



## The Spanish Financial Crisis

### *Economy the Size of Portugal, Ireland, and Greece Combined is at Risk*

8/2/2012

#### Key Points

- ❖ European leaders have agreed to a €100 billion (\$122 billion) bailout of the Spanish financial sector; however, it is unlikely this assistance package will place the Spanish economy on a sustainable path.
- ❖ The Spanish economy is suffering from the aftermath of a collapsed real estate bubble. Its government debt level is nearly unsustainable. Now, the Spanish government must overcome the difficult task of continuing its fiscal consolidation plan while its economy contracts.
- ❖ This task is nearly impossible, meaning Spain will likely require an economy-wide bailout. However, supporting Spain will exhaust the capacity of Europe's financial assistance mechanism.
- ❖ Obtaining more emergency funding for Europe will be politically difficult, and it is likely that the Germans will eventually be on the hook for financing the weaker peripheral Eurozone countries.
- ❖ The stakes are high. An unmitigated crisis in Spain would have substantial adverse effects on the rest of the Eurozone and might threaten the viability of the euro going forward.

#### Introduction

After equivocating for many months, the Spanish government agreed on June 9 to a €100 billion (\$122 billion) bailout of its financial sector by the European Union.<sup>1</sup> The Spanish finance minister made a formal request for aid on June 25, and Eurozone finance ministers unanimously approved a memorandum of understanding on July 20. Spanish banks—particularly the regional savings banks known as “cajas”—have sustained significant losses stemming from real estate loans that soured in the wake of a bursting of the Spanish housing bubble. Those regional banks are now in need of substantial recapitalization, which is the primary reason behind the financial assistance package.

***After equivocating for many months, the Spanish government agreed on June 9 to a €100 billion (\$122 billion) bailout of its financial sector by the European Union.***

Although the majority of the rescue package's features have been approved, the final details will not likely be finalized until September when the results of an independent audit of the Spanish banking system

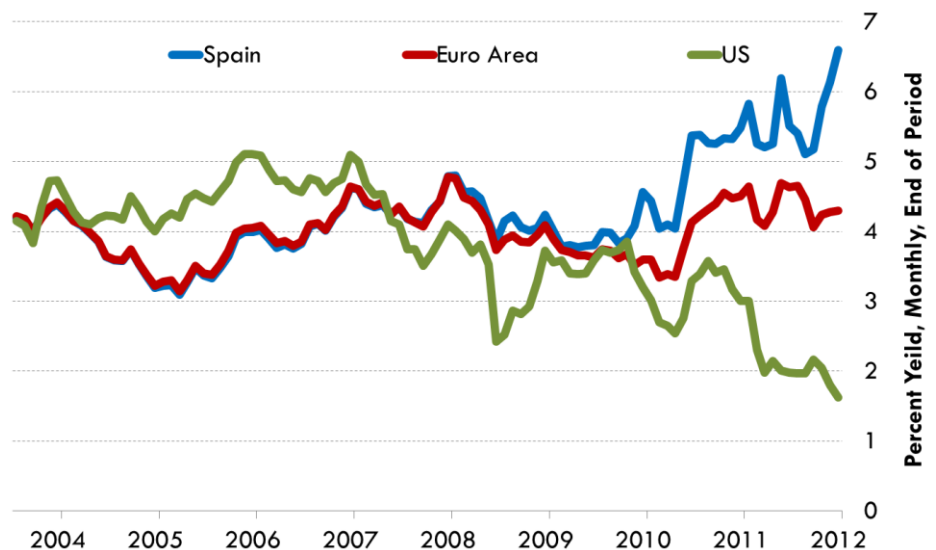
will be completed. The EU will directly recapitalize Spanish banks, instead of funneling the funds through the Spanish government. By taking this approach, Spain can avoid increasing its debt-to-GDP ratio by nearly 10%.<sup>2</sup> Spain's sovereign debt had been significantly lower than other Eurozone periphery countries, but it is now approaching a nearly unsustainable level. This high debt level has contributed to a recent dramatic increase Spanish borrowing costs.

