

S T R A T E G Y E C O N O M I C S

18TH OCTOBER, 2012.

SPAIN – THERE COULD BE A BALE-OUT INSTEAD OF A BAIL-OUT

SUMMARY

- **Spain does not want to request aid from the ECB – it is politically humiliating.**
- **It has already seen what happens to countries that get 'rescued' by the EU and the ECB.**
- **There could be a bale-out rather than a bail-out – in the sense that Spain may decide to exit the euro.**

The markets are spending a huge amount of time trying to figure out the answer to a very simple question. When will there be a Spanish bail-out – a request for emergency aid from Prime Minister Mariano Rajoy that will trigger ECB intervention to start buying on bonds on a massive scale.

But they may have missed the real story.

There could be a bale-out – in the sense of a pilot baling out a plane – instead of a bail-out. In other words, the Spanish might decide to quit the euro rather than submit to the demands of an EU-led rescue package.

Crazy? Not completely. In the election last year Rajoy promised not to seek a bail-out. Investors have grown cynical about politician's promises – and rightly so. They get broken so often they aren't usually worth listening to. But it is just possible that he actually meant it – and right now, the only way he can make good on that pledge, and save his own political skin, is to start plotting for the return of the peseta.

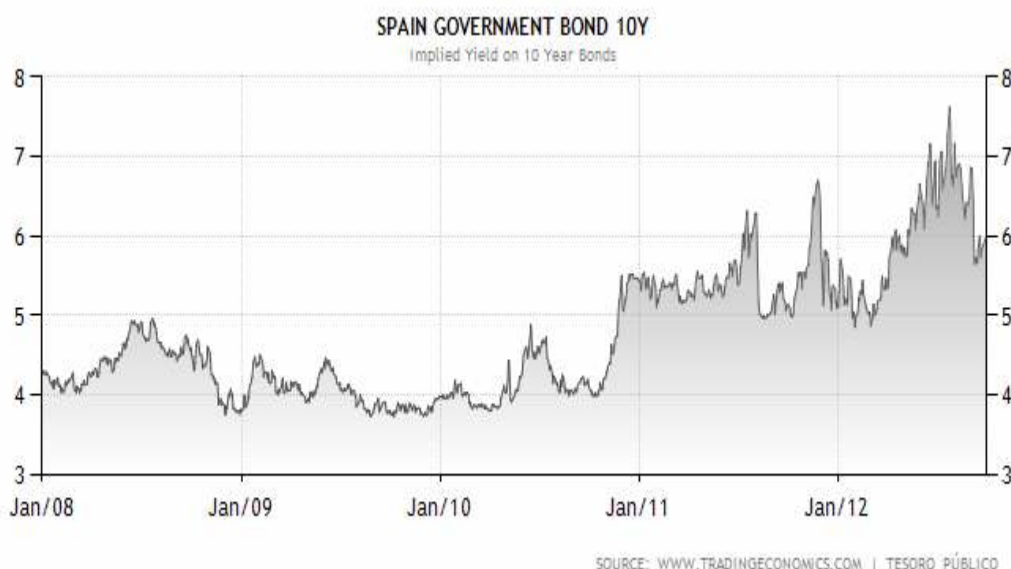
ONE: SPAIN DOES NOT WANT TO REQUEST AID

There can be little doubt that Rajoy will avoid applying for an ECB rescue if he possibly can. The right-of-centre leader took power in December last year after winning the election on a platform of avoiding the fate of Greece, Ireland and its neighbour Portugal, and being forced into a rescue from the rest of the euro-zone. If he has to break that pledge, he'll look like both a liar and a clown, and that is hardly a happy combination for anyone seeking re-election.

True, he might still get away with avoiding a bail-out. There is a slim chance the mere threat of ECB intervention will bring Spanish bond yields back down to acceptable levels. It has got them back under 6%, but that is mainly because dealers suspect the ECB may wade into the market any day, and don't want to be on the wrong side of the trade when it happens. Delay too long and yields will spiral out of control again.

Likewise, it is possible that labour market reforms might eventually restore the competitiveness of the Spanish economy, and that its banks will eventually get all the dud property loans off their books, allowing the country to start growing again within the single currency.

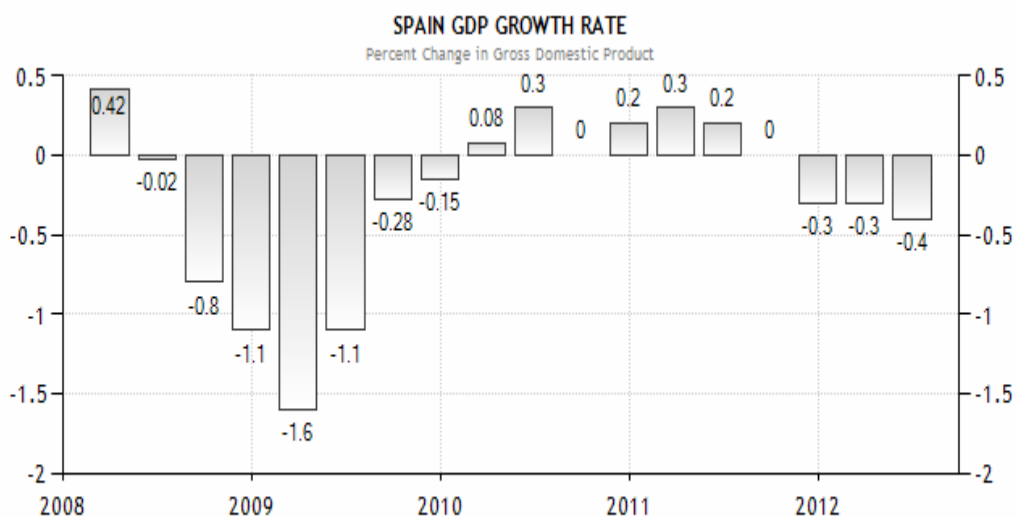
Possible. But both seem very unlikely. Right now, Spain is sinking into a Greek-style depression, with escalating debts, and a shrinking economy. There is, however, one way the Spanish could avoid a bail-out. They could leave the euro and restore the peseta.



