Spain is now making Ireland's mistakes
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Spain is now heading down the same path that bankrupted Ireland. It doesn't have to be this way; and indeed, it shouldn't be this way. Ireland is not a role model for austerity policies, but rather a cautionary tale.

The parallels between Spain and Ireland are striking. Just like Ireland, Spain had a credit boom financed mostly with external debt, which meant that the balance sheets of their banks are now stuffed with bad debts as asset values collapse. Both governments have now injected billions into these ailing banks, to the detriment of their respective debt profiles. The Spanish Prime Minister has become preoccupied with creating market confidence, as was the Irish Prime Minister in the run up to the EU/IMF bailout. Confidence talk may buy some time, but ultimately it doesn't make the problem go away.

The accent heard today in Madrid has a distinct Irish lilt to it. The script is the same. First, deny the problem. Second, underplay its size. Third, look for external help to solve it once you have promised what you cannot deliver.

Clearly we are in phase three now. Over the weekend it was announced that Spain's banks — not the Spanish state — are getting a series of loans of up to 100 billion euros, which will be added to Spain's national debt. Spain's debt was 81 percent of its output before the bank bailout and is roughly 91 percent now, heading close to the same levels of government debt Ireland, Greece, and Portugal have.

How things change. Before the crisis, both countries had respectable debt profiles. And yet in the run up to the collapse in 2007, the combined asset footprint of the three main Irish banks was around 400 percent of GDP. One of those banks, Anglo-Irish Bank, lent 67 billion euros to the non-financial sector (real estate) in 2007 alone. For a sense of scale, the national ouput of Ireland in 2007 was 155 billion euros. Following this foolish bank guarantee, Irish government debt has quadrupled to over 108 percent of national output as the government injects money into the banking system. Despite this, credit growth has collapsed and domestic demand has still not recovered.

In Spain, really only the scale is different. Real estate had become so central to the Spanish economy that construction alone generated 14 percent of employment and 16 percent of national output in 2007. Once related sectors are included, those figures jump to nearly a quarter of national output and employment, respectively. Unsurprisingly, given such a construction boom, credit expanded to meet demand. Housing loans as a percentage of national output increased from 28.4 percent to 102.9 percent over the ten years of the construction bubble, while loans to developers constituted nearly 50 percent of national output by 2007. When the bubble burst, national output contracted 6.3 percent in the first quarter of 2009 alone.

While the true size of the Spanish banking problem is unclear, a good rule of thumb from Ireland is to stick a zero the end of whatever the government is saying it needs, which would be about $1.2 trillion dollars. But whatever it really is, when you're talking about the 4th biggest economy in Europe and 10 percent of euro zone output, you have a problem that is "too big to bail." Ireland went bankrupt stopping its banks going bankrupt. Spain simply cannot do this even if it wanted to: the problem is too big.

The banking collapse has led, inexorably, to a collapse in the real economy. Unemployment in Spain, just like Ireland, has soared as austerity has compounded the bursting of the bubble. In March 2006, Spanish unemployment was 8.1 per cent. By March 2012 unemployment was 24.1 per cent, Spain's highest for nearly 20 years, with more than half of all workers under the age of 25 without jobs. Such levels of unemployment will accelerate defaults in the mortgage market; depress growth; and may lead to large-scale social unrest and political turmoil.

Ireland has managed to avoid such social unrest for a variety of reasons, but indicators of social disruption like suicide, depression, and crime have all increased markedly as overall unemployment reached 14.5 percent and youth unemployment reached 29 percent in early 2012.

So what is to be done? First, either explicitly or implicitly, the Spanish sovereign must not make the same kind of blanket guarantee to the Spanish banking sector that happened in Ireland. That way leads directly to an IMF program of adjustment. With youth unemployment at such extreme levels, an IMF program is likely to be both economically wrenching and politically impossible.

Second, either Spain's bondholders should be lined up and politely told they are taking a loss, or failing that, most of the banks should be nationalized. Ireland's great mistake was in not taking one of these crucial steps quickly. In Ireland a National Asset Management Agency was formed to cleanse private banks' balance sheets and disburse the bad loans over a longer period. So far, it has not been a success. Spain's problems are too big for a bad bank solution.

Third, bank runs are not fiscal problems. The resolution of Spain's banking problem, not its fiscal problem, should take account of both the creditors and the debtors in Spain's system.

Right now, all resolution attempts are aimed at ensuring creditors get their money back. A program of debt forgiveness, targeted to reduce moral hazard, is necessary given the precarious nature of the balance sheets of both financial corporations and households. It is important to remember the historical context: since the end of World War II, for a highly indebted country, growing its way out of a large debt overhang has almost never worked.

There is almost always a debt restructuring and financial repression, sometimes taking the form of capital controls.

In Ireland, moves are being made to free up the country's arcane insolvency laws while the number of residential mortgages in arrears has climbed to over 10% of total outstanding mortgages. Spain is already in worse shape. Spain can, and should, do better, if it learns from Ireland's mistakes. If it fails to do so and follows the same path, the results will be too big to bear.

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