Our Winter of Discontent

The financial crisis, the inklings of which first bubbled to the surface in August 2007, has finally reached the real economy. This is giving rise to a global recession: European recession is hot on the heals of the slump in the US economy and it’s becoming clearer and clearer that impact is being felt in emerging countries, with China most affected.

The high level of globalisation in the world economy has led to a rapid transmission of financial disturbances through the various parts of the economy, generating a crisis whose magnitude and duration remains undetermined, and yet without doubt is the most serious in recent decades. This complicated situation is causing monetary and tax authorities of different countries to take massive unprecedented steps.

We are faced with a situation of excesses: Extreme reactions of governments in response to the extreme behaviour of the private sector. We are seemingly unable to escape the dreaded pendulum effect.

The deep failure of the financial system that has driven us to the current state of affairs came about through a series of unintended consequences that led the private sector to value ‘making a quick buck’ more than properly managing risks. The resulting situation has created a breading ground for free market detractors, along with a plethora of disproportionate government action.

In this context it is important to highlight that what happened was a market failure, not a failure of the market system. Market failures can be corrected with appropriate regulation, not through resorting to excessive governmental intervention.

Government overregulation and the potential tendency towards protectionism are real risks which can not be allowed to materialise if we are to avoid the remedy causing more harm than the illness.

Gluing the world economy back together

The international financial system has undergone an historic disaster which has swept away the greater part of the banking model based on originating credit to globally distribute the risk through structured financial products and derivatives. The months of September and October 2008 will go down in history.

The central banks have had to act as market creators and have had to dive in and save large financial institutions. Governments have contributed capital to their banks guaranteeing their debts and providing them with liquidity through the purchase of the assets on their balance sheets.

The financial crisis has caused an economic recession in the US and Europe and has gone on to affect emerging markets. The new US president, Barack Obama and other world leaders are in the process of implementing fiscal stimulus programmes to prevent further family bankruptcies and corporate insolvencies.

The European Economic and Monetary Union faces the first test of the Euro, against a backdrop of negative growth rates. The European Central Bank has relaxed its monetary policy with reductions in interest rate in an attempt to support growth.

The Spanish economy has deteriorated due to the breakdown of its growth model and the credit restrictions arising from the global crisis. Economic policy trails behind the events, hinged on transfers to families and wide decisions on public spending. If we are to getting out of the crisis steps must be taken towards structural reform focused on improving the Spanish productivity/competitiveness ratio.
Credit sourcing: entities providing credit must perform an adequate risk-evaluation of the potential borrower and have sufficient systems in place for ongoing evaluation. They must also keep the risk on the balance sheet to avoid moral hazard (where insulation from risk may provoke different behaviors than exposure to risk) and an adverse selection of clients. Banks should also have to guarantee their operating model with sufficient available funds.

Capital requirements: reduce leverage through a revision of Pillar I of the Basel II accords. The banking entities’ level of capital and reserves must be increased in cycles of expansion to absorb the downturns, and should be based on capturing new capital rather than selling assets. Hybrid instruments should be limited and harmonized to back the quality of an entity’s resources. The level of capital should not only be based on the mechanical application of regulatory coefficients, but also on risk analyses. Similarly, the portfolio counterpart risks must be in line with greater capital requirements. Applying these new capital requirements should be gradual so as not to exacerbate the current cyclical contraction, even though their adoption means delaying the normalization of credit flows.

Securitization: this process must be simplified, separating the underlying assets, and securitized debt must be backed by capital reserve. Issuers must avoid conflicts of interest by retaining a share in the different risk tranches for each securitized asset.

Qualification of risk: the rating agencies should avoid the current conflict of interest whereby their paying customers are the very entities that they rate, and work on a rota system.

Regulation and supervision: there needs to be a greater demand for transparency and regularity in the supply of information, particularly focused on risk. International financial norms should incorporate lessons learned from recent experience, particularly on provisions for credit risks. Greater supervision of liquidity risk is required, as are contingency plans, although over-regulation must be avoided.