TWO: THE BALE-OUT OPTION

That has always been an attractive option for the Spanish – and more so than the other countries struggling to survive in the single currency. This was a country that had tired of authority before it had even begun – it was in Madrid that the *indignados* protests started last year. It had terrible unemployment – more than 10% of the workforce and 20% of young people – before the downturn even began. A recession is a hard thing to bear when that many people are already out of work.

On the flip side, life outside the euro-zone doesn't hold much fear for the Spanish. Unlike the Greeks, they don't have to worry about how they will make their living in the world. Underneath the euro-crisis, Spain has a robust, successful economy. It has a similar export to GDP ratio as the UK and France – about 27% - meaning it makes lots of stuff and sells it around the world. And, rather like the Britain, it has broader horizons than the euro-zone economy: Spanish companies look towards the fast-growing South American economy rather than sluggish Europe as a place to sell their goods. They are members of the single currency for largely practical reasons. If it works, great. If not, they could easily be off.



Right now, there are two extra factors that have to be added into the equation.

First, it is now clear the euro rescue packages are a road to nowhere. The Greek economy is still shrinking rapidly two years after it was 'rescued', and is currently having to negotiate a humiliating third bail-out. Portugal is back in crisis: the government has already had to back down on tax rises to try and meet the EU imposed deficit reduction goals, and the country is sinking into a deepening recession. Even the hyper-competitive Irish economy shows little sign of recovery two years after its 'rescue'. Who could willingly sign their country up for a program which has been demonstrated, beyond any reasonable doubt, to involve vast sacrifices for no apparent gain?

Worse, euro-imposed austerity may tear the country apart. Catalan nationalism has resurfaced, with snap elections in the region scheduled for later this year. Spain has always been a splintered nation. What happens to Catalonia's debts should it leave Spain and declare independence? No one really knows. But it is certainly possible for opportunist local politicians to argue they should be repudiated. Regional independence parties can promise an easy way out of austerity.

A Spanish PM who asks for a bail-out is risking the unity of his nation. That is a big call to make. Against that, wouldn't the bail-out be more attractive?

After all, Spain is a competitive economy, with lots of successful companies. If Rajoy announced he was restoring the peseta, and started touring the world's capital markets, he'd have a good story to tell. With its own currency, and its own central bank standing behind its financial institutions, the country could devalue, restore its competitiveness at a stroke, and start taking market share from French and German rivals. Reformed labour markets would deliver more jobs once austerity was eased. And the tourist industry would boom on the back of a cheaper peseta. It's not a bad pitch – and certainly good enough for plenty of investors to buy into, and to start investing in the new currency.

It could be a surprising painless transition. Far-fetched? Possibly. But it is not so crazy that investors should assume the bail-out is a done deal. Spain could simply walk away instead.

- Matthew Lynn
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FORECASTS

THE UK ECONOMY

	2012	2013	2014
GROWTH:	-0.2%	0.9%	1.5%
INFLATION:	3.1%	2.9%	2.7%
UNEMPLOYMENT:	9.2%	10.2%	9.5%

THE EUROZONE ECONOMY

	2012	2013	2014
GROWTH:	-0.7%	0.2%	1.2%
INFLATION:	2.0%	1.8%	1.8%
UNEMPLOYMENT:	9.4%	9.2%	9.4%

THE GERMAN ECONOMY:

	2012	2013	2014
GROWTH:	-0.5%	1.0%	1.4%
INFLATION:	2.0%	2.2%	2.4%
UNEMPLOYMENT:	6.6%	6.8%	6.9%

THE FRENCH ECONOMY:

	2012	2013	2014
GROWTH:	-0.7%	1.0%	1.0%

INFLATION:	1.9%	2.3%	2.6%
UNEMPLOYMENT:	8.9%	8.7%	8.8%

THE ITALIAN ECONOMY:

	2012	2013	2014
GROWTH:	-2.5%	-1.7%	0.1%
INFLATION:	2.1%	2.0%	2.1%
UNEMPLOYMENT:	8.9%	10.1%	10.7%

THE SPANISH ECONOMY

	2012	2013	2014
GROWTH:	-2.0%	-0.5%	0.6%
INFLATION:	1.9%	2.1%	2.3%
UNEMPLOYMENT:	22.3%	24.8%	25.6%

EXCHANGE RATES

	2012	2013	2014
EURO/\$1:	1.15	1.10	1.21
POUND/\$1	1.60	1.71	1.78

COMMODITIES:	2012	2013	2014
GOLD:	1,900	2,500	2,600
BRENT CRUDE:	125	140	150

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