Evolution of Spanish government debt holdings

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Non resident holdings of Spanish government debt continue to decrease. Without a credible solution to the institutional problems of the EMU and the recovery of economic growth, it is unlikely that investor confidence will return.

The crisis that began in the summer of 2007 marked a turning point in the stock of Spanish government debt held by non-residents, which had increased in absolute and relative terms since the middle of the 1990's. This phenomenon has been common for most economies of the periphery of the euro, and its coincidence with episodes of sharp widening of sovereign spreads vs. Germany shows that non-resident investors now perceive a higher credit risk in some member states' government debt than in the past.

Recurring fall in the central government debt holdings among non-residents since the beginning of the crisis

The percentage of Spanish government debt held by non-residents has fallen by almost 18 full points to 32.4% in February 2012 from levels slightly higher than 50% in the spring of 2007, according to the latest available data (see Exhibit 1). This percentage does not entirely reflect the drop in Spanish debt holdings of private non-resident investors, due to the fact that this data is not net of the debt in the hands of the ECB and other central banks outside the EMU. In fact, assuming that of the current 215 billion euros of the SMP , about 40 billion euros are holdings of Spanish debt, the previous number of holdings would be reduced to just 26%.

The absolute level of non residents' debt holdings at February 2012 (195 billion euros) is the lowest since September 2009 (189 billion euros), a point in which non residents held 43.9% of total central government debt in circulation. In other words, the 172 billion euro increase in the stock of debt since September 2009 (from 432 to 604 billion euros) has been fully assumed by domestic investors.

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The sharp decline of non-resident holdings of Spanish debt over the past three years breaks more than a decade of continuous relative increase in holdings of Spanish government debt of non residents. Indeed, after the first part of the decade of the 1990's, marked by very intense tensions in most European currencies,

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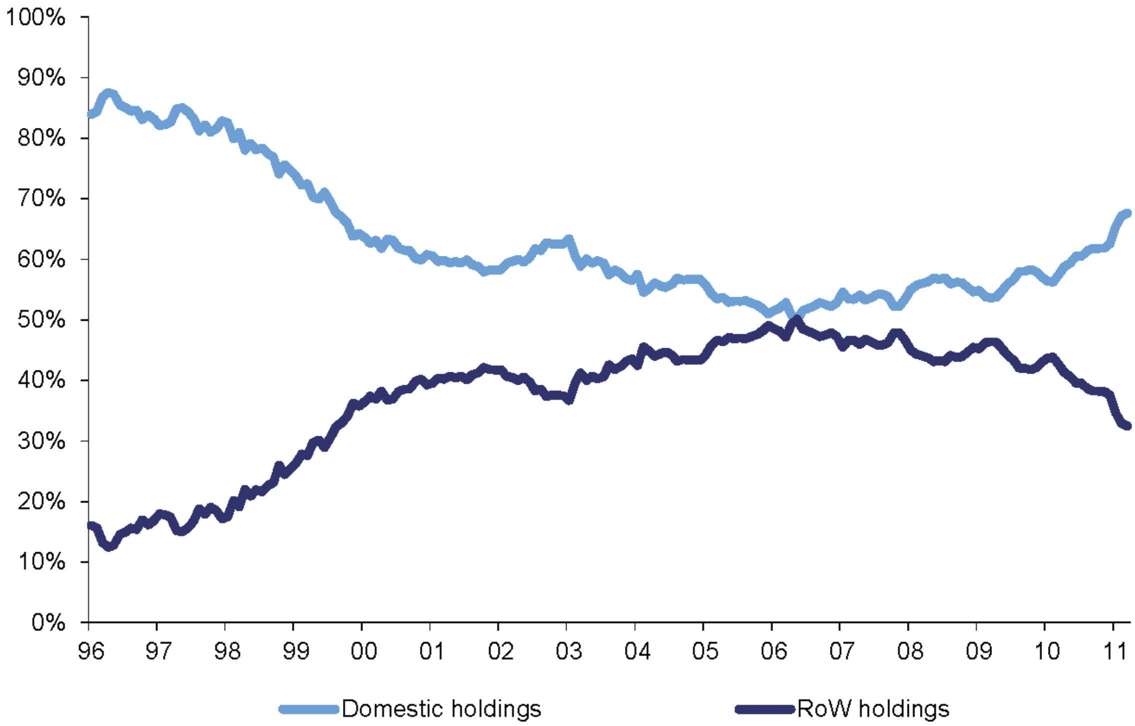
the economic convergence process into the EMU and the adoption of the single currency (with the consequent elimination of exchange rate risk) led to a rapid convergence of yields among all sovereign bonds from issuers to form part of the EMU. This evolution was accompanied by a generalized increase in the proportion of government debt held by non-residents. Once in the EMU, the holdings of domestic debt of non-residents continued to rise in almost all member states, reaching a common maximum around late 2006, early 2007.

