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- APRIL 18, 2011

Will Spain Be a Domino or a Dam?

- By IRWIN STELZER



So restructuring—some dare call it default—is on the table. German officials let it be known over the weekend that they have alternative restructuring plans at the ready to offer Greece when its government abandons the fiction that it can indeed repay every euro it has borrowed, and do so on time. Even with newly announced spending cuts and asset sales, estimated to prune another €26 billion (\$37.5 billion) from the deficit, the nation's debt:GDP ratio exceeds 10%, its debt burden will hit 160% of GDP in 2013, the yield on its bonds continues to soar, and its economy is shrinking. Olli Rehn, the EU economic affairs commissioner, says that Greek restructuring, now reportedly deemed inevitable by the International Monetary Fund in 2012, is not an option, but has not explained how a country that has to pay almost 18% for two-year money can escape the debt trap while its economy shrinks at an annual rate of over 3%.



Reuters

Spain's Economy Minister Elena Salgado is adamant that a bailout is 'ruled out.'

Whether Ireland or Portugal will be next in the restructuring queue is hard to tell, because details of the austerity plan that will take the Portuguese economy from no-growth to recession have not been worked out. We do know that Moody's just downgraded Irish debt to a notch above junk, and kept its negative outlook. The European Central Bank's decision to keep German Chancellor Angela Merkel happy by raising interest rates in response to rising inflation will make it more difficult for Ireland, itself relatively inflation-free, to service its debt. One size just doesn't fit all.

Defaults would, of course, wreak havoc with the balance sheets of many European banks, loaded down with the sovereign debt of these countries, and with the IOUs of their banks. Fear of what default would mean for shaky German banks, holders of €46.5 billion in Greek, Irish, Portuguese and Spanish bonds, has converted Iron Chancellor Merkel into Lady Bountiful of the Bailouts. But tiny countries are one thing: Spain, twice as large as the troubled trio, would be quite another if the bond vigilantes can roll east and conquer Spain, the euro zone's fourth largest economy.

Not to worry. "We have gone from being another domino to being a dam protecting the euro zone," claims Alfredo Pérez Rubalcaba, first deputy prime minister. Angel Gurría, secretary-general of the Organization for Economic Co-operation and Development, agrees. He believes that labor market, pension, deficit and banking reforms will see Spain through its current difficulties.

If this version of reality is correct, if Economy Minister Elena Salgado is right that a bailout "is absolutely ruled out," and if the markets continue to remain relatively calm about Spain's prospects, there surely will be a sigh of relief in Brussels, Berlin and Paris. Even euro-enthusiasts Angela Merkel and Nicolas Sarkozy, both with already-shaky grips on their jobs, would be reluctant to ask their voters to fund a Spanish bailout.

Although there is no question that Spain is in better shape than the bailees, it is far from being a rock-solid bet to avoid the need for help. The government is projecting growth of 1.3% this year, 2.3% in 2012 and 2.4% in 2013, with exports leading the way even though the export sector is relatively small and 9% of Spain's exports typically

are sold to Portugal, not the most promising of markets. But Spain's central bank expects the economy to grow a mere 0.8% this year and 1.5% in 2012. Even that is above the economists' consensus forecasts of 0.6% and 1.2% for those years, and far above Citigroup Global Markets' forecast of "close to zero." Stunted growth will make it very difficult for Spain to reduce its deficit from the 2009 peak of 11% and over 9% in 2010 to 6% this year. "That target will not be breached," promises Ms. Salgado. Only maybe, since Madrid is finding it somewhere between difficult and impossible to rein in the spending of largely autonomous regional governments.

The unemployment rate seems stuck above 20% (40% for younger workers), jobless claims rose to 4.3 million last month, and analysts at Citigroup say that "unemployment has resumed its rising path." Real disposable income is declining at the fastest rate since records began in 1970. This hardly suggests a recovery in domestic demand is around the corner. To make matters worse, the ECB's interest-rate increases will raise the monthly mortgage payments of Spanish home-owners, already hit by rising inflation.

Then there are the twin problems: the housing and banking sectors. There are about one million unsold homes on the market, which researchers at financial consultant GaveKal point out is three times the inventory in the U.S. on a per capita basis. Don't look there for new construction jobs for many years.

But do keep a close eye on the banking sector, which Fathom Consulting estimates has to roll over debt equivalent to 5% of the nation's GDP this year and 9% in 2012. Spain's banks have an estimated exposure of €65 billion to Portugal, the largest of any euro-zone country and twice the exposure of Germany and of France. With house prices falling and default rates set to rise, the already under-capitalized banks will need to raise about €20 billion to offset write-downs, says the government; Moody's says that the cost of filling the balance-sheet hole created by write-downs could be as high as €120 billion.

In deciding whom to believe consider this: The government proudly announced that China's sovereign wealth fund had agreed to invest €9 billion in Spain's banks, the fund's largest single investment.

Untrue, says China Investment Corporation. An "error of communication" says an embarrassed Spanish government.

—Irwin Stelzer is the director of economic policy studies at the Hudson Institute in Washington.