The Economist

The euro crisis

How to save Spain

The focus should be on fixing the banks, not on cutting the deficit

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GREEK politics may determine the euro's short-term future, but it is Spain that poses the single currency's most difficult problem. The euro zone's fourth-biggest economy is caught in an increasingly desperate spiral of deepening recession, drowning banks and soaring borrowing costs.

Spanish firms and banks are all but cut off from foreign funds. On May

30th yields on ten-year sovereign bonds rose above 6.6%, close to the level at which Greece, Ireland and Portugal had to seek a bail-out. After the government's botched nationalisation of Bankia, a troubled savings bank, Spanish depositors are jittery (see article (http://www.economist.com/node/21556256)). A bank run is all too plausible—especially if Greece, which is bracing itself for a fresh election on June 17th, is forced out of the euro soon. Even if that calamity is avoided, Spain's slump will drag the country inexorably towards insolvency.

Time to solve Spain's debt crisis is running out. Doing so requires a radical rethink in Madrid, but above all in Brussels and Berlin. Spain's government should be free to focus less on fiscal austerity and more on cleaning up the banks. Its European partners should also help by allowing joint rescue funds to be injected directly into banks.

The problem in Spain is not that its politicians lack the resolve to reform. In recent months Mariano Rajoy's new conservative government has pushed through a labour-market overhaul. Over the past year or so Spain has pared pensions and written debt limits into the constitution.

Spain's problem is one of misdiagnosis. Its government and European officials reckon the main challenge is fiscal. They argue that the budget deficit, which reached 8.9% of GDP last year, must be brought down as fast as possible to boost confidence and cut borrowing costs. Spanish politicians have dithered about cleaning up the country's banks, for fear that doing so would demand an injection of public funds which, in turn, would worsen the government's finances.

Private debt, public pain

This fiscal focus gets things exactly backwards. Spain's poor public finances, unlike those of Greece, are a symptom rather than the cause of the country's economic woes. Before the crisis Spain was well within the euro zone's fiscal rules. Even now its government debt, at around 70% of GDP, is lower than Germany's. As in Ireland, the origins of

Spain’s debt problems are private, not public. A debt binge by Spanish households and firms fuelled a property bubble and left the country enormously in hock to foreigners. After adjusting for all the foreign assets they own, Spain’s households, firms and government collectively owe foreigners almost €1 trillion ($1.25 trillion), or more than 90% of GDP. That is on a par with crisis-hit Greece, Ireland and Portugal, and far higher than in any other big rich economy. Spain’s banks were the conduit for this private borrowing binge, and are being hit hardest by the bust.

Fortunately, the long history of bank crises shows what needs to be done. Rather than doing too little too late, as it has so far, Spain’s government should quickly admit the scale of the problem, clean up the banks, preferably by removing bad assets, and shut down, or recapitalise, what is left. All this inevitably costs public money: an average of 10% of GDP in previous episodes, though much more in some countries, notably Ireland. In rich countries governments typically borrow the money from the markets. In emerging economies that cash has usually come from international rescue funds.

Spain’s government might be able to cover the costs itself. It could inject as much as €100 billion, or 10% of GDP, into its banks and still keep sovereign debt below 100% of GDP. But if the problem turned out to be Irish in scale, it would need help; and anyway, putting money from European funds into Spain’s banks would boost confidence more convincingly. If euro-zone countries collectively injected funds directly into Spain’s banks, the rescue would do less harm to Spain’s public finances, and the vicious link between the country’s weakening banks and its worsening sovereign debt would be broken.

The idea of European-funded rescues for struggling banks has support from the IMF and the European Commission. But there are political hurdles. Allowing the European rescue funds to put money into banks requires approval from national parliaments. Germany objects, on the ground that putting money directly into banks leaves less room for extracting policy reforms in return. That need not be the case. European rescuers could demand reforms as a condition of putting cash into banks, much as if they were lending to the Spanish government. The difference is that a jointly funded plan to deal with the banks might actually work.

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