Exhibit 1

Spanish central government debt: holdings by sector

(% of outstanding amount)



Source: Afi from Bank of Spain

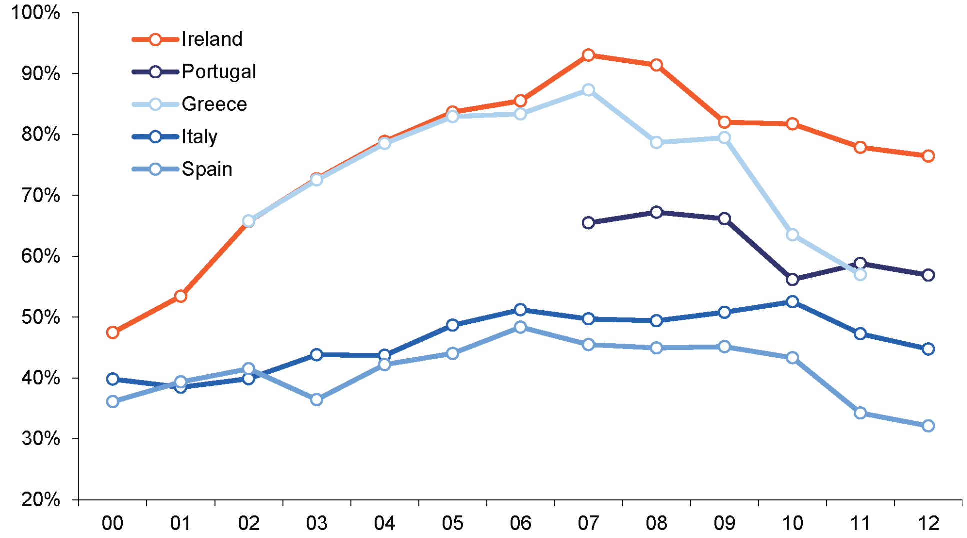
Returning to the recent past, it must be said that the reduction in the debt held by non-residents has been common to most EMU member states, although it has been more pronounced in those countries most affected by the crisis, and especially in those who have been subject to a bailout (see Exhibit 2), such as Ireland, Greece and to a lesser extent, Portugal. In analyzing these countries, it should be noted that, on the one hand, most of the central government debt is today held by official creditors, including the ECB and the IMF. On the other hand, private non resident investors have reduced positions aggressively due to their fear of possible debt restructuring, such as the one that occurred in Greece in early 2012.

Return of the "home bias" and dramatic increase of interest rate spreads vs German debt

The sharp reduction in holdings of government debt of non residents in most EMU countries has occurred in parallel to a sharp rise in spreads

Exhibit 2

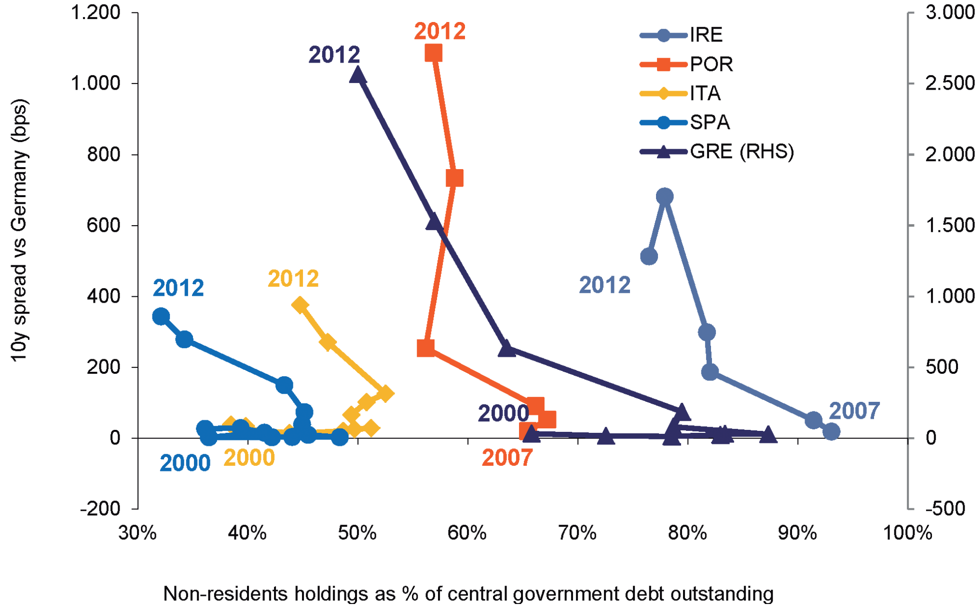
Non-resident holdings of central government debt in selected EMU countries
(% of debt outstanding)



Source: Afi from National Central Banks.

