THE FEDERAL RESERVE BANK OF ATLANTA

SOVEREIGN DEBT AND DEFAULTS AFTER THE FINANCIAL CRISIS 2007-2008
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SOVEREIGN DEBT AND BANKING CHALLENGES FOR SPAIN

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1. Macro environment and debt problems

After the bail-out of Greece, Ireland and Portugal, countries such as Italy or Spain are concentrating most of the attention in what the so-called sovereign debt crisis is concerned. In Spain, as in other EU member states, the economic recovery has weakened and there are symptoms that the country may face recession in the next few quarters. According to preliminary estimates of the Spanish Statistical Office (INE), real GDP was 0% in the 2011Q3 (0.8% year-on-year), after a quarterly growth of 0.2% in 2011Q2. Preliminary data suggest that a positive contribution from net exports has been offset by a further contraction in domestic demand.

Although official estimates forecast a growth in Spain of near 0.7% in 2012, most economic analysts expect a zero economic growth or recession in 2012 which, in turn, implies significant downside risks to Spain's fiscal consolidation efforts. Actually, Spain's budget deficit targets 6.0% of GDP for

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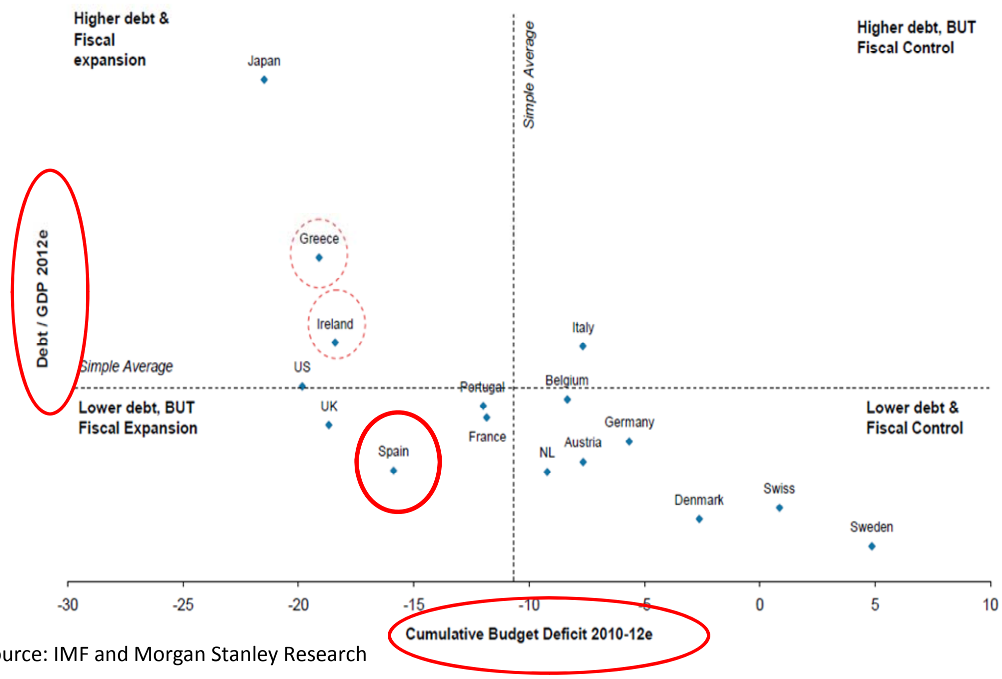
2011 and 4.4.% for 2012 (based on growth assumptions of 1.3% in 2011 and 2.3% in 2012).

The worsening of economic perspectives can be, to some extent, related to the persistent economic governance problems in Europe. In particular, the difficulties in designing a new aid programme for Greece and the recent political and economic tensions in Italy have prompted a renewed process of financial instability.

European countries show a different mix of public debt/GDP ratio and budget deficit. As seen in Figure 1, the main problem for Spain, in this matter, is that cumulative budget deficit while debt/GDP ratio is relatively lower than other euro area counterparts.

