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A BAIL-OUT THAT LEAVES QUESTIONS UNANSWERED

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Good strategists know that it is risky to have to fronts open at the same time while in a state of internal weakness. That is why the Euro Zone, which is at its darkest hour, has decided to close the Spanish front in order to focus on the Greek one, which could open up again after the elections on 17 June. This is good news to the extent that it was evident that Spain needed outside help to recapitalise its banks once it was (inexplicably) decided that no financial institutions would be allowed to go under regardless of whether it was systemic or not (bear in mind that allowing a bank to collapse does not mean its depositors would lose their money: that is what the Deposit Guarantee Fund is for). The formula adopted for the bail-out is a loan to the State, which will then channel the funds to the banks via the Fund for the Orderly Restructuring of the Banking Sector (FROB), but not a direct re-capitalisation by pumping European funds into banks. However, this will not break the diabolical vicious circle between public and banking debt so that, within a few months, the Spanish sovereign debt markets could be under pressure again.

Pulling Spain out of the firing line to deploy the EU's full firepower on the Greek front, if the latter defaults or drops out of the Euro in the near future, could have been done in two ways. The first, which was the Spanish government's choice, was for the ECB to intervene in the debt markets to lower the risk premium and allow Spain to issue debt at reasonable prices in order to recapitalise its banks. This had already been done last summer, when the Italian and Spanish sovereign risks reached an all-time high. But neither the ECB nor Germany have been willing to give in. They do not want the risk premium to relax because they believe that the reforms and adjustments they want Spain to implement will only be carried out if the government feels it is under pressure from the markets. Hence, it has been necessary to resort to the second option: to request financial help from Europe. This means that Spain will receive external financing for the first time in decades. The funds, which could total up to €100 billion, will not be directly injected into the banks, as Spain would have preferred, as current EU legislation does not allow it. The loans will be channelled to the FROB which, in turn, will transfer them as capital to the financial institutions that require them. This has two consequences for Spain: one good and one bad.

The positive aspect is that the bail-out will be different (and milder) to those of Greece, Ireland and Portugal because, in principle, conditionality is limited to

the financial sector, which is the recipient of the funds. This should mean that Spain will not entirely lose its economic sovereignty and that the budget will continue to be drawn up in Madrid and not in Brussels (this explains why the IMF is not directly involved in the bail-out, since it only lends under strict macroeconomic conditionality). What can be expected is that the banks receiving funds will refrain from paying out dividends, will cut staff and management salaries, close down branch offices and acknowledge as soon as possible the losses brought about by the real estate bubble, in accordance with the two laws approved by the Spanish government during the past few months.

The negative aspect is that the loans will go to the Spanish State and will, therefore, involve a significant increase in Spain's level of sovereign debt, strongly hinting to a similarity with the Irish case, in which bailing out the banks led to the country not having recourse to the financial markets. If the aid had been channelled directly to the banks, Spanish public debt would not have risen and the situation would have effectively led to the embryo of a European Banking Union, in which banks would no longer be national but European. This would have broken the vicious circle whereby public debt is no longer sustainable because the State is expected to bail out the banks, which –in turn– are in trouble because they are the main holders of a public debt whose risk premium is high because the markets discount the possibility that the State will absorb the banks' losses. But for such a Banking Union to materialise, accompanied by a European Deposit Insurance Fund and a single financial supervisor, we shall still have to wait.

Open questions

From now on, Spain will have a lifeline, allowing the Euro Zone countries to focus on Greece. Nevertheless, the bail-out might not solve the Spanish economy's problems with funding and other issues and, what's more, it may even give rise to new questions.

The first question has to do with the cost and timing of the European loans and the sustainability of Spain's public debt. Although the interest rate applied to the bail-out's loans will be lower than what Spain is paying when it issues public debt, the loan will lead to a sharp increase in the level of public debt over GDP (and, furthermore, austerity policies will make it rise even further as GDP is falling). This, along with the fact that the European Stability Mechanism (ESM) –from which most funds derive– has preferred creditor status could prompt investors to demand higher interest rates for Spanish bonds, which would again lead to a surge in the risk premium and bring about a second bail-out, but bigger this time and, furthermore, subject to full conditionality. In such a scenario, Spain would be excluded from the financial markets and would only be able to fund its payments through ESM and IMF loans, as is already the case with the other three countries that have been bailed out. No one wishes to even contemplate a scenario like this, both because it would absorb the ESM's entire funds and could spread the contagion to Italy, for which no more funds

would be available. For the time being, all that can be done is to closely monitor the cost of Spanish public debt issues over the next few weeks, since this will give an indication of whether investors believe the conditions of the bail-out to be sufficient.

The second has to do with conditionality. The Eurogroup's declaration insists that the economic policy conditions required for the loan will only affect the financial system. But it also underlines that the Spanish government must sign a Memorandum of Understanding (MoU) with the European institutions which lays out the accord's small print, ie, what Spain must do to receive each instalment. As the declaration says that 'the Eurogroup is confident that Spain will honour its commitments under the excessive deficit procedure and with regard to structural reforms, with a view to correcting macroeconomic imbalances in the framework of the European semester' and that 'progress in these areas will be closely and regularly reviewed also in parallel with the financial assistance', it cannot categorically be affirmed that there is no conditionality outside the financial sector. We shall have to wait until the MoU is made public to see to what extent there is an explicit Spanish commitment to continue implementing reforms and adjustments. This means that in the future we may see measures such as an increase in the age of retirement, higher VAT, the creation of an independent tax council or the drawing up of multiannual budgets. In any case, the key is that these and other measures, if adopted, should be based on a consensus with the national authorities, who best know the Spanish economy's strengths and weaknesses.

As in the past, Spain needs to implement structural reforms to enhance its growth potential and better exploit the opportunities offered by the globalised economy. And, also as before, Europe is the springboard from which to carry them out. But, contrary to previous occasions, the Europe of the Euro needs Spain to recover swiftly as it is now a systemic country within the single currency. Therefore, it is in everyone's interest for the bail-out to be effective, which requires Spain and the EU to both do their part.

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