Exhibit 3

Evolution of non-resident holdings of government debt (% of total) and 10 year spread vs Germany (bps)



Source: Afi from Eurostat, Bloomberg.

against German debt, even to levels at or above those existing in the mid 1990s for almost all the sovereigns of the periphery of the EMU (see Exhibit 3). This is symptomatic of a return of the "home bias" in investment decisions on sovereign debt among international investors, a move in which three factors are at play: i) the high uncertainty about the debt sustainability of several member states, ii) the possibility of future debt restructuring episodes and last but not least, iii) the existence of a very small, but no longer negligible, probability that there could be changes in the current configuration of the euro area.

The increase in the probabilities assigned by the market to episodes of sovereign default or debt restructurings (voluntary or imposed) among the countries of the EMU periphery, and the fact that official aid packages and direct purchases of debt by the ECB under the SMP introduced a "de facto" subordination to private bondholders, help to explain the withdrawal of non-resident investors from the debt of those EMU countries currently facing economic difficulties.

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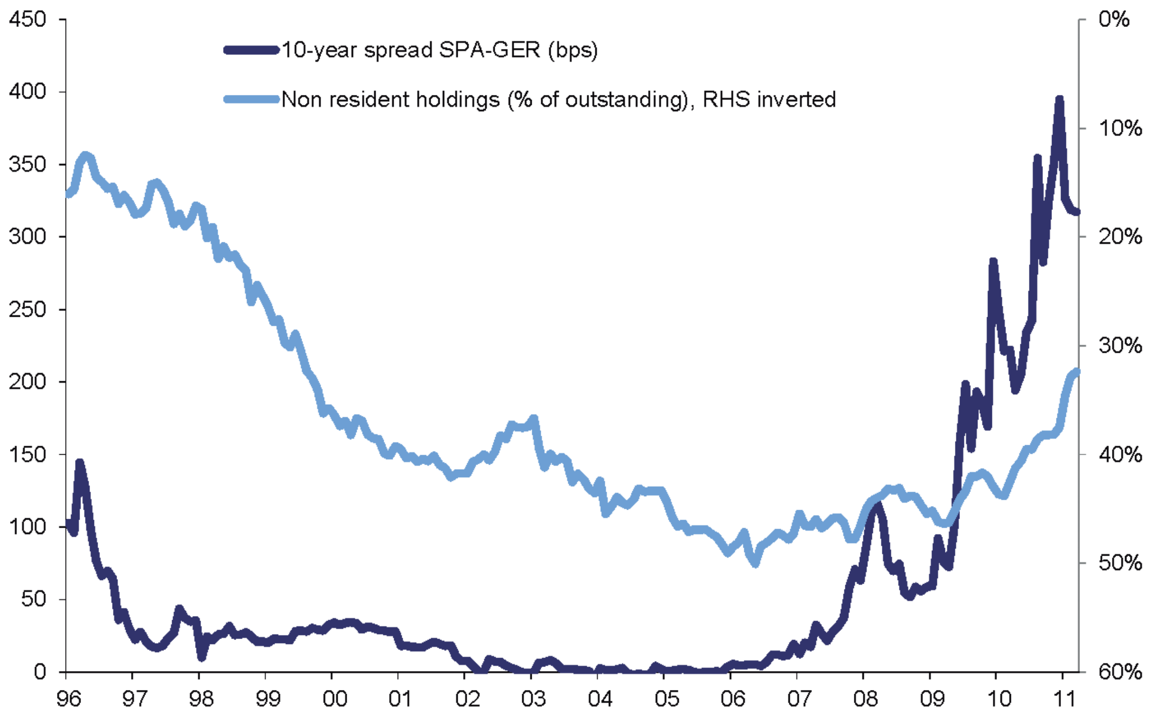
Exhibit 4

Spanish central government debt: non-residents holdings (% of outstanding) and 10 year spread vs Germany (bps)



Source: Afi, Bank of Spain, Bloomberg.

In the case of Spanish public debt (see Exhibit 4), the return to levels of debt held by non residents not seen since mid-2000 (32% of total) was accompanied by an increase in bond spreads to German debt that far exceeded the levels seen in the years prior to the adoption of the euro.

