Spain: A Political Risk Analysis

Soeren Kern

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1. Introduction

Spain is in the throes of the worst economic crisis in its recent history. Reeling from the collapse of a debt-driven construction boom, Spain entered recession in the second quarter of 2008 and posted six consecutive quarters of negative growth. Although the economy grew by 0.1 percent during the first quarter of 2010, Spain's growth prospects are poor and any pick-up could be short lived.

Spanish GDP fell 3.6 percent in 2009, and a package of harsh austerity measures announced since then will undermine any economic recovery during the foreseeable future. The International Monetary Fund (IMF) says there will be no positive GDP growth in Spain until 2011, at which point it will still be below 1 percent.

The Spanish Finance Ministry on May 20 said it now predicts a 0.3 percent contraction in 2010. It also cut the forecast for Spanish growth in 2011 to 1.3 percent from 1.8 percent.

Meanwhile, Spain now has the highest unemployment rate in the European Union. More than 20 percent of working-age Spaniards (or 4.6 million people) were without a job during the first quarter of 2010. That compares with an average rate of 10 percent among the 16 countries that use the euro currency. Persistently high unemployment presents an obvious threat to political stability in Spain.

As unemployment soars, Spain is also facing an exploding budget deficit. The collapse of the labor market, which has resulted in a steep drop in tax collections, and the Socialist government's spendthrift policy response of increasing unproductive public sector stimulus spending skyrocketed the deficit to 11.4 percent of GDP in 2009 (or five times higher than in 2008).

The combination of negative GDP growth, rising unemployment, and a high deficit has raised concerns about the sustainability of Spain's finances. Indeed, two international ratings agencies, Fitch and Standard & Poor's, have recently lowered Spain's long-term sovereign credit rating, citing the risk of a prolonged period of below-par economic growth and persistently high fiscal deficits.

The downgrades will make it more expensive for Spain to finance its debt, and increase concerns over Spain's overall creditworthiness. Indeed, investors anxious that a debt crisis in Greece could create a domino effect in Spain are already demanding higher interest rates to hold Spanish debt.

Although Spain's problems have been known for years, concerns about the Spanish economy were thrust into the international spotlight in January 2010, when noted New York University Professor Nouriel Roubini said Spain posed a major threat to the stability of the European single currency. Speaking from the World Economic Forum in Davos, Switzerland, Roubini warned: "If Greece goes under, that's a problem for the eurozone. If Spain goes under, it's a disaster."

A debt crisis in Spain would make the problems in Greece look tame by comparison. At €1.3 trillion, the Spanish economy is more than four times the size of Greece's. (While Greece represents about 2.5 percent of eurozone GDP, Spain accounts for about 11.5 percent.) Spain is also the fourth-largest economy in the 16-nation euro zone, the eighth-largest in the OECD, and the tenth-largest in the world. Many analysts believe Spain is simply too big to be bailed out, and that a Spanish default would almost certainly lead to the breakup of the euro zone.

Fearing for the future of the euro, the European Union and the IMF have put intense pressure on Spanish Prime Minister José Luis Rodríguez Zapatero to implement a series of austerity measures aimed at bringing the public deficit down to a eurozone limit of three percent of GDP.

The IMF, for example, has called for "urgent" labor and banking reforms in Spain. "Spain's economy needs far-reaching and comprehensive reforms," the IMF said in a May 24 report. The IMF described the challenges facing Spain as "severe," citing a "dysfunctional labor market, the deflating property bubble, a large fiscal deficit, heavy private-sector and external indebtedness, anaemic productivity growth, weak competitiveness, and a banking sector with pockets of weakness."

But the prospect of draconian cuts in government spending will not sit well with Spanish voters, and growing resistance to reform will pose a continuing threat to the stability of the Zapatero government. In a preview of things to come, the government barely averted collapse on May 27 when the Spanish parliament narrowly passed a €15 billion austerity package with a one-vote majority. A defeat of the bill would have forced new elections and thrown Spanish markets further into instability.