Fair value accounting: this is the best way forward, but care must be taken to avoid pro-cyclical effects. Similarly, a standard method for valuing illiquid assets must be established.

Infrastructures: creation of a clearing house to minimize counterpart risks, particularly in the derivatives markets (Credit Default Swaps).

Remuneration and incentives: these must be aligned to the achievement of long-term performance against risk taken, rather than the trend over the last few decades for rewarding big-bang, short-term (and often false) fluctuations.

Investor protection: financial service providers must meet certain requirements of organization, operation and conduct. Investors must know the risks of the financial products’ underlying assets.

Cooperation between supervisors, regulators and central banks: it is vital that these entities share information and coordinate their activities internationally. They need to be able to detect the accumulation of systemic risk and burst the bubble before it explodes.

Proposals for a new financial system
**The Dream Team**

President Obama has surrounded himself with an **economic team** comprising the good and great of American economic intelligentsia:

As Treasury Secretary, he has chosen **Timothy Geithner** who, in his role as president of the New York Federal Reserve, has had to contend with crises such as Bear Stearns, Lehman Brothers and AIG, during which he became known as the lowest-paid dealmaker in Manhattan. Geithner lived through the Japanese deflation of the 90s, living as he did in Tokyo at the time. Furthermore, his experience as the Treasury’s US representative in the ensuing Asian crisis of 1997-98 also gives him the expertise to deal with his new responsibilities.

Obama also named **Larry Summers** as director of the White House National Economic Council. Ex-Treasury and ex-president of Harvard University, Summers is a straight-talking and often polemic economics professor who leaves his audience in no doubt about his point of view. Another academic, **Christina Romer** from Berkeley, will chair the Council of Economic Advisors.

As the new Director of the Office of Management and Budget, **Peter Orszag** will have to deal with the enormous pressure of the budget deficit, as well as the requirements of greater indebtedness. Holding a Ph.D from the London School of Economics and a BA from Princeton, Orszag was previously Director of the Congressional Budget Office.

Obama has also created an Economic Recovery Advisory Board, and this will be headed up by the economic heavyweight, **Paul Volcker**, best-known as Chairman of the Federal Reserve under Jimmy Carter and Ronald Reagan. With Professor **Austan Goolsbee** as staff director and chief economist, the Board’s main focus will be on the battle against deflation rather than inflation.

**From Wall Street to Main Street (Financial Crisis to Economic Crisis)**

The financial crisis that started on Wall Street has long since moved into Main Street, affecting as it now does the daily lives of families and firms throughout the United States. Obama’s new economic team, therefore, will have to postpone the fulfilment of some election promises and concentrate their efforts on the more urgent need for economic recovery.

Families are suffering through unemployment, lower income and, in many cases, crippling levels of debt. The bursting of the real estate bubble and the stock market crash have caused an abrupt re-evaluation of assets which, together with the restriction of credit, has had a profound effect on consumption, and caused many retired folk to watch with mounting fear as their portfolios and savings continue to depreciate.

Similarly, companies are suffering through tighter or non-existent credit lines, while observing a continued decline in sales which many fear could simply aggravate deflation. Reduced bank balances also mean reduced credit with which to weather the storm; Detroit’s ailing car industry is highly visible victim, but by no means the only one.

All in all, the grave situation requires a comprehensive program of economic stimulus through public investment and packages to help struggling companies and families alike.

**Scenario A: the “Just Do It” road to recovery**

The chief aim in 2009 is, without doubt, to overcome the recession and the threat of deflation as soon as possible. The most probable scenario is that the US economy will suffer a continued drop in activity throughout Q1, reaching a low in Q2, and finally begin a slow recovery towards the end of Q4 and throughout 2010. This pattern has been dubbed the “Nike recovery” due to its similarity to Nike’s logo when plotted as a graph.

One of the main factors in this recovery scenario is, on the one hand, the supposed entrepreneurial spirit of the American citizen, who is disinclined to simply wait for better times while accepting handouts. Additionally, the relatively-poor level of handouts in the US system will force Americans to rapidly adjust to the new labour realities in which variable salaries, geographical mobility and retraining are the norm.

