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Spain Is Still Awaiting the Payoff From Austerity

By LANDON THOMAS Jr.

LONDON — Since the beginning of the debt crisis in Europe more than two years ago, defenders of the euro currency union have stuck to a basic argument: if the euro zone's weaker economies would only keep pursuing policies of austerity, even as growth collapsed and job losses mounted, they would be rewarded by investors more willing to buy their bonds.

Yes, the social cost would be high, but over the long term economies would benefit from the lower interest rates that can come with the seal of approval from global bond investors. Or so goes the argument.

That approach, though, has failed in Greece, Ireland and Portugal. And now it is being severely tested in Spain, where the more the government promises to cut its budget deficit, the more foreigners are unloading their Spanish bond holdings.

Late Thursday, when Standard & Poor's jumped into the fray by slapping Spanish bonds with a two-notch downgrade, it gave public voice to what investors have been sensing for months now — that it will be nearly impossible for Spain to meet its current deficit-lowering target amid one of the most severe recessions in the euro zone.

Yet another batch of grim job figures from Spain on Friday seemed to underscore this contention. Spain's unemployment rate is now 24.4 percent, the highest in Europe and an especially stark figure given that the Madrid government has not yet begun to lay off public sector servants in any significant number.

None of this comes as news to foreign bond investors, the lenders who are supposed to help Spain stay in business. And it is not news to the growing number of economists and analysts who predict Spain might soon need to bail out its banking system, which could force it to seek European aid that might end up far larger than the bailouts of Greece, Portugal and Ireland.

Over the last year, close to 100 billion euros ($132 billion) has fled Spain, according to Iñigo Vega, a bank analyst at Crédit Agricole Cheuvreux in Madrid. Most of the outflow has come from insurance companies and pension and sovereign wealth funds reducing their holdings of Spanish bonds.

Those distress sales have picked up speed in the last few months. Many foreigners have been selling to local Spanish banks temporarily flush with cash from the European Central Bank’s cheap lending program, even though Spain’s banks have an impending wave of real estate loans at risk of going into default.

With investor expectations already at rock-bottom levels for Spain, its benchmark 10-year bond yield held fairly steady on Friday, ending the day at 5.9 percent. That is just below the 6 percent that has been considered the threshold of danger. But the fact that the yield, or interest rate, did not spike higher was further indication that the downgrade by S.& P. provided little new information to the market.

On Thursday, S.& P. lowered Spain’s bond rating by two rungs, to BBB+ from A, leaving it two notches away from losing investment-grade status.

If history is a guide, the other two main ratings agencies, Moody’s and Fitch, may soon follow S.& P.’s lead. So far the two are rating Spain at the A level, but with a negative outlook.

In January, when Spain and many other euro zone countries were downgraded, S.& P.’s two-notch reduction was shortly followed by a similar downgrade for Spain by Moody’s.

Driving the investor exodus from Spain is a view that Europe’s current policy of forcing countries to improve their competitiveness by cutting spending and lowering wages will not result in a growth payoff — whether in Greece or Italy or Spain.

“As growth retrenches, investors will run for the exits,” said Matt King, a credit strategist at Citigroup in London. “Policy makers are underestimating the role of contagion."

Mr. King points out that foreign bond holdings in Spain and Italy have fallen sharply and are likely to decrease further as more downgrades reflect and reinforce investors' loss of hope.

For either of those countries, further downgrades toward junk territory could result in the same vortex that eventually pulled Greece, Ireland and Portugal under. Unable to raise money in the global debt markets, they had little choice but to seek bailouts from Europe simply to keep their governments in business. Even before a junk designation, though, the lower ratings will also make it more difficult for Spanish banks to use the government bonds they own as collateral when seeking new loans from the European Central Bank.

Under its deficit reduction agreement with the European Union, Spain is supposed to lower its budget deficit — currently 8.5 percent of gross domestic product — to 5.3 percent of G.D.P. this year. In its report on Spain on Thursday, S.& P. said it expected the country to end up at no better than 6.2 percent.

S.& P. also downgraded its growth forecast this year for Spain to negative 1.5 percent, from a positive 0.3 percent. But that was merely bringing S.& P.'s outlook in line with the consensus view that Spain will see no growth this year or next.

Friday's new unemployment figures underscored the dire condition of Spain's economy. The country now has 5.6 million people without jobs, the highest such figure on record for the country. Spain's 14 million households include 1.7 million in which no one holds a job. Unemployment among those ages 16 to 24 remains above 50 percent.

And any Spaniard who still has money to spend probably took little comfort in another announcement from the government on Friday. The economy minister, Luis de Guindos, announced that Spain would raise consumer taxes next year, including the value-added tax and other special duties on goods that are likely to include tobacco and alcohol. Only weeks ago, the minister had argued that increasing the VAT — now at 18 percent — could further reduce consumer spending.

Over the long term, Spain and its backers in Europe contend that economic reforms being put in place will free up rigid labor markets in ways that will eventually lead to more job creation.

But, as Greece and Ireland have shown, such changes take time to put in place. And in the interim, spending cuts and recession force job losses up, not down. That is why analysts now expect Spain's unemployment rate to rise to as much as 30 percent before starting to improve.

For the moment at least, Europe and Spain continue to say this is the best way forward.

Most bond investors, though, are voting with their feet.

Raphael Minder contributed reporting from Madrid.