Although Zapatero's spending cuts have been met with praise from abroad, Spanish trade unions are now calling for nationwide strikes. In a climate of rising social tension, it remains unclear whether the Zapatero government will risk its own survival by actually following through with its pledges to cut government spending. Either way, Spain is facing a prolonged period of economic, social and political instability.

2. Labor Market and Unemployment

Spain suffers from a jobless rate that is by far the highest of the main eurozone economies. At 20 percent, it is almost double the bloc's average. During the first quarter of 2010, Spain's unemployment register topped 4.6 million, according to the National Statistics Institute. Roughly 800,000 Spaniards lost their jobs in 2009, on top of nearly a million in 2008. The number of unemployed is forecast to remain well above 4 million until at least 2013.

The recession has hit young workers hardest, with the unemployment rate increasing from 17.5 percent three years ago to over 40 percent today. According to Eurostat, the European Union's statistics agency, 41.5 percent of people under 25 in Spain were without work during the first quarter of 2010.

Spaniards who do have a job are not faring much better than those who do not. More than 50 percent of the country's workforce belongs to a new social category popularly known as the mileuristas, those who earn less than €1000 a month. Roughly two in three Spanish workers (63 percent) earn less than €1100 a month, according to the Gestha union of tax inspectors.

The IMF has called for sweeping labor market reforms in Spain. In a May 2010 report, the IMF says: "The [Spanish] labour market is not working. Unemployment is structurally high and excessively cyclical, reflecting the high degree of duality in labor markets. The wage bargaining system, which hamstrings wage and firms' flexibility, is ill-suited to membership of a currency union." The IMF has asked for a "radical overhaul" including lowering severance payments, boosting wage flexibility and altering the collective bargaining system.

A recent poll shows that unemployment is the chief concern among Spaniards, ranking far higher than terrorism or immigration. In March 2010, 82.9 percent of Spaniards said unemployment was their main concern, according to the CIS polling institute.

Mindful of its falling popularity, the Zapatero government says that is putting "job creation" at the center of its economic strategy. But efforts to revitalize the job market through fiscal stimulus measures have been unsuccessful to date.

In November 2008, Zapatero announced an €11 billion, two-year stimulus package to boost the flagging economy and cut unemployment. The majority of the cash, €8 billion, was destined for local public works projects, aimed at creating 300,000 low-skilled jobs by the end of 2010. Another €800 million was destined for Spain's ailing car industry, which accounts for 20 percent of exports. Since then, however, the stimulus has been slashed in half by the government's subsequent austerity measures.

3. Sovereign Ratings

The main ratings agencies believe Spain is caught in a Catch-22 situation. If the government cuts public spending to the level needed to reduce the deficit, it will drag down economic growth and make it more difficult for Spain to emerge from recession. But if the government fails to reduce spending, the chances increase that Spain will default on its debts.

Fitch Ratings on May 28 removed Spain's AAA credit rating, dropping it by a notch, on expectations that the moves to cut the nation's debt will slow its economic growth. The move came just one day after the Spanish Parliament approved the government's new austerity measures for 2010 and 2011, aiming to cut a budget deficit in the double digits of gross domestic product despite its likely effect of slowing economic growth. The downgrade to AA+ moves Fitch closer in line with Standard & Poor's Ratings Service.

Standard & Poor's on April 28 downgraded the country's credit rating by one notch to AA from AA+, with a negative outlook. S&P believes the Spanish government is underestimating its fiscal problems and overestimating its growth prospects. "Our conclusion is that challenging medium-term economic conditions will further pressure Spain's public finances, and additional measures are likely to be needed to underpin the government's fiscal consolidation strategy and planned program of structural reforms," S&P said. "The negative outlook reflects the possibility of [another] downgrade if Spain's fiscal position underperforms to a greater extent than we currently anticipate."

S&P had already stripped Spain of its coveted AAA status in January 2009. Explaining the downgrade, S&P cited the "structural weaknesses in the Spanish economy" and predicted a long recession that will raise public debt by 18 percent of GDP and may entail a huge bank bail-out.

