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MACROCOSM

I Love the Smell of Bailouts in the Morning

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Lorcan Roche Kelly

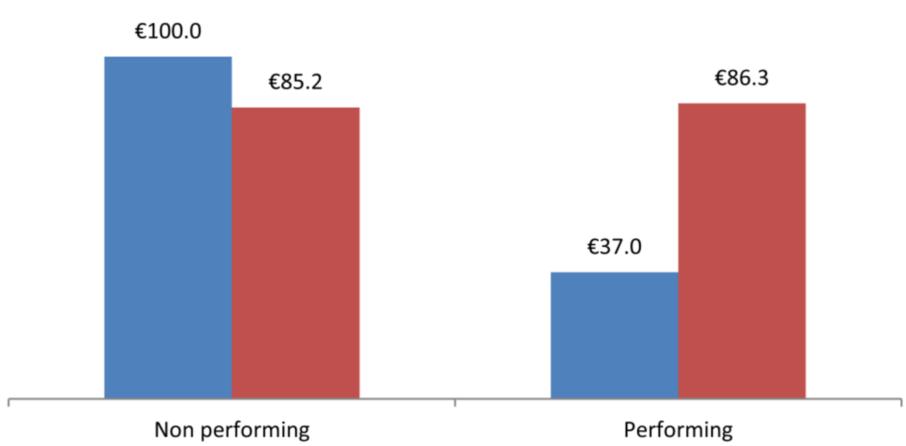
For Spain and Spain's banks, it smells like victory. But any rally will be fragile.

Spanish Prime Minister Mariano Rajoy has hailed the deal to use the European bailout mechanisms -- the temporary European Financial Stability Facility (EFSF) and its permanent replacement the European Stability Facility (ESM) -- as lenders to Spanish banks as a "victory" for Spain. If that was a little selfish-sounding, he also said, "It was the credibility of the euro that won."

The statement released by the Eurogroup (the meeting of euro area finance ministers) on Saturday outlines what victory looks like.

- An estimated -- *not maximum* -- €100 billion is to be made available for recapitalization of the Spanish banking system.
- Spain's banking crisis is focused on €309 billion in loans to property developers, the majority of which are non-performing, but less than half of which have been provisioned, leaving a worst-case gap of €172 billion -- about 16% of Spain's annual gross domestic product (please see the chart below). The estimated €100 billion bailout goes a long way toward filling the gap.

Spanish bank loans to developers, EUR billions **Provisioned** **Not**



Source: Ministerio de Economía y Competitividad, TrendMacro calculations

Update to strategic view

EUROPE MACRO, EUROPE BONDS: Spain's banking bailout elegantly cures a euro crisis hot-spot for now, recapitalizing the banks without making Spain itself a "program country" like Greece. But the devils in the deal's details leave the Spanish government on the hook, and may raise difficult issues if bailout debt is deemed senior to other sovereign debt. With French and Greek elections coming up, and SYRIZA agitating to get a Spain-like deal for Greece, there's no "all clear" signal in Europe yet.

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- The money will be channeled through the Spanish Fund for Orderly Bank Restructuring (FROB) an agency created by the Spanish government in 2009.
- As an organization under the control of the Spanish government, but operating at arm's length from it, FROB acts as a fig-leaf for both the EFSF/ESM and the Spanish government. Lending to it covers the EU rule that bail-out funds cannot lend directly to banks. And yet because FROB is not the government itself, it allows Spain to borrow without having to become a full "program country" like Greece, Portugal and Ireland.

There is no fiscal "conditionality" for the Spanish government itself under the deal. But the Eurogroup does impose conditionality on "specific reforms targeting the financial sector, including restructuring plans in line with EU state-aid rules and horizontal structural reforms of the domestic financial sector."

- Horizontal structural reforms have already been undertaken by FROB, leading to a reduction in the number of *cajas* (saving banks) from 45 to 11.
- "EU state-aid rules" mean that no institution in Spain can receive aid which gives it a competitive advantage. But this rule is unlikely to be breached now, when the money is about institutions merely surviving.
- The Eurogroup said that the pace of Spanish structural reforms -- highlighting fiscal and labor market reform -- will be closely monitored. It seems that the Eurogroup is happy with the supply side reforms Rajoy's government has implemented to date. There is no mention of sanctions if Spain fails to keep up the pace of reform.
- Spain has managed to get itself a goldilocks bailout: enough cash to recapitalize its banking system, but without the usual conditions attached.

A "victory" indeed, or so it would seem at first blush. Initial market reaction was very positive -- but already as of this writing Spanish sovereign bonds are weaker, and there is the inevitable market chatter that Italy will be the next nation in the crosshairs.

- The need for reform in Spain continues. Despite FROB being the nominal recipient of the funds, it is still the Spanish government that is ultimately on the hook for any shortfall in repaying the loans.
- The term of the loans to FROB will be important. FROB will need to earn a return on its investment in the Spanish banks in order to repay the EFSF/ESM loans. If it fails to get this return, or has to repay the loans before a return can be realized, then the Spanish government will have to pick up the bill.
- Further, there may be an issue of seniority for the portion of the EFSF/ESM loans funded by the ESM. EFSF loans are not senior, but loans from the ESM would, most likely, rank senior to other debt. It is annoyingly typical of Europe's muddle-through approach

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to crises that a detail as important as this is left as a loose end, for markets to fret about -- and to wonder what else might be wrong with the deal under the surface.

So for now, the bailout is good news for Spain, and for global markets that have been calling for a euro area response to the problems of the Spanish banking sector. But, there has been no true ultimate reduction of risk to the Spanish government, and there is now the real possibility that holders of Spanish debt may find themselves subordinated in the future -- "may" indeed: so far, no one knows.

Europe's fiscal compact cleared the hurdle of referendum in Ireland, and that is the only nation requiring such a vote. And now the Spanish bailout should ease investor worries at least about the banks, and at least in the short term. But June will continue to be an eventful and risky month for Europe.

- The coming weekend sees French legislative elections which will, whatever the outcome, perturb the new balance of power developing between Germany and France (see "Nein! Well, Maybe" May 29, 2012). The first round of those elections, held yesterday, showed strong support for Hollande's socialists, leaving a real possibility of a parliamentary majority following the second round on June 17.
- At the same time we have the re-run of the Greek election, with the result too close to call. The far-left SYRIZA party, which has promised not to honor the Greek bailout, has already said that the Spanish deal -- without fiscal conditionality attached -- means that Greece can renegotiate its current deal along the same lines. If this position leads to rising popular support for SYRIZA -- and a strong election victory -- any rally on the back of the Spanish deal will be short-lived.

Bottom line

Spain's banking bailout elegantly cures a euro crisis hot-spot for now, recapitalizing the banks without making Spain itself a "program country" like Greece. But the devils in the deal's details leave the Spanish government on the hook, and may raise difficult issues if bailout debt is deemed senior to other sovereign debt. With French and Greek elections coming up, and SYRIZA agitating to get a Spain-like deal for Greece, there's no "all clear" signal in Europe yet.