EUROPEAN ECONOMICS FOCUS

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Can Spain take the pain?

- **Markets may have become more confident that Spain can get its public finances under control. But if Spain is to restore external balance within the euro-zone, it may have to accept a decade of deflation, stagnation and sky-high unemployment. Accordingly, while the short-term costs of leaving the euro-zone may seem prohibitively large, it may still be in Spain's best interest to do so.**
- Thanks to its large fiscal stimulus, Spain appears to have avoided an economic meltdown. **But with the Government now embarking on a long and punishing bout of austerity, Spain may soon re-enter recession.** Indeed, since firms and households are still sitting on mountains of debt and given a need for a long bout of deflation to restore external balance, Spain may yet suffer its own "lost decade".
- Against this backdrop, the Government will struggle to reduce its budget deficit over the coming years. If it is also forced to implement an expensive bailout of the banking sector, public debt might eventually peak at around 120% of GDP – on a par with the current level in Greece.
- **Despite all this, we think that there is a good chance that Spain could still get its public debt down to a more sustainable level in the medium term without defaulting.** But it is questionable whether it will be willing to accept a decade of deflation in order to restore full competitiveness.
- For now, there remains a strong political will to remain in the euro-zone and the Government is optimistic about the prospects for growth, meaning that Spain is unlikely to abandon the euro any time soon. **But if Spain is still mired in recession a few years down the line, with no end in sight, support for the euro could begin to disintegrate.**
- By then, Government debt might have reached 100% of GDP or more, meaning that it would be too costly to leave the single currency and continue to service its euro-denominated debt. **Accordingly, the Government would almost certainly be forced to restructure its debts by converting them from euros to Spain's new currency (the new peseta?)**. While this would certainly lead to frictions in financial markets, the likely losses would probably not be big enough to prompt a financial market meltdown, unless it prompted other economies, such as Italy, to abandon the single currency too.
- **In all, then, while we doubt that Spain would be the first euro-zone economy to exit the euro-zone, we think the benefits of leaving may outweigh the costs. If another peripheral economy abandoned the single currency and thrived, we think that Spain would probably follow suit.**

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Can Spain take the pain?

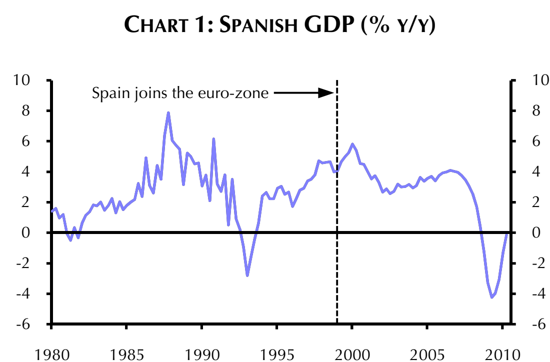
We have long warned that the huge build-up of private sector debt, asset price busts, banking sector problems and a poor competitive position, could result in a prolonged bout of stagnation, or a depression in Spain. (See *European Economics Focus* "Spain: how long will the pain last?" 6th July 2009.) Accordingly, the fact that Spain recently embarked on an economic recovery suggests that our analysis may have been too gloomy.

In this *Focus*, we argue that the economic imbalances within Spain remain acute and the recent pick-up in activity will prove a false dawn. Indeed, we continue to think that if the economy is to return to a more even keel then it will have to go through a prolonged period of stagnation at best. We then examine how long this process is likely to take and whether or not this might eventually prompt the Spanish Government to default or choose to exit the single currency.

A golden decade?

On the face of it, it seems that membership of the euro-zone has been a huge success for Spain. Between 1999 and the outbreak of the global slump, the economy grew by 3.7% per year on average – the only other euro-zone economies to expand more rapidly were Greece and Ireland. Not only was Spanish GDP growth pretty strong by historical standards over this nine year period, but it was also stable. (See Chart 1.)

CHART 1: SPANISH GDP (% Y/Y)



Source – Thomson Datastream

Admittedly, these figures exclude the 4.6% contraction during the recent recession. **But note that during the global slump, Spain's economic contraction was smaller than the peak to trough decline recorded in the euro-zone as a whole.** Indeed, between 1999 and 2009, annual growth still averaged a creditable 2.7%, far higher than the equivalent figure for the euro-zone of 1.5%.