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Debt markets have remained turbulent in spite of the news of a Spanish financial sector bailout, as the yield on Spanish 10-year bonds jumped to a 15-year high of 6.83% in the second trading day following the program's announcement and have since increased to a high of 7.62% (see Figure 1 below). The ongoing turmoil likely relates to the belief held by many economists and market watchers that Spain will eventually need a full Greece-style bailout in order to set its economy on a more sustainable path and calm the market for Spain's sovereign debt.

In addition to the bailout news, European finance ministers agreed to extend by one year Spain's fiscal targets under the European Stability and Growth Pact. In order to meet these targets, Spanish Prime Minister Mariano Rajoy announced a new fiscal consolidation plan amounting to €65 billion (\$80 billion) and consisting of a mix of tax increases and spending cuts.

**Figure 1. Yields on 10 Year Government Bonds**



Source: Haver Analytics, Banco de España, Eurostat, Bank of Greece, Federal Reserve Board

The Spanish government will need to continue its fiscal consolidation program over the next several years. Although it has secured additional time to meet its goal, the Spanish government must overcome the difficult task of reducing budget deficits even while the economy contracts. Spain must also take steps to further liberalize its labor and product markets, and decisively address its persistent housing woes. However, it is unclear whether or not the benefits from these structural reforms will take hold soon enough to provide sufficient growth to Spain so that it can avoid additional external support.

Meanwhile, a key summit on June 28-29 provided Eurozone leaders an opportunity to take incremental steps toward further financial integration. Many economists believe the Eurozone suffers from structural flaws because it consists of a single market and monetary union, but not a fiscal and political union. During protracted meetings, European leaders agreed to move closer toward a banking union by creating a single supervisory body for Eurozone banks. Leaders also created new rules allowing Europe's bailout funds—the existing temporary European Financial Stability Facility (EFSF) and the forthcoming permanent European Stability Mechanism (ESM)—to directly purchase the sovereign debt of individual Eurozone countries and agreed to a stimulus package of €120 billion (\$146 billion) focused on infrastructure investment and small- and mid-sized business incentives.

