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Spain must avoid an Irish turn

Until recently, Spanish banks were in trouble despite, not because of, the country's bank policy. Madrid pioneered dynamic provisioning. It did more than other governments to push for transparent and comprehensive stress tests. But today Prime Minister Mariano Rajoy's government is on a path that, unless it changes direction, leads into the trap that engulfed Ireland.

"We are not going to let... any bank fall... if that happens the country will fall," Mr Rajoy said on Monday. That is the message Ireland's government insisted on as it piled private banks' debts on to its puny sovereign shoulders. By the end of 2010 markets had lost faith in Dublin's ability to repay and it was strong-armed into a eurozone rescue loan.

Ireland's folly made clear that the interdependence of sovereigns and national banks is at the heart of the monetary union's present dysfunction. But to judge from Mr Rajoy's words, Madrid will tighten this deadly embrace instead of loosening it – even as its sovereign bond spreads hit euro-era records.

Losses at Bankia – spawned of a shotgun marriage between savings banks – has made Madrid promise a bailout of €19bn on top of what the state has already provided. It may reportedly place sovereign bonds directly with Bankia so as to give the bank collateral for European Central Bank liquidity while avoiding market borrowing at current punishing yields. This trick would not change the key fact of Spain increasing a debt burden it already struggles to refinance.

Some want the European rescue fund to bail out banks directly. Mr Rajoy has dismissed this; and it is an unappealing idea to make other countries' taxpayers pay for banks' bad loans. But it could become the only option left for the eurozone periphery. The alternative is for Spain, and other states with troubled banks, to copy bank resolution laws put in place in Germany and the UK. These allow states to restructure failing banks and create fresh equity from writing down creditors rather than extorting taxpayer funds. To make depositors safe, such laws should give insured deposits priority status, and the ECB must satisfy any liquidity needs during a restructuring.

Converting Bankia's non-deposit liabilities could recapitalise it to the hilt. But it may be too late, not least politically: shareholders, who would be hit first, are often Bankia depositors lured into buying the bank's stock. Still, Madrid can signal how future capital needs will be met – in Bankia or elsewhere. Promising that no bank will fall is what truly brings a country down.

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