



## IMF Special Report: Sorting Out Spain

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While banks in France are threatened by their exposure to the sovereign debt of Greece, the greatest risk facing the banks of Spain is the weak economy of Spain itself, says Mauro Guillen, professor of international management at Wharton.

Spain's unemployment rate remains in the 20 percent range, and growth prospects for next year are now 1.1 percent, down from a forecast of 1.6 percent just three months ago, the IMF said on Wednesday. The terrible economic picture pressures the profitability of Spanish banks, at the very least. And over the longer run, the weak economy could pressure tax revenues to the point where Spain has trouble paying down its own debt, much of which is held by the banks of Spain.

Guillen, who has researched and written about banks in his native Spain, discussed the relationship between Spain's economy, its banks and the large amounts of Spanish debt on balance sheets of those institutions. Here are highlights of his conversation with Institutional Investor contributing writer Steve Rosenbush.

**Institutional Investor: It's a foregone conclusion for people that Greece will default, threatening the viability of banks that hold its debt. What's the exposure of Spanish banks to Greek debt?**

Spanish banks have a lot of exposure to the sovereign debt of Spain, and quite a bit of exposure to the debt of Portugal. But exposure to Greek sovereign debt is mostly a problem for Greek, French and German banks. Spanish banks have about €1 billion of exposure to Greek debt, while French banks have about €11 billion of exposure, and German banks have €19 billion of exposure.

**The government has set aside €15 billion to €20 billion to recapitalize Spain's banks. So where are the weaknesses in the Spanish banking system?**

Spanish banks have a lot of exposure to the Spanish real estate market. They have more than €300 billion of exposure to real estate, which much of it concentrated in the smaller banks, known as cajas. That's a problem because unemployment is very high, at about 20 percent, and economic growth is slow. As a result, credit quality is deteriorating and there is a high risk of default.

So the vulnerability of Spanish banks all goes back to the economy, and the need for growth. The problem is the economy is so depressed. It is just not growing. If the problem persists long enough, Spain could face a solvency problem of its own.

### **How should the government of Spain, Europe, the IMF and other authorities address the problems facing Spain and the rest of Europe?**

The situation right now is very similar to the summer of 2008. But there are some differences. In 2008, governments had not yet engaged in emergency measures. Now they have, and they are in some ways more constrained than they were three years ago. They have tried emergency measure, and they haven't worked very well. In 2011, the situation is more difficult.

I think we are getting our priorities wrong. In the short run, it is most important to get growth, well, growing. Deficit reduction is important, but not as urgent. Growth is the most important thing. It is not clear how that will be achieved, though. Government measures have not been very successful. Consumers are weak. Exports can help, but you have to know how to sell in export markets. And not every country in the world can plan its future on exports. There has to be a source of demand.

Most people, including myself, believe that exports will not be enough to increase economic growth in Spain. There has to be an increase in demand, and it is unclear which sector it will come from. It is unlikely to come from the government and it can't come from the private sector right now. We are in kind of a Catch-22 situation.

### **How are Spain's two largest banks, Santander and BBVA, positioned in this crisis?**

They are positioned relatively well. The real estate debt is concentrated among the smaller banks, and the two largest banks have less exposure to Spain's domestic market than they did five years ago. They are truly multinational corporations, with businesses in Europe, the United States and elsewhere.

**In the past, Spanish banks have been somewhat better capitalized than the European average, with higher Tier 1 capital ratios. Is that still the case? How would you characterize the financial strength of the sector, especially when it comes to smaller Spanish banks?**

Yes, Spanish banks in general are better capitalized than the average European bank, as shown in the latest stress tests. It's a diverse picture, though. The two large banks are well capitalized. So are several of the medium-sized banks. The cajas are a mixed picture. A few are in very good shape, but others will need injections. The one caveat is that if low growth and high unemployment persist for more than two to three years, more of them could get into trouble.