

ECONOMICS: EUROPEAN PERSPECTIVES—JULY 16, 2010

Improved Household Finances Could Help Cushion Spain's Fiscal Adjustment

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Spain is still running a substantial current account deficit and the financing environment remains hostile. Foreign borrowing is likely to fall further as the government starts to cut its massive budget deficit. Fortunately, the household sector is now running a huge financial surplus which could act as a cushion against aggressive fiscal tightening.

Ever since Europe's sovereign debt crisis erupted at the end of last year, financial markets have been trying to identify the next "Greece". Not surprisingly, Spain is one of the countries that have come under the microscope. Still, it's important to realize that the roots of Spain's problems are very different from those of Greece.

Spain is essentially the story of an explosive private sector credit boom that spiraled out of control and is now spilling over onto the public sector balance sheet. Two factors provided the fuel for this boom. First, monetary conditions became highly expansionary after Spain joined the euro, with real interest rates averaging -0.1% between 1999 and 2007.

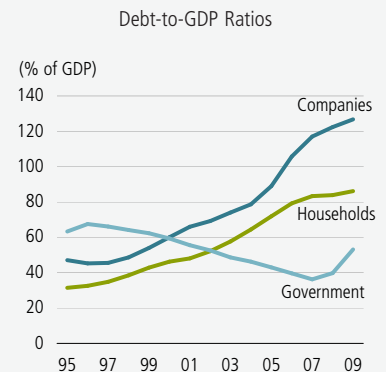
Second, membership of the single currency led to an unprecedented increase in credit availability from abroad. This allowed households and—especially—companies to live well beyond their means. At the

height of the boom, Spanish households and nonfinancial companies were running a combined financial deficit equal to 13.5% of GDP.

This persistent borrowing has led to a rapid rise in the stock of private sector debt. Since 1999, Spanish household debt has risen from 43% to 86% of GDP. Company debt has increased even more strongly, from 54% to 127% of GDP (**Display 1**). With the economy buoyant, government debt fell from 62% of GDP in 1999 to 36% in 2007. But the subsequent recession has led to a rapid reversal of this downward trajectory.

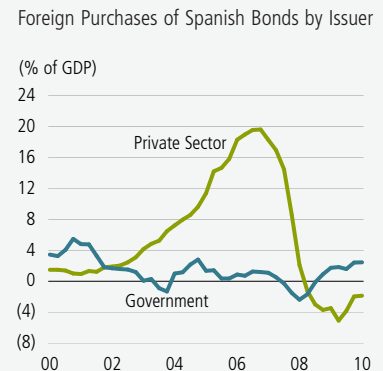
The tightening of global credit conditions that began in the second half of 2007 led to an immediate change in the financing environment for Spanish companies and households. Until then, the credit boom had ultimately been financed by nonresident purchases of bonds issued by banks

Display 1
Huge Increase in Private Sector Debt



Source: Haver Analytics and AllianceBernstein

Display 2
Collapse in Nonresident Bond Purchases



Source: Bank of Spain, Haver Analytics and AllianceBernstein

and other financial institutions. These inflows peaked at €193 billion, or 20% of GDP, in 2006 but came to an abrupt halt in the fourth quarter of 2007 (**Display 2**).

This had an immediate impact. Between 2007 and 2009, Spanish households cut their combined current and capital outlays by 7%, and companies reduced investment spending by 24%. As a result, the household sector converted a financial deficit equal to 2.4% of GDP into a 7.1% surplus and the corporate sector reduced its deficit from 11.1% to 2.2% of GDP (**Display 3**).

The effect has been to turn the Spanish nonfinancial private sector into a net saver: The combined financial surplus of households and companies was 4.9% of GDP last year. But, because there has been an offsetting deterioration in government finances—the budget deficit was 11.2% of GDP last year compared with a 1.9% surplus in 2007—the current account is still in the red and Spain remains heavily dependent on external finance (**Display 4**).

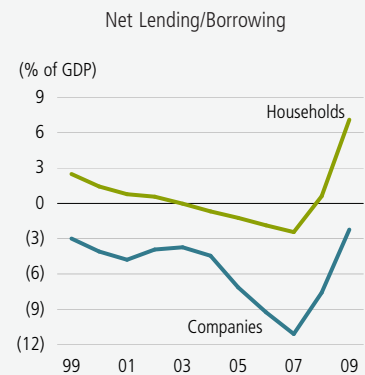
When nonresidents halted their purchases of private sector bonds in the second half of 2007, current account financing initially switched to purchases of government bonds and money-market paper (**Display 5**). But with confidence in the Spanish government and banks fading, even these flows cannot be taken for granted. There is still considerable pressure for Spain to reduce its current account deficit.

This should be achieved via much lower public sector borrowing: The government plans to reduce its budget deficit to below 3.0% of GDP by 2013. This, in turn, is likely to have a deflationary impact on the economy. However, we should not ignore the recent improvement in private sector finances.

The position of the household sector is particularly encouraging. Last year, Spanish households had an even bigger financial

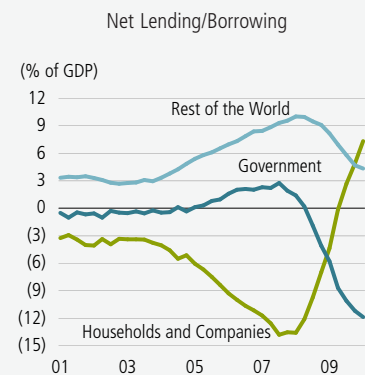
surplus than Germany (7.1% of GDP against 6.2%). The stock of outstanding household debt may also be less problematic than is often assumed. Because most mortgages are at variable rates, debt-servicing costs have fallen very quickly (from 6.9% of disposable income in 2008 to just 3.7%) and are now back in line with their pre-boom average. While rates remain low, there is little pressure to de-leverage, and households could provide an important cushion as the government starts to tighten fiscal policy. ■

Display 3
Rapid Private Sector Adjustment



Source: Haver Analytics and AllianceBernstein

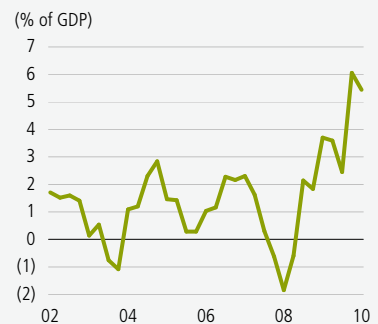
Display 4
Still Dependent on External Financing



Source: Haver Analytics and AllianceBernstein

Display 5
Change in Source of External Finance

Nonresident Purchases of Government Bonds and Money-Market Paper



Source: Bank of Spain, Haver Analytics and AllianceBernstein

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