Moody's Investors Service on June 15, 2009 downgraded the senior unsecured debt and deposit ratings of 25 Spanish banks, 18 by one notch and seven institutions by two notches. Moody's also ranks Spain at the top of its Misery Index, a metric which adds a country's fiscal deficit and the unemployment rate to grade how miserable an economy is.

4. Banking Sector

Spain's worst recession in 60 years has driven up defaults at the country's banks, which have made loans worth €470 billion to finance activities related to construction and real estate. Loan defaults in Spain have more than tripled since the global financial crisis began in 2007, fuelling concerns that the Spanish banking sector will be the next big problem to hit Europe.

The Bank of Spain on May 22, 2010 was forced to take over the troubled CajaSur, a small regional savings bank crippled by property loan defaults. CajaSur, which is based in the southern Spanish city of Córdoba, has €13 billion in loans and holds 0.6 percent of the total assets in the Spanish financial system. The Bank of Spain provided CajaSur with €500 million in funding to keep it solvent, but the rescue of the bank could end up costing up to €2.7 billion.

CajaSur is the second bank to fail in Spain since the start of the global financial crisis. The Bank of Spain on March 29, 2009 was forced to rescue Caja Castilla-La Mancha with as much as €9 billion to shore up the lender's finances and to protect depositors.

Spain's extensive network of 45 *cajas de ahorros* (quasi public savings banks), has been hit hard by the collapse of the country's once-robust housing market. The cajas make roughly half of all loans in Spain, and nearly half of the €3 trillion in assets held by cajas are mortgages or other real estate loans. More than 7 percent of their loans could go bad this year, compared with 5.1 percent in 2009, according to the Spanish Confederation of Savings Banks.

The Bank of Spain is now promoting a series of mergers and co-operation agreements to restructure the country's financial sector. On May 24, four other cajas announced plans to merge. The combination of Caja Mediterraneo, Grupo Cajastur, Caja Extremadura and Caja Cantabria will create Spain's fifth-largest lender, with more than €135 billion in assets. The new entity will likely take advantage of funds that are available from a government program called Fondo de Reestructuración Ordenada Bancaria (FROB), which has been set up by the Spanish government to support and reorganize struggling savings banks in the country.

But the problems in Spain's banking sector extend beyond the cajas. In May 2010, BBVA, Spain's second biggest bank, was squeezed out of the US commercial paper market as a source for funding because of punitive interest rates.

Meanwhile, speculation is rife that Spanish banks are hiding their losses. In a report titled Spain: The Hole in Europe's Balance Sheet, London-based Variant Perception writes: "The value of outstanding loans to Spanish developers has gone from just €33.5 billion in 2000 to €318 billion in 2008, a rise of 850 percent in 8 years. Adding in construction sector debts, the overall value of outstanding loans to developers and construction companies rises to €470 billion, or nearly 50 percent of Spanish GDP. Most of these loans will go bad."

Standard & Poor's on March 15 downgraded its risk assessment level for Spain's banking sector, warning of "high credit losses" during the country's recession. "We believe that Spanish financial institutions are likely to operate in a difficult economic environment over a prolonged period," it said in a statement. "Spain's financial system is likely to suffer high credit losses during the recession, owing to the corporate sector's high indebtedness, rapid credit expansion, and financial institutions' meaningful exposure to the real estate sector.

On May 26, the Bank of Spain initiated a consultation process to force banks to recognize provisions due for past loans faster, and take bigger provisions on real-estate assets they acquire or foreclose on. If implemented, these changes in regulation imply that the Bank of Spain is getting serious about cracking down on non performing loans.

5. Austerity Measures

The Spanish government has come under intense pressure from other EU countries to reduce spending to avoid being dragged deeper into the Greek crisis. The IMF has also warned Spain to enact urgent labour and bank reforms. And as concerns over Europe's sovereign debt crisis spread to markets in the United States, US President Barack Obama on May 11 called Zapatero and urged him to take "resolute action."