But as we and many other commentators have previously argued, the GDP figures do not tell the full story. For a start, acceleration in GDP growth was largely down to an influx of foreign workers into the economy – *per capita* GDP growth was unchanged at 2.4%. (See Table 1.)

TABLE 1: SPANISH ECONOMIC INDICATORS (% Y/Y UNLESS STATED)

	Average		
	1979-1988	1989-1998	1999-2007
GDP	2.2	2.7	3.7
GDP per capita	1.7	2.4	2.4
Breakdown by expenditure			
Household spending	1.8	2.5	3.9
H'hold spending per capita	1.2	2.3	3.6
Investment	3.2	3.3	6.1
Government spending	4.4	3.7	4.9
Exports	5.7	8.9	5.3
Imports	8.0	9.7	8.3
Domestic demand (y/y contribution)	2.3	2.9	5.0
Net trade (y/y contribution)	-0.1	-0.1	-1.2
Breakdown by output			
Services*	3.9	2.9	4.1
Industry*	2.0	2.5	2.1
Construction*	2.1	2.6	5.6

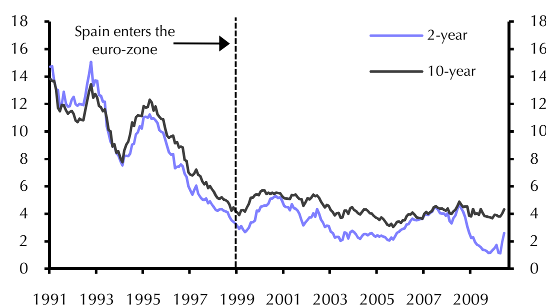
* Growth rates are for 1981-1988, rather than 1979-1988.
Source – Thomson Datastream

What's more, the economy became distinctly lopsided. Domestic spending accelerated and residential construction investment as a share of GDP doubled. But export growth plunged,

resulting in the external sector becoming a larger drag on the economy.

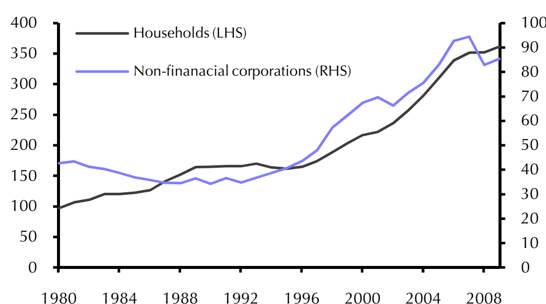
A key factor behind the surge in household spending and residential property construction was a surge in credit growth. In response to lower nominal and real borrowing costs and easier access to credit, both households' and non-financial firms' liabilities as a share of GDP roughly doubled in the ten years to 2005. (See Charts 2 & 3.) Not only did cheap credit prompt a surge in domestic spending, it also led residential property prices to boom, which in turn prompted ever greater numbers of houses to be built. As in Ireland, banks' fortunes have become heavily tied to residential property.

CHART 2: NOMINAL GOVERNMENT BOND YIELDS (%)



Source – Thomson Datastream

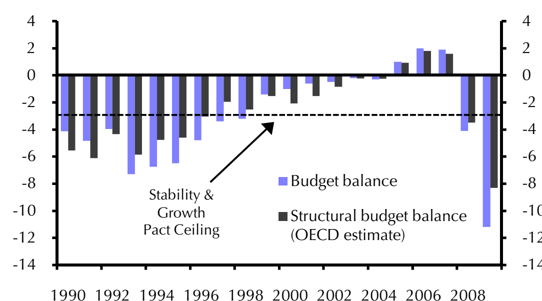
CHART 3: FINANCIAL LIABILITIES (% OF GDP)



Source – Banco de España

Admittedly, while the private sector was embarking on a spending binge, the Government steadily reduced its budget deficit from more than 7% of GDP in the early 1990s to a surplus of 2% in 2006. (See Chart 4.) This is in sharp contrast to the fiscal excesses that took place in Greece over the same period.