Repairing the damage after the storm

There is a rumour among US economic circles that when President Barack Obama realised the gravity of the economic situation, he immediately asked for a recount of the November 4 votes...
Exposure from bridging loans.

Products, backed by a pool of company

Loan Obligations - structured financial

business), and CLO (Collateralized

a share in the future success of the

rather than carrying interest, carries

usual covenants for protecting the

firms heading straight into

high-grade bonds and

financed many leveraged buy-outs,

and obligations too great to survive,

with many firms heading straight into

Chapter 11.

It remains to be seen whether the

and monetary support committed

thus far will be sufficient to restore

families to solvency and instill confidence

in the future. The stimulus packages of

the Bush administration, the housing

guarantees, the bank bail-outs and the

mortgage guarantees have all proved to

be insufficient. At the end of 2008,

the Federal Reserve and the Treasury

created an entity to direct thousands

of millions of dollars in support of

consumer credit (student loans, credit

cards, car loans, small- and medium-
sized businesses), and are buying debts

and assets of Fannie Mae, Freddie Mac

and Ginnie Mae.

It looks like the Fed and the

Treasury have come to the conclusion that

there’s no point in saving ammunition

for after the war’s been lost.

Dollar vs Euro: Nothing like a beauty contest

The Federal Reserve will need to be very cautious in 2009, looking for any signs of inflation caused by a

recovery and immediately taking steps, such as raising interest rates, to keep it in check. Meanwhile, the European economy will have entered into a period of less-marked recession thanks to its social protection model. Ironically, however, the inertia that led to this model’s creation will be the cause of its prolonging, with the ECB maintaining low interest rates throughout this period of zero-inflation low activity.

This dynamic counterpoint of the American and European economies will lead to the appreciation of the dollar, not because of its own merits but due to external demerits. After all, the exchange rate is a relative price, which is why the appreciation of the dollar will not be due so much to the recovery of the US economy and the rise in interest rates as to the stagnation of the European economies. It’s not so much a beauty contest – more an ugly contest.

Too big to fail or too big to bail out?

If the US financial markets calculate that, in the mid-term, the federal budget cannot cover the indebtedness arising from rescue operations and the real budget (families, companies), then the Credit Default Swaps (CDS) will implode. The fear of a default, however improbable, would deter global investors and this in turn would lead to a calamitous depreciation of the dollar far beyond anything seen to date. Official announcements to withdraw troops from Iraq will have more to do with budget than strategy or politics.

Perhaps it’s just a sign of the times, but it is certain that the National Debt Clock in Times Square has had to, and probably will have to again, increase the number of displayable digits just to keep up with the external indebtedness of every American family, an already-staggering number ($34,821.51 per person, January 2009). The Fed’s rescue plans and injections of liquidity have substantially deteriorated its balance sheet. There will be further prices to pay, in every sense. Even in the best of cases where the liquidity turns to credit, the American monetary authorities will be forced to implement preventative rises in interest rates, which will put even more financial pressure on firms and families.
Latin America: vulnerable once again

The global financial crisis has crossed the seas of international commerce and landed on the shores of Latin America, causing reduced flows of direct foreign investment and withdrawal of short-term capital. This has been exacerbated by the panicked drop in exchange rates and stock market indices; both discouraging investment from abroad. Furthermore, the region has witnessed a reduction in the amount of money that emigrants are sending back home, especially in Mexico, Ecuador and Peru - the region’s countries with the greatest emigration.

Nevertheless, the cycle of economic expansion of the last few years has given these economies certain elements of resistance to foreign crises - one of these elements is due to the expansion in these economies being sustained by increased internal demand (consumption and investment) due to the progressive sociological development of the middle classes. Similarly, the increasing ‘bancarization’ has also brought an increased demand for economic discipline in families and firms.

During 2008, Latin America experienced an inflationist process of global origin and reach, but the central banks in the area that follow orthodox monetary policies reacted with interest rate increases that, together with the global recession, have steered prices towards the desired levels.

