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The International Financial Crisis and its Impact on the Spanish Economy

Abstract

This paper tries to explain in a summary way the causes and effects of the international financial crisis that is affecting the world; and also gives a glance into its main particular consequences or effects on the Spanish economy. The longest period of continued world economic growth and prosperity that has brought millions of people out of poverty has come to a fast halt with the international financial crisis which appeared quite suddenly after the summer of 2007 and that is causing the world economy to decrease its activity abruptly, sending millions of people into unemployment. The subprime mortgages issue in the US, which backed many other financial products spread through the international financial systems, was the spark when the guarantees could not be made effective. The fire spread together with the realization of the lost trust within the interconnected world financial institutions has created a big contraction of credit, cutting the cash flow to the economy and consumers. Some large banks have gone bust and some industries and countries with credit exposure are "bursting" their bubbles .In Spain ,The financial crunch creates unemployment and particularly in the construction and real estate industry with people not being able to pay their mortgagers and construction companies backing up credits with the shrinking value of land and house properties, the international financial crisis is creating a very hard economic situation with decreasing activity and almost 4 million people unemployed. Banks having to be saved by the state, strong cash injections by the central bank and large public deficits for a country with not enough internal savings and having lived on borrowing money internationally. The global and coordinated answers, measures taken so far, and those that will be taken will, hopefully bring back trust into the system. Nevertheless, after this sudden "wakeup" call, the world financial and economic environment is changing, with a return to less risky, better known policies, and financial products, at least until the financial tsunami gets calm again.

Keywords: *economy, crises, Europe, Spain, financial*.

The International Financial Crisis and its impact on the Spanish Economy

Suddenly in the summer of 2007 the trust in the international financial system broke, the problems of the subprime mortgages in the US had infected their banks and those international banks that had bought those “contaminated” products used by the American banks to get more funds for more lending. In a few weeks, the “virus” spread like fire through the American, European and Asian more developed financial systems. The interbank money borrowing and lending stopped the quality of all assets guaranteeing loans were questions and scrutinized. Nobody was sure of what was the value of those assets. Rating Agencies were questioned; they had not seen the risks. People started withdrawing money and bank deposits reduced alarmingly. Then the panic reached Central Banks in USA, Europe and Asia. These financial authorities all over the world started to give credits to their banks, governments did not know what to do, the access to money was reducing in the end for the economic activity, and some major banks were intervened by governments guaranteeing the deposits not to create social panic. The first one to be intervened and saved was the British Northern Rock, and the many others followed in Europe and the US. Governments lent money against equity and the de facto nationalization of banks, the so dreaded figure of nationalization in liberal democracies took place. So in brief, the international financial crisis had taken place, and spread internationally fuelled by the spark in the US, about doubts of the quality of mortgages, the so called, “subprime”, or the fear of mortgage credit non repayment. Soon, doubts on the quality of assets spread to all other credit backing up ones, and the trust was gone! Particularly symbolic of this lack of trust was the international interbank market of short term lending/borrowing almost disappeared. Nobody wanted to lend to other banks, neither in their own country nor to foreign ones. The same case happened in Spain.

Such a deep, fast, strong and global crisis affected and affects all national financial systems, since it happens in the context of a globalized world, and particularly in the financial sector, with thousands of international financial, commercial and investment transactions every day. The globalization makes the world grow faster, but a t the same time makes it be weaker or more affected by facts happening in other continents, which in principle don’t depend on oneself directly. The fact that the world is “flat”, the expansion of the American monetary policy, with China, India and other BRICS countries (Brazil, Russia, India and China) demanding more and more money. The market freedom in more and more countries growing their economies with more and more capital needs.

Not all this fast economic growth the developed and developing world could have been possible without foreign direct investment, FDI, bank credits, and low interest rates. However, in the end of the expansion period, the longest in the world history, many excesses began to be detected in the large amount of credits to companies, families and states.

The financial crisis international monitoring

Perhaps one of the most striking features of the crisis was abruptness and the speed at which it developed. The answer given by the Central banks and by the International Financial Institutions like the IMF, the G20 and the WB giving massive quantities of money and "rescuing" their banks and financial institutions and their large economic strategic sectors, such as the Automobile is not going to be enough for a lasting solution,.

