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Latest Europe Rescue Aims to Prop Up Spain

By CHARLES FORELLE in London and GABRIELE STEINHAUSER in Brussels

Spain's acquiescence to a bailout of as much as €100 billion ($125 billion) for its banks is a prelude to a much bigger question: Will Spain need a bailout for itself? WSJ's Charles Forelle has the latest developments. Photo: Reuters

Spain's acquiescence to a bailout of as much as €100 billion ($125 billion) for its banks is a prelude to a much bigger question: Will Spain need a bailout for itself?

Some say Spain faces a daunting struggle convincing reluctant creditors that the country is a viable borrower. In the first market reaction to Saturday's events, Asian stocks rallied early Monday, in part on the Spanish developments.

Japan's Nikkei climbed 2.2% and South Korea's Kospi was 1.6% higher. China's May inflation data, which pointed to a weakening economy but weren't as bad as some expected, also lifted sentiment.

Reuters

A woman in Malaga, Spain, covers her mouth with a fake euro note Sunday in protest against the bank bailout.

Streaming Coverage

Prime Minister Mariano Rajoy on Sunday expressed hope that the bailout would help the country's ailing economy, saying, "The European project, the future of the euro and our banking system all won new credibility yesterday." But he warned against expecting a quick turnaround following the banking rescue.

"This year is going to be a bad one, growth is going to be negative by 1.7%, and also unemployment is going to increase," he said.

That leads many to conclude Spain will have an even larger deficit—and need even more borrowing from capital markets—than it now projects.

Helen Haworth, head of European interest-rate strategy for Credit Suisse in London, said there could be a bit of a relief rally this week. But fundamentally, she said, "to me, there is still no buyer of Spanish debt beyond the domestic investor base, which is basically the Spanish banks."

Whether Spain can avoid another bailout, for itself, is crucial to the future of the euro zone as it enters a tumultuous summer. Greece holds elections next Sunday that could set it on a path to leave the currency union. Italy is laboring to refinance its own giant debt pile under

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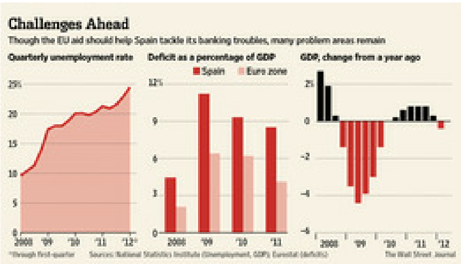

immense scrutiny.

Amid these threats to the euro, a full bailout of Spain could be a cataclysmic event. Spain's economy is the fourth-largest in the euro zone—larger than those of Greece, Portugal and Ireland combined. Finding the funds for a rescue would greatly strain the euro zone's bailout vehicles.

The question of a broader bailout follows Saturday's announcement that Spain would accept as much as €100 billion in aid with the intent of funneling the money into its ailing banking sector. Officials sought to portray the move as a limited intervention that falls short of the other euro-zone rescues—which have come with painful overhauls of entire economies.

In the short term, market analysts said, Spain's bonds could see a boost. The European aid for banks means Spain won't have to issue new bonds right away to fund the rescue. The Spanish government-bond market rallied last week in anticipation of an aid deal, and 10-year bonds yielded 6.25% Friday, off the peaks above 6.7% on May 30.

Even as Spain accepts help, many eyes are on the elections in Greece, the home of Europe's most biting overhaul. Sunday's vote pits a mainstream party that supports the country's bailout measures against an upstart party, Syriza, that wants to rip up the deal.

The two sides are running neck and neck, and officials fear a decisive win by Syriza could raise the odds of a fracture in the currency union and trigger further tumult in the Spanish financial sector.

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Spain's economy is flailing and foreign investors have fled from its government bonds all year. That has created a pressing worry: How will Spain pay for its sizable government deficit, officially projected at 5.3% of gross domestic product but widely expected to be larger?

Early this year, Spanish banks picked up the slack, but now they are backing off. Spain says it needs to borrow €86 billion this year to cover deficits and repay maturing debt; it has raised around €50 billion so far, leaving it to find a further €36 billion from capital markets. By turning to its euro-zone peers for help with its banks, Spain is tacitly admitting money will be hard to find.

"What you have to say now is that Spain is likely to lose access to the bond markets completely at some point," said Justin Knight of UBS in London. "It has demonstrated to everybody that market access is limited by requesting aid."

With foreign investors almost completely absent from Spanish bond markets for months, Spanish banks have propped up the government, which is now forced to turn to Europe for help propping up the weaker banks. Meanwhile, the stronger banks are shying away from buying government bonds—for fear they would be dragged down, too.