The expansion cycle was fuelled by exports of raw materials as well as other products such as soy and iron ore from Brazil, petroleum from Venezuela, metals from Peru, soy and oilseeds from Argentina, copper from Chile, and gas and tin from Bolivia. Trade and current account surpluses have permitted these economies to accumulate a large volume of reserves, although the contraction in export activity and the lowering of raw material prices is having a negative impact. That said, the lack of readily-available substitutes means the raw materials should provide a relatively stable source of income in the face of world recession. The degree to which China decreases its orders will be the largest determinant in the future evolution of the area’s trade balances, since China is Brazil’s second trading partner and Argentina’s third, while being the leading export market for Chile and the second for Peru. Any drop in China’s growth rate will cause a drop in the price of raw materials, directly affecting areas like Latin America.

Thanks to these large reserves, the main countries of Latin America have reduced their public deficits and consolidated their public funds. This budgetary discipline has reduced the volume of public debt, particularly abroad. Furthermore, global investors have “forgiven the original sin” (says Ricardo Haussman) of the impossibility of stating external public debt in terms of domestic currency, and this has allowed the re-evaluation of indebtedness and thus reduced the vulnerability of being exposed to the dollar exchange rate.

Spreads of sovereign debt measured in terms of EMBI (Emerging Markets Bond Index) or through CDS have grown throughout the area, underlining the problems in Argentina, Venezuela and Ecuador. Argentina, particularly, faces major changes in its economy. Four months of farmers’ strikes and the drop in export prices put a stop to the government’s plans to establish a movable tariff. Access to funding from the IMF and international private investors is decreasing, while the continued issuing of public bonds to the Venezuelan government is linked to the evolving price of petroleum. Imposed nationalizations and unilateral changes to the rules of foreign investment will continue to reduce Argentina’s attraction as an investment and thus drive capital away. Finally, the seizure of private pension funds only signifies a step further towards a future marked by inability to meet the promised payments.
China, the key to the vault

The Chinese economy is, for the first time, putting to the test its “factory of the world” growth model, which attracted direct foreign investment thanks to its low salaries, strict labor relations and the low exchange rate of the Yuan.

The drop in activity in its major export markets (United States, European Union) is causing the closure of many companies in Guangdong and Zhejiang, with unemployment at unprecedented levels. The poor conditions of the emigrants from the interior rural zones is being protested in social disturbances, while the Chinese stock exchange has seen some of the largest drops in the world. The real estate market of Shenzhen has crashed, dragging down other large cities including Shanghai and Beijing, and the role of the Chinese Communist Party as a helmsman steering the country towards a “harmonious society” is being questioned.

As a result, the government has announced for 2009-10 a program of large investments in infrastructure, rural development and environmental projects, valued at almost 600,000 million dollars. The People’s Bank of China has abandoned its restrictive monetary policy to combat inflation, in favor of drastic interest rate cuts and reductions in requirements for granting credit.

China’s trade surplus has grown to be the world’s largest in just a decade, standing at over 1.9 billion dollars. The Chinese government has earmarked this for the importation of raw materials required for the growth of the economy and the financing of public debt and of the US current account balance; China has overtaken Japan and the Middle East as Uncle Sam’s largest creditor.

If China needs its resources for domestic necessities and can’t finance the growing debt issues of the American Treasury, then the dollar will be profoundly shaken. Given the recent dollar losses for the Central Bank (Treasuries, Fannie Mae and Freddie Mac bonds) and Chinese sovereign bonds (Bear Stearns, Morgan Stanley, Blackstone), as well as the foreseeable reduction in performance of US bonds, the Chinese authorities may be understandably reluctant to increase its already-shaky credit position. The problem is that the Chinese economy needs to keep underpinning the dollar, given that its growth is based on exports to the American market, and those exports are charged in US dollars...

A drastic change of perspectives

During the last quarter there has been a radical shift in macroeconomic perspective in the euro zone, from preoccupation with inflation, to worries about falling growth.

