How Spain Can Avoid the Irish Error

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In seeking solutions for the euro zone debt crisis, the more manageable Irish and Spanish cases should be distinguished from the much less tractable Greek case of egregious budget profligacy. Years of fiscal irresponsibility make it almost certain that Greece will default on its sovereign debt and exit from the euro zone, absent a massive fiscal transfer from the EU. Greece's public debt (already approaching an unsustainable 150% of GDP and still rising) simply cannot be repaid. By providing ample liquidity, the EU-IMF assistance to Greece thus far has postponed the collapse of Greece's public finances, but it will not avoid its eventual need for restructuring. Indeed, by plunging the Greek economy into the deepest of economic recessions, the austerity program is worsening Greece's debt service ability.

The struggles of Ireland and Spain do not reflect fiscal recklessness. That should allow for a much more favorable resolution than in the Greek case. Neither country had large preexisting amounts of sovereign debt relative to GDP, as neither had engaged in unsustainable spending or dishonest public accounting practices during the pre-2007 boom. In contrast to Greece, both countries also enjoy much healthier political systems and lower levels of corruption and tax evasion; and both countries also boast records of global success for key domestic enterprises.

Rather than fiscal profligacy, the root of the economic malaise in Ireland and Spain was their extreme housing bubbles, which both saw housing price appreciation twice that experienced in the United States. The housing booms were financed by bank lending, largely financed from non-deposit wholesale borrowing in international debt markets. The bursting of those bubbles spawned serious losses for their banks, despite the fact that, in Spain, those losses remain largely unrecognized. Spain's unrecognized losses include massive amounts of mortgages that are underwater, as well as "evergreened" loans to real estate developers on which losses remain largely unrecognized, according to Moody's. The ending of the property booms in Ireland and Spain also substantially eroded these countries tax bases, which adds to their fiscal deficits.

Ireland has managed to make what should have been a manageable banking insolvency problem into an irresolvable public finance problem. It did so by agreeing to have its government provide a blanket guarantee for practically all the liabilities of its failed banks. And it is now being bullied into maintaining those ruinous guarantees by its European partners and the IMF in return for multilateral assistance in rolling over its debts.

In an act of egregious political callousness, Ireland's European partners have effectively thrown the Irish economy under the bus. They have done so by effectively sacrificing Ireland's long-term economic viability in order to postpone the recognition by the European banking system of its losses on debts of Irish banks. As shown in the table below, a number of important European countries have huge banking system exposures to Irish debt, which amount to over 9 percent and 14 percent of GDP for the United Kingdom and Belgium respectively. As Patrick Honohan, the Irish central bank governor has acknowledged, the Irish government agreed to the bargain because they saw no other viable means of financing their short-term fiscal deficits without EU and IMF support.

For its own sake and for that of the euro's viability, Spain needs to learn from this sorry tale. What should Spain do?

First and foremost, Spain must stop listening to the EU and the IMF and start listening to the debt markets, whose drumbeat of rising sovereign interest rates requires an urgent response. This would seem to be particularly the case in light of Spain's heavy financing needs in 2011 and the depressing effect of rising Spanish interest rates on its banks profit margins. Spain must avoid the IMF-European Financial Stabilization Facility (EFSM) bailout trap and instead move expeditiously to hatch a four-part plan with the overarching objective of maintaining its sovereign solvency to avoid an Irish-style disaster:

(1) The Bank of Spain should immediately use its independent authority to shut down both insolvent and severely undercapitalized Spanish savings banks (cajas). Even large institutions like Bancaja and Caja Madrid, if their true condition is sufficiently weak, should be closed. Such an approach will prevent Spain from endangering its own fiscal sustainability or the health of its large banks by bearing the cost of further losses going forward or by encouraging healthy Spanish banks to acquire insolvent cajas. The ECB should lend its support by giving healthy Spanish banks full access to liquidity facilities during the process of shutting down the failed cajas.