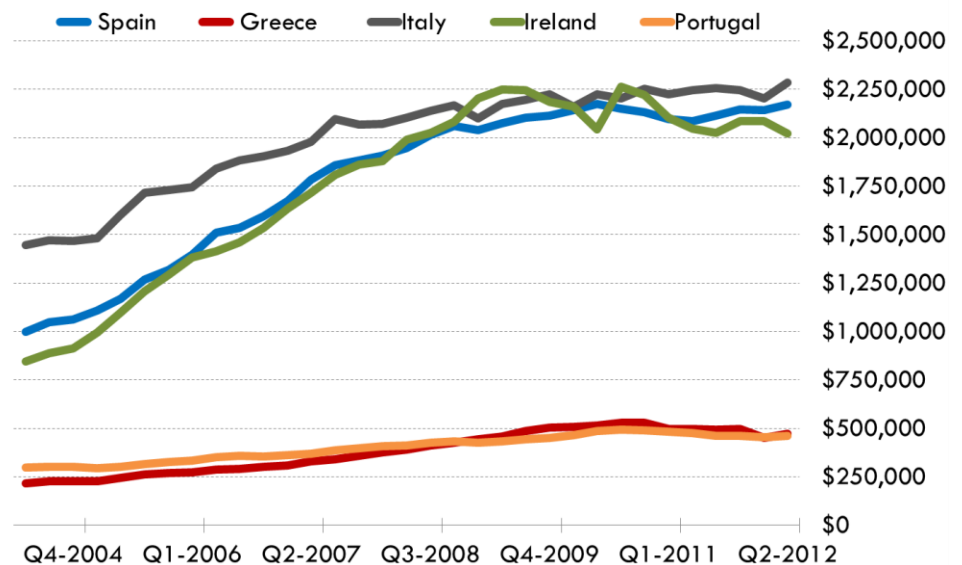
### **Why is Spain so important?**

An unmitigated crisis in Spain would have substantial adverse effects on the rest of the Eurozone and might threaten the viability of the euro going forward. The Spanish economy represents approximately 12% of the entire Eurozone—nearly double the share of Portugal, Ireland, and Greece combined. Spain has Europe's fourth largest economy. Additionally, Spain's gross external debt—the debt that all Spanish entities, including consumers, businesses, and the government, owe to foreign creditors—is approximately €1.75 trillion (\$2.13 trillion) (See Figure 2 on the next page). In short, Spain has a large economy and is an interconnected debtor—one whose default would cause significant negative impact on the financial sector and real economy of the remainder of the Eurozone. Most notably, a further deterioration in the Spanish economic position will negatively impact another large Mediterranean country—Italy—because debt markets view the prospects for both countries as being closely related.

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**Figure 2. Gross External Debt (millions of \$)**



Source: Haver Analytics, Banco de Portugal, Banco de España, Bank of Greece, Banca d'Italia, Central Statistics Office, JEC Republican Staff Calculations

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***(1) the financial stability of the Spanish banking system has deteriorated substantially in recent months, risking the possibility of a banking collapse, and***

***(2) the fallout from a full-blown Spanish crisis threatens the survival of the euro because Spain has the fourth largest economy in the Eurozone.***

Although the European Union—through the EFSF and the ESM—and the IMF together have the financial resources to provide a full back-stop to Spain, such a program would likely exhaust the capacity of the existing European assistance facilities. As a result, providing follow-on support to Spain, Portugal, Ireland, or Greece, or to providing initial support to another weak economy such as Italy, would require the European Union and IMF to raise additional capital for their assistance funds. Raising additional capital in Europe would necessitate ratification by each of the Eurozone countries—politically, an unlikely scenario.

**Why hasn't Spain had a crisis sooner?**

Until recently, the primary focus of most Eurozone financial crisis commentary has been on Portugal, Ireland, and Greece—each of which experienced major financial turmoil in the immediate aftermath of the global financial crisis of 2008 and continue to struggle today. Now, concerns have turned to Spain for two primary reasons: (1) the financial stability of the Spanish banking system has deteriorated substantially in recent months, risking the possibility of a banking collapse, and (2) the fallout from a full-blown Spanish crisis threatens the survival of the euro because Spain has the fourth largest economy in the Eurozone.

The Spanish economy has experienced difficulties since early 2010, but the pace of its financial crisis did not quicken until recently for several reasons. First, Spanish policymakers enacted a front-loaded fiscal consolidation plan in May 2010 that temporarily restored confidence in Spain's fiscal prospects. That plan included a 5% wage cut for public workers, a 10% reduction in the number of public workers through

attrition, and a 2 percentage point increase in the value-added tax rate.<sup>3</sup> The fiscal consolidation plan also included several structural reforms, including increasing the statutory retirement age from 65 to 67 and increasing the years of contribution required for full pension benefits.

Second, the Spanish real estate market, which is a primary driver of the Spanish banking crisis, has been deteriorating at a quickening pace in recent months. Previously, the Spanish market had experienced a slow downward correction in home prices following the bursting of its real estate bubble. This delayed correction has in turn delayed the realization by banks of losses due to bad real estate investment. In Ireland, which also suffered a real-estate driven financial crisis, the downward correction was swift and severe, with home prices in that country having fallen nearly 50% since their peak in the fall of 2007. Home prices in Spain are down just 22% since their peak in early 2008. This is a particularly striking contrast given that home prices appreciated 150% in Spain between 2000 and the peak in 2008, while they increased 116% in Ireland over the same period.<sup>4</sup> In recent months, however, the pace of the downward correction in Spanish home prices has accelerated markedly, with home prices dropping a staggering 12.6% year-on-year in the first quarter of 2012.<sup>5</sup> This deterioration has caused banks to realize losses, thereby worsening their condition.

