



Conclusions: The Implications of ‘Bank Bargains’ for Democratic Politics

BANK BARGAINS

This book has attempted to answer the central question posed in Chapter 1: *Why couldn't Spain build a banking system capable of providing stable and abundant credit?* Following Calomiris and Haber's analysis of other countries (2014), it has identified the role of political factors and shown how they have determined banking outcomes and caused banking crises in Spain. Throughout its chapters, the book has examined the effects of political conditions on banking system outcomes, and it has done so from a historical perspective understanding that such outcomes are contingent and also depend on changes to the historical context. For instance, in Spain (like in many other countries), fiscal affairs have been influenced by the need to finance wars, close widening fiscal deficits, or finance large infrastructure or industrialization projects, which have historically driven the funding of banks (and central banks). The book has taken a panoramic historical perspective to try to identify systematic patterns in the run-ups of crises.

Indeed, in Spain, shifts in banks' outcomes have reflected dramatic political (and economic) changes, and banking crises have arisen primarily from political and/or economic crises that have produced substantive changes in the structure of the Spanish banking system. These changes, in turn, have impacted dominant political coalitions in charge of banking policy and often have led to their replacement by a new coalition. The examination of the Spanish case shows that domestic social, political, and

economic factors are crucial to understand coalition formations and policy choices. These coalitions are not neutral, and they influence the stability and resilience of the banking system and its ability to provide credit. It is therefore crucial to examine their objectives and strategies.

The central argument of the book has been that political conditions underpin what Calomiris and Haber call the '*Game of Bank Bargains*': a process of political bargains in which parties with different interests come together to form coalitions that determine what banks will create and how they will function. These outcomes in turn determine the level of access to credit and the stability of the banking system (Calomiris and Haber 2014, pp. 477, 479). The examination of Spanish banking crises confirms that thesis. Spanish banks have been the outcome of political partnerships that included coalitions between the government and citizens that gained control over the banking system. And these coalitions have set the rules of the banking game: How they are chartered, how they are regulated, and how they interact with the state.

Prior to the late 1970s when democracy was finally established in Spain (with the notable exception of the 1930s, in which the country had its first brief experience with democracy but it ended in a tragic civil war and a 40-year dictatorship), the country's autocratic regimes produced a mixed banking system that included both public and private banks (and *cajas*), whose main function was to finance the government and the interests of the sectors that controlled those institutions. This banking system was the result of a partnership between the governments and a group of financiers (mostly domestic) in which the '*Game of Bank Bargains*' was played by a small group of government officials and businessmen who were often closely linked by a dense network of personal, economic, and political ties. As we have seen, throughout Spanish history these coalitions have been conditioned by the state chronic financial needs. The country needed banks and has sought partners that provided those funds. This '*Game of Bank Bargains*' led to rent-seeking coalitions that ultimately undermined access to credit and the stability of the system.

The advent of democracy coincided in time with a major banking crisis in the late 1970s–early 1980s. While the new democratic regime made the supply of credit more readily available, it did not bring full stability to the banking system as proved by the most recent crisis of the second half of the 2010s, which was also the result of the historical circumstances that shaped the formation of new political coalitions and institutions that determined that outcome. Two crucial elements (see Calomiris and

Haber 2014, p. 459) that have separated Spain from other successful countries (like Australia, Canada, or New Zealand) have been the country's comparatively new democratic institutions that emerged after the transition to democracy in the late 1970s, and even more importantly the weakness of the institutions that limit rent-seeking. Indeed, both crises were underpinned by rent-seeking coalitions between bankers and populists that ended up undermining the stability of the banking system.

As we have explained, within the complex bargains among politicians, bankers, shareholders, depositors, debtors, and taxpayers, it is crucial to describe the identities and motivations of the players in explaining their policy choices and decisions. Indeed, banking crises in Spain were not pre-ordained, nor were they accidents due to unforeseen circumstances. On the contrary, they have been a function of choices made by bankers and regulators regarding how much cash to hold, how much equity to raise, how much risk to assume, and how to diversify that risk across different kinds of loans and assets. While Spanish governments have been (nominally) committed to prudential regulation, establishing safety nets to protect banks and consumers, the rent-seeking coalitions that we have examined throughout the book have undermined that system and allowed bankers to be less cautious in the management of risk. Ultimately, Spanish banking crises show that the extent of the safety nets and prudential regulation were also political choices made by individuals who were part of those coalitions, and who were largely motivated by maximizing their own short-term interests (which not always coincided with society's ones). In other words, the banking structure failed to insulate the banking system from populist politics and the rent-seeking interests of the members of those coalitions of politicians, bankers, and governments, making it feasible for them to fashion a banking system that suited their interests. And these coalitions have been quite durable as their members have gained wealth and political power, thus reinforcing and entrenching their bargaining power. In the end, Spain got the banking system that the country's dominant coalitions and political institutions permitted.

