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The Bull Case for Spain

By Michael Heise
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Spain has yielded to the pressure to seek refuge under the wing of the European rescue fund. Will a bailout stabilize the situation and improve the country's economic outlook? The chances are good, but only if some of the other challenges facing the Spanish economy are also addressed.

From a purely fiscal perspective, there is no need to implement a bailout program of the same form as the ones enacted in Greece, Ireland or Portugal. At 68.5% of GDP in 2011, Spain's debt ratio is relatively low: Among the major industrial countries, only Australia's is lower. Madrid's interest payments are approximately on par with Germany's, at 2.5% of GDP.

Yet Spain has had a rough time in capital markets due to its dithering approach to its banking-sector problems. Sealing a rescue deal with the European Union should therefore remove a major element of uncertainty. Allowing Spain to use funds from Europe's bailout mechanisms should reduce borrowing costs and remove some pressure from sovereign debt issuance.

That said, recapitalizing the banks will not be a panacea. The root of Spain's malaise is not so much uncompetitive companies or exorbitant wages but private-sector debt. The country is grappling with the classic symptoms of a balance sheet recession. A debt-fueled boom in the property and mortgage markets, skyrocketing consumer lending and an increase in corporate debt had generated an artificial boom in demand, with soaring imports pushing the current account deep into the red.

Two years of deleveraging has yielded some progress. The current account is almost back in balance, import demand is being reined in, and exports are rising. These adjustments are taking place even though the wage level has fallen only moderately since the crisis began.

What needs to be done on the policy front? The main threat to social peace and public acceptance of the reforms comes from the deterioration on the labor market. Spain's unemployment rate is the highest in the EU; one in two young Spaniards is out of work. This is a big burden for government finances, which are deeply in the red and provide no leeway to combat unemployment via additional expenditure. The labor reforms enacted by Mariano Rajoy's government in February were important and could eventually prove as successful as the so-called Hartz IV reforms in Germany nearly a decade ago.

But these will take time to bear fruit, and with the economy in the dumps, they might initially have the opposite effect from what is intended. Reforms such as simplified dismissals or the option to cut wages give companies more flexibility to adapt hiring more readily to the economic situation. But further measures are urgently needed, going beyond simple qualification drives to include other re-integration measures. These should be soundly financed—not with new debt, but with using EU structural and regional funds, for instance.

If necessary, a further instrument to shield Spain from the fallout of the Greek crisis is available: the so-called "Precautionary Program" of the European Financial Stability Fund, which could provide Spanish bonds with partial risk cover. With a 30% guarantee, for instance, this could reduce interest rates on new issues by at least 200 basis points, thus ensuring capital market access at acceptable conditions.

As with the banking recapitalization, using this cover would not require Spain to sign up to a full troika intervention program. The conditionality could be based on the commitments Spain has already made within the framework of the Stability and Growth Pact as well as the Excessive Imbalance Procedure.

Spain's economy is essentially sound but is suffering from the fallout of a classic property and lending bubble, which means that the country has much to gain from using the flexible instruments offered by the European rescue funds. Proposing extreme solutions—such as eurobonds or prolonged troika restructuring programs with extensive loss of fiscal sovereignty—fails to do justice to the far subtler reality in Spain. It creates uncertainty and prevents simpler, more helpful measures from being taken. With these, Spain has a good chance of regaining market confidence soon.

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