Third, the Greek financial crisis has worsened in recent weeks and is causing spillover effects in Spain. Many market participants now believe a Greek exit from the Eurozone is the most likely outcome of that country's economic malaise. This is because Greek voters are rejecting the notion of further fiscal consolidation, which is a condition to ongoing support from the EU and IMF, and exiting the Eurozone will allow the Greeks to revive their economy by fostering currency depreciation through a loose monetary policy. As the likelihood of a Greek exit increases, debt market participants turn to Spain as the next weakest country. As a result, Spanish government debt yields have jumped in recent months—now at 7%—precipitating concerns that the country will be unable to finance its economy for much longer.

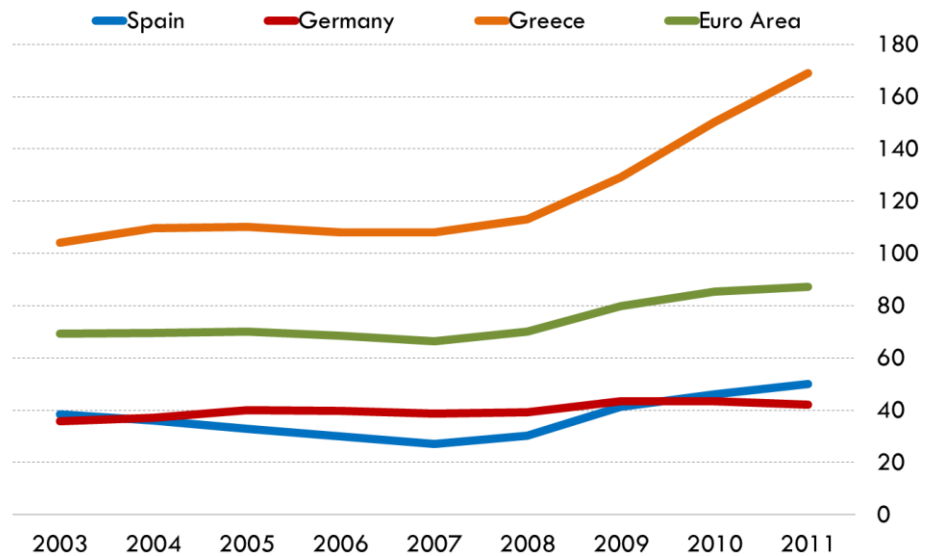
### **What is the underlying cause of the Spanish crisis?**

The underlying roots of the financial crises occurring in various Eurozone member-states differ in large degree. For example, the Greek crisis is largely driven by central government profligacy and public sector mismanagement.<sup>6</sup> In essence, the Greek state provided unsustainable benefits to its citizenry within the context of an economy that was government-dominated and characterized by swiftly rising production costs. By contrast—similar to the crisis in Ireland and the United States—the roots of the Spanish financial crisis are largely real estate driven.

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In fact, the Spanish central government was among the most fiscally prudent in the Eurozone before the global financial crisis of 2008. Spain's general government debt was just 36.3% of gross domestic product (GDP) in 2007—nearly half of the pre-crisis Euro area average of 66.2% of GDP and one-third of Greece's ratio (see Figure 3). That same year, Spain ran a government budget surplus of 1.9% while the Euro area on average experienced a slight budget deficit and Greece ran a 6.3% budget deficit.

Figure 3. Central Government Debt as % GDP



Source: Haver Analytics, Eurostat, Banco de España, Greece Ministry of Finance

However, the fiscal responsibility of the Spanish central government did not extend to the country's autonomous regional governments. These regional governments overspent and overborrowed, but, more importantly, they were the source of political interference in the regional savings banks known as "cajas." That political interference was a major driver of the overinvestment and malinvestment Spanish cajas made in real estate and construction, which led to unsustainable regional real estate booms.

