The Spanish Public Debt, a New Bubble?
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ABSTRACT
Spain is different. In 2009 Spain was playing the "Champions League" with the best possible risk rating, Aaa - Moody's methodology-, rubbing shoulders with Germany, Denmark, France, UK, and the USA.

While other countries within the same privileged group (Germany, Denmark, and the USA) were able to successfully navigate the crisis and maintain their risk ratings at the top, in the Spanish case, the result was an eight notches downgrading of its sovereign risk, a disappointing Baa2, much closer to the junk level than to the highest note. This leveraging leaves little room for maneuver to finance future deficits.

With a Debt/GDP ratio of 140.5% - the higher level in history -, the situation may well cause that new public spending policies financed with more debt could lead to increased interest payable, whose perverse direct effects would be that of a reduction in social spending, and the added uncertainties about debt repayments and burden relief to the next generations.

Understanding the meaning of sovereign risks ratings and their direct influence on the planning of monetary and fiscal policies, should be a subject of required knowledge by those who assume the highest government responsibilities, be it that of the nation, autonomous regions or municipalities.

Likewise, understanding that political decisions involving spending or public investments must be financed by appealing to either the taxpayer through taxes, and/or the financial markets through the issuance of debt, requires the maximum care and diligence in the responsible maintenance of sovereign ratings within their comfort zone i.e. Investment Grade. Outside this area, the appeal to capital markets is almost an impossible and very costly mission. The markets in this globalized world follow their own rules; lending is the lender's wilful act to those who demonstrate solvency, nothing else.
1. Introduction

During 1983-2016, the Spanish sovereign debt shows two distinct stages. The first 1983-2009, with its stagnation phase in the early 90s, and the second that started in 2009 with a deep recession and the GDP shrinking 3.3% from its peak in 2008. To date, the Spanish economy offers no conclusive signs of improvement and stabilization.

Though the economy is growing above EU average and unemployment is decreasing, at the same time, the much needed fiscal consolidation and recent concerns about the sustainability of the social security system, are casting shadows over its near term performance.

Until 2008, Spain was able to manage comfortably its public debt -barely 53% of GDP-, giving a healthy cushion easing the funding of future public deficits, while at the same time, and thanks to this low level of indebtedness, the country’s sovereign risk received the strong Aaa rating -Moody’s methodology-(Moody’s ratings, symbols and definitions, July 2016), the highest credit quality rating with the lowest credit risk possible.

The seven following years after 2008 fuelled the creation of the new debt bubble which grew 2.5 times or 935 billion euro to March 2016.

Figure 1 depicts the three magnitudes GDP -green line-; Gross Public Debt -light red filled-; and Debt as per the EU Excessive Deficit Procedure (EDP) -dark red dashed line- of classical comparisons, GDP v. Debt.

The year 2012 marked a new milestone in the history of the Spanish economy. The amount of total debt exceeds GDP -the value of goods and services that an economy produces yearly-, for the first time in history. As at the end of 1Q 2016, the ratio Debt/GDP shows a worrisome 140.5%1.

Meanwhile, debt measured under the most benign EDP rules2 moves closer to GDP at the end of 2015 to a threatening 99.3%.

The Spanish public finances highly leveraged position, offer little room for maneuver to finance future deficits. With Debt/GDP ratio at 140.5%, the situation may well cause that new public spending policies financed through more debt could lead to increased interest

1 Source: http://www.bde.es/bde/es/secciones/informes/boletines/Boletin_Estadist/ Banco de España’s statistical bulletin, July 2016, p. 211-212

2 EDP considers approximately 76.5% of total debt. source: http://www.bde.es/bde/es/secciones/informes/boletines/Boletin_Estadist/ Banco de España’s statistical bulletin, July 2016, p. 407
payable, whose perverse direct effects would be that of a reduction in social spending, and the added underlying uncertainties and risks about debt repayments, higher risk premiums and interest rates.

