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Spain's economic problems are not being helped by attempts to disguise debt in official figures.

by Blog Admin

This week Spain formally requested 39.5 billion euros of European funds to recapitalise Spanish banks. **Luis Garicano** *writes that one of the key issues exacerbating Spain's economic crisis is the tendency to disguise debt in official figures. He argues that in several areas of the Spanish economy it is better to accept money has been lost, rather than spend further funds simply to maintain an appearance of sustainability.*

Suppose you run a business and have a customer, company X, which owes you money and has already been given several deferrals on its promises to pay. You investigate and discover that the customer is in no condition to pay at all. Company X comes back to your shop and asks for yet more credit in order to keep on buying. It would seem obvious, surely, that you will tell it to get lost and that on no account will you give it more credit?

In our financial crisis (just as in Japan´s earlier crisis) this logic does not hold: it is precisely troubled institutions which tend to follow the opposite reasoning. For example, if customer X is a real estate developer, the bank thinks: if I do not extend his credit, I have to declare a bad debt and make provisions, which will use up what little capital I have. Therefore, it would be better to give the developer more money, maintain that the loan is a "good" one, and keep going "till things get better." And so the economy is controlled by zombie banks, which appear to be alive but are in fact dead and use up the capital which should be going to businesses, especially exporters, which could get the economy going again.

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Well, this logic, which has caused so much damage to the financial system and the Spanish economy, is also applied at government level, in Spain and in Europe. The Government´s main concern, shared by the press, is whether such and such an expenditure item "counts" as part of the deficit. How Eurostat calculates the deficit (unfortunately, quite badly, because it does not deal very well with contingent obligations, company debt or Social Security, see this Banco de España document) affects the excessive debt procedure, and that matters, of course, but what is ultimately important is for the debt to be sustainable, and hidden debt does affect sustainability. Unfortunately much has been done to disguise the truth, often contrary to economic logic. If we lose our credibility in order to get the numbers to "work out" then all the effort will have been in vain. And there are reasons to believe that the Government is so obsessed with the numbers that it is pushing the limits of what is reasonable.

1. **The bailout of the financial system** has been carried out in the least transparent manner possible, just so that it will not "count", using guaranteed debt (see the sums involved), asset protection schemes and ECB money against collateral from the financial system which is however guaranteed by the Banco

de España. For example, in the case of Bankia, as we discussed in May, before the Spanish taxpayer was even aware of the problem, it was already too late because the total explicit and implicit guarantees given by the State, the Deposit Guarantee Fund (FGD) and the Banco de España totalled 250 billion euros. These guarantees were cheerfully handed out as if the banks only had liquidity problems when they were in fact insolvent. Just as the banks granted credit extensions to the developers so as not to have to face reality, the state was granting the financial institutions a lifeline for the same purpose.

2. **The energy tariff deficit**, totalling 30 billion euros by the end of the year, is another example of how we cheat at solitaire. The "liberalised" market generated high prices, but nobody wanted to frighten the taxpayers. So, instead of changing the system or accepting the higher prices, from the year 2000 the electricity companies were granted the "right" to recover the tariff deficit, which is the difference between what energy was worth according to the "market" and what the consumers actually paid, and so they were allowed to issue securities (you know what is coming, don´t you?), guaranteed by the state (to a total value of 20 billion, of which 13 billion have already been issued and 7 billion are still to come) against future earnings which would be charged to the energy consumers. Again this is a debt that does not "count" and so everybody is happy: the electricity company managers show a "profit" with no cash flow, the politicians avoid frightening the consumers, and the deficit keeps piling up. Only a system as opaque as this one could lead to a situation where out of every 100 euros in subsidies granted for renewable energy in the world, 15 are handed out in Spain, as César Molinas told us. Note that this hidden deficit is the worst of all possible worlds, because consumers are not aware of the costs they are really incurring, and so have no incentive to save, while companies are earning much more than they should. What is the result? The costs of the "liberalised" system have risen from 6.75 billion in 2004 to 17.13 billion in 2011, while revenue has increased from 7.16 billion to 13.28 billion, according to El Economista.