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The "cajas" are at the center of the Spanish real estate crisis, which in turn drives Spain's financial crisis. For years, these unlisted regional savings bank were controlled by a mixture of local politicians and depositors and were operated in many cases "by regional barons as development banks that could further their political purposes."<sup>7</sup> Because these banks were closely held and lacked independent shareholders, proper corporate governance and risk management was virtually nonexistent.<sup>8</sup> As a result, these banks were able to fuel unsustainable property booms in local markets throughout Spain. From 1995 to 2007, property prices tripled in Spain and the amount of real

estate and construction loans grew from 10% of GDP in 1992 to 43% of GDP in 2009.<sup>9</sup> Much of this growth was driven by the regional cajas, which experienced a growth in market share from which experienced a growth in market share from 10% in the 1960s to approximately 50% of the Spanish banking market by 2010.

The collapse of the real estate bubble has ravaged Spanish cajas and driven the banking crisis in Spain. Thus far, Spain has addressed the problem by promoting mergers among many of these failing banks—while there were 45 cajas pre-crisis, only 11 remain. The largest Spanish caja—Bankia—was created in December of 2010 through the merger of seven failing cajas. Bankia was effectively nationalized in May 2012 through a €19 billion (\$23 billion) Spanish government bailout. Spain's bailout of Bankia contributed to the worsening of the current phase of the Spanish crisis.

As the real estate market continues to deteriorate, Spanish cajas will continue to take additional losses on their loan portfolios. The Spanish government's own difficulty borrowing in sovereign debt markets is compounding the troubles. As foreign investors pull out of the market for Spanish government debt, increasingly fragile domestic banks have stepped in to purchase the great bulk of Spain's recent debt issuances.<sup>10</sup> This dynamic makes domestic banks less likely to provide credit to consumers, further worsening economic performance, and risks a total collapse should Spain become unable to pay its debts.

For the above reasons, the Spanish banking system has hit a wall in recent months. Banks do not have enough equity capital to cover their mounting real estate-related losses and cannot purchase Spain's

sovereign debt indefinitely. Much like in the United States, the void created by the building and real estate bust has been especially destructive to Spanish growth. The combination of these factors underlies the current Spanish economic malaise.

### **What is the current bailout package and will it save Spain?**

The final details of the European bailout of Spain are forthcoming, which is one factor contributing to the ongoing turmoil in that country and the lackluster response by market participants. The present bailout figure stands at a maximum of €100 billion (\$122 billion), although Eurozone governments did not approve a specific final amount in their July 20 agreement.<sup>11</sup> Contrary to initial reports, those funds will not be funneled through the Spanish central government, thereby avoiding and increase of Spanish debt-to-GDP of nearly 10%.

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The approved memorandum of understanding specified that loans to Spanish banks will have an average maturity of 12.5 years and a maximum of 15 years. Interest rates will range between 3 and 4 percent, well below currently available private rates. The final loan amount is expected in September, when an in-depth independent audit of Spanish banks is completed. The preliminary results of that audit were released on June 21 and suggest that Spanish banks face a €62 billion (\$76 billion) capital shortfall.<sup>12</sup> The final results of the audit should reveal whether the €100 billion figure will be sufficient to cover the expected losses Spain's banks will experience on their bad loan portfolios.

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Currently available information suggests that the announced financial sector bailout package will be insufficient to place the Spanish economy on a sustainable path, and it is likely that Spain will eventually need a Greece-style bailout from the EU and IMF. First, the Spanish crisis is fundamentally a real estate-driven crisis was not addressed by the bailout package and continues to deteriorate. Although home prices in Spain have fallen approximately 22% from their peak in 2008, many economist and market participants expect to home prices to fall an additional 25% or more.<sup>13</sup> A continued drop in home prices will lead to further losses at Spain's ailing regional banks.<sup>14</sup> Thus, it is likely those banks will need additional recapitalization, which will likely stretch beyond the capacity of the Spanish government.