It was in response to these fears that the ECB began cutting its rates in October, reducing 0.5% to 3.75%, then again in November (0.5%), December (0.75%) and January (0.5%) to its current level of 2%, while every country is unveiling rescue and support packages and introducing ‘relaxed’ policies as a stimulus for growth. Monetary policy throughout the zone will continue in this vein for the next few months at least, but this alone will not be enough. What are needed are efforts to stimulate demand and productivity, and any such efforts must be pan-European and in place during 2009 – criteria that make them very difficult to implement.

Forecasts of growth and inflation

Even with governments rolling out support packages and cash injections, our forecasts for growth in 2009 are gloomy indeed, while we predict a drastic drop in inflation.

Our forecasts (see left) are mathematically modelled and use internal and external macroeconomic evolutions as their bases:

- Drastic changes in the price of raw materials: +20% in 2008 and -25% in 2009
- Global economic growth of 3.5% in 2008 and 2% in 2009
- Federal Reserve rates of 2% in 2008 and between 0% and 0.25% in 2009

We can see that the continued decline in growth, dropping sharply to 1.2% in 2008, actually becomes negative in 2009, with the zone predicted to shrink by 0.7%. Furthermore, after a substantial increase in 2008, inflation will decrease throughout 2009 to settle at around 1.3%.

In short, the forecasts present a situation where, for the first time since the introduction of the common currency, the zone is experiencing a true recession, with a clear reduction in economic activity and the lowest inflation in almost a decade.


The long cycle of expansion enjoyed by the Spanish economy appears to be over. The boom in the consumer and housing markets, lasting for almost 15 years, propelled Spain to the forefront of European economies and, while the banking crisis has not been so sorely felt in Spain thanks to previous reforms, the crash in the housing market has more than made up for that. The economy is now officially in recession, and is expected to remain so for quite some time; indeed, unemployment is expected to continue growing until at least 2010.

Consumer spending has been hard-hit, with all levels - from manufactures and distributors to retailers and customers - experiencing a severe crisis of confidence, especially in sectors such as cars and domestic appliances. This severe contraction is directly linked to the reduced disposable income faced by many families and the further expected deterioration in the coming months. Add to this the fear of job-losses and actual job-losses, perceived and real price inflation of basic items in the shopping basket, and the negative-wealth effect caused by the reduction of values in housing, investments and pensions, and it’s easy to see the cause and effect of a once-dynamic consumer society becoming prudent and even timid.

Housing: Back home to mum and dad

Simply put, the drop in real estate prices is leaving many people with an asset of lower value than the unpaid balance of their mortgage. This equity differential is exacerbated by the excessively high original valuations and the long term repayment plans – often as much as 30 or 40 years. Furthermore, Spanish mortgage law dictates that the borrower remains responsible for the repayment of the entire principal sum lent, which means that it is not sufficient to simply hand the keys over to the bank; the borrower will still, in many cases, need to repay the difference between the house’s current market value and the sum outstanding.

To make matters even worse, there is not going to be any price recovery in the short or even medium term, thanks to the excessively-high levels of valuation and credit given, as well as the new, stricter risk-assessment by the lending and supervising authorities. Consequently, a large number of young householders, having jumped on the bandwagon that society expected – some would say demanded – are now finding themselves trapped in a situation where they are struggling to meet payments on a loan that has no bearing on the value of their houses. They face many years of working to pay for, in their opinion, nothing.

In the case of those becoming classified as long-term unemployed towards the end of 2009, when their unemployment benefit payments will then be reduced, the situation will become even more grave. One of the few silver linings in this otherwise cloudy vista is that many older families in Spain own their own houses, which means that their children, the ones now facing such financial nightmares, will at least be able to return to their parents and somewhere relatively cheap to live when the bills become too much to bear. Pity, then, the large immigrant population faced with the same financial constraints, but with no parents living just down the road...