CHART 4: GOVERNMENT BUDGET BALANCE (% OF GDP)



Source – Thomson Datastream, OECD

But the private sector spending binge, which was financed by Spanish banks channelling overseas money into the economy, meant that by the early part of the decade the economy as a whole had become a large net borrower. Indeed, by 2007, the current account deficit exceeded 10% of GDP. What's more, this was mainly funded via short-term money inflows, raising the risk that these inflows could rapidly reverse. Persistent large current account deficits also led to a steady deterioration in Spain's net external asset position. **By Q4 2009, the economy's net external *liabilities* were equal to around 94% of GDP, a little higher than the equivalent figure for Greece.**

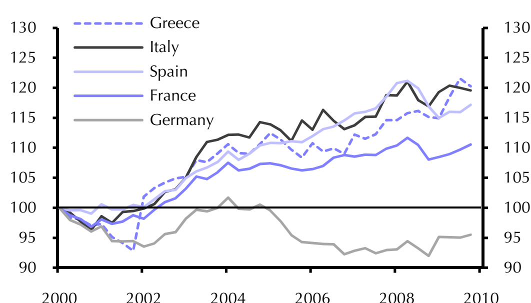
Competitiveness

The widening in the current account deficit was not just down to excessively strong domestic demand. A loss of competitiveness was undoubtedly an important factor too.

Between 2000 and 2009, compensation per employee rose by just over 40%. Over the same period, the only euro-zone economies to have recorded sharper increases were Ireland and Greece. **But relatively high wage growth did not reflect particularly strong productivity growth.** In fact, between 2000 and 2007, Spanish output per employee was broadly unchanged. Accordingly, since, Spain's real effective exchange rate, based

on whole economy unit labour costs has risen by about 17%, only slightly less than the rise in the equivalent Italian and Greek indices. (See Chart 5.) Given that the current account deficit was already a substantial 4% of GDP in 2000, a larger real exchange rate adjustment could be required to restore the current account to balance.

CHART 5: REAL EFFECTIVE EXCHANGE RATE (WHOLE-ECONOMY ULC-BASED MEASURE Q1 2000=100)



Source – ECB

Note that the CPI-based measure of the real exchange rate points to a similar sized appreciation this decade. Worryingly, the manufacturing unit labour costs-based measure points to an even larger appreciation of 30% or so since 2000. Note, however, that we think the manufacturing-based statistics are less reliable and we would therefore put more weight on the other real effective exchange rate measures.

Econometric models based on a country's economic fundamentals or its net external asset position can also be used to estimate the adjustment required to restore external balance. Using such models, the IMF estimates that by late last year, Spain's real effective exchange rate may have needed to fall by around 14% to eliminate the current account deficit.

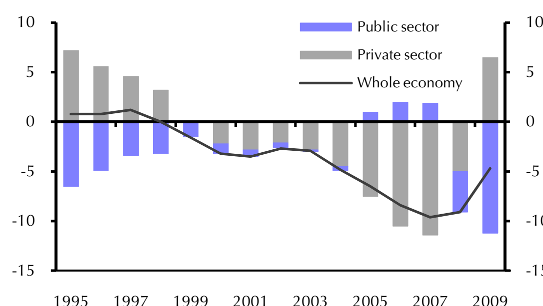
In all, then, it is clearly difficult to pinpoint how large a fall in the real exchange rate will be needed to return Spain's current account to balance. **But even after factoring in the fall in the euro since the start of the year, we think that an adjustment of between 10% and 15% might be needed.**

Why has Spain not suffered a harder landing?

In the decade or so since Spain adopted the euro, then, it has enjoyed a period of healthy growth. But Spain now faces severe headwinds. Like many of the other PIIGS, Spain has seen a steady rise in private sector indebtedness and declining competitiveness. And in some respects Spain's housing bubble has left it in a rather more vulnerable position than its Southern European peers. After all, falling Spanish house prices have left households', property developers' and banks' balance sheets looking distinctly vulnerable.

Despite all this, optimists will note that Spain's recent recession has actually been pretty mild by euro-zone standards. **But this reflects the fact that the Government reacted to the private sector switching from being a large net borrower to a big net saver by implementing a large fiscal stimulus.** (See Chart 6.) Indeed, between 2008 and 2009, the Government stimulus measures amounted to just over 7% of GDP, far larger than the fiscal boosts implemented in the euro-zone as a whole.

