

**IDEALISTA**

26/02/10



## THE BIG READ

# Debt-burdened Spain emerges as euro's next battleground

*The problem is, thanks largely to its membership in the currency, Madrid lacks the means to heal its economy*

BY STEPHEN FIDLER  
 Madrid

**G**REECE set off the crisis rattling the euro zone. Spain could determine whether the 16-nation currency stands or falls.

The euro zone's No. 4 economy, Spain has an unemployment rate of 19%, a deflating housing bubble, big debts and a gaping budget deficit. Its gross domestic product contracted 3.6% in 2009 and is expected to shrink again this year, leaving Spain in its deepest and longest recession in a half-century.

At the center of the crisis are millions of Spaniards like Olga Espejo. The 41-year-old lost her administrative job at a laboratory in Madrid, then found a temporary post replacing someone on sick leave—until that job was abolished. Her husband and her sister have also been laid off—all among the one in nine working Spaniards who have lost jobs in the past two years.

Each gets an unemployment check of at least €1,000 a month, or about \$1,350, part of a generous social safety net that the government says it won't cut. But Ms. Espejo's benefit runs out in July and her husband's in May.

"What prospects do any of us have now?" Ms. Espejo asks.

That question haunts Spain and the entire euro zone as the Continent faces its biggest economic crisis since the common currency launched in 1999. Worries over Greece's ability to finance its huge debts have spread to other, weaker members of the euro zone, but these same fears are now nipping at Spain's heels. The problem is that, thanks largely to its membership in the euro, Spain lacks tried-and-true means to heal its economy.

Spain can't devalue its currency to make its exports more attractive and its sunny beach resorts cheaper because the euro's value is driven by Germany's bigger, competitive industrial economy.

Madrid can't slash interest rates or print money to spur borrowing and spending, because those decisions are now made in Frankfurt by the European Central Bank.

Spain could still try to stimulate growth through tax cuts and spending increases. But it has already mounted enormous stimulus spending that swelled its budget deficit to 11.4% of GDP last year, and it would need to sell more bonds to raise fresh cash. Buyers of Spanish government bonds, spooked by the prospect of a Greek default, have already demanded higher interest rates from Madrid.

"Spain is the real test case for the euro," says Desmond Lachman of the American

Enterprise Institute in Washington. "If Spain is in deep trouble, it will be difficult to hold the euro together...and my own view is that Spain is in deep trouble."

The government rejects talk of crisis. "The fundamentals of our economy are solid," Elena Salgado, Spain's economy minister, said in an interview.

Ms. Salgado said the country's big banks are sound, its economic statistics credible and its companies dynamic enough to maintain their share of export markets. She pointed out that Spain was running budget surpluses until the financial crisis struck, and its government debt has grown from a very low base.

Euro-zone heavyweights Germany and France have pledged to support Greece if necessary. But any bailout for Spain—whose \$1.6 trillion economy is nearly double those of troubled euro-zone partners Greece, Portugal and Ireland combined—would be far costlier.

A "shock and awe" infusion aimed at renewing faith in Spain's finances, should it be necessary, would take roughly \$270 billion, according to an estimate by BNP Paribas. It estimates similar confidence-restoring moves in Greece, Ireland or Portugal would require \$68 billion, \$47 billion and \$41 billion, respectively.

Some observers, to be sure, believe Spain will ride out the troubles. Emilio Ontiveros, president of AFI, a financial analysis firm in Madrid, says recovery is in sight in the second half of the year. "We've had some luck. France and Germany, our biggest markets, are beginning to grow," he said. This should be enough to stop unemployment rising much beyond 20%, a level Spain has coped with as recently as the late 1990s.

Most economists see three options for Spain.

The first is for the government to do nothing, leaving the economy to wallow through years of high unemployment and debt defaults.

The second is for the government to take a more active role, slashing its spending while taking unpopular measures to boost the supply side of the economy, including overhauling a rigid labor market.

On Tuesday, Spain's top central banker strongly urged this path, calling in a speech for swift government action to reduce the budget deficit and reform the labor market.