The state of the state

Being a very open economy, Spanish fiscal expansions largely filter out to the external sector. Spanish fiscal position is deteriorating at a fast pace. In 2008, the forecast was to have ended the year in surplus, to the tune of 6,000 million Euros but, clearly, the reality will have been a significant deficit. Add to this the effects of reduced taxes and waived VAT charges (to stimulate the economy) and 2009’s position can only worsen. Belonging to the Euro zone will help to mitigate the worst effects of the international turbulence but, similarly, it precludes any unilateral moves such as currency devaluation – a move that has worked previously. On this occasion, and for the first time, Spain must balance its exterior finance needs through the prudent exploitation of domestic spending and price corrections relative to the rest of the world.

Spanish economic policy, as well as looking after its citizens and other groups affected by the crisis, must face,
once and for all, the reforms that could bring about a higher productivity (Spain has one of the lowest in Europe) and greater competitiveness - in terms of price and quality – in the European and global markets.

So far, however, Spain has opted for the easy route of spending and public debt, instead of boldly facing a reduction in domestic spending and an improvement in productivity and competitiveness. The challenge is there, and time will be the judge.

In debt to the rest of the world
Spain’s greatest vulnerability is its elevated finance needs from abroad, reflected in its current account deficit. Its net exports – exports minus imported goods - has experienced a continuous deterioration during recent years, aggravated by the energy dependence and the price and quality – in the European and global markets.

Looking ahead to 2009, the Spanish economic recession will mean a reduction in house purchases by families, and a reduction in asset investment by companies. Meanwhile, the state will be feeling the effects of reduced tax income and higher spending. As a consequence, families and companies will reduce their demand for finance from the rest of the world. Conversely, though, the state, in the form of Public Administration bodies, will be seeking huge amounts of foreign financing. Spain is already the second biggest player after Italy, with a huge volume of the Treasury backed by Credit Default Swaps, and the continued deterioration in the Spanish economy will only increase the price of covering public debt.

Paying the price
There is clearly a need for urgent re-balancing of the books. With devaluation ruled out, the best options would appear to be macroeconomic measures for reducing domestic spending and microeconomic measures for improving productivity and gaining a foothold on the ladder of global competition. However, these options appear unlikely in the current political climate of half-measures and softly-softly approaches, and it therefore appears that, for now at least, the journey ahead is one of recession and stagnation, lower wages and higher unemployment, and, for sure, a general lowering of the hitherto-high standard of living.

SPANISH BANKS AND CAJAS
A few kilos of cash and tonnes of trust
Spanish banks and cajas (like those the world over) take on short-term liabilities and make long-term investments. A bank’s liabilities are made up of their equity (capital contributions of their shareholders and reserves), long-term debt (mortgage bonds traded on the international financial markets), interbank debt, monetary market funds and their clients’ savings deposits. The bank channels these resources (provided its mandatory liquidity requirements are met) into credit to families, companies and other loan applicants. So the banking system depends “on a few kilos of cash, and on tonnes of trust on the part of shareholders, stakeholders and savings depositors.” The deposit guarantee funds help to reaffirm this trust.

Credit Risk
The international financial crisis has shown that the credit portfolios of Spanish banks and cajas are not directly exposed to latent losses caused by structured financial products, revealed as opaque and difficult to value. Spanish deposit entities did not create any of the off-balance sheet investment vehicles which managed to elude credit risk controls in other markets. The Spanish banking system also avoided the risk that provoked the proliferation of insurance contracts to cover risks, offered by US monolines. Sub-prime or Alt + A mortgages, where the default rate has reached over 25%, simply do not exist in the Spanish mortgage market.

Nevertheless, the Spanish recession has a direct impact on the credit risk of Spanish banks and cajas. The starting point was very low since the rate of total defaults was only 0.61% in December 2007. Spanish banks did not make the mistake of adversely selecting clients during the increase in credit concessions. However, the recession is causing an increase in mortgage and personal loan defaults, especially in some segments, where the level of defaults has surpassed half the value of the portfolio. The price fall in real estate assets is reducing developer credit guarantees and those for housing purchase, particularly in the portfolio of mortgages granted to resident immimmigrants and foreign retirees (7% of the total).