That knot between the government and its banks has been devilishly difficult to untie. Ireland couldn't do it, and its banks' huge losses

Big Events

A series of events affecting the crisis are set for this month:

- **June 13** German parliament to decide whether it will vote on European Stability Mechanism and fiscal pact before the end of June. Euro zone wants ESM to come into force as quickly as possible so it can finance loans to Spain.
- **June 17** Second round of French parliamentary vote; Greek national elections. Failure of pro-bailout parties to gain majority could create further shock waves.
- **June 18-19** G-20 leaders' summit in Los Cabos, Mexico. G-20 likely to pressure euro zone to resolve crisis.
- **June 21** Euro-zone finance ministers meet. Could nail down Spanish banks' financing needs.
- **June 22** Leaders of the bloc's four largest economies—Germany's Angela Merkel, France's François Hollande, Italy's Mario Monti and Spain's Mariano Rajoy—meet; they are expected to discuss reforms to the currency union.
- **June 28** EU leaders to meet in Brussels, seeking a road map toward deeper economic and political union in the euro zone.

Source: WSJ research

eventually demolished public finances and thrust the country into a bailout program.

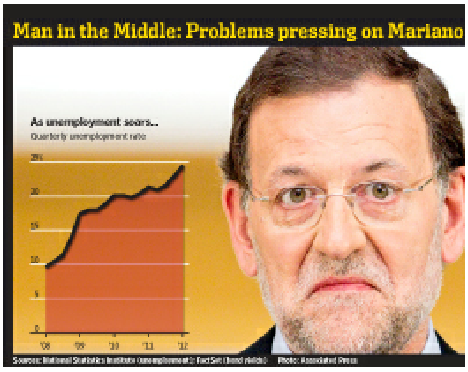
After a meeting with European finance officials Saturday, Spain said it would try to cut the knot by soon requesting aid from the euro zone. Those funds, coming from the bloc's bailout vehicles, would be lent to Spain, which would take stakes in troubled banks in return for cash or bonds.

The plan is short on details, particularly on what would be demanded of Spanish banks in return for the help—a reflection of the speed with which the plan was assembled. A senior euro-zone official involved in the discussions said the governments moved quickly because "Spain was on the verge of being unable to finance itself on the markets."

Spain will lose control over the supervision of its banks to international and European authorities, who will scour the banks' books and may order banks to shed assets—or even demand the closing of lenders seen as unviable.

The bailout will help Spain in one clear way: It is a low-cost means of rapidly cobbling together large sums that Spain would otherwise have had to pay dearly for—if it could find anyone to lend to it at all.

But it comes with a number of pitfalls. First, economists and market analysts point out, the costs of the bank rescue still fall on Spain: It must repay the European loans.



Second, the parameters of that aid make it more difficult for Spain to raise additional money. That is because lending from the European Stability Mechanism, the new euro-zone bailout fund that is expected to handle the bulk of the aid, is intended to have a "senior" creditor status: The ESM is meant to be repaid before holders of regular Spanish bonds if Spain were to default on its debts. Mr. Knight of UBS said "the fear that bondholders are subordinated by this" will make investors reluctant to buy Spanish debt.

If Spain is to avoid its own bailout, it will have to convince lenders its banking problems are under control. That isn't easy: Ireland was forced to take aid after repeatedly underestimating the extent of its banks' problems. And then Spain will need to convince lenders that, banking problems aside, it can survive.

Video

Spain's Indignado movement and their supporters protest over Spain's decision to ask for a bailout for its banks. Video Courtesy of Reuters.

Spanish Prime Minister Mariano Rajoy welcomes euro zone finance ministers' agreement to lend Spain up to 100 billion euros. Deborah Lutterbeck reports. Video Courtesy of Reuters.

To that end, Europe's strategy—and now Spain's—is to present the bailout commitment as a limited support program, far from the intrusive rescues that were needed for Greece, Portugal and Ireland. Thus, Madrid won't see the regular visits from the troika of the European Commission, the European Central Bank and the International Monetary Fund to go through government books and closely check on the implementation of promised spending cuts and overhauls.

"There will be no new conditions in other areas like fiscal policy and structural reforms," European Union Economic Affairs Commissioner Olli Rehn said Sunday.

It will be a tough sell. Spain's banking-sector problem is a deep one but not the only one the government faces. The economy is contracting viciously and unemployment is staggeringly high. The central government has had difficulty controlling the finances of its regional governments.

The continuing implosion of its property bubble pushed Spain back into recession in the first quarter and almost one in four workers is without a job. The unemployment rate among young people is near 50%.

"At the end of the day, we also know that the Spanish regions are going to need a lot more funding than has been assumed," said Ms. Haworth of Credit Suisse. "The Spanish deficit forecast of 5.3% is clearly not going to be met."

Pavan Wadhwa, a strategist at J.P. Morgan, said Spain faces a trio of problems: a troubled banking system, an overextended government and an economy in tatters. With the aid, he said, "you have resolved one of three things, so you might actually see a relief rally on Monday. But a relief rally is not going to last for a very long time."

—David Román, Santiago Perez and Jonathan House in Madrid contributed to this article.

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