(2) This will only work if Spain stops cooperating with European obfuscation of loan losses, and stops relying on selective disclosure of unrealistic "stress test" scenarios for its banks. Such stress tests have been thoroughly rejected by the financial markets. Mortgage losses at cajas, and likely losses to creditors of failed cajas, should be recognized and publicized, and portfolio information must be disclosed in detail for both healthy and unhealthy banks. Such an approach would make it clear how large losses are likely to be, and which creditors are likely to suffer losses. Recognizing losses now and being clear about their incidence among creditors of the cajas will greatly calm market concerns about systemic risk, and focus attention where it is warranted on a few weakened European creditor banks.

The necessary regulatory interventions to recognize bank losses will also encourage the housing market to clear, which is essential to resolving ongoing financial uncertainty. To their credit, the Bank of Spain has imposed high provisioning requirements on mortgage loans, compared to other countries. However, a policy of regulatory forbearance has discouraged foreclosures and has prevented home prices from finding their bottom. Home prices have been allowed to decline by only around 15 percent after their approximate 200 percent run up during the bubble years.

Such a policy initiative by Spain would also seem to be in the longer run interest of European and global financial stability. The risk of contagion to Spain would be minimized once it is clear that Spain will not be complicit in an Irish-style destructive bargain to absorb the large loan losses on the European banks' books. Spain will also have much greater bargaining power for receiving the short-term assistance it needs from private and public lenders.

While many policy makers today are frightened of transparency and bank closures, the historical record is clear: only by credibly recognizing banking system losses can governments put an end to financial markets uncertainties. This has been the successful historical approach to dealing with banking

crises for centuries. For example, in 1900, the legendary Russian finance minister, Sergei Witte, allowed some banks to fail, protected others, and was able to raise the funds needed to provide liquidity protection to the survivors easily in international markets, putting an end to Russia's banking crisis. More recently, Argentina brought its banking crisis to an end in 1995 through the transparent recognition of losses, the closure of failed banks, and the willingness to impose losses on uninsured creditors. By way of contrast, Ireland's policy this year of withholding information and avoiding bank closures and creditor losses produced bank runs that led to the withdrawal of one third of its banks' deposits.

(3) Long-term reforms of labor markets and cuts in pensions, which are already underway, should be accelerated and intensified. Stuck within the euro straightjacket that precludes devaluation, such reforms are desperately needed to restore international competitiveness. Spain's dual labor market (consisting of protected workers whose wages are rigid and a smaller group of unprotected workers) has forced a small percentage of workers to absorb a disproportional amount of the variation in employment demand over the business cycle. That is not only unfair, it is unworkable for a country with a 20% unemployment rate that is desperately in need of substantial wage adjustment.

Spain boasts many globally successful enterprises, as well as substantial capabilities to export and to attract foreign capital. If labor and pension reforms are enacted, Spain's competitiveness will be restored, its current account deficit will reverse, and Spain will have no trouble maintaining a sustainable foreign balance.

(4) Spain should persevere with long run budget consolidation mainly through spending reform. Spain should resist tax increases or draconian additional short-term spending cuts, which are counterproductive for restoring growth. As Greece's unfortunate experience has shown, maintaining sovereign creditworthiness is challenging without positive short-term growth prospects. Spending reforms that focus on long-run declines in spending as a share of GDP are desirable, but short-run fiscal austerity programs that drive more people out of work or increase the tax burdens on firms or consumers will not restore international investors' confidence.

Now is the time for Spain to take its destiny into its own hands, and in doing so, restore the viability of at least a large part of the euro zone economy.

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Lending, Expressed as % of GDP of lending banks' country, to:

Lending from Banks in:	**Ireland**	**Spain**
Belgium	14.1	5.0
Denmark	7.3	0.8
France	2.5	8.9
Germany	6.0	6.2
Ireland	----	14.5
Netherlands	4.2	16.4
Portugal	10.3	13.4
UK	9.4	5.7

Source: BIS Quarterly and Danske Markets