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Detailed evolution of Spanish government debt holdings: country breakdown, holdings by instrument, and domestic holders' evolution

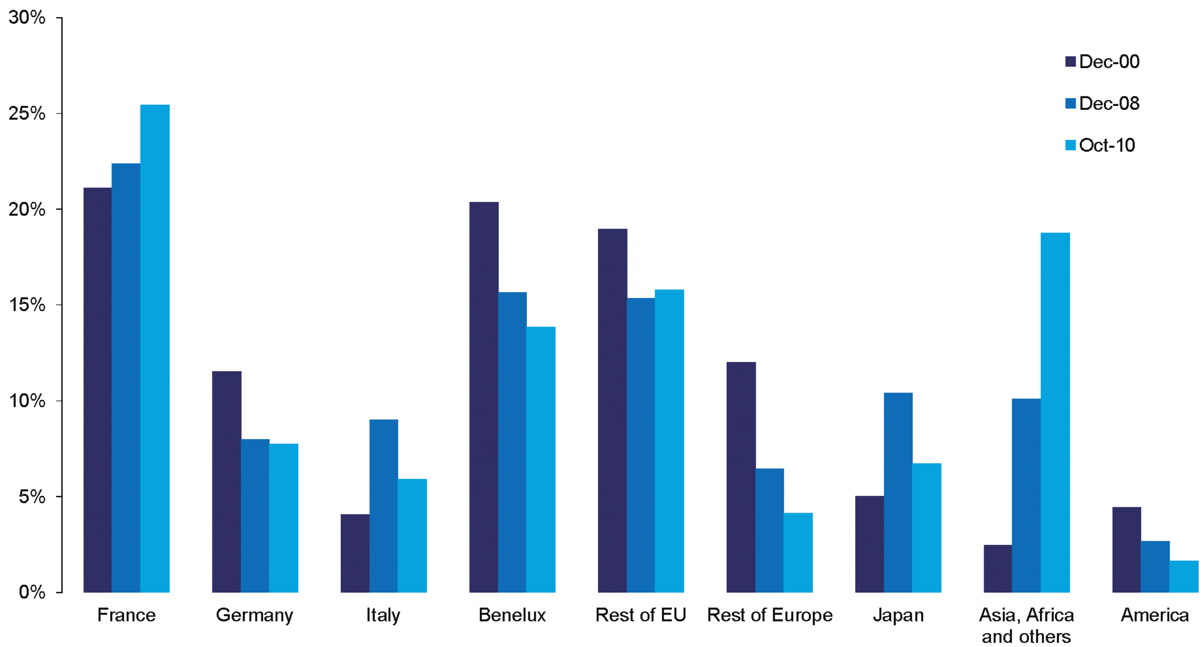
In this section, we provide a detailed analysis of the evolution and current situation of the stock of public debt issued by the Kingdom of Spain from several viewpoints: country of residence of the holder, holdings by type of instrument (Treasury bills, Notes and Bonds) and the structure of holdings among domestic investors.

With respect to the debt holdings of non-residents by country of residence (for which the Spanish Treasury only provides detailed information through October 2010), about 73% is concentrated in investors domiciled in European countries, particularly in France, Benelux and Germany. About 19% of the total debt held by

Exhibit 5

Non-resident holdings of Spanish government debt by country of residence

(% of total non-resident holdings)

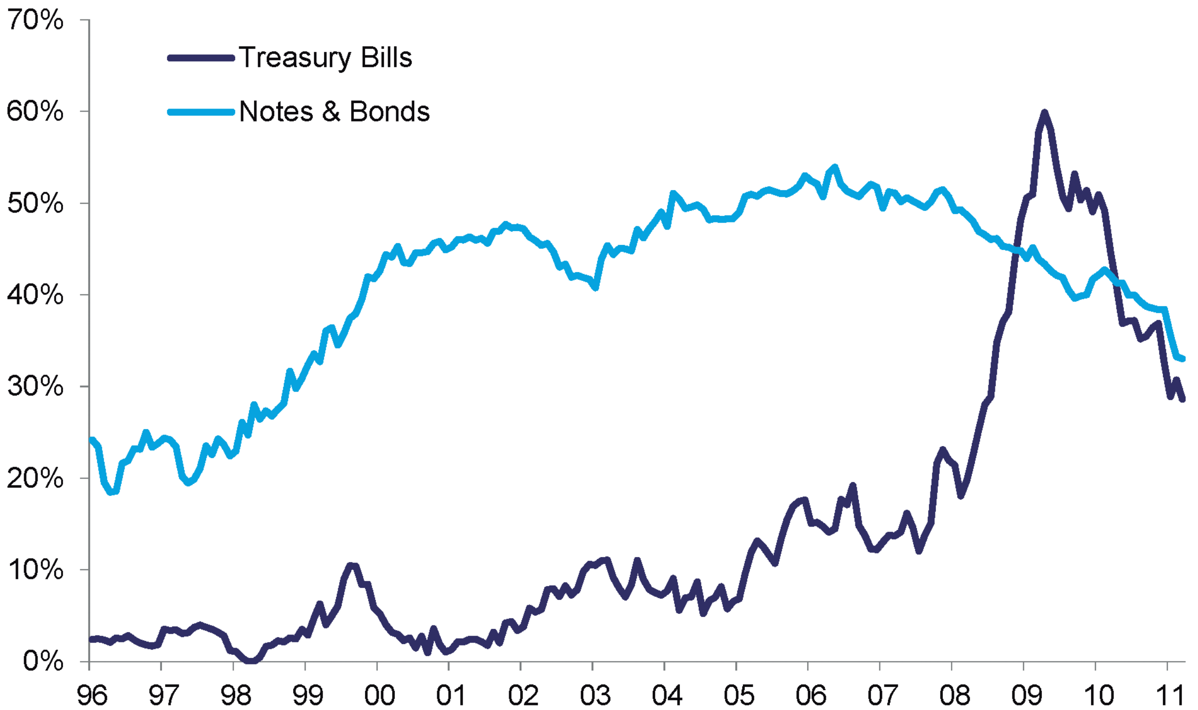


Source: Spanish Treasury.