The recipe to bring back trust into the economy is going to have a lot to do with the fact that the banking sector has to be restructured and stricter monitored according to tighter regulations, all over the world (including the "financial havens)." For such intervention reforms, it is important that the IMF refines and performs their surveillance role properly and better. Some politicians have called for better monitoring by the IMF; however, one can only wonder whether that is the actual problem. Many of the problems underlying the crisis were spotted by the IMF but it is the responsibility of the national governments to actually deal with the problem. Furthermore, the USA never received an assessment because inspectors where not allowed to do their job. Hence, it seems rather that enforcement instead of surveillance is the core difficulty. In this respect there have been proposals of a new global regulator, also recently Dominic Strauss-Kahn, the IMF's president suggested regional regulators. The rather more important issues standards and regulations are heavily discussed. There is common agreement on regulations that are more intrusive but the exact form and shape is still being discussed. The next step will be made at G20 meeting in April where there will surely be further recommendations on this subject. In the end the role of the IMF primarily lies with surveillance, still as one of the most experienced and renowned financial institutions in the world its voice and recommendations on other issues are valued as well.

Global activity is now projected to contract by ½ to 1 percent in 2009 on an annual average basis—the first such fall in 60 years, the IMF said in an analysis provided to the Group of Twenty (G-20) industrialized and emerging market economies.

Hard times

The IMF's March 2009 projections show a contraction in world growth this year, followed by a small recovery.
(percent change, unless otherwise noted)

		Proj.	
	2008	**2009**	**2010**
World output	3.2	**–1.0 to –0.5**	**1.5 to 2.5**
Advanced economies	0.8	–3.5 to –3.0	0.0 to 0.5
United States	1.1	–2.6	0.2
Euro area	0.9	–3.2	0.1
Japan	–0.7	–5.8	–0.2
Emerging and developing economies	6.1	**1.5 to 2.5**	**3.5 to 4.5**

Source: IMF.

Table 1: Advanced economies will suffer deep recessions in 2009.

The Characteristics of the Spanish Crisis

The Construction and the Financial System

The Spanish economy began to show symptoms of deceleration in the first quarter of 2008, during the rest of the year it continued it's slowing down until actually the last quarter when there was a decrease. This growth contraction continues to happen during the first quarter of 2009 and we can say technically Spain has entered into recession with two quarters in succession of negative growth figures. The growth recovery expectations don't expect it to happen during 2010, but more toward the end than art the beginning of it. The International Financial Crisis has had a double negative effect on the Spanish economy; on one hand, it has accelerated the adjustment process of the construction sector and on the other side, it has revealed the excesses of the financial system. Therefore, there are two problems, the overdevelopment of the real estate and construction sector and the lack of liquidity for the financial institutions. These two problems are independent, but at the same time, they are related.

In this paper, we are trying to explain how these two crises are interlinked. In addition, particularly the lack of cash affecting the Spanish banking system, in which we include, not just the banks but the credit cooperatives and the savings banks. This lack of liquidity is immediately transferred to the families and enterprises in the form of not unavailable credit. Let's see the different ingredients of this situation; Banks own funds are relatively high, but insufficient for a credit strategy based on the value of the real estate value and the guarantee of their clients. The consequences of the pronounced and sudden price fall of the real state assets are affecting companies, families and eventually banks. The result is that the liquidity crisis will end up being, and it is already and it will be more so in the future, a solvency crisis.

The peculiarities of the Spanish Financial System

Before going into the analysis of the Spanish financial situation, let's explain a bit how it works.

- The Spanish banking system is a **regulated, very controlled and inspected** by the Spanish Central Bank and the Stock and Securities Authority for those traded at the Stock Exchange. They have limitations and regulations on how to attract money, and with the entering into the Euro zone, it follows the EU Central Bank, which for instance has many more regulations about the "modus operandi" of banks than the US Federal Reserve which is more permissive about it (well, it is getting more and more restrictive about the circulating financial offerings, derivatives, hedge funds etc, after this huge financial crisis).
- **Banking system**, also in Spain, are normally **an oligopoly**, that is to say, it is not just another economic sector. One can only compete in it if allowed by the government, which is the ultimate financial authority. In Spain the main feature is the amount of branches per capita, with "a bank at each corner" in the retail banking.
- The **government has total responsibility for the functioning and well being of the banking system**. In fact that's is why all back account owners know that like in all European countries there is a Deposit Guarantee Fund which guarantees up to 100.000 Euros per account owner. In fact in practice, the monetary authority can't afford for bank clients to lose their deposits, because that would break the trust, which is the main pillar of any banking system.