Figure 1. Public Debt/GDP and cumulative budget deficit (2010-2012e)



Source: IMF and Morgan Stanley Research

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In this context, the main efforts are being concentrated on fiscal consolidation and economic and financial reforms. It should be remarked, however, that the sovereign debt crisis in the euro area has interacted negatively with the situation of the banking sector and that this interaction is reflected in the low issuance of bank debt and in the investors' fears. The problem has implications not only for Europe but also elsewhere. For example, as shown in Figure 2, the foreign claims of US banks in Greece, Ireland, Italy, Portugal and Spain are very significant ($725 bln).

Figure 2. US Banks exposure to GIIPS (2011Q1)

Country Holding Exposure	Cross Border Exposure to: Greece	Ireland	Italy	Portugal	Spain	GIIPS
US Banks						
Foreign claims	**8,678**	**58,925**	**44,065**	**5,593**	**57,918**	**175,179**
Public sector	1,936	1,741	14,380	1,269	6,060	25,386
Banks	2,662	14,539	16,121	2,628	24,696	60,646
Non-bank private sector	4,080	42,645	13,564	1,696	27,162	89,147
Unallocated by sector	...	...	...	...	...	
Other potential exposures	**38,353**	**59,670**	**248,042**	**49,399**	**154,564**	**550,028**
Derivatives contracts	1,048	7,993	18,600	1,635	6,198	35,474
Guarantees extended	37,001	48,757	222,864	47,509	139,942	496,073
Credit commitments	304	2,920	6,578	255	8,424	18,481
Total	**47,031**	**118,595**	**292,107**	**54,992**	**212,482**	**725,207**

Source: BIS as of 1Q11. $US millions.

2. Debt problems and bank capital: recent developments in Europe affecting Spain

The worsening of financial conditions and the increase in bond yields during September and October 2011, led to new agreements at the European summit of EU Heads of State or Government on 26 October. These agreements can be summarized in three aspects: (1) defining the burden for the Greek case, including a voluntary acceptance by the private sector of a nominal discount of 50% on Greek debt; (2) the enlargement of the European Financial Stability Facility (EFSF); and (3) a programme to recapitalize European banks.

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Table 1. Estimated capital needs according to the European Banking Authority (data as of Sep. 2011)

Country	Estimated target capital buffer	Sovereign capital buffer*
AT (1)	2,938	224
BE (2)	4,143	5,634
CY	3,587	3,085
DE	5,184	7,687
DK	47	35
ES	26,161	6,290
FI	0	3
FR	8,844	3,550
GB	0	0
GR (3)	30,000	/
HU	0	43
IE	0	25
IT	14,771	9,491
LU	0	0
MT	0	0
NL	0	99
NO (4)	1,312	0
PT	7,804	4,432
SE	1,359	4
SI	297	20
Total	106,447	

amounts in million Euros

* The sovereign capital buffer is indicative and can already be covered by existing CT1 capital if the CT1 ratio exceeds 9

The recapitalization plans were based on calculations made by the European Banking Authority (EBA) and involved a raising of the Core Tier 1 capital ratio to 9% for the Systemically Important Financial Institutions (SIFIs). It also includes a process of "marking to market" of all sovereign debt exposures. As shown in Table 1, bank capital needs for Spain where estimated in Eur 26.1 bln while those of Germany and France together were set at Eur 14 bln. This

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was, somehow, surprising given the market performance of some French and German banks in recent months. It was also surprising to see that mark-to-market only affected sovereign debt while other securitizations and debt exposures are not required to be marked-to-market.

As the lack of resolution for sovereign debt problems in the euro area remains, many banks are making efforts to reduce their exposures on public debt and this is implies more pressure on bond yields and even (as shown in Figure 3 for Italy) a decoupling of sovereign debt and bank debt CDS curves.

Figure 3. Sovereign debt and bank debt CDS curves in Italy

Source: Markit

It is worthwhile noting that all the solutions that are being proposed in the euro area are mostly based on fiscal austerity and bank solvency requirements.

