Letter from the Editors

Over the past few years, the Spanish authorities, supported by efforts of the Spanish financial sector, have taken noteworthy steps towards restructuring and recapitalizing Spanish credit institutions. Government intervention mostly took the form of provision of funding for consolidation and recapitalization through the national public backstop facility, the FROB, in addition to guarantees and other liquidity support measures. The Spanish financial sector also played its part through substantial contributions to the Deposit Guarantee Fund, mergers and acquisitions, and strong provisioning regimes over recent years, reducing the amount of public sector funding ultimately channeled into the banking sector. Despite progress on the whole, Spain´s financial sector policy has failed to deliver expected results. By the end of May 2012, Spain experienced higher market tensions and a widening of spreads over the German bund relative to preceding months, ultimately, leading the government to request EU assistance for the banking sector.

In our opinion, July 2012 marked a turning point in the resolution of the banking crisis in Spain. The Eurogroup agreement to provide up to 100 billion euros in contingent aid for the recapitalization of Spanish banks - and the strict conditionality imposed in the Memorandum of Understanding (MoU) – significantly commits the Spanish Government´s and the Bank of Spain´s discretionary powers and decision making processes with respect to the banking sector. The roadmap outlined in the MoU has the potential to bring the crisis to an end, restore confidence, and achieve a better capitalized Spanish banking sector relative to its European counterparts. Along these lines, in this issue of SEFO, we analyze the implications of recent developments for the banking crisis and its resolution. In particular, we examine Spanish bank recapitalization within the context of a future European banking union, as well as the results of the independent valuations, under extremely adverse scenarios, of Spanish banks´ capital needs.

As for the critical role of foreign banks in financing the Spanish economy, we explore this issue from different angles, raising some key questions and providing answers on: i) which foreign countries' banking sectors are lending to Spain? ii) did foreign banks reduce their exposure to Spain over the past year? and, iii) how do foreign banks react to a country being bailed out? In looking at experiences of sovereign debt crises in other European countries, we can learn some key lessons. In particular, how the stigma of a bailout causes bank capital flight and how reduced exposure by European banks further eroded confidence.

Lack of a clear strategy for financial sector crisis resolution and high dependence on external financing is making it increasingly difficult for Spanish banks to tap wholesale funding markets - currently their main source of funding. In the actual context of greater risk aversion for peripheral Eurozone countries, only the Spanish Treasury is successfully able to raise money in the primary market. Temporary ECB liquidity support measures have provided some necessary breathing space for the Spanish financial system. But, Spanish credit institutions must recover the confidence of the markets and come back to traditional funding channels in order to reduce their heavy dependence on Eurosystem liquidity.

Finally, we examine how market uncertainty and lack of transparency have fuelled a boom in the market for short selling of Spanish bank shares. Although this activity serves an important function in the stock market, it can also have significant destabilizing consequences, which explains the reason behind its temporary prohibition. In the case of Spain, the effect of that ban has been a decrease in volatility and asymmetry in price formation, while at the same time reducing considerably market liquidity.

Under EU assistance and supervision, the Spanish authorities have the opportunity to complete a meaningful financial system reform, helping to minimize the negative consequences of the adverse feedback loop between the banks and the sovereign. Nevertheless, the EU as a whole must avoid further setbacks on the path towards European integration. Also, since the MoU leaves many important details undefined, correct implementation will be critical for a successful resolution of the crisis.