Exhibit 6

Non-resident holdings of Spanish government debt by type of instrument

(as a % of total outstanding for each instrument)



Source: Spanish Treasury.

non residents is in the hands of investors based in Asia and Africa these areas being the fastest growing in terms of Spanish public debt holdings and the remaining 8% is split between Japan (with about 6.7% of the total) and the Americas.

By type of institution, central banks were the major holders of Spanish debt as of October 2010 with about 33% of non resident holdings, followed by the non-financial private sector (28%) and financial institutions (banks) with 19%. The remaining holdings are split between insurance companies, pension funds and collective investment institutions (investment funds).

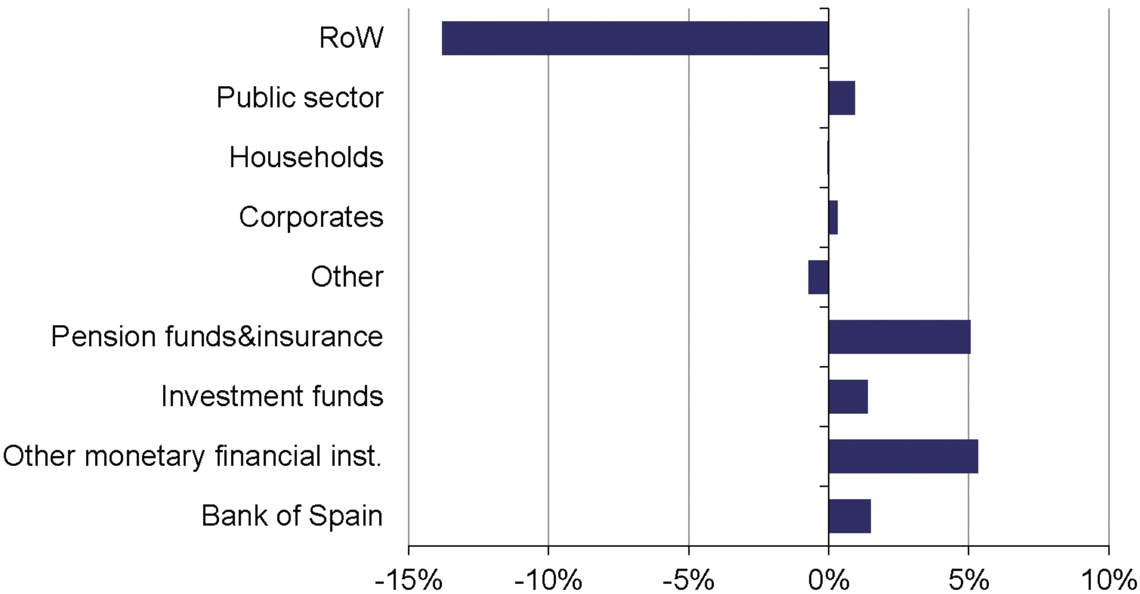
As for the evolution of debt holdings by type of instrument issued by the Spanish Treasury (see Exhibit 6), the fall in the share of non-resident holdings is much higher for Treasury Bills: holdings have dropped from 59.9% of the total outstanding in March 2010 to 28.6% in February 2012. In absolute terms, non-resident investors have shed positions (or not renewed) for about 26 billion euros since March 2010, for a current holdings figure of 24 billion euros (see also Exhibit 8).

In the case of Notes and Bonds (see Exhibit 10), the relative decline in the share of debt holdings of non-residents has been somewhat smaller than in the case of Treasury bills, but in any event, worth noting: from 53.3% of the total outstanding as of March 2007 to the current 33.0%. From the beginning of 2010, when market tensions over Spanish government debt began to be very relevant, the holdings of Notes and Bonds by non

Exhibit 7

Change in relative holdings of Spanish government debt since January 2010

(%)



Source: Afi from Bank of Spain

residents dropped 12.2 percentage points (from 45.2% in January 2010 to 33.0% in February 2012), although in absolute terms, holdings have remained almost constant (174 billion euros in January 2010 vs. 171 billion euros at present).