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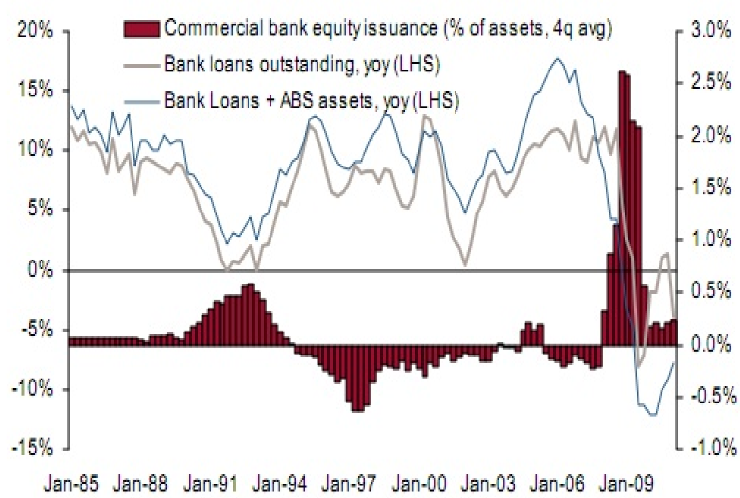
However, all these initiatives taken together will not benefit credit flows and will make difficult that banks continue financing and contribute to invest in the following next years. As shown in Figure 4, historical experience suggests that credit has been severely reduced in the short-term following the implementation of bank solvency regulations. This may be particularly harmful for countries as Spain where bank credit to the private sector is a key matter for investment and growth.

Figure 4. Bank capital regulations and credit growth in the world



Source: Credit Suisse, Haver Analytics®

3. The necessary steps in Spain and the additional efforts required for the banking sector

Given the complicated environment described above, Spain and its new government will have to face significant challenges in the near future and the banking sector will be one of the most important. Even if this note mainly concentrates on banking issues, Spain will have to face an ample set of

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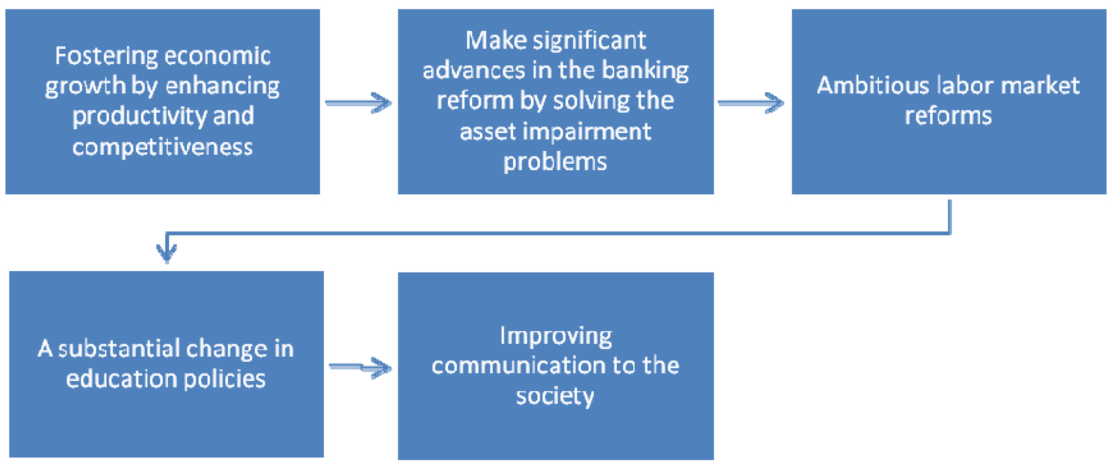
reforms, as summarized in Diagram 1, including: i) improving competitiveness and fostering economic growth by enhancing productivity instead of cutting spending in key sectors; ii) making significant advances in the banking reform by solving the problem of asset impairment that represents one of the main worries for foreign investors; iii) designing and implementing a more ambitious labor reform; iv) setting a modern and more meaningful education policy; v) improving the communication of all the reforms to the society so that all parties can be part of an intense forthcoming transition.

