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Rajoy must enact a radical plan for Spain

By Jesús Fernández-Villaverde and Luis Garicano

Mariano Rajoy, Spain's prime minister, has succeeded for decades in politics by letting time do his bidding. He seems to believe that problems are not solved but dissolved through patience. His government has applied this lesson to the eurozone crisis with catastrophic results. A six-month delay to announcing the 2012 budget savaged Spain's creditworthiness. Now he waits for the European Central Bank to clarify its future actions, while postponing the key reforms requested by the EU and letting the problems in the banks and regions deteriorate further.

This strategy is a path to nowhere. As the recession deepens, more loans that were formerly viable are not paid back. Last month the value of non-performing loans increased by €8bn. Public confidence in the economic stewardship of the government is dwindling. Recent polls put Mr Rajoy's favourable ratings at historical lows. And, as confidence evaporates, so do bank deposits, which are decreasing at an annual rate of about 6.5 per cent. Unemployment is approaching 30 per cent.

Austerity is crowding out support for reforms, as voters perceive no difference between budget cuts and structural reform. Worse, the economic crisis is quickly becoming a constitutional crisis, as some of Spain's regions start considering a genuine push towards independence.

In the meantime, Spain's bargaining power in Europe is slowly draining away. Its strategy was to try and obtain unconditional EU financing by threatening to bring down the euro. It was a bluff. You cannot play a game of chicken when you drive a car and your opponent, the ECB, drives a tank. The basic fact is that the Spanish financial sector cannot survive without unlimited access to the ECB's cash.

Some observers, using as examples the gold standard and Argentina, have argued for Spain to leave the euro. We disagree. Spain does not have its own currency and therefore its situation is different. Contracts would need to be redenominated, unleashing years of costly litigation. Solvent and insolvent companies would lose access to external funds, much more relevant for Spain in 2012 than for Argentina in 2002.

A sounder plan is to take a more decisive approach towards reform and deleveraging to improve Spain's growth rate over the medium term.

The good news is that, in the past few months, Europe has set out a framework for stabilising the eurozone, both in the long term, with a banking union and the seeds of a fiscal union, and in the short term, with new financing facilities. In particular, Spain has received a reasonable loan to clean up its troubled regional savings banks sector and will this week set up a "bad bank". The new arrangements for the use of the eurozone bailout mechanisms promise a larger and more flexible rescue fund. Most importantly, the ECB has indicated it will drastically increase its support for Spain and Italy in the near future.

But success requires a radical policy change by Spain. First, after securing the resilience of the financial system, Spain must engineer a speedy but orderly restructuring of the debt of insolvent state-owned corporations (including those owned by the regions), banks and regional governments. It must follow the lead indicated by the ECB and impose substantial losses on all (including senior) creditors of insolvent institutions. Second, the Spanish government must restart a deep structural reform programme centred on reducing obstacles to entrepreneurship and job creation. Third, Spain must craft a credible plan for fiscal consolidation that is focused on medium-term goals rather than on arbitrary short-term targets.

This new growth agenda requires a forceful commitment by all. The eurozone must understand that the current practice of making all private sector creditors whole is unfair and counterproductive. The Spanish government must abandon its ingrained populist temptations, refrain from embarrassing public announcements and reignite a programme of real economic reform. And Spaniards need to understand (and be told) the true reality of the situation. Unfortunately, time is running out for these tasks.

The writers are respectively professors at the University of Pennsylvania and the London School of Economics