The Banking Crisis of the 1970s

The transition from dictatorship to democracy in Spain that began in the late 1970s showed how banking-system outcomes can have significant and unanticipated political consequences. Spaniards were denied the right to effective suffrage until the mid-1970s. During the previous four decades,

the country was governed by an authoritarian regime. As examined in Chapter 3, that period provided an opportunity to examine how authoritarian political leaders formed coalitions with other groups to create a banking system. Calomiris and Haber (2014) show that autocracies can generate stable banking systems when governments are strong enough to centralize decision making, but not so strong that it can weaken property rights of bankers and shareholders with impunity. As in Mexico (Calomiris and Haber 2014, p. 21), the examination of the Spanish case showed that the Spanish government regulated bank entry tightly to increase rates of return sufficiently to compensate bank insiders and shareholders for the risk of expropriation. Political bargains gave big banks rents in the form of market power and lax prudential regulation in exchange for their commitment to share those rents with favored constituents. The transition to democracy in the 1970s led to the establishment of a new democratic regime, which led to new political bargains regarding the banking system.

Indeed, the transition to democracy helps illustrate the impact of regime changes on these coalitions and their bank bargaining. Spain's Francoist authoritarian regime fitted into Calomiris and Haber's "centralized autocratic network" taxonomy (2014, pp. 42–44). Franco lacked absolute power but was strong enough to control the levers of power while building a network of alliances, including bankers, to hold onto power. In Spain, the course of financial and banking policies was largely influenced by a contest within the country's policy-making elite that preceded the democratic transition, and with long roots in Spanish history. Bankers allowed the regime to finance expenditures in excess of tax revenues. This coalition did not lead to the development of a competitively structured banking system. On the contrary, high expropriation risk constrained entry into the system, which was characterized by entry restrictions and privileges to favored bank insiders who in turn provided a portion of their rents to the regime, hence giving it a vested interest in the favored banks and thus reducing the risk of expropriation.¹ Franco and the country's financiers crafted a set of institutions designed to attract capital into the banking system by limiting competition.

The big joint-stock banks that operated during the Franco regime dealt largely in commercial banking, attracting deposits and making loans, but

¹ According to Calomiris and Haber (2014, p. 46), under such regime returns to equity holders are high, loans to insider firms are subsidized, governments and banks insiders extract significant rents, and periodic fiscal firms result in expropriations.

many of them also actively promoted industrial firms and public utilities, and controlled industrial groups. This banking schema was accompanied by active banking repression, as well as “tight government controls of interest rates, restriction of competition, government intervention in banks’ policies such as distribution of dividends, fields of investment, [and] creation of branches” (Tortella and García Ruiz 2013, p. 3). This compact was accepted by bankers because it granted them almost riskless profits.

As in other autocratic regimes like Mexico and Brazil (see Calomiris and Haber 2014, pp. 44–45, 332), the rents generated by that oligopolistic system were split among the bankers (who received dividends, directors’ fees, and used the banks to fund their nonfinancial enterprises), bank minority shareholders (who earned healthy benefits in the form of dividends and benefitted from above-normal stock returns), the government (who got access to cheap capital in the form of low-interest loans), the individuals who controlled the government (who obtained board seats for themselves and their acquaintances, as well as cheaper loans), the dictator (who received a source of public finance that also helped to cement alliances with other groups), and the bank insiders (who earned high rents in a non-competitive market), at the expense of depositors (who did not have access to a low-risk, liquid means of savings because deposits often earned negative real returns and were subject to risk of loss, but they offered taxpayer-financed deposit insurance). That coalition established a framework of banking laws and regulations that enshrined the terms of the bargain and ensured benefits to the members of the coalition. Everyone else (notably the majority of the population and those potential investors and entrepreneurs who did not have links to the banking sector) was left out, with limited access to credit (as noted in Chapter 1) and scant opportunities for economic mobility. The consequence of this system, characterized by a small number of banks and a high level of insider lending, was scarce credit and a high concentration of finance dependent, downstream industries. However, this alliance between the Franco dictatorship and Spain’s bankers was always fragile. One of the main reasons that held it together was the dictatorship’s need to reward the corporatist labor union for its political support. Organized workers were employed by industrial conglomerates who also owned (or were owned by) banks, which acted as their funding arm, thus providing bankers some protection because it tied up them with manufacturers.

As we have seen in Chapter 3, by the 1970s as a result of the oil shocks the country got into a recession and government expenditures started to outstrip revenues. The government could have closed the gap by increasing taxes, but the dictator was on his last legs, and he did not want to increase its political problems and pay the political price of raising taxes by alienating the bankers and industrializers that supported the regime. It was easier to expand the money supply, with the consequent impact on inflation.

Political and/or economic crises often galvanize pressures for reform and lead to new coalitions that push for changes in the structure of financial systems (Hoffman et al. 2007). However, the Spanish transition to democracy, which coincided with a global economic crisis, shows the endurance and stickiness of these coalitions and bargains, as it did not result in an instantaneous reorganization of the banking system. On the contrary, in Spain, domestic elites promoted agendas to advance their domestic interests, which were not just driven by market pressures. Following the democratic transition, Spain was still characterized by an interventionist state, and the state elites who played a crucial role in the banking sector (including elected officials, reformers, and technocrats) had a major goal: monetary control. In interventionist states, state elites sought to subsume monetary policy instruments to the government's policy objectives to slow down credit growth while boosting investment.