The circular letter on accounting (CBE 4/2004) should be borne in mind when considering the registration of default since it calls for a quicker and deeper recognition of troubled assets. In a similar way the Spanish Insolvency Act includes incentives for calling a creditors meeting, and thus obliges credit entities to provide more credit. The bankruptcy proceedings of a handful of large property developers have suddenly increased the default rate.

The Spanish banking system enjoys a high level of generic provisions in the form of hedge funds on troubled assets, which have allowed banks to absorb the increase in insolvencies onto their Profit and Loss Accounts, giving them temporary relief from the increase in troubled assets forecast for 2009. The intensity of the economic crisis will determine the amount of cover for losses through credit risk, since the recuperation of default amounts can be made against the highest value of the asset guaranteed.

A default rate of 4% should be considered an amber traffic light, which
changes to red from a rate of 7%. Nevertheless, the Spanish banking system can withstand up to a 9% default rate. This rate takes into consideration the level of insolvency cover funds and three quarters of the profit on the P&L from two consecutive years.

**Liquidity risk**

The banks and cajas financed part of the credit increase through the issue of medium and long-term security bonds and covered bonds on the wholesale financial markets. The securitization structures in Spain were very simple and transparent (many diversified loans of small amounts, average loan-value rate of 70%), with a rating of AAA for 93% of the issues. The international financial crisis has practically closed off the liquidity and depth of this route, although the Spanish financial institutions have made the most of some issue opportunities investors have offered. In any event, the stability of this financing is clear from the fact that the credit balance of the medium- and long-term issues over is six times more than the credit balance of the short-term debt. Further, the maturity terms are extended since 60% of them are later than 2013.

Recent Bank of Spain figures show that given composition and widely spread risk of the underlying assets, the bonds issued by Spanish entities can withstand defaults on the credit portfolio and decreases in housing prices, which futures fail to consider.

Spanish banks and Cajas also regularly take part in tenders offered by the European Central Bank (ECB). Liquidity obtained this way carries a reduced weight on the balance sheets, in line with the relative weight of the Spanish economy and the country’s financial system within the EMU. On 15th October 2008 the ECB approved a liquidity line with a fixed rate tender and full allotment, a decision which aids the Spanish entities in alleviating the pressures of finding short-term financing.

**Solvency and business model**

Spanish banks tend to have a high solvency rate in terms of capital plus reserves over the risk adjusted assets (core capital). They have capital coefficients of above the minimum requirements, solid resources and a relatively low leverage level. However, some large entities have successfully increased their share capital. As such, public recapitalization of the banks is only likely to be contemplated as a possibility if the international crisis makes it necessary. This would involve a rethinking of the basis of competition in the financial market, since some entities would be operating with the support of public shareholders. In general, however, the reputation of Spanish banks will be reinforced by the international crisis.

Spanish banks and cajas operate under a retail banking model, with close, long-term relationships with clients through their network of branches. This model facilitates a P&L with recurring income, through cross-selling of products (savings, investment funds, life insurance, etc.). The Spanish securitization model that keeps the risk management of credit on balance sheet (buy and hold) did not give rise to the incentives for taking on subprime loans, as the US/UK ‘originate to distribute’ model did.

Spanish savings banks have experienced an intense period of international diversification (EMU, UK, US, Latin America, China) with some entities expanding throughout 2008. This strategy means they must consider the exchange rate risk in their consolidated results.

**Lasting credit contraction**

The financial crisis has created a lack of confidence which has withdrawn liquidity from investors in all markets (wholesale, inter-bank, etc.) a situation which is leading banks to hold on to the liquidity they capture through savings deposits, ECB tenders or public asset purchases, in order to deal with the possible needs upon maturity of contracted debt.

At the same time, the credit risk evaluation requirements for taking out loans have quickly adapted to the situation and economic perspectives of families, companies and other entities. As a consequence banks and cajas have started a necessary and unavoidable deleveraging process, restricting the amount of credit available to families and companies (the ‘credit crunch’) as well as to the inter-bank market.
Public intervention and competition

On 10th October 2008, the Spanish government decided to increase the level of the deposit guarantee fund from 20,000 to 100,000 euros. Moreover, the government created a fund for the acquisition of maximum quality bank assets charged to the Treasury, with an initial contribution of 30,000 million euros (increasable to 50,000 million euros). With this move the Treasury took on functions more commonly pertaining to a central bank.