The Financial Institutions Balance sheets

A little capitalized sector; banks own funds, or equities including long term clients deposits or liabilities, are relatively low. it is a highly "leveraged" sector. Typically, bank own equities represent about 6%/7% of total available funds. In addition, their lending capacity is about 10/12 times the amount of their own funds, long term liabilities and other financial provisions. Norms about liquidity, solvency ratios and other financial ratios are very strict. For instance if a bank loses 10% of their equity and other computable long term liabilities, it has to reduce their loans in ten times that amount. That is why in these past months Santander and BBVA the two biggest banks and Spain and among the top 5 in Europe had to recapitalize in about 10 billion Euros, very quickly in order to being able to maintain the amount of lent money, and therefore maintaining the system liquidity, the main cause for the financial crisis that we are suffering internationally, Spain included

In the middle of the international financial crisis, Spanish politicians, the Spanish Central bank, economic specialists and commentators in he country and abroad, have mentioned the good health of the Spanish financial model. It is true to a certain extent. Spanish banks have on average a higher own equity to loan ratio, about 12% versus an international average in Europe of about 6%/7%. More provisions and reserves for unpaid loans than the average European bank, and the orthodox control of the Spanish Central bank about asset management and the possibility of being more risky about off balance assets (like hedge funds and subprime mortgages for instance) have made the Spanish system more solid and conservative.

The main problem and the weakest link of the Spanish financial system is the Savings Banks, which represent about 50% of loans, they are managed with a political bias, since they are managed by the Regional Governments in the proportion of the political representations and therefore their focus and controls are more "lax". And that is why, two weeks ago, one of them the CCM (of the Castilla-La Mancha Region) had to be intervened by the Spain's Central Bank, changing their top managers (chosen by the regional government) and appointing their own financial officers, and above all guarantying all clients deposits.

Total Credit to finance economic sectors. Q1 2008 (million Euros)
*Fist quarter, Source: European Central Bank, Spanish Central Bank

Year	Total	Agriculture	Industry	Construction	Commerce	Hotels& restaurants	Transport and comm.	Financial services	Real State and Construction
2000	302,034	13.141	78,588	42,627	37,067	10,483	21,829	16,268	33,559
2001	330,591	13,320	82,959	46,412	40,179	12,322	22,368	13,029	41,840
2002	368,466	15,122	85,762	57,376	42,589	14,061	26,723	12,707	55,031
2003	411,986	16,402	85,829	65,784	45,010	16,041	27,386	12,373	77,980
2004	482,984	18,104	90,487	78,372	49,360	18,636	31,144	17,686	112,165
2005	604,061	20,738	104,695	100,761	59,629	22,126	35,469	13,521	162,087
2006	781,644	23,014	119,488	134,317	70,899	25,633	40,170	18,364	244,050
2007	943,086	25,245	141,571	153,453	82,397	29,260	43,875	32,432	303,514
2008*	962,333	25,003	143,816	154,237	84,491	29,523	45,672	34,149	311,279

Table 2: Risk of the Spanish Financial System

Year	Equity	Year	Equity
2002	80,977	2006	148,787
2003	90,437	2007	174,922
2004	111,688	2008* (June 08)	172,927
2005	130,561		

Source: European Central Bank, Spanish Central Bank

Table 3 Net Equity Worth of Spanish Financial Institutions (million Euros)

In these two tables, we can how the credits to the Real State and Construction Sector have multiplied ten fold in the last 8 years, while the Financial Institutions Net Equity has just double in value in the same period. Moreover, with the deep fall of housing prices and therefore the collateral for those loans, will probably mean that some Construction and real state companies will bankrupt and the knock-on effect on the financial system is being devastating, particularly for the small banks and saving banks.

The international financial crisis and its effects on the Spanish economy

Since August 2007, the financial crisis is perceived as a crisis of lack of liquidity in the financial markets, and by extension to all economic sectors. For some banks, even some of the biggest banks this has become and is becoming liquidity first and then a solvency crisis. Governments and Central Banks all over are injecting money, so the deceleration of the economies with all the social effects of unemployment is not left just to the market forces. The intervention by Governments and Central Banks in private banks has been the biggest in the history, since this 2007 financial crisis is being compared to the 1929 Wall Street Crash. The Spanish economy faces a series of problems such as the lack of flowing cash to the companies and families and public, regional institutions like municipalities which hold debts of several thousand million Euros to suppliers mainly small and medium enterprises, which have small credit lines to put up with these delays and many of them are closing down their enterprises. All these factors are making the Spanish economy to decrease its activity and have negative growth figures for the first time in 16 years.