"If the reforms come late or are insufficient, our future is undoubtedly worrying," Bank of Spain Governor Miguel Ángel Fernández Ordoñez said.

Mr. Lachman of the American Enterprise Institute is among the pessimists who doubt the government will take this course.

He thinks Spain's chronic inability to restart growth will lead it to contemplate a third option: splitting the euro zone asunder by withdrawing from the common currency. That would permit a devaluation that would, at a stroke, increase Spain's competitiveness and allow the economy to grow again.

A more mainstream view holds that no government, Spain's included, would dare to brave the financial chaos such a move would unleash.

"It's extremely costly to leave the euro," said Jean Pisani-Ferry of Bruegel, a pro-European think tank in Brussels. The moment a government hinted at a possible devaluation, there would be a run on the banks and an effective default on every euro financial contract with that country. "The day you start to admit that you're thinking about it, you're in a financial mess."

The government has announced plans, starting with tax rises and spending cuts this year, to slice the budget deficit to 3% of GDP by 2013, a program financial analysts have described as credible. It forecasts that public debt will crest at around 74% of GDP in 2012, compared with 113% today in Greece and Italy.

Still, Socialist Prime Minister José Luis Zapatero has drawn criticism from economists for saying he will deal with the crisis without hurting the country's social programs.

"That's not a plan, but an announcement," said Lorenzo Bernaldo de Quirós, president of Freemarket International Consulting in Madrid. As a result, he said, Spaniards don't yet understand that their comfortable way of life, cushioned by the state, is about to change. Spaniards still "think like Cubans and live like Yankees," he said.

Spain's troubles are a mirror of the boom years after it and 10 other countries entered the monetary union in 1999. The euro was meant to cement a single market across Europe, reducing cross-border costs for trade, investment and travel.

In close to a decade of good times, Spaniards overtook the Italians and approached the French in terms of what their salaries could buy. Spanish energy, infrastructure, utility and banking companies spread world-wide.

But seeds of trouble were being planted. Spain's wages grew fast, making its econ-

omy less and less competitive. Low euro interest rates, set with low-inflation Germany in mind, began generating a housing bubble.

Spanish house prices more than doubled in real terms in the decade ending in 2008. At the peak, the country of 45 million people was building more houses than Germany, France and Italy—combined population 200 million—put together.

Spain's housing market has been slow to adjust, likely delaying recovery. The Bank of Spain estimates prices have fallen 15% from their highs, about half the U.S. peak-to-trough decline. "In the U.S. market, the day of reckoning came quickly. In Spain, it's been postponed," said Mr. Ontiveros of AFI.

The housing bust shows how Spain differs from Greece in the current crisis. Economists say Greece's troubles stem from its profligate government. Madrid ran budget surpluses for years—but Spain's private sector went on a debt-fueled spending binge.

Spanish private and public debt rose an average of 14.5% a year from 2000 to 2008, according to McKinsey Global Institute. Total debt peaked at the end of 2008 at \$4.9 trillion, or 342% of GDP—a higher percentage than the level in the U.S. and most major economies except Britain and Japan. Six-sevenths of that is owed by the private sector.

McKinsey expects households, indebted companies and real-estate developers to shed debt, a widespread "deleveraging" that is likely to trigger defaults and harm the banking system.

Most analysts say Spain's banking problems are concentrated in the country's 45 *cajas*, regional savings banks usually run by local politicians that often went deep into real-estate lending.

Nonperforming loans in Spain's banks and regional savings institutions are now estimated at 5% of the total, up from 3.2% a year ago. Santiago López Díaz, a bank analyst at Credit Suisse in London, estimates this may underestimate the total by 30% to 40%.

Some private estimates suggest that roughly half of Spain's estimated 1.3 million unsold houses are now on the books of *cajas* and banks, which have been slow to sell them because they don't want to realize losses. Financial institutions "have become the biggest realtors in Spain," said Fernando Encinar, co-founder of Ide-alista.com, Spain's largest property Web site.