CHART 6: NET LENDING (% OF GDP)



Source – Banco de España

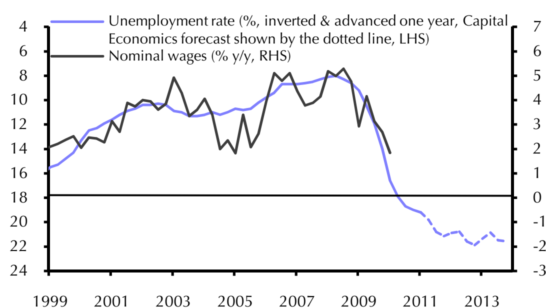
Needless to say, the Greek fiscal crisis, coupled with the fact that the Spanish budget deficit ballooned to more than 11% of GDP in 2009, means that from now on the public sector will act as a drag on the wider economy. Indeed, the Government has already announced measures that it hopes will generate savings worth 6% of GDP between 2010 and 2013. And over this period it aims to lower the budget deficit to just 3% of GDP.

Private sector recovery

Accordingly, if the economy is to stage a healthy and sustained recovery, private sector or external demand will need to begin expanding again. Unfortunately, the likelihood of a strong and sustained pick-up in either household spending or investment seems fairly low.

While there are signs that the worst of the labour market downturn is over, employment is still contracting pretty sharply. What's more, with the unemployment rate at 20% and rising, it is inevitable that wage growth will slow further. Indeed, it could eventually turn negative. (See Chart 7.) **This, combined with the fact that the fiscal squeeze is only just starting to take effect, and the fact that house prices may fall further, suggests that households' disposable incomes will contract for some time to come.**

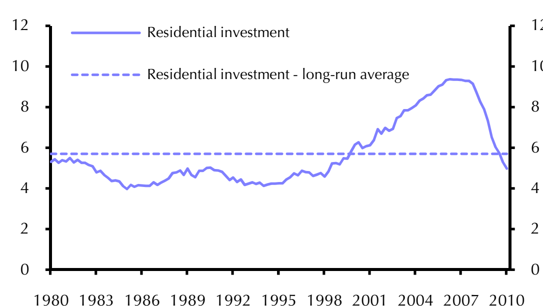
CHART 7: UNEMPLOYMENT & WAGES



Sources – Thomson Datastream & Capital Economics

Meanwhile, the fact that residential construction investment as a share of GDP has fallen below its long-run average, might provide hope that the construction downturn is coming to an end. (See Chart 8.) **But with homebuilders still potentially sitting on one and a half million unsold properties, this ratio may need to fall far further to eliminate the existing oversupply of dwellings.** Indeed, the experience of Germany during its post-reunification construction boom and bust suggests that it may be years before any recovery takes place. (See *European Economics Focus* "Spain: how long will the pain last?" 6th July 2009.) And with plenty of spare capacity in the economy equipment investment may remain weak too.

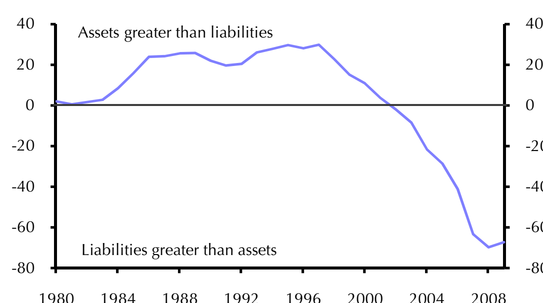
CHART 8: RESIDENTIAL INVESTMENT (% OF NOMINAL GDP)



Source – Thomson Datastream

Of course, low interest rates might still encourage households and firms to run down savings or even take on more debt. However, this seems unlikely. Despite the private sector reducing its liabilities over the past couple of years, they remain at very high levels. **What's more, the net asset position of the private sector has recently been little improved, suggesting that balance sheet adjustment is far from over.** (See Chart 9.)

CHART 9: H'HOLDS' & FIRMS' NET FIN ASSETS (% OF GDP)



Source – Banco de España

Finally, as we have long argued, a period of deflation could prolong the much-needed bout of belt tightening. (See *European Economics Focus* "Who is most at risk from deflation?", 28th October 2009.) After all, falling prices, wages and profits will increase the real value of firms' and households' debt, making the cost of servicing and paying down debt more expensive.

Even if we are wrong and households and firms are willing to go on another credit binge, they are likely to struggle to gain finance. Admittedly, the results of July's Spanish bank stress tests may have reduced the degree of uncertainty around the health of banks' balance sheets. But while this appears to have prompted some of the larger Spanish banks to be able to issue bonds at lower interest rates, other banks have reported that their funding situation remains fundamentally unchanged. This is not that surprising.

