zapatero is now boxed in, experts say, because he failed to adopt changes that challenge existing political interests when he enjoyed much greater popularity after his re-election in 2008.

The leading Popular Party opposition has rallied against his economic management, often with the backing of trade unions that once supported the Socialists. While the P.P.’s own credibility has suffered because it is engulfed in a bribery investigation, it now enjoys an advantage over the Socialist government in public opinion polls.

Perhaps the biggest obstacle to any serious efforts to overhaul the economy is a Spanish electoral calendar likely to put regional priorities ahead of national ones. While Mr. Zapatero has had another two years to serve as prime minister, by then most of Spain’s regions will have held their own elections, starting with Catalonia this autumn.

The regional governments already account for 57 percent of Spain’s public spending, double the level of two decades ago, according to Carlos Sebastián, economics professor at Complutense University in Madrid. “The two big parties really value their regional strongholds and are not willing to do anything that would risk losing control over one of them,” he said. “Until these regional elections nobody will want to push for reform.”

Federal and regional interests diverge on some key aspects, notably labor legislation, whose overhaul is seen by economists as essential to reduce the unemployment and increase productivity. For instance, the regions of Andalusia and Extremadura in the southwest apply looser rules on eligibility for unemployment assistance than those in the rest of Spain. That helps the seasonal work forces that underpin their large but fragile farming sector.

Both regions have Socialist governments that face tough re-election campaigns and therefore have little incentive to support any proposal from Mr. Zapatero that could upset their own workers.

Indeed, Mr. Zapatero has recently shown little inclination to force changes upon his people. In late January, his government proposed pushing back the retirement age to 67 from 65 to rein in social security expenditures to help cope with a rapidly aging population. After a series of protest marches, the plan was put on the back burner.

But now, fresh from their crusade against Greece, investors are turning their guns on southern Europe’s other ailing economies. And this comes as the weakest spots in Spain’s economy show little sign of improvement. In a research note last week, analysts at Credit Suisse argued that, beyond agreeing on a multiyear rescue package for Greece, Europe should also work to stand-By arrangements for Spain and Portugal, allowing them to “fund their ongoing budget deficits while carrying out tough fiscal adjustment programs.”

In the first quarter, Spain’s government budget expenditure overshot income by 8 percent. Again, economists partly blame politics for this imbalance, as the Madrid government maintained its own bloated ministerial structures while devolving more power and authority to regional governments.

The result, said Mr. Sebastián, the economics professor, “often makes no sense and is just an enormous duplication of costs.”

As for the ailing savings banks—which are worse off than the big name banks like Santander and BBVA, in part because they earn little from lending abroad to offset their real estate losses at home — both the Spanish central bank and the government have recently stepped up the pressure on them to consolidate. That followed a warning in March from the finance ministry that a third of the 45 cajas faced solvency issues.

To help ease the consolidations, the government created a €90 billion re- structuring fund last June to help banks pay for merger-induced job cuts and branch closures. Access to the fund is supposed to expire next month, but the deadline is bound to be extended because the Galician banks are not the only ones still unable to agree on terms. Another proposed tie-up, led by Caja Madrid and Caja Murcia, could involve as many as eight cajas. While the plan foresees sharing activities rather than a full merger, it is proving even more contentious as its political stakeholders represent different regions.

“When politics intervenes in the banking sector, obviously you get a whom,” said Jamie Dannhauser, who covers Spain for Lombard Street Re- search in London. But as a result, “I don’t think that the recognition process of bad loans has really got going at all.”
Spain Seen as Moving Too Slowly on Financial Reforms

A Madrid employment office on Friday, when Spain said its jobless rate reached 20 percent.

By RAPHAEL MINDER
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MADRID — A planned merger has stalled between two weak savings banks in Galicia, in northwestern Spain, illustrating the reluctance of the Spanish government to take a firmer hand to its financial problems.

The longer consolidation is delayed among the banks, which are saddled with losses on loans to the construction industry, the more expensive it may be to deal with them.

What’s more, regional banks are deteriorating not just in Galicia, but throughout the country.

Investors and analysts say the lack of progress in tackling the banking issue underscores the Spanish government’s shortcomings in addressing its broader problem: crushing fiscal deficits arising from high unemployment and a persistent recession.

Spain risks falling into the same trap as Greece, these investors say, unless it takes more forceful action. It could find itself unable to raise money on the private markets at acceptable interest rates — even though its government debt burden, as a share of the overall economy, is only half what Greece carries.

“Any further wavering could lead to a much more critical situation,” said Xavier Vives, an economics and finance professor at the Iese business school of the University of Navarra.

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from financial markets, they are at least talking about reforms. But the government really needs to get going.”

So far, the federal government has delayed significant fiscal tightening. It fears that doing so would cause political harm, particularly in regions where elections are coming soon, while also choking off a long-awaited recovery.

José Luis Rodríguez Zapatero, the center-left prime minister, presented an austerity plan this year based mostly on measures that would not kick in until next year at the earliest. The measures include spending cuts amounting to a modest 2.5 percent of gross domestic product.

But Mr. Zapatero may no longer be able to wait. Just as he has been unable to force the savings banks, Caixanova and Caixa Galicia, to consolidate before the situation deteriorates further, he finds Spain increasingly vulnerable to forces beyond its control.

The planned merger of Caixanova and Caixa Galicia — banks known here as cajas and important to local politicians — is caught up in squabbling over who would dominate the combined institution. Desperate to break the deadlock, a Galician government official warned last week that fighting between power brokers from the cities where the banks are headquartered could lead to “self-destruction.”

In a broader setback, Spain joined Greece and Portugal last week in being downgraded by Standard & Poor’s, the rating agency. While Spain remains well above the junk level S.& P. gave to Greece and ahead of Portugal’s A-rating, its fall from AA+ to AA was a blow.

Among the reasons for its decision, S. & P. highlighted Spain’s private sector indebtedness of 178 percent of G.D.P. and an inflexible labor market that was likely to leave Spain with a jobless rate of 21 percent this year.

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Yet the jobless rate has already reached 20 percent, according to government statistics for the first quarter released Friday, almost double the level when Spain’s recession began in 2008.

The bleak outlook makes it difficult to come up with a coherent policy. Mr. Zapatero is now boxed in, experts say, because he failed to adopt changes that challenged existing political interests when he enjoyed greater popularity after his re-election in 2008.

The leading Popular Party opposition has rallied against his economic management, often with the backing of trade unions that once supported the Socialists. While the Popular Party’s own credibility is suffering because it is engulfed in a bribery investigation, it now enjoys an advantage over the Socialist government in polls.

Perhaps the biggest obstacle to overhauling the economy is a Spanish electoral calendar likely to put regional priorities ahead of national ones. Though Mr. Zapatero has two years remaining as prime minister, most of Spain’s regions will have held their own elections by then, starting with Catalonia this autumn.