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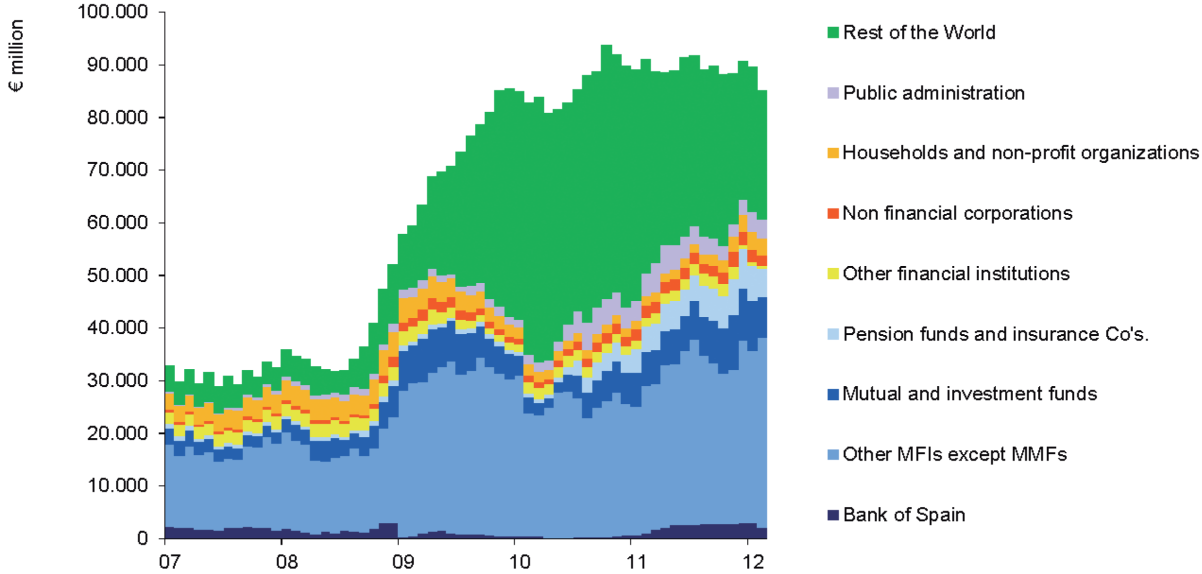
The domestic counterweight to the decline in total debt holdings of non-residents since January 2010 (13.8 percentage points) has been dominated by the banking sector (+6.8 points increase) followed by the insurance industry, investment and pension funds (which collectively increased their holdings by 6.5 points). Households, non financial corporations and public administrations also added absolute and relative positions, although smaller than those of the above sectors (see Exhibit 7).The domestic financial sector has been instrumental in offsetting the fall of holdings of non resident investors, especially during the last 12-18 months. It is worth mentioning two important aspects. First, the increase in domestic debt holdings of pension funds, insurers and investment funds the latter despite the sharp drop in assets under management a group of investors lured by the high yields offered by Spanish public debt, especially at medium and long-term maturities, given their need to match assets and liabilities. (In the case of investment funds, the trend towards reducing equity positions and replacing them with short and medium term fixed income has been very intense in response to the increased risk aversion among retail investors.)

Second, the increase in holdings of government

Exhibit 8

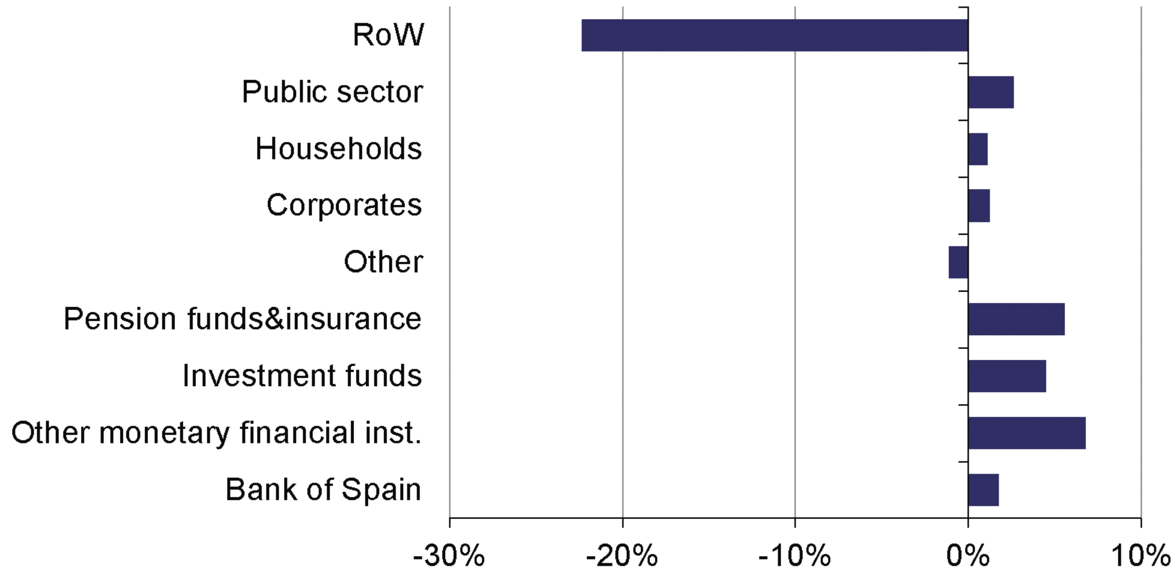
Holders of Spanish Treasury Bills 2007-2012



Source: Afi from Bank of Spain.

