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A Spanish Bailout Would Test Europe’s Strained Finances

By RAPHAEL MINDER

MADRID — Europe so far has survived the bailout of Greece. The financial rescue of Ireland also is manageable. Even if Portugal becomes the third country to succumb and seek aid, as many people widely predict, it is unlikely to push Europe to the financial brink.

But any bailout of Spain — with an economy twice the size of the other three combined — could severely stress the ability of Europe’s stronger countries to help the financially weaker ones, and spell deep trouble for the euro, Europe’s common currency. Even though Spain, like Ireland, has adopted an austerity plan to help it avoid the need for a bailout, it still could need aid if its banking system proves frailer than the government thinks it is, as was the case in Ireland.

This troubling possibility has unnerved lenders, with Spain’s borrowing costs rising even though Madrid has cut its deficit and the country’s banks maintain they have sufficient strength to absorb their bad real estate loans. “Europe can afford the collapse of Ireland, even perhaps that of Portugal, but not that of Spain, so Spain’s ultimate line of defense is in fact this knowledge that it’s too big to fail and that it represents a systemic risk for the euro,” said Pablo Vázquez, an economist at the Fundación de Estudios de Economía Aplicada, a research institute here.

Reflecting the worries of investors, the yield spread between Spanish 10-year government bonds and those of Germany continued to widen on Wednesday — to as high as 2.59 percentage points, the biggest gap since the introduction of the euro. Spreads typically widen when investors perceive greater risk of not being repaid.

The problem for Spain is one of “self-fulfilling expectations,” said Jordi Galí, director of the Center for Research in International Economics at Barcelona’s Pompeu Fabra university. “If investors expect Spain to have trouble refinancing its debt, now or somewhere down the road, then Spain will have trouble,” he added. “This is only aggravated by the fact that the reluctance of investors to purchase the country’s public debt leads to an increase in the interest rate it has to pay and thus in the budget deficit and the amount of debt it has to issue.”

Elena Salgado, Spain’s finance minister, insisted on Wednesday that Spain would not need rescuing. She told Spanish radio that “we are in the best position to resist against these speculative attacks.” Indeed, some say that one of Spain’s relative strengths is that a large amount of its government debt — 203.3 billion euros ($271.1 billion) — is owed to its own banks, rather than foreign lenders. If the government's financial condition worsens, the thinking goes, Spanish banks would have a greater incentive to help out by easing terms on the loans than would foreign banks, which might take a harder line.

Of course, it is a bit of a double-edged sword; if the Spanish banks need to ease terms to help the government, they could be forced to swallow steep losses, hurting their balance sheets.

The likelihood of entering such a vicious circle could also rise next year, when Spain is due to repay lenders 192 billion euros, or about a fifth of the total debt. As a result of increasing interest it would have to pay for new borrowing, Spain faces a rise of 18 percent in the cost of financing its debt, according to the government's budgetary plan.

Investor nervousness is mounting just as Madrid is reining in a budget deficit that reached 11.1 percent of gross domestic product last year. Prime Minister José Luis Rodríguez Zapatero, initially slow to recognize the crisis, narrowly pushed through Parliament last May an austerity package that included 15 billion euros of spending cuts. As a result, Spain's central government deficit fell 47 percent in the first 10 months of this year, according to government figures released on Tuesday.

Ireland also made steep spending cuts, but still needed a bailout. The main reason is that its banks were a lot more troubled than the government realized, and it could not afford the cost of supporting them without help from Europe.

The looming question is whether Spanish banks are really as healthy as the government and the banks say they are.

Last July, Spanish banks emerged relatively unscathed from stress tests carried out across Europe, which showed that only five Spanish entities might have insufficient capital. All of them, however, were among the weaker cajas, or savings banks, that were already due to tap into a 99-billion-euro state restructuring fund and get absorbed in a consolidation round aimed at cutting the number of cajas to about 20 from 45.

But the credibility of the stress tests has since been undermined by the collapse of Irish banks. Spanish banks avoided the catastrophic subprime investments made by Irish and many other European financial institutions, but Spanish banks nonetheless had a "problematic exposure" of 180.8 billion euros to real estate and Spain's collapsed construction sector, like substandard and repossessed assets, according to a study by the Bank of Spain. The bank has gradually been tightening the provisioning requirements for repossessed assets.

Moreover, Spanish banks could suffer if Portugal's financial problems worsen. Spain is not only Portugal's biggest trade partner, it is also its biggest creditor, with Spanish banks holding $78 billion of Portuguese debt, according to the Bank for International Settlements.

"Spain's banks already have enough problems, but the exposure to Portugal could just turn into the wild cart which upturns the whole apple cart," said Edward Hugh, an independent economist based in Barcelona. Ireland's near collapse has revived concerns about Spanish banks, resulting in a plunge in their stock prices this week.

Spain's vulnerability would rise, warned Ralph Solveen, an economist covering Spain at Germany's Commerzbank, should the government veer away from its deficit-cutting objectives or Spanish banks show further signs of fragility. "One clear risk factor is the banking system and possible bad news from there, because then many people would start to draw parallels with the situation in Ireland, whether justified or not," Mr. Solveen said.

Another concern is that the central government's cost-cutting zeal might not be matched by regional and local authorities, which accounted for 57 percent of public spending last year. Coming regional elections, starting with Catalonia this Sunday, could persuade politicians to make some unsustainable spending pledges, in particular in regions like Andalusia, where some municipalities have already fallen behind in paying staff salaries.

The central government, however, appears determined to force greater fiscal discipline even on Spain's capital city. Last week, Mr. Zapatero rejected an appeal from the mayor of Madrid, which has debt of 7.15 billion euros, to relax recent restrictions on municipal debt issuance.

"Saying 'no' to the most powerful municipality in this country does send a very strong signal," said Antonio Fernández, head of restructuring and insolvency at Garrigues, a Spanish law firm.