Diagram 1. Key reforms for the Spanish economy



Although all these reforms are very important, probably the most urgent problems in Spain (together with unemployment) are those related to the banking sector. As shown in Figure 5, bank lending to the private sector decreased by 3% on average from June 2010 to June 2011 with construction & property development (-7.6%) and households and mortgage loans (-7%) being the most negatively affected. Most importantly, the lower chart in Figure 5 reveals that even if lending to construction & property development has

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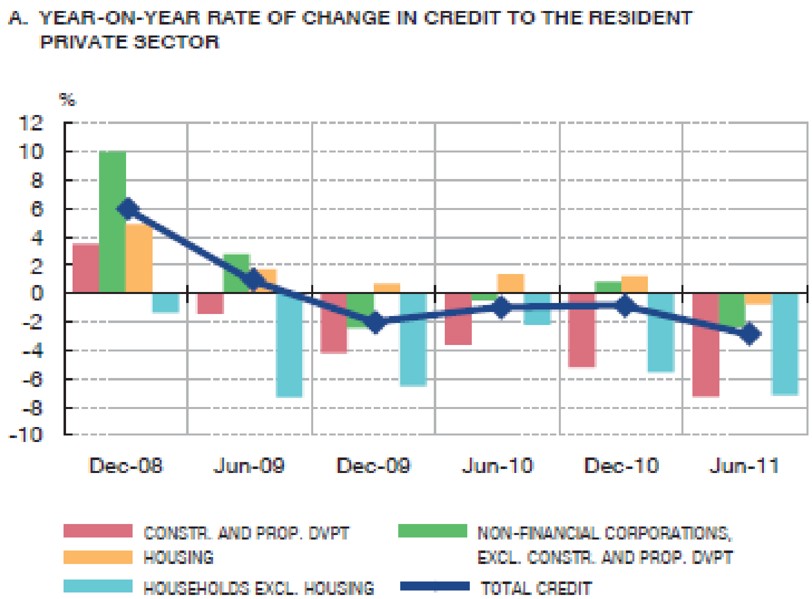
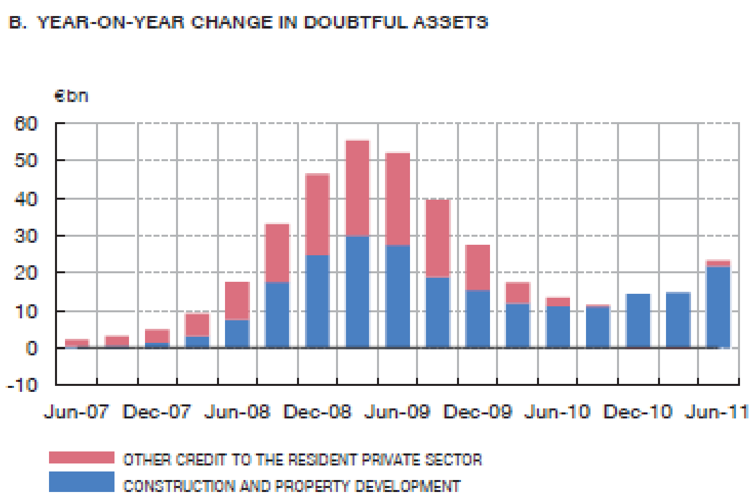
declined, the doubtful loans related to this sector are growing again in 2011 at a fast path. This reveals the dynamic nature of the bank asset impairment problem and it suggests that banks have been refinancing this type of loans but they are becoming non-performing faster.

Figure 5. Bank lending and doubtful assets in Spain (2008-2011)





Source: Bank of Spain

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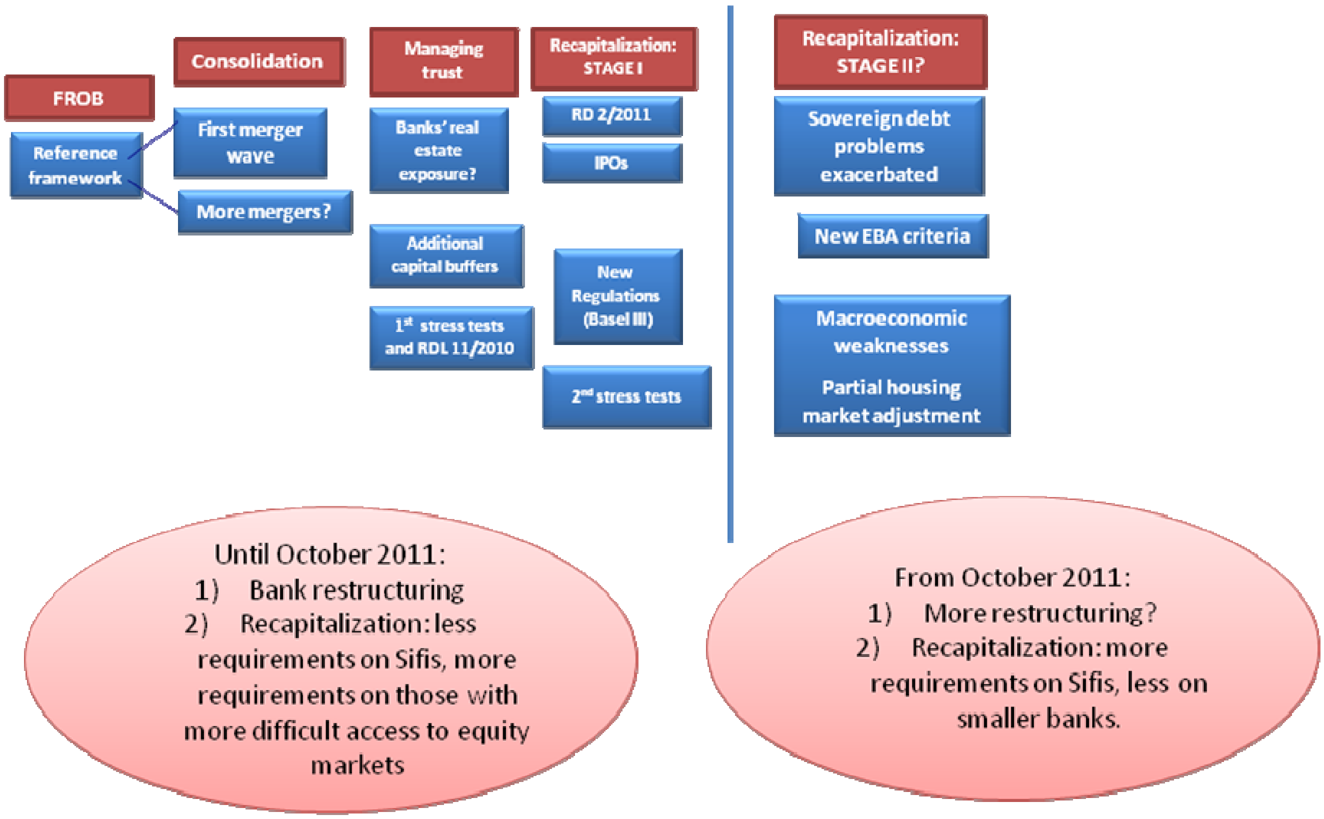
Diagram 2. The reform of the banking sector in Spain



What has been done so far in Spain? As shown in Diagram 2, Spain has been developing one of the most ambitious and intensive reforms in the banking sector. While the focus in other European countries has been on recapitalization (with almost no restructuring of the banking sector), in Spain the primary objective has been to undertake bank restructuring first and bank recapitalization afterwards. The aim of the recapitalisation of the banking sector has been that all Spanish banks should have a core capital ratio of at least 8% (10% if they were not an stock company and, hence, had difficult access to equity markets as some savings banks had). Those that did not meet the new minimum requirements had until 30 September to increase their capital, either