**Figure 1**
GDP and Public Debt in Spain

2. **Key Facts**
   - Spanish public debt increased 2.5 times in the period 2008-2016.
   - Public debt as of March 31st, 2016 totalling 1,095 billion euro measured as per the EU Excessive Deficit Procedure (EDP).
   - Eight years 2008-2016 of governments PSOE-PP pumping up the debt bubble.

Sovereign credit risk rating degraded eight notches, from Aaa down to Baa2 in just six years.

3. **Public Debt and Budget Deficit Go Hand in Hand**

The former provides the financial resources that the latter needs as the main cause public expenditures exceed revenues that the state collects through taxes or generate via the disposal of assets.
Since 1993 the government accounts only registered surpluses during the years 2005, 2006 and 2007 –see Figure 2- accumulating €55,000 million (Zapatero’s government), while at the same time the public debt stock decreased by a timid €6,100 million.

The period 2004-2008 portrays a situation of economic prosperity (GDP growth, budget surpluses, and modest increases of public debt), a positive trend that could be observed since 1995.

The crisis however, that its outbreak was so vehemently denied by the Zapatero government in conjunction with some prominent bankers, seemed to leave to outright improvisation the budgetary and structural reform policies that the Spanish economy was claiming in order to contain the much expected deficits of the following years and, as the chart below shows. These deficits seemed to ride wildly in the absence of effective controls and appropriate economic policy measures.

The years 2009 (Zapatero’s) and 2012 (Rajoy’s) showed the largest expansion in both budget deficits and public debt stock.

The need to bringing down future deficits and to comply with EDP requires the implementation of decisive fiscal consolidation policies, in order to maintain a reasonable level of national debt that is sustainable over time. Spain should endeavor to keep public deficits within EDP’s thresholds -3% deficits and 60% debt in GDP terms-. First to avoid the bitter and costly -taxpayer money- consequences of being fined by EU Economic and
Financial Affairs Council (ECOFIN), and second to see its sovereign rating substantially upgraded which will ease keeping the public finances in a healthy condition.

The added value of EDP compliance would be that of substantial improvements on the quality of the Spanish sovereign ratings, the reduction of risk premia and the betterment of accessing conditions to financial markets. Additionally, lowering premiums entail savings on debt service payments, thus freeing much needed finance to support social spending policies which shape one of the basic foundations of the Spanish welfare state.

4. Inflating the Bubble

During the 33 years of alternative government PSOE-PP, Spain has experienced a remarkable economic and social development. However, the last two government presidents, Messrs Zapatero and Rajoy -who faced the worst economic recession in 40 years-, have managed the recent crisis at the cost of highly leveraging from public debt borrowings.

These borrowings came almost unnoticed -its adverse effects to finance future public policies will appear soon-, thanks to the cushion available for future finance (GDP minus Debt) that in 2008 stood at 46.7% of GDP. This cushion was depleted very quickly along the next following years 2009-2012 which marked the last three years of Zapatero’s office, and the first year -2012- of Rajoy’s term.

The governments of 2009-2012, found leveraging from public debt the tool to finance their erratic policies applied at the outbreak of the crisis that materialised in further tax increases (Giles Tremlett, July 12, 2012 13.45BST, The Guardian) (e.g. VAT, Personal Income, Corporate, Capital gains and Property taxes) while tax collection decreased -at a period of economic stagnation-, big cuts in social expenditures and raising unemployment, whereas at the same time keeping almost intact the costly bureaucracy of the entire public administration.

Rajoy’s 573 billion euro debt in 4.3 years in office bypassed the 479 billion that Zapatero appropriated during his 7 years term.
5. The Big Spenders

Out of the four government presidents compared in this analysis, Mr Rajoy with a service term of 4.3 years -his second term is not clinched yet-, is by far the biggest borrower that indebted the country with 135 billion euros per year. This record high more than doubles Mr Zapatero’s legacy of 63 billion.

Still the Spanish saying of “taking the bull by the horns” of fiscal consolidation and structural reforms is anxiously waiting for the next governments to come.
Figure 4
President Indebtedness per Year

6. Best Rating, Best Solvency and vice versa

What the sovereign risk rating means? A rating qualifies the solvency of the credit subject.