Second, the Spanish government must continue its fiscal consolidation program within the context of an economy that is in recession again and will continue to experience an economic decline for some time. Although the Spanish government's European Growth and Stability Pact deficit targets were lowered by the EU Commission on July 9—from 6.3% of GDP to 5.3% of GDP in 2012, and to 4.5% in 2013 and 2.8% in 2014—the country will likely miss even the revised targets.<sup>15</sup>

Although its exact composition is not yet known, the new Spanish fiscal consolidation program includes substantial tax increases including a three percentage point increase in the value-added tax, additional indirect taxes on energy, and increases in property taxes.<sup>16</sup> The previous Joint Economic Committee Staff Study entitled *Spend Less, Owe Less, Grow the Economy* found that such tax-heavy fiscal consolidation plans tend to fail.<sup>17</sup> Instead, successful fiscal consolidation plans are heavily weighted toward real reductions in government spending, product and labor market reforms, and the privatization of government-held assets.

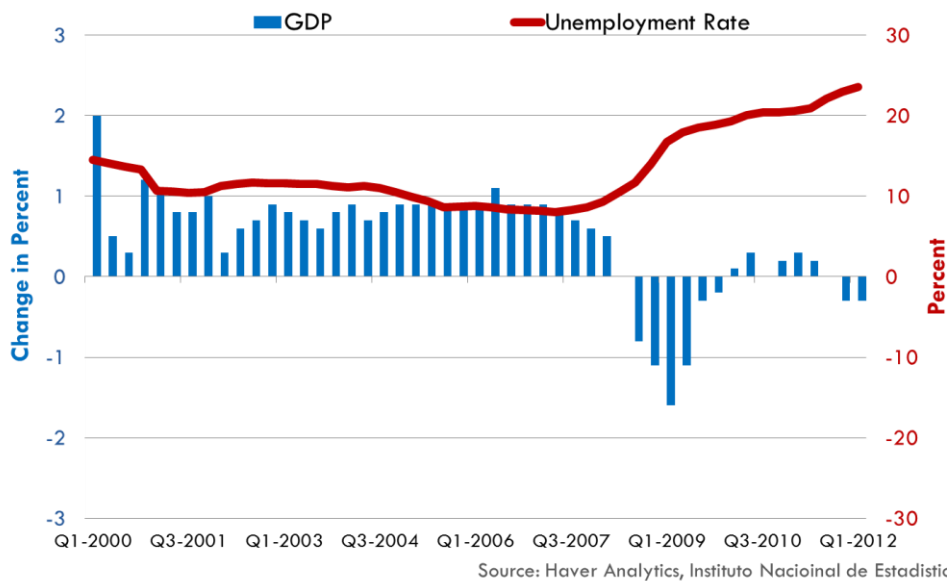
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example, Spain's most recent manufacturing index reading of 42.0 (below 50 suggests a contraction in the sector) is the fastest decline percentage points from a year ago.<sup>18</sup> These increasing bad-loan ratios have contributed to the tightening of credit extension in Spain and exacerbated the contraction in private sector demand. The current deterioration in Spanish economic indicators only compounds the challenges Spain faces in a general unemployment rate of 24.3%, up 3.6 percentage points from a year ago, and a youth unemployment rate of 51.5%, up 6.5 percentage points from a year ago (see Figure 4 below). This sub-par economic performance means the situation is actually even worse in Spain than one might currently expect; in fact, the Spanish government now forecasts a 1.7% contraction in 2012.<sup>19</sup>

Figure 4. Spanish Real GDP & Unemployment Rate



Finally, the spillover effects from the Greek financial crisis will further diminish the ability of the Spanish government to borrow in sovereign debt markets. Continued acute turmoil in Greece will lead to additional upward pressure on Spanish bond yields as the prospects of a Greek exit from the Eurozone increase. Now above 7%, Spanish government borrowing costs are approaching an unsustainable level and are contributing to a further deterioration in the public sector's balance sheet.