Exhibit 9

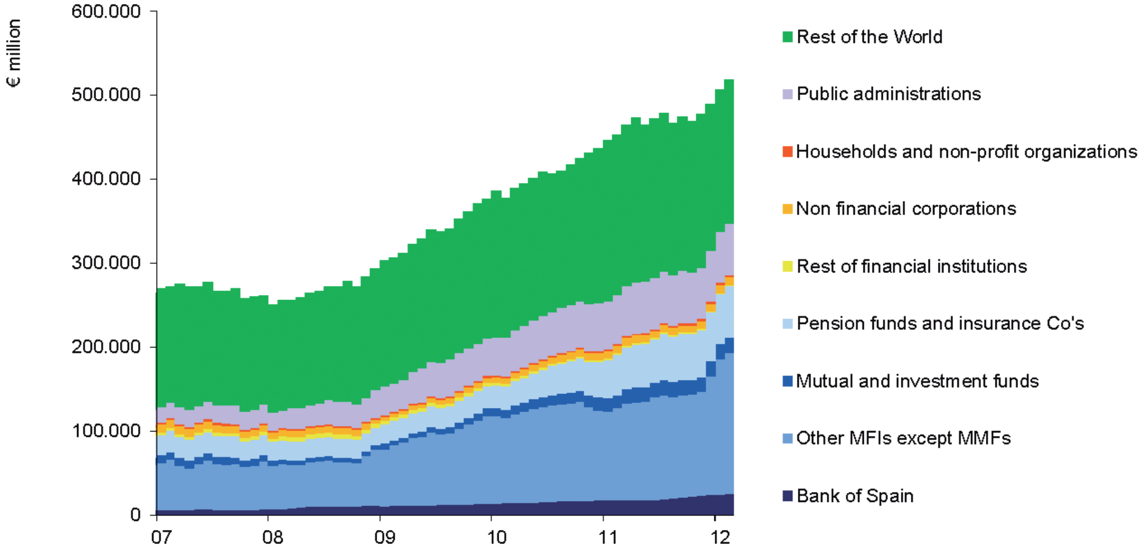
Change in relative holdings of Spanish Treasury Bills since January 2010



Source: Afi from Bank of Spain.

Exhibit 10

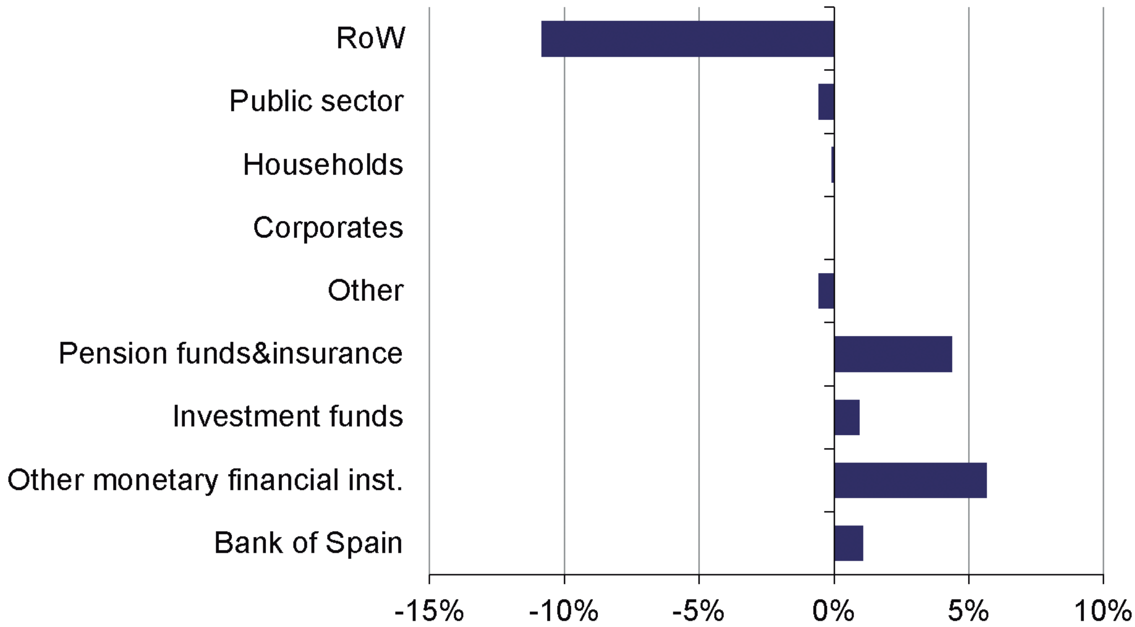
Holders of Spanish Government Notes and Bonds 2007-2012



Source: Afi from Bank of Spain.

