

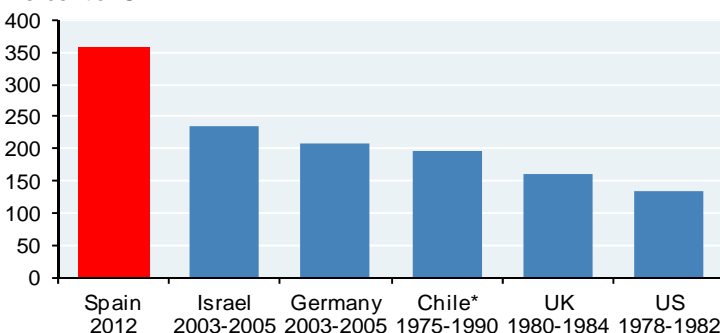
A brief note on the problems in Spain

It's hot everywhere this summer¹, but problems are boiling over in Spain where credit spreads have reached crisis-high levels. I don't want to dwell on this, and I promised myself I would focus next on investment opportunities (we are working on a note on *Big Data* related investments which will be released in August). Q2 S&P 500 profits are coming in more or less in line with lowered expectations (0% earnings growth year-on-year; roughly flat to analyst estimates for the quarter; margins stable; much fewer positive revenue surprises vs. prior quarters; forward guidance a bit weak relative to history). But I read something the other day from a Wall Street firm that's worth quickly commenting on, since it epitomizes the Don Quixote-like hope that problems in Europe will solve themselves with some economic and political wizardry. Paraphrasing, the piece says:

- The much needed internal European economic rebalancing has begun. Germany will be the next Spain, and Spain will be the next Germany. How so? Like Spain when the Euro was launched, Germany is very competitive, has a tight labor market and is seeing higher wages and house prices. This will support consumption and will gradually erode its current account surplus, benefiting Spain which will be able to export more to Germany
- Germans might learn to live with much higher inflation, since it will be the by-product of a strong labor market and rising asset prices.
- By contrast, Spain is going through an austerity process with tough labor market and social security reforms similar to those implemented by Germany a decade ago

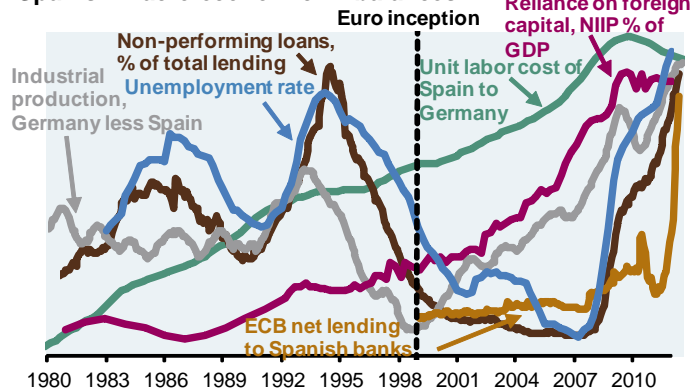
Spain is the next Germany and Germany is the next Spain? Hope springs eternal. **Trying to turn Greeks into Germans has been a disaster; turning Germans into Spaniards is likely to be just as pointless.** Comparing Germany a decade ago to Spain today is very inapt. In fact, comparing *any* country undergoing a structural adjustment to Spain 2012 has problems. Why? Countries undergoing adjustments have to do painful things: liberalize labor markets, allow banks to fail, cut government spending, privatize nationally owned companies, etc. Carrying a lot of sovereign, corporate and household debt while making such an adjustment is very difficult, and creates substantial risk for bondholders and shareholders in that country. Our Chief Economist Michael Vaknin and I took a look at some of the largest such episodes, and as shown below, **Spain leads the pack in terms of economy-wide debt owed during an adjustment.** The second chart looks at Spain's macroeconomic situation, with a line at the Euro's inception. Spain is making some inroads regarding competitiveness vs Germany, but (a) they have a long way to go, and (b) the recent catch-up of the green line on relative unit labor costs is more a function of 25% unemployment than structural changes to the Spanish labor market. To those skeptical of Europe's currency union and its inherent flaws (now conceded by Delors, one of its founders), Spain's current predicament is la cronica de una muerte anunciada.

Economy-wide debt at the start of major reform programs
Percent of GDP



Source: JPMAM, country sources. *Est. using external debt data in 1985. See page 2 for descriptions of structural adjustments.

