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MACROCOSM

S&P Sp BBB = ECB SMP?

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Spain: ratings down, unemployment up. But this is no crisis, and the ECB won't act.

Update to strategic view

EUROPE MACRO, ECB: Standard and Poor's downgrade of Spain coupled with a worsening employment situation might be expected to lead to panic, and to ECB action. However, Spain is not suffering the loss of market access that makes a true crisis, and would meet the ECB's very high bar for intervention. The ECB meets in Spain next Thursday. We expect no new policy announcements or actions from them.

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Standard and Poor's cut Spain's sovereign rating by two notches to BBB+ after markets closed yesterday. This morning Spain announced that its unemployment rate has hit 24.4% -- just below 1994's record high of 24.5%.

Surely this double whammy for Spain will force the ECB to act in support of Spain's sovereign debt -- especially considering that the next ECB monetary policy meeting is being held in six days in Barcelona?

Well, no.

First, as usual, the ratings agencies are late to the party. S&P cut its growth projection yesterday for Spain for 2012 from +0.3% to -1.5%. Even the European Union was ahead of them, predicting Spain's 2012 growth at -1.0% last February.

- The Spanish government's reaction has been predictable, but is not without merit. They argue that the measures being implemented in Spain are for the medium and longer term, a point that S&P concedes in its announcement, saying, "we believe that the new government has been front-loading and implementing a comprehensive set of structural reforms, which should support economic growth over the longer term."
- The measures being implemented by the Spanish government are necessary to allow the Spanish economy to grow (see "A Spaniard in the Works" April 11, 2012). In the short term, the necessary restructuring will put growth in Spain under pressure -- but without the reforms, it is hard to see Spain ever achieving sustainable growth.
- So for Spain the argument seems to be either suffer a downgrade now for doing the right thing, or suffer a downgrade in the future for not doing the right thing now. We are certain they have made the right move.

But in Spain, the government is not in complete control of its fate. Further bank recapitalizations -- if necessary -- will increase the pressure on sovereign yields.

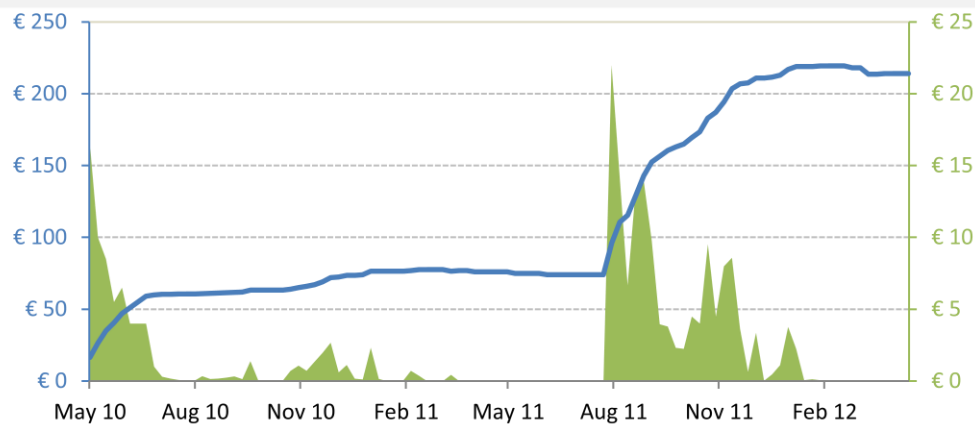
However, both Santander and BBVA -- Spain's two biggest banks -- have reported better than expected results in the past few days. Between them, these two banks hold nearly 25% of Spanish residential mortgages. The CEO of Santander, Alfredo Saenz, said with perhaps some degree of hubris that anyone who considers Spanish mortgages to be a problem is "saying something stupid." But this quarter's earnings reports from both Santander and BBVA back up his assertion. Unless there is outright fraud going on, it is very unlikely -- for the larger banks, at least -- that we will see a repeat in Spain of the disastrous banking rescues, and subsequent sovereign infection, which occurred in Ireland.

On the employment side, there is no escaping the sad realities of today's numbers. But again, the increase in unemployment is an expected -- if unpleasant -- side effect of the labor market reforms being undertaken by the Spanish government (see "Spanish Flu?" March 16, 2012). We've said repeatedly that unemployment will have to go up before it goes down, just as it did nine years ago when Germany painfully implemented similar reforms (see "Europe's Supply-Side Revolution" February 17, 2012).

The ECB, for its part, still sees no reason to act, and it is hard to disagree with them.

- ECB vice-president Vitor Constâncio today said that the market problems Spain is having are due to "misperceptions" and that Spain is pursuing the ECB's "scenario."
- In the past, the ECB has only intervened in the market when there was severe tension.
- Though Spanish bond yields are elevated, Spain still has access to markets. It does not seem to be causing enough concern for the ECB to activate its Securities Markets Program (SMP) under which it purchases peripheral sovereign debt.
- The SMP today reported purchases of €0 for the seventh week in a row, and has only purchased a total of €273 million since the end of January (see chart below).

ECB Securities Markets Programme EUR billions
Cumulative holdings **Weekly purchases**



Source: Bloomberg, TrendMacro calculations

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- So we do not see the necessary conditions to be in place -- yet -- for a reactivation of the SMP. But if the pressure gets so intense that markets become dysfunctional and the risk of contagion arises, we have no doubt the ECB will act.

Spain's current struggles are due to the reform of labor and product markets that has been driven through financial market pressure (see "Unquestionable Success?" March 9, 2012), and that pressure has to be maintained to finish the politically difficult process. However, the balancing act required to ensure just enough pressure is applied -- but not too much -- is a delicate one. If the pressure for Spain gets high enough that it risks derailing the process, the ECB will act. Until then, it will continue keep its SMP on the sidelines.

The calls for growth measures are increasing, with even ECB President Mario Draghi getting in on the act this week, calling for a "growth compact" for the euro area. He knows that he cannot solve that problem for the euro area -- one which requires a political solution, and that solution takes time.

When Mr. Draghi is in Spain next week for the ECB's monthly monetary policy meeting, we do not expect him to do more than compliment Spain on the progress it is making on a difficult path, and perhaps enjoy some *Rioja*.

Bottom line

Standard and Poor's downgrade of Spain coupled with a worsening employment situation might be expected to lead to panic, and to ECB action. However, Spain is not suffering the loss of market access that makes a true crisis, and would meet the ECB's very high bar for intervention. The ECB meets in Spain next Thursday. We expect no new policy announcements or actions from them.