On the 13th October the Spanish government approved the possibility of publicly guaranteeing new transactions (debt issues with maximum maturity 5 years, inter-bank deposits) of the credit entities up to a maximum of 100,000 million euros in 2008 and 2009, aimed at contributing to the progressive reopening of markets. The government also authorised the possible recapitalisation of banks through the one-off acquisition of preference shares which reinforce the equity of the credit entities concerned.

The transparency of these operations has been subject to some controversy, and prudence is required in order to avoid the creation of a stigmatisation index by the market. Otherwise, these moves may end up affecting competition and cause discriminatory treatment.

For its part, the Bank of Spain is carefully monitoring the liquidity risk and solvency of the entities ensuring they do not degenerate into a systemic crisis causing an increase in the risk-country premiums of the public and private issuers.

Mergers and acquisitions

Faced with a situation of prolonged closure of the wholesale financial markets and the deterioration of the Spanish economy provoking an unsustainable increase in the bad debt ratio, the banking system in Spain would have to go through a consolidation process. The overlapping of the dense network of branches and the potential for cutting expenses would eventually lead to the generation of economies of scale.

This scenario is hindered by the fact that the large Spanish banks are not interested in acquiring small entities in Spain because their strategy is focused on growth in international markets. For the medium entities organisational problems would arise from mergers between institutions of a similar size.

In terms of the cajas, the increase in political awareness created by regional government, political parties and other interested parties will be a key factor, except where the financial situation of the entity requires urgent decisions to be made in order to avoid systemic effects. In this case, either a public rescue operation would arise or mergers between entities in different regions would be induced. In addition, regional governments may be assigned supervisory competencies for the financial monitoring of the cajas.

Complacency: our worst enemy

Spanish savings entities are recomposing their balance sheets through the deceleration of credit in assets and intense deposit taking in liabilities.

In terms of assets, Spanish banks and cajas have undertaken a progressive reduction in their exposure to the property sector and other sectors where credit grew at rates of over 25% per year. The credit risk evaluation criteria have been tightened for families and companies. The Real Estate Investment Trusts (REITs) may be an adequate way to rent the assets that the developers can’t sell, and which are accumulating on the balance sheets of financial institutions.

In terms of liabilities, banks and cajas are making a great effort to attract savings, focusing less on on-demand deposits and more on long-term deposits, despite the latter’s increased cost.

Throughout 2009 the Spanish entities will see the return over equity reduced due to the slow-down in profit and pressure on the intermediary, ordinary and operating margins.

Banks and cajas must get fully involved in the control and rationalisation of operating costs in order to improve their profit and efficiency rates. The banks should also significantly reduce profit distribution, such as dividends to shareholders, and the cajas should carefully evaluate the priorities of their community projects.

In any event, the Spanish financial system has shown exceptional solvency when faced with an international financial crisis that has rewritten the basis of global banking. The investment banks’ criticism of Spain’s backwards banking model or the complaints about the country’s excessive applications for ECB tenders are behind us now. All was not in vain. The bank that recently issued a report entitled “Spanish Banks: A House of Cards” had to be acquired in a situation of technical insolvency.

As the governor of the bank of Spain has highlighted on numerous occasions, the Spanish financial system’s worse enemy is complacency.

ABOUT THIS PUBLICATION

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ABOUT ESADE

Founded in 1958, ESADE Business School (www.esade.com) has campuses in Barcelona, Madrid and Buenos Aires. Known for its highly international outlook and dynamism, ESADE is one of the world leaders in business education. Each year, more than 6,000 participants take part in Executive Education, MBA and undergraduate programs in ESADE. In recognition of its international scope, The Wall Street Journal ranked ESADE as the world’s top international business school in 2006 and 2007. ESADE currently has a network of 35,000 alumni occupying positions of responsibility in businesses around the globe.