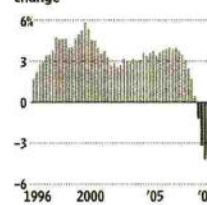
The government has tried to force *cajas* to merge into stronger institutions, and has set up a fund to encourage them to restructure and bolster capital. Analysts expect *cajas* to post big losses this year that will likely force the government to raise more money to boost the fund.

Massive joblessness could further slow Spain's climb out of debt. Even in good times, unemployment never got below about 8%. Now the rate is nudging 20% overall and close to 45% among young people—statistics that reveal to economists a deeply flawed employment market.

Wages are set through a complicated

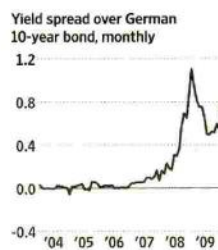
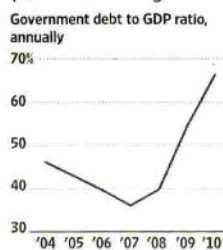
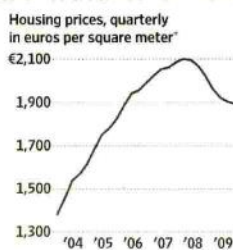
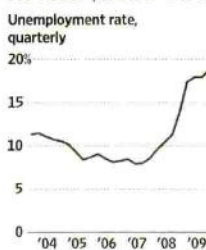
### Reversal of fortunes

Spain's year-over-year GDP change



Source: National Statistics Institute of Spain via Thomson Reuters

### No relief | Entrenched economic troubles have raised Spain's borrowing costs



Source: Thomson Reuters Datastream

€1 = \$1.36. 1 square meter = 10.8 square feet

Estimate



## THE BIG READ



From left, Olga Espejo, her husband José Antonio Sacristan and her sister, Marisa Espejo, have all been laid off. They are among Spain's 4.3 million unemployed.



Alvaro Leiva for The Wall Street Journal (3)

Housing starts in the country dropped last year. A housing development, left, in Vallecas, and Spaniards waiting at an unemployment office in Santa Eugenia, both in southern Madrid.

system of bargaining with trade unions that imposes wage increases on firms even if their business can't afford it. Because wages are inflexible, Spanish companies can cut labor costs only by firing workers. Yet some workers, hired on so-called indefinite contracts, are deeply entrenched, not least because they are entitled to 45 days' severance pay per year of service.

So, when the economy turns down, those on temporary contracts bear the brunt. When prospects brighten, companies think long and hard before inking more indefinite contracts.

That bodes poorly for Eduardo García, 55, who was huddling in line outside a job center recently in Madrid's Santa Eugenia neighborhood.

Unemployed for the first time, Mr. García worked for 25 years at a book-and-magazine distributor that closed in November. His wife and 20-year-old daughter are also unemployed. Mr. García said he has had no work offers. "At my age, it will be difficult."

Madrid has vowed to reform the labor market. One proposal would reduce the severance-pay entitlement for new workers by 12 days, to 33 days.

Fernando Eguidazu, director-general of the Circulo de Empresarios, a business association, said Madrid has avoided locking horns with labor. Demonstrations against a proposal to raise the retirement age from 65 to 67 took place in several Spanish cities Tuesday and Wednesday.

Unions could resist new labor proposals,

he said, but it's a needed step: "If they [the government] try to keep being nice to everybody, we are wasting time and the people and the markets are losing confidence."

That sentiment is already apparent in the market for insurance against a Spanish default. The price to insure €10 million in Spanish bonds for five years—just €2,350 three years ago—rose this month to €171,750 before falling to €125,000, said data firm Markit Group Ltd.

That translates into increased borrowing costs for Spain, which now pays about 0.8 percentage points more than Germany to borrow money for 10 years.

For years to come, Spain will largely be at the mercy of wary bond investors to finance its governments, banks and compa-

nies. The national government says it will have to raise €76.8 billion this year and pay back an additional €35 billion of maturing bonds.

Amid it all, Mr. Bernaldo de Quirós predicts, investors' worries will ebb and flow over what he calls "a real risk of default" as they await decisive government action. "They more time you lose," he said of the government, "the more devastating the adjustment has to be."

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