Bowing to the pressure, the Zapatero government has announced a series of austerity measures designed to help bring its massive public budget deficit down to 3 percent of GDP by 2013, from 11.4 percent currently. The government says the spending cuts, nicknamed the "scissors action" by Spanish media, would cut the budget deficit to 9.8 percent of GDP in 2010, 5.3 percent of GDP by 2012, and eventually fall in line with EU limits of 3 percent by 2013.

On January 29, the Zapatero government said it would cut spending by almost €50 billion over three years. The hastily introduced measures include an increase in Value Added Tax of two percentage points, a gradual increase in the minimum retirement age by two years, to 67 (beginning in 2013), and a near total freeze on hiring new civil servants. The budgets of most government departments are also to be cut.

On May 27, the Spanish Parliament narrowly approved an additional €15 billion in spending cuts over two years. This austerity package aims to freeze pensions and cut the wages of civil servants. According to government estimates, total spending cuts for public employees should amount to a reduction equivalent to 0.3 percent of GDP through 2013, taking into account reduction measures such as hiring freezes.

More specifically, Zapatero will cut public wages by 5 percent in 2010, freeze them in 2011, suspend a pension rise promised during the last election, scrap a €2,500 subsidy for new parents, trim foreign aid assistance, and let public investments fall by €6 billion in 2011. In addition, the cabinet members themselves will see their wages cut by 15 percent to achieve a 6 percent deficit by 2011, down from 11.2 percent in 2009.

In an April 2010 interview with the London-based Financial Times, Zapatero said he will implement the economic austerity measures to cut the budget deficit "whatever the cost", and will introduce even harsher measures if necessary. "We have a plan, a credible, quantified plan which we have already begun to implement, a plan to reduce the public deficit," he added.

Such cuts represent a sharp reversal of Spanish government policy, which was previously focused on emergency spending in an ultimately unsuccessful effort to slow the rise of unemployment and stave off depression. In November 2008, the government launched an €11 billion stimulus plan intended to boost the weakening economy and create 300,000 jobs. In October 2009, the government approved an additional €5 billion for public works programs in a new bid to stimulate the recession-hit economy.

Although Zapatero's spending cuts have been greeted with approval from abroad, Spanish labor unions, a core source of his Socialist Party's strength, are now calling for nationwide strikes. In a climate of rising social tension, it remains unclear whether the Zapatero government will risk its own survival by actually following through with its pledges to cut government spending.

6. Labor Unions

Spanish labor unions, traditional allies of the Socialist government, are opposed to most of Zapatero's budget cuts. Union leaders are warning that if the government implements labor reforms without union approval, they will call for a general strike that could paralyze the country and cause further turmoil on global markets.

The Spanish union UGT says the government measures mark a "change in relations with the unions," a "rupture in the government's political discourse," and will result in protests. The CCOO union has also criticized the government's measures as "unjust" and says the government "is leading the country to disaster."

On May 21, thousands of public sector workers took to the streets of Spain to protest the government's austerity plan. Waving flags of the country's major labor unions, workers demonstrated outside the finance ministry in Madrid, blocking one of the main roads in the center of the capital. Similar protests took place in front of public buildings in other parts of the country.

The UGT and CCOO called a general strike of public service workers on June 8 to protest the austerity cuts. The protests mark the first mass street demonstrations against the Zapatero government organised by trade unions since it came to power in 2004.

Nevertheless, it remains unclear what impact a general strike would have outside the public sector. Only 16 percent of Spanish workers as a whole are represented by a union. According to an opinion poll commissioned by La Sexta television, 47.9 percent of respondents say the unions are justified in calling a general strike. However, exactly the same number those polled, 47.9 percent, say a general strike is inappropriate. More than 80 percent of those polled believe the government will have to make further budget cuts to fight the economic crisis.