After all, €1.1trn or so of bank lending is either mortgage lending or credit to construction firms or real estate companies. This is the equivalent of around 60% of total bank lending, but the ratio for many banks will be even higher. **What's more, anecdotal evidence suggests that some banks are avoiding posting losses by using tactics such as rolling over loans to insolvent firms and purchasing properties from borrowers before loans go bad.** With the official house price statistics widely criticised for failing to provide an accurate picture of actual price developments, there is clearly a huge amount of uncertainty about just how big banks' "plain vanilla" losses from residential property will eventually be.

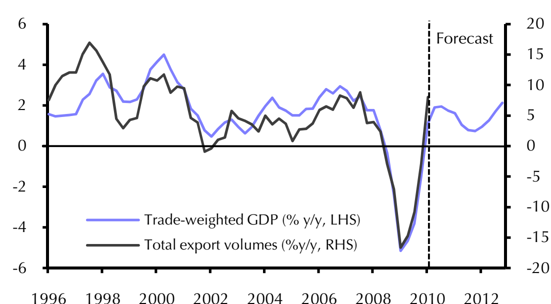
Accordingly, there is clearly a risk that many Spanish banks may need to wait for firm signs that property and land prices have plateaued, a solid economic recovery is under way and capital ratios have been boosted before they regain access to wholesale funding markets. In the meantime, if the ECB scales back its emergency lending operations further, things could get worse rather than better for Spanish banks. Not only does this all point to a prolonged period of tight credit, it suggests that the Government could be forced to follow its Irish counterpart's lead and pump huge amounts of cash into its banks.

External sector

Given all this, then, it seems that the external sector will have to be the source of growth if Spain is to embark on a sustained recovery.

But even if the euro reverses its recent gains and plunges to parity against the dollar, as we are forecasting, we remain unconvinced that this will trigger a sustained recovery in the wider economy. After all, almost 60% of Spanish exports are to other euro-zone economies (compared to just over 40% in Germany and Italy), suggesting that euro-zone demand will be the key. **Worryingly, however, our forecast for trade-weighted GDP growth in Spain's major euro-zone and non-euro-zone export markets suggests that the external revival will soon lose steam.** (See Chart 10.)

CHART 10: SPANISH EXPORTS & GDP GROWTH IN SPAIN'S MAJOR EXPORT DESTINATIONS



Source – Thomson Datastream

Of course, it is possible that our global growth forecasts are too gloomy or that the weaker euro prompts export growth to be stronger than Chart 10 implies. **Even so, any such gains may be offset to some degree if Spain loses global market share due to its poor competitive position.**

Admittedly, we expect weaker wage growth in response to the past slowdown in the labour market to lead Spanish unit labour costs to fall by around 2% over the next couple of years. But since overall euro-zone unit labour costs are also likely to fall slightly in response to weaker wage growth and stronger gains in productivity, further considerable falls will be needed in the medium term to restore external balance.

To illustrate the magnitude of the likely adjustment, Table 2 shows how long it might take Spanish unit labour costs to fall by 10% and 15%

relative to the euro-zone's (the amount which we think the real exchange rate might need to fall to restore external balance), under a range of different assumptions for wage and productivity growth. As a base case, we assume that beyond 2012, when our forecasts end, Spanish productivity rises by around 0.5% a year and euro-zone unit labour costs rise by 1% (both broadly in line with their averages of the past decade). If Spanish wages were unchanged beyond 2012, competitiveness would not be restored until 2018 if a 10% adjustment in relative unit labour costs were required, and 2021 if a 15% relative reduction were needed.

TABLE 2: REQUIRED COMPETITIVENESS ADJUSTMENT

Spanish Productivity	Spanish wages	Euro-zone ULC	Year in which Spanish competitiveness will be fully restored if	
---------------% y/y -------------			Spanish ULCs need to fall by 10% relative to euro-zone ULCs	Spanish ULCs need to fall by 15% relative to euro-zone ULCs
Stagnant wages, rising productivity				
0.5	0.0	1.0	2018	2021
0.5	0.0	0.5	2020	2024
Falling wages, rising productivity				
0.5	-0.5	1.0	2016	2018
0.5	-0.5	0.5	2018	2021
Falling wages, rising productivity				
1.0	-1.0	1.0	2015	2016
1.0	-1.0	0.5	2016	2017
Rising wages, unchanged productivity				
0.5	0.5	1.0	2020	2025
0.5	0.5	0.5	2028	2037

Source – Capital Economics

Of course, if productivity growth was stronger and wages fell, the adjustment would be quicker. But as Table 2 shows, even under fairly optimistic scenarios, it still might be at least 2015 before external balance is fully restored.