The main international problems affecting the Spanish economy after August 2007 were:

- Lack of liquidity in the local financial system: as a consequence of the 2007 International financial crunch. Spanish banks cant get international financing. There is no credit for Spanish companies and therefore many small and big companies and particularly in the Construction sector go bust.
- Unemployment: In the last 12 months, there have been over 800.000 more unemployed workers, including many immigrants in the construction industry who face an uncertain future in the short term with all the social implications, and consequences in crime rates increase.
- Sudden slump in house and land prices due to the credit crisis and its effect on purchase financing, unemployment and the fact many families cant afford mortgages, investors not getting positive return

(negative sometimes)and construction/real estate firms put their house for sale, therefore creating in the market an unbalance, with much larger offer than demand.

- The deficit of the Current Account Balance reached in 2007, 100.000 million Euros, a 10% of GDP. That shows our national savings deficit, and therefore our need to borrow from abroad.
- The foreign debt of Spanish economic agents, being, financial institutions, Public administrations, national companies, foreign companies operating in Spain and families, was at the end of 2007, 728.000 million Euros, figure that represents about 70% of Spain's GDP.

In Spain, we face in fact, two crises that are successive and overlapping at the same time. The crunch of financial system, and the adjustment of the construction sector. Unemployment will be a consequence, and will reach in 2009 between 4 and 4,5 million people. And from the from financial stand point which is the one we are focusing on in this paper, some banks will have to be intervened by the Administration, o some will be bought by others and some may go bust altogether,

The monetary contraction is being so strong in Spain that prices will grow less those of the Euro zone in 2009. In addition, in fact for the first time since the beginning of democracy in Spain in 1978, there is a negative price increase, that is to say we are bordering deflation. The worst scenario would be in 2009, and with the Spanish economy in recession, the Balance of Payments deficit would not be reduced significantly.

Conclusions

Economics is a difficult subject to grasp, something as immense as the global economy is even more difficult. The ideas presented are just the tip of the iceberg. The international financial environment is changing; toward more restrictions in monetary policy, therefore the economic growth will be affected. It is very difficult to evaluate but world economic growth in the next few years, will not be as spectacular as it the last decade.

The slowing down of the economy will have nevertheless, negative and positive effects. Energy prices and industrial raw materials will go down and inflation will decrease (here the problem of trust may create the unwanted effect of deflation (particularly in Western Europe). In the medium term, the issue is whether investment will create the necessary offer and keep a supply-demand balance with contained prices.

From the financial ;point of view, and according to the latest FMI's report on Financial crisis **stimulus packages announced by advanced economies and several emerging markets, trade volumes have shrunk rapidly, while production and employment data suggest that global activity continues to contract in the first quarter of 2009.**

In Spain, the credit crunch will keep affecting the liquidity of financial institutions y hence families and enterprises will suffer, unemployment will grow, and social spending and public deficit will reach highest figures in the last 30 years. The housing market will keep its brutal adjustment since some (the unemployed who run out of social coverage) of the 90% of families that are paying, their mortgages will have to give up their houses, increasing the house supply and decreasing prices. The danger of entering a period similar to the 90's in Japan with stagnation and deflation is present more than ever before.

The banking system will probably concentrate where big banks will absorb those smaller ones and with solvency problems. The very specific regional savings bank systems associated to the political power will probably change their legal framework to adapt it to a new financial environment. Restoring confidence is key to resolving the crisis, and this calls for tackling problems in the financial sector head on. Politicians must resolve urgently balance sheet uncertainty by dealing aggressively with distressed assets and recapitalizing viable institutions.

Since financial market strains are global, greater international policy cooperation is crucial for restoring market trust. Monetary policy should be eased further by reducing policy rates where possible, and support credit creation more directly.

One thing is clear though, in order to come out of the crisis countries should not cry over spilt milk instead they should look for solutions, acting swiftly and strongly. It is important to offer a way out of the current crisis as well as ensuring a more stable global economy in the future. This requires funds and reorganization, if members can commit to both next year might not be as gloomy as it looks today.

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