3. **The SAREB**. The SAREB (the 'bad bank' created in Spain to process unrecoverable loans), as Tano explained so wonderfully, is another example of the obsession with making sure things "don't count", instead of doing things right for once. Yet again, we minimise what we ask for from the EU in order to limit the debt. We ask for too little, and so enable the real estate developers to emerge clean and shining and free of debt (in the case of real estate developers, a deed in lieu of foreclosure IS legal) but not the ordinary citizens. Moreover, pure (guaranteed!) debt is used to pay for it and the SAREB is highly leveraged so that most of its capital is private, so that it seems that the risk is private. In fact the risk is all borne by the kind Spanish taxpayer. Ah, but that does not "count", because all the Spanish state has contributed is (as the smart reader has already grasped) the guarantees!

What is even more galling is that our dear developer, whose welfare has been the top priority of our economic policy for the past five (or rather 15) years, will be refinanced by the SAREB. Please look at page 11 of SAREB's blueprint because it is enough to make you weep. "Sareb, under specific conditions, may advance additional financing to a debtor so as to improve recoveries and the value of the assets." And, "Sareb will work actively with all debtors and will engage in consensual restructuring, refinancing or termination of loans, based on what the optimal commercial strategy is. However, this will be subject to debtors being cooperative, transparent and realistic."

In other words, in theory we are to believe that if we give these gentlemen in arrears just a little more of that money Spain does not have, then they will finish the house they have been building for the past five years, which of course will be a wonderful house and, unlike the other million and a half, it will be sellable. Not only that, but despite these gentlemen´s excellent political connections and their seat in the executive box at the Bernabeu stadium, the management at SAREB will use strict technical criteria when it comes to handing out the money. Well, I am sorry, but we do not believe it. That is what we were told five years ago by CCM, four years ago by Caja Sur and three years ago by Bancaja and CAM, and look how they ended up. The SAREB cannot be used to keep financing the construction industry moguls at the expense of the productive economy. It is not a matter of refinancing them "in order not to lose money". The money has already been lost. It is a matter of not admitting that the money has already been lost.

4. **The Social Security accounts**. There is a serious structural problem with the social security accounts, which must be recognised and resolved. At the moment, there are two workers paying towards each pension, which means we are at the limit of what is sustainable. The Social Security deficit will reach

10 billion euros this year (when there was a surplus of 9 billion in 2009). Moreover, Spain´s demographic future is difficult. But two instruments are being used to give an appearance of sustainability: the state is "paying" the Social Security contributions for the unemployed (by moving money from one account to another) and it is using 7.5 billion from the reserve funds. Here again, the problem is not just that the truth is disguised, but that in so doing, it leads to bad decisions being taken on the pension increases which would make the system more sustainable, and to postpone facing up to the structural reality.

5. **Greece**. Greece is insolvent. Nobody in the private or public sector has come up with a model to the contrary. They are not going to pay the debt and, as the IMF admits, relief is going to have to be agreed. However, the creditor countries, including Spain, are going to give them more money to refinance the debt and avoid a declaration of bankruptcy, against the wishes of the Fund. The money has already been lost, and the fact that we do not wish to admit it in our bookkeeping will not change this hard fact. But refusing to admit reality is costing Spain and Europe a lot of money, and a lot of suffering is imposed on the Greek citizens who have to keep on working under a huge weight of debt they can never cast off, as they know perfectly well.

One of the things that those of us who teach economics most emphasise to our students is the difference between economic and accounting profits. There are many decisions which might make sense from an accounting point of view, but make no sense in the real world of business and so should not be taken. This principle also applies to states. Let us stop worrying about what "counts" and "does not count" and try to take decisions in the interests of everyone´s welfare in the medium and long term.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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