Taken together, these points suggest that Spanish banks will need recapitalization over-and-above the €100 billion committed thus far, the Spanish government will see its borrowing costs rise and its fiscal position further deteriorate, and the Spanish economy more broadly will not experience growth for some time. Because Spain cannot offset

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these negative factors through monetary accommodation, it is likely that the EU and the IMF will be forced to bailout the Spanish government.

### **What steps were taken during the June 2012 European Summit?**

***European leaders met on June 28-29 to discuss additional steps the crisis-stricken Eurozone might take toward further financial integration.***

European leaders met on June 28-29 to discuss additional steps the crisis-stricken Eurozone might take toward further financial integration. During the summit, leaders agreed to create a single, integrated banking supervisor for Eurozone banks and to allow the Eurozone rescue funds—the temporary ESFS and the permanent ESM—to directly purchase sovereign debt. The latter provision was included to relieve market pressure on Spain and Italy.

Related to the Spanish crisis specifically, European leaders agreed to allow Spain's rescue funds to be injected directly into Spanish banks, rather than being funneled through the Spanish government as was originally contemplated. Injecting capital into Spanish banks directly will avoid a dramatic increase in Spanish debt-to-GDP.

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While the summit produced an incremental step toward banking integration, the summit did not address many of the other fundamental economic problems in the Eurozone. German Chancellor Angela Merkel said on July 5 that the summit agreement does not involve any additional sharing of liabilities across the Eurozone and, as such, does not go beyond existing Eurozone treaties.

Many market participants have been expecting European leaders to agree to Eurozone-wide deposit insurance and a unified banking resolution scheme. Comprehensive deposit insurance is the most effective means for quelling the nascent bank runs that have begun in the weaker Eurozone peripheral countries.

### **What underlying structural problems does Europe face and what steps might European leaders take to address the ongoing euro crisis with more finality?**

***Beyond the ongoing troubles in Spain, the Eurozone is experiencing widespread disruptions stemming from the economic disparities between its diverse member-states... many economists believe that the Eurozone, as it is currently constructed, suffers from a fundamental flaw.***

Beyond the ongoing troubles in Spain, the Eurozone is experiencing widespread disruptions stemming from the economic disparities between its peripheral countries (e.g., Spain) and its core countries (e.g., Germany). This problem reflects the belief of many economists that the Eurozone—as it is currently constructed—suffers from a fundamental flaw, which relates to the fact that the Eurozone is a single market and monetary union, but not a fiscal and political union.

Put another way, the fundamental flaw of the Eurozone is that it is not an “optimum currency area.” Economist Robert Mundell introduced the idea of an optimum currency area in a seminal 1961 paper.<sup>20</sup> A useful way of describing an optimum currency area is that it consists of

a single currency area that is economically efficient at balancing the three objectives of full employment, balanced international payments, and stable domestic prices.<sup>21</sup> These objectives are the underpinnings of long-term economic growth—a universally desired end. But, optimum currency areas are not universal.

Optimum currency areas exhibit three primary characteristics: (1) various regions in currency area are not subject to asymmetric shocks; (2) there is high labor mobility and wage flexibility within the currency area; and (3) the entire currency area shares a common fiscal policy that transfers resources from economically prosperous regions to underperforming regions within the area.

The Eurozone, as a whole, does appear to embody the characteristics of an optimum currency area. The many countries of Europe have distinct economic strengths and weaknesses (subjecting them to asymmetric shocks). European countries are culturally and linguistically diverse (reducing labor mobility). Each country has drastically different levels of state and union control over their economy (inhibiting wage flexibility). And, finally, there is no common fiscal authority. This last point, above all others, is a prerequisite to an effectively functioning single currency area.

The optimum currency area theory suggests that Eurozone leaders must pursue a fiscal union for the euro to function properly over time. The alternative is that one or more peripheral countries exit the Eurozone, which will cause significant negative spillover effects across the Eurozone and to a lesser extent on the United States and the rest of the world.