Spanish macro-economic imbalances



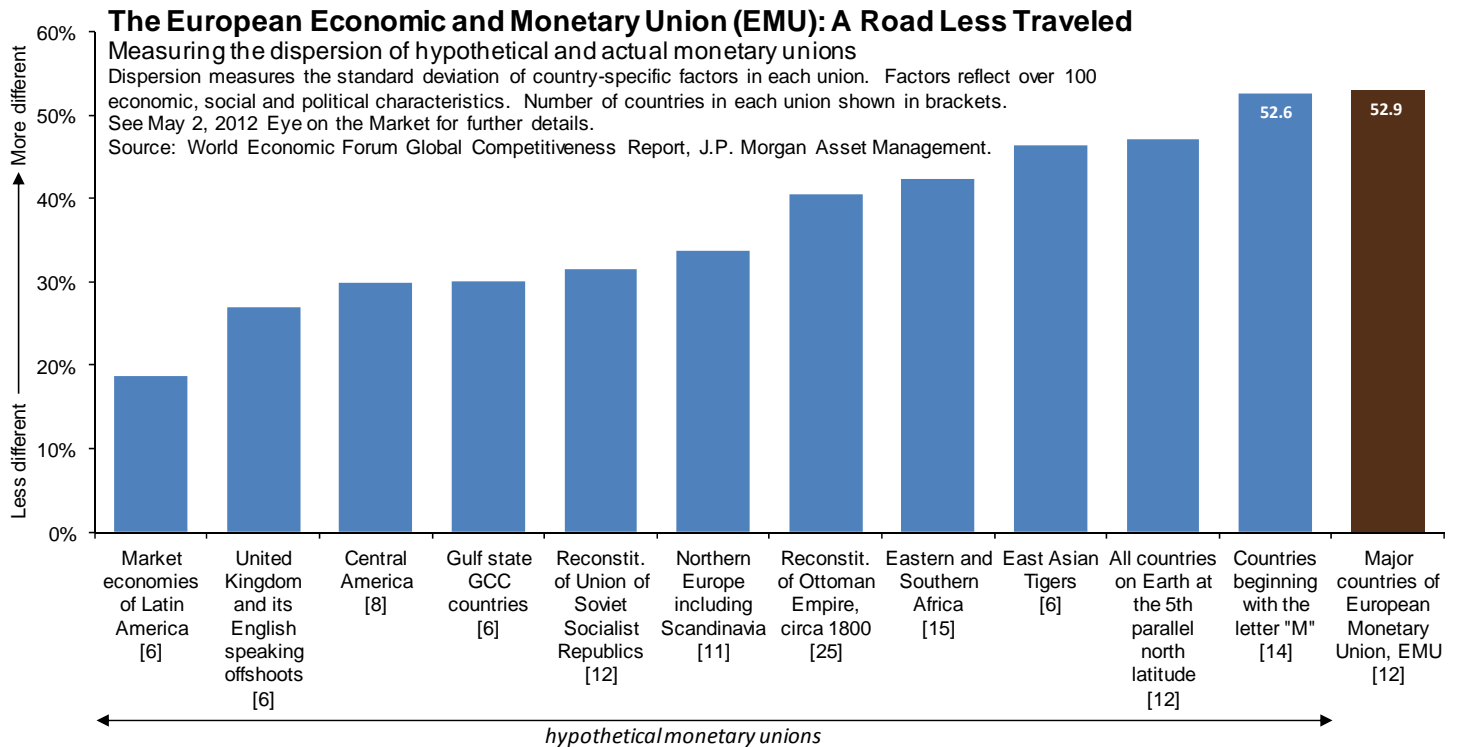
NIIP = Net International Investment Position. Source: See appendix.

I start every presentation on Europe with the chart on the following page, which we have included before. The EMU is one of history's most ambitious balloon flights, given the very different economic, social and political characteristics of its members. As soon as the Euro was launched, capital flooded into the South, financed a consumption boom which has gone bust, leading to massive flight of banking sector and other capital flows. I have no idea what Europe will do next, since I don't think they do either. Spain may need 500-700 billion Euros to finance upcoming sovereign and bank bond maturities, fiscal deficits and bank recapitalization needs. If, when, how and from whom they receive it are among the critical questions for 2012 and 2013.

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¹ AccuWeather said last week that 2012 could surpass 2011 as the hottest summer in recorded US history. One consequence is lower than usual water levels in lakes and rivers. In upstate NY, low water levels surfaced a 45 pound alligator snapping turtle which was terrorizing a local swimming and fishing pond. After a prolonged battle, I relocated it (picking it up by its tail). Picture available on request.

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What kind of monetary union is this?



Structural adjustment programs in the chart on page 1

Spain 2012: reduction of firing costs, incentives for small businesses to hire under permanent contracts (particularly young workers and the long-term unemployed), decentralization of collective bargaining

Israel 2003: tax reduction (income, VAT and corporate), reduction in unemployment/social welfare payments, privatizations, measures to increase competition in various industries

Germany 2003: reduction in the duration of unemployment benefits and conditioning benefits on accepting work if a job is offered

Chile 1975: transitioning from a military dictatorship to an open, market-based economy: privatizations, reduction of import tariffs, reduction of payroll taxes, decentralization of wage bargaining, financial deregulation

UK 1980: reduction of union power, reduction of unemployment benefits, privatization, tax reduction, reduction in the size of government

US 1978: deregulation of several industries: airlines/trucking/railroad (removed government control of fares, routes and market entry), financial (allowed banks to merge and decide what interest rate they want to charge)

Sources for Spanish macro-economic imbalances chart

Instituto Nacional de Estadística, Banco de España, Statistical Office of the European Communities, Organization for Economic Cooperation & Development. Some people do not like charts without a y-axis, but they allow for a lot of variables to be shown at once. The point here is not the exact levels, but the trends.

La Cronica De Una Muerte Anunciada (Chronicle of a Death Foretold), a 1981 novel by Gabriel Garcia Marquez.

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