The evaluation analysis that institutions specialized in risk ratings (eg. Moody’s, Fitch, S & P) carry out continuously to inform financial markets lenders (banks, pension funds, other governments, savers, businesses), involves an examination or assessment about the country’s solvency or confidence in honoring its debts.

The rating includes, among others, economic, social and political factors as well as future expectations that together, assess the solvency and serve to determine the so-called "risk premium" representing the differential price a country pays respect to the German 10-year bund.
A higher risk premium means higher interest expenses paid by a country, draining resources to social spending and/or causing tax increases and even further debt issuance to pay such interests (Ponzi or pyramid scheme, Bubble).

7. **Spain is Different**

Spain in 2009 playing “Champions League” with the best possible risk rating, the Aaa – see Figure 5- and rubbing shoulders with Germany, Denmark, France, UK, and the USA.

While other countries within the same privileged group (Germany, Denmark, and the USA) were able to successfully navigate the crisis and kept their risk ratings at the top, in the Spanish case, the result was an eight notches downgrading of its sovereign risk, a worrying Baa2, much closer to the junk level than to the highest note.
8. How Spain Compares to Others?

Spain’s Debt/GDP –see Chart 6- ratio slightly higher that EU average, would not offer a worrying alert if the chart is compared, without further analysis, with Italy, 33.8% higher, Japan 131% and USA 5%. 

**Figure 6**
Rating Changes for Spain

**Figure 7**
Percentage of Debt/GDP
Is it enough to qualify sovereign credit risks by focusing only on the Debt/GDP ratio, and from here concluding that higher indebtedness ratios derive to more expensive finance? Radically not.

Hence the main contributing factors, past, present and expected, of political, social, and economic performance, turn out to be essential ingredients in configuring the qualifying basis of sovereign risk ratings.

9. Risk Ratings v. Risk Premia

Spain, with a Debt/GDP ratio barely higher than France’s, navigates six notches under –see Figure 7- with its Baa2 rating.

Compared to USA, Spain also holds a ratio slightly lower, but its Baa2 plunges eight steps down.

And finally Japan whose ratio exceeds 2.3 times GDP while rated A1, travels four notches above the Spanish grade paying a negative premium relative to that of Germany’s nil.

Debt/GDP ratio becomes meaningful when analyzing it alongside the sovereign risk rating. Both, among other factors, make up key drivers that financial markets rate to determine the value of the so called Risk Premium. This Risk Premium represents the “price” of a certain country debt with regard to the risk-free German 10yr bund. In advanced economies, risk premia prices reflect markets and country dynamics on an almost daily basis.
10. Conclusion

Understanding the meaning of sovereign risks ratings and their direct influence on the planning of monetary and fiscal policies, should be a subject of knowledge required to those assuming the highest government responsibilities, be it that of the nation, autonomous regions or municipalities.

Likewise, understanding that political decisions involving spending or public investments must be financed by appealing to either the taxpayer through taxes, and/or the financial markets through the issuance of debt, demand the maximum care and diligence in the responsible maintenance of sovereign ratings within their comfort zone i.e. Investment Grade. Outside this area, attracting capital markets interest is almost an impossible and very costly mission. The markets in this globalized world follow their own rules; lending is the lender's wilful act to those who demonstrate solvency, nothing more.

Pretending that politics and politicians impose their rules against the lender, is ignoring the “invisible hand” (Adam Smith 1759, 1776) of the markets, how the markets govern themselves in the allocation of the financial resources they are entrusted to manage. Setting public expenditure policies do not automatically confer the right to borrowing from, neither the obligation to lending by, financial markets.

It is then the sovereign’s duty to adhere to a sound management of the public finances by expending less and more wisely.

“There are but two ways of paying debt: Increase of industry in raising income, increase of thrift in laying out.”

Thomas Carlyle (1795, 1881)
11. References