Exhibit 11

Change in relative holdings of Spanish government Notes and Bonds since January 2010

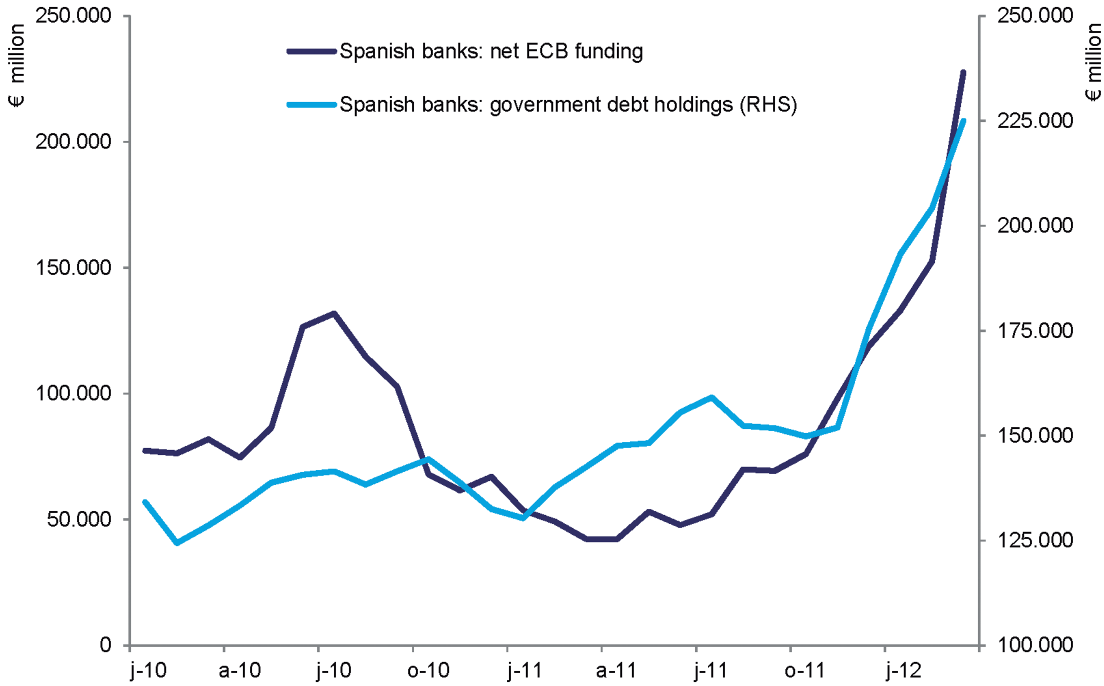


Source: Afi from Bank of Spain.

Exhibit 12

Spanish banks gross funding at the ECB and holdings of Spanish government debt

(data in € million)



Source: Afi from ECB and Bank of Spain.

debt of the banking sector which has nearly quadrupled since early 2010 to reach almost 220 billion euros at present (see Exhibit 12). Two key factors explain this evolution. On the one hand, the need to compensate, via generation of returns on fixed income portfolios, the fall in traditional business margins, heavily penalized by the economic crisis (especially by the increase in the cost of retail and wholesale funding). On the other hand, and crucially, the introduction of extraordinary monetary policy measures by the ECB, namely the extension of liquidity facilities first to 12 months (summer 2009) and later to 36 months (in December 2011 and February 2012). The effect of the last two long term ECB refinancing auctions (LTROs) alone may have led to an increase in Spanish government debt holdings in bank portfolios of close to 75 billion euros between November 2011 and March 2012.

In summary

The crisis marked a turning point in the previous trend of increasing holdings of Spanish government debt of non-residents, which had been observable since the mid 1990's. Spain was not the only country that saw its sovereign spreads widen relative to those of Germany, as investor risk perceptions for euro area members states increased.

At this juncture, it seems unlikely that international investors' confidence will return without a credible solution to the institutional problems of the EMU and the recovery of economic growth in those countries most affected by the crisis. This places domestic investors, especially the domestic banks –thanks to the invaluable help of the ECB- as the main source of demand for government debt issued by the countries in the EMU periphery (Spain included). The resulting situation is quite risky, as it increases the feedback loop between the sovereign and the banks, a factor viewed by international investors as one of the sources of the current problems.