Apart from the austerity package, the Zapatero government is also in three-way negotiations with business leaders and unions on a reform of the country's rigid labor laws. Economists say cutting the cost of hiring and firing is vital if Spain is to regain competitiveness lost during years of relatively high inflation and achieve sustainable growth. Debt markets fear that without labor reform, unemployment, already at 20 percent, will stay high, pushing the government down the path of fiscal unsustainability.

7. Loss of Confidence in Government

Zapatero was re-elected in 2008 on pledges of higher pensions, better welfare and full employment. By implementing highly unpopular austerity measures, which will infuriate his party's traditional allies among the Spanish labor unions, and lead to massive public protests, Zapatero may be signing his own political death sentence.

Underscoring just how much political authority Zapatero has already lost, the Spanish parliament on May 27 passed a €15 billion austerity package with a one-vote majority, narrowly averting a government collapse. The vote received 169 in favor, 168 against and 13 abstentions. The Socialist government's 169 seats do not give it an absolutely majority in Spain's 350-seat lower house, so it relies on support or abstentions from opposition parties to pass measures.

The austerity bill passed after the regional Catalan party, Convergence and Union (CiU), abstained from the vote. CiU said it was opposed to the bill, but did not vote against it for fear of unleashing a Greek-style crisis. However, in a sign of trouble ahead for Zapatero, the CiU said it would not support the 2011 budget bill. Moreover, CiU leader Josep Duran i Lleida told parliament that Zapatero should call early elections for next year, saying the "Zapatero era has come to a close."

Without an absolute majority in parliament or support from either the PP or the CiU, Zapatero's only way to avoid a vote of no confidence will be win backing from small parties such as the Basque Nationalist Party (PNV) to pass the budget. But the PNV voted against Zapatero's austerity plans on May 27. Securing the PNV's political support will only come at a high cost.

Zapatero says his "responsibility is to think of the future of my country, rather than any political or personal future." In an apparent bid to shore up public support, Zapatero also says he plans new tax hikes for the rich. He said he expects "an extra effort from those who have the most." But populism will not be enough to for Zapatero to save his job.

In fact, new opinion polls show Zapatero far behind the opposition. They also show that many voters believe he will have to call early elections as support for a 2011 austerity budget will be hard to muster.

An opinion poll published by El Mundo on May 30 showed that if elections were held today, the conservative opposition Popular Party would take 45.6 percent of the vote, 10.5 percentage points ahead of Zapatero's Socialists. The same poll shows that half of Spaniards expect general elections to be brought forward from 2012.

Another poll published by El Periódico de Catalunya said the conservative opposition Popular Party would win up to 42 more seats than the Socialists in the 350 member parliament, just short of an overall majority, if elections were held now.

But the opposition remains highly fractured and it remains to be seen whether it will be able to topple Zapatero's minority government. A major test will be the negotiations over the 2011 austerity budget, which will begin in July. If Zapatero is unable to garner sufficient political support to get the budget through parliament, it is unlikely that he will serve out his full term.

8. Conclusion

Spain's debt-laden Socialist government is caught in a Catch-22 situation in which it has failed to satisfy conflicting demands to cut its budget and stimulate job creation and economic growth. If the government cuts public spending to the level needed to reduce the deficit, it will drag down economic growth and make it more difficult for Spain to emerge from recession and reduce unemployment. But if the government fails to cut spending, the chances increase that Spain will default on its debts.

Either way, the Zapatero government is facing not only an economic crisis, but also a political crisis. By giving in to pressure from the rest of Europe to reduce public spending, Zapatero's popularity has plunged amid calls for a general strike.

Zapatero's most immediate political challenge will be to pass the 2011 austerity budget. Without an absolute majority in parliament, Zapatero's only way to avoid a vote of no confidence will be to win backing from small parties that have already voted against his austerity plans. If Zapatero fails to secure their support, chances are slim that his government will survive beyond autumn.

Soeren Kern is Senior Analyst for Transatlantic Relations at the Madrid-based Grupo de Estudios Estratégicos / Strategic Studies Group.