Preserving the Euro will require Europe and its leaders to incur great financial and political costs. A July 26 speech by European Central Bank President Mario Draghi suggests that the ECB, at the very least, is “ready to do whatever it takes to preserve the euro.”<sup>22</sup> Draghi is confident that ECB actions “will be enough” to preserve the euro; however, it is not entirely clear that is the case. Most economists and commentators believe that in order to preserve the euro as it now exists, German voters will need to accept the inevitability that Germany must make massive and ongoing fiscal transfers to the peripheral countries at great domestic expense. So far, Germans have been unyielding in their rejection of that notion. As a result, it appears that European leaders will continue to make incremental steps toward integration only as market pressures rise to such a great extent as to force their hands. The longer this dynamic persists, the more likely weak Eurozone periphery countries exit the Eurozone.

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***In order to preserve the Euro as it now exists, German voters will need to accept the inevitability that Germany must make massive and ongoing fiscal transfers to the peripheral countries at great domestic expense.***

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- <sup>1</sup> Minder, Raphael, Kulish, Nicholas, and Geitner, Paul, "Spain to Accept Rescue from Europe for Its Ailing Banks," *The New York Times* (June 9, 2012).
- <sup>2</sup> Crumley, Bruce, "E.U. Summit: Up All Night, But Consensus Finally Reached," *Time* (June 29, 2012).
- <sup>3</sup> International Monetary Fund, "Article IV Consultation" (July 2011).
- <sup>4</sup> Zero Hedge, "S&P: Spanish Home Prices to Drop Another 25%," (June 14, 2012).
- <sup>5</sup> Reuters, "Spain House Prices Fall at Steepest Rate on Record," (June 14, 2012).
- <sup>6</sup> See Joint Economic Committee Republican Staff Commentary, "Greek Economic Crisis: Growing Contagion Risk for the U.S. Economy" (June 1, 2012).
- <sup>7</sup> Economist, "The Spanish Bail-out: Going to Extra Time" (June 16, 2012).
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- <sup>9</sup> Economist, "The Spanish Bail-out: Going to Extra Time" (June 16, 2012).
- <sup>10</sup> Thomas Jr., Landon, "Madrid Leans on Its Troubled Banks to Buy Its Bonds," *The New York Times* (June 7, 2012).
- <sup>11</sup> See "Eurogroup to approve Spanish banking sector bailout Friday," *Reuters* (July 20, 2012).
- <sup>12</sup> Fontevicchia, Agustino, "Spanish Banks Need up to \$78 Billion in Extra Capital to Survive, Audit Shows," *Forbes* (June 21, 2012).
- <sup>13</sup> See e.g., Münchau, Wolfgang, "There is No Spanish Siesta for the Eurozone," *The Financial Times* (March 18, 2012); Zero Hedge, "S&P: Spanish Home Prices to Drop Another 25%," (June 14, 2012).
- <sup>14</sup> See Doyle, Dara, and Brennan, Joe, "Irish Tell Spain to Imagine the Worst in Banking Bailout." *Bloomberg Businessweek* (June 14, 2012).
- <sup>15</sup> Johnson, Miles, "Spain Given Extra Time to Cut Deficit," *The Financial Times* (July 9, 2012).
- <sup>16</sup> Reuters, "Spain Unveils New Austerity Under European Pressure" (July 11, 2012).
- <sup>17</sup> Republican Staff Commentary, "Spend Less, Owe Less, Grow the Economy," *Joint Economic Committee* (March 15, 2011).
- <sup>18</sup> Penty, Charles and Meier, Simone, "Spanish Bad Loans Jump, Adding to Recession Concerns: Economy," *Bloomberg* (June 18, 2012).
- <sup>19</sup> Ross-Thomas, Emma and Benoit, Angeline, "Rajoy Announces 65 Billion Euros of Cuts to Fight Crisis," *Bloomberg* (July 11, 2012).
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- <sup>22</sup> See Verbatim of the remarks made by Mario Draghi, Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London (July 26, 2012).