By contrast, if structural rigidities in the labour market meant that wages continued to expand, or unit labour cost growth in the euro-zone was lower than its long-run average, the adjustment could last a decade or more.

Accordingly, unless global demand rockets over the coming years, it seems unlikely that weak public and private demand can be offset by a boost from the external sector.

What does this mean for the public finances?

The upshot is that the economic outlook remains pretty bleak and Spain is far more likely to fall back into recession than embark on a healthy and sustained recovery. Indeed, with further austerity measures on the way, and the private sector saddled with a high level of debt, we expect domestic demand to continue contracting until at least 2013. And if Spain goes through a prolonged period of wage deflation to restore external balance, the downturn could last far longer.

As a result of all this, we have pencilled in small annual contractions in Spanish GDP in 2010, 2011 and 2012. By contrast, as Table 3 shows, the Government is taking a much more optimistic line. The stronger government forecasts primarily reflect a much more optimistic outlook for household spending and investment.

TABLE 3: SPANISH GDP FORECASTS (% Y/Y)

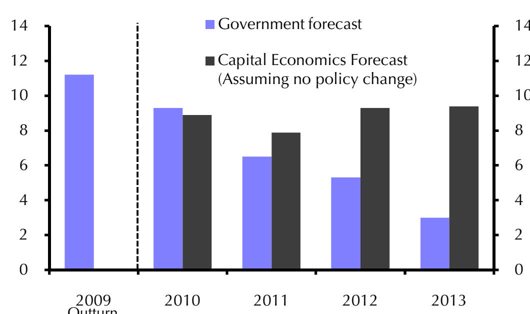
	2010	2011	2012	2013
Ministry of Finance	-0.3	1.3	2.5	2.7
Consensus Economics	-0.5	0.6	-	-
Capital Economics	-0.5	-1.0	-0.5	0.0

Sources – Spanish Economy & Finance Ministry, Capital Economics & Consensus Economics

Given our gloomier growth forecasts, we think that it will be no mean feat for the Government to meet its budget deficit reduction goals. **Indeed, if the structural (cyclically-adjusted) deficit is reduced in line with the Government's plans, but nominal GDP expands in line with our own forecasts, then we estimate that the overall budget deficit may remain close to 10% of GDP over the next few years.** (See Chart 11.) In other words, if Spain comes under pressure to meet its exiting headline

budget deficit goals, it will need to implement a far bigger fiscal squeeze than its current plans imply.

CHART 11: BUDGET DEFICIT FORECASTS (% OF GDP)



Sources – Spanish Ministry of Finance, Capital Economics

Based on all this, we think that the Government is unlikely to reduce its budget deficit to 3% of GDP by 2013. Instead, we think that 2015 is perhaps a more realistic timeframe to meet this goal. By then, it is not inconceivable that years of large budget deficits and stagnant or falling nominal activity will have pushed public debt up to almost 100% of GDP. Of course, if Spain were forced to implement an expensive bailout of its banking sector, the ratio could potentially rise higher. Note that it is estimated that the Irish banking crisis may cost the tax payer the equivalent of more than 20% of GDP, suggesting that it is not implausible that Spanish public debt could reach 120% of GDP. This would be on a par with the current Greek ratio.

Fiscal pain to continue in the medium-term

Given all this, returning the budget to balance will only be a first step in getting the public finances under control. The second stage will be to lower the debt to GDP ratio to a more sustainable level in the medium term. **After all, if the Government does not, it will be left with little scope to provide any fiscal stimulus in the future.**

To get an idea of how tight fiscal policy might have to be in the medium term, Table 4 shows the primary surplus (the budget surplus excluding interest payments) that the Government would need to run between 2015 and 2025 to return the public debt to GDP ratio to 90% of GDP by 2025. If nominal GDP growth expanded by around 5% and the average interest rate the government paid on its debt was 4.5% (these figures are broadly in line with the Government's own forecasts for 2013), then it would only need to run a primary surplus of 0.5% to lower the debt to GDP ratio from 100% to 90% of GDP.