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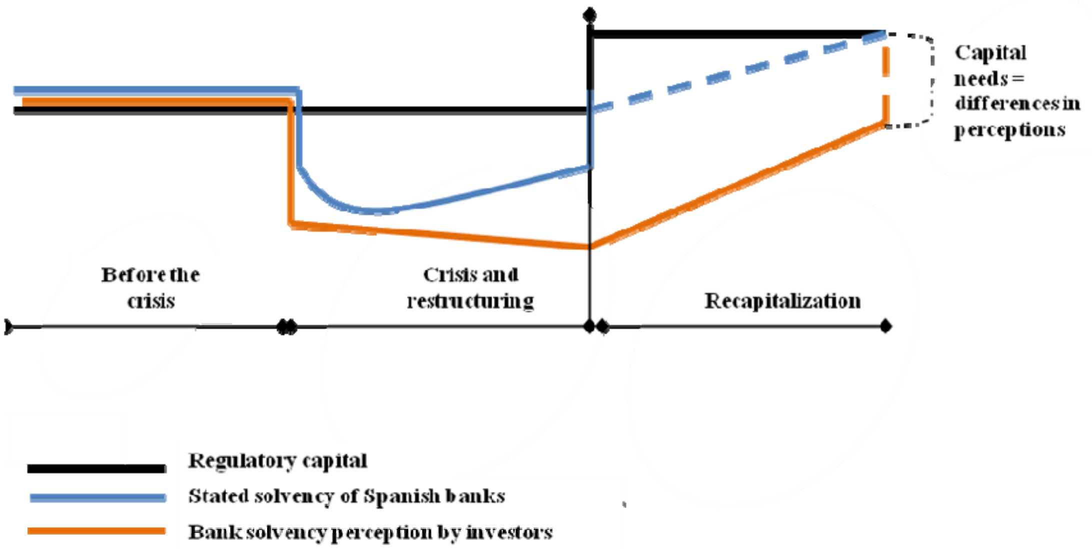
through private investors or through the Fund for the Orderly Bank Restructuring (FROB). On 30 September the Bank of Spain reported a contribution of Eur 7.5 bln by the FROB and the raising of Eur 5.8 bln billion of private capital, making for total additional capital of Eur 13.4 billion for those institutions that have had to strengthen their capital to meet the new minimum regulatory requirements. However, as Diagram 2 shows, the new EBA capital requirements may force Spain to make additional efforts, since the EBA now requires a core Tier 1 capital ratio of 9% to SIFIs (while in Spain is 8%). Ironically, markets require now a 9% for any bank, no matter if it is a SIFI or not.

Nevertheless, four years since the crisis started, the main problem for the Spanish banking sector is still the same one: the asset impairment problem has not yet been clearly solved. The latest Financial Stability Report of the Bank of Spain (November 2011) shows the painful exposure (doubtful assets, foreclosures and standard loans under surveillance) linked to real estate development, which accounts for Eur 176 billon, (52% of the total exposure to real estate development). This volume of troubled exposure is 11.4% of the credit portfolio (credit to the resident private sector for business in Spain, including, for this purpose, foreclosed assets) and 5.2% of consolidated assets. However, it would be useful to know to what extent these loans are still deteriorating (as economic conditions do) and what implications for banks' balance sheets and asset valuations it has. Outstanding in Figure 6, there seems to be a persistent difference between the solvency reported by Spanish financial institutions and the perceptions of investors. This difference generates a gap between regulatory capital and the capital that investors perceived as needed to cover the potential risks. As long as this information asymmetry is not corrected with additional information disclosure and further action to face the asset impairment problem, the perception on the solvency of the Spanish banking sector will continue to be negatively affected.

Figure 6. A roadmap for financial stability in Spain: regulation, investors' perceptions and bank recapitalization



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