TABLE 4: FISCAL CONSOLIDATION (2015-2025)

Long-run nominal GDP growth (% y/y)	Average interest rate paid by the Government (%)	Primary surplus needed to return the debt to 90% of GDP (Debt = 100% of GDP in 2015)	(Debt = 120% of GDP in 2015)
Optimistic scenario			
5.0	4.5	0.5	2.5
5.0	6.0	1.9	4.0
Trend growth & 2% inflation scenario			
4.0	4.5	1.5	3.5
4.0	6.0	2.8	5.1
Moderate growth & low inflation scenario			
2.5	4.5	2.9	5.1
2.5	6.0	4.3	6.7
Weak growth & low inflation scenario			
1.0	4.5	4.3	6.7
1.0	6.0	5.7	8.3

Source – Capital Economics

Admittedly, a surplus of 2.5% of GDP would be required to meet this target if public debt ballooned to 120% of GDP by 2015. But such a tightening appears feasible. After all, between 1996 and 2004, the Belgian annual primary surplus averaged more than 5% of GDP. Note too that Finland's primary surplus averaged almost 4% in the ten years to 2007.

Of course, there is a strong chance that these assumptions are too optimistic. But even if debt reached 120% of GDP, it might take a combination of nominal GDP growth of 2.5% or less *and* a pick-up in the average interest rate to 6% before the Government reached a point where the costs of debt service were deemed to be so great that it sought to restructure its debts.

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Based on all this, it seems that Spain might be able to go through a prolonged internal devaluation to restore external balance within the euro-zone and prevent the public debt to GDP ratio from surging to an unsustainably high level.

Euro-zone exit may benefit Spain

In comparison to Greece, then, there seems to be a much smaller chance of Spain defaulting on its public debt and then choosing to leave the euro-zone. But this does not necessarily mean that it is in Spain's best interest to keep the single currency. **From a medium-term perspective, it could conceivably be better for Spain to leave, even if it involves further economic pain in the short term.**

Of course, it is highly uncertain what the economic effects of exiting the euro-zone would be. Some commentators have suggested that the immediate costs, stemming from factors such as a potential banking crisis, increased uncertainty and higher borrowing costs, might exceed 10% of GDP. For the sake of argument, were Spain to immediately abandon the euro-zone and the economy contracted by 10%, activity could still return to its 2008 peak by 2018, providing that growth quickly returned to its trend rate of 2% thereafter. Were output to decline by 15%, it would take an additional three years or so for GDP to reach a new record high. If exiting the euro-zone prompted a smaller economic contraction of say 5%, output could reach its 2008 peak by 2015.

Meanwhile, if Spain remained in the euro-zone, and suffered a decade of near stagnation, it might be closer to 2025 before it reached the same milestone. Of course, we may have overstated the benefits of abandoning the euro or the costs of keeping the single currency. **Nonetheless, the economic costs of adopting a new currency may not necessarily be a large enough barrier to prevent Spain from exiting the euro-zone.**

Of course, policymakers would consider other factors too, such as its impact on the public finances, when assessing whether it made sense to leave the euro-zone. If the Government were to abandon the euro and the value of its new currency plunged, as seems likely, then the costs of servicing its existing euro-denominated debts would rise sharply, making a default much more likely. We estimate that if Spain did re-establish the peseta, experienced a 15% economic contraction and an immediate 15% depreciation of the currency, government debt might quickly exceed more than 100% of GDP and could eventually peak at more than 130%. Accordingly, the Government might have to run primary budget surpluses of well above 5% over the next decade to return the level of debt to a more sustainable level.

In other words, there is a strong chance that the Government would restructure its debts, probably by converting its debt into new pesetas, even if it abandoned the euro immediately. If the Government delayed leaving the euro-zone, leading its euro-denominated debts to climb higher, the chances of it avoiding a debt restructuring in the event of it ditching the single currency would be even more remote. If the Government were reluctant to default, due to reasons of international prestige or for fear that it could have damaging political consequences, it might resist quitting the euro-zone, even if there were clear medium-term economic benefits in the form of improved competitiveness and the ability to set monetary policy.

Note too that quitting the euro-zone and restructuring its debts would probably result in the Government being unable to tap the markets for funds for a period of time. Given that we expect the primary budget deficit to equal about 8% of GDP this year, an immediate exit and default would inevitably lead to an incredibly vicious fiscal squeeze. This suggests that Spain is unlikely to abandon the euro until it has eliminated its primary deficit, which we think could take more than four years.

For now at least, then, there remains a strong political will to remain in the euro-zone. This,

combined with a belief within the Government that Spain will soon embark on a strong and sustained recovery, suggests the chances of it abandoning the euro-zone imminently are slim. But if our gloomy economic forecasts prove correct and the unemployment rate climbs further above the 20% mark, euro disillusionment is likely to grow. **We doubt that Spain would be the first economy to choose to leave the euro-zone.** But if other peripheral economies, such as Greece, exited the region and performed well then there is a strong chance that Spain would follow.

The impact of a Government debt restructuring

So if Spain were to exit the euro-zone, perhaps in four or five years' time, and the Government restructured its debts too who would bear the costs of the debt restructuring?

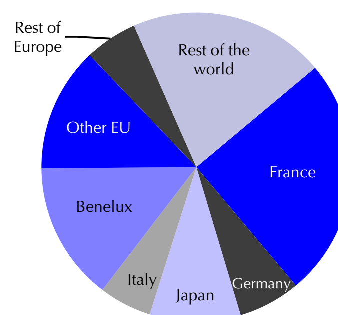
If the Government quit the euro-zone, redenominated its debts in its new currency, along with *all* other domestic debt contracts, this should, in theory, have no real effects on the domestic economy. **After all, the relative size of domestic firms' and households' assets would remain unchanged.**

But even if all debt contracts between Spanish debtors and creditors were converted, some banks, firms and households would still be left with euro-denominated debt. For instance, if a Spanish firm borrowed from a German bank, the latter would be unlikely to agree to redenominate the debt contract and there could potentially be a prolonged bout of litigation before it was decided whether the contract should be converted to pesetas or not. Note however, that these are costs associated with abandoning the euro *not* the restructuring of government debt.

While a redenomination of Spanish government debt might not hurt domestic investors, the same will not be true for foreign bondholders. If the new peseta weakened against the euro, foreign holders of government debt would see the euro value of their debt contracts fall. In Q1 2010, just over €300bn of Spanish government debt was held by foreigners (or just over 50% of the total stock of government debt). Accordingly, if the new peseta dropped by 20% as soon as Spain exited the euro-zone, the euro-value of foreign investors' *existing* government debt holdings would decline by €60bn (300*0.2).

As Chart 12 shows, around three-quarters of foreign-owned bonds are held by European Union investors. A 20% drop in the new peseta would result in these investors losing around €45bn. Within the region, French ownership is highest, suggesting that the impact here could be particularly great. Although the size of such losses would be bound to cause tensions in financial markets, note that the ECB estimates that euro-zone bank write-downs between 2007 and 2010 are likely to be many times higher, at around €515bn.

CHART 12: FOREIGN OWNERSHIP OF SPANISH GOVERNMENT DEBT (% OF TOTAL FOREIGN HOLDINGS, Q4 2009)



Sources – Banco de España

Accordingly, unless the Spanish government redenominated its debt into pesetas and altered other terms of the debt contract too, we doubt that the direct costs of converting debt into new pesetas would prompt financial market meltdown, particularly if European banks have managed to build up rather larger buffers by then. But note that the direct costs related to the collapse of Lehman Brothers were also small and the market implications were huge.

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Conclusion
In all, then, with Spain set for a huge fiscal squeeze, the private sector saddled with huge debts, banks in no position to lend and the external sector hampered by a lack of competitiveness, a sustained and strong recovery remains far away.

On the face of it, Spain's low level of government debt may mean that the public finances can withstand a long period of stagnation even if the potential future costs of supporting its banking sector are factored in. But it is more questionable whether voters and politicians will be willing to go through more than a decade of internal devaluation to restore external balance, particularly if another peripheral economy were to leave and do well.

Were an economy of Spain's size to choose to leave, it would inevitably cause increased speculation that others could follow suit. **Indeed, if it prompted markets to become significantly more concerned about the full break-up of the single currency, the impact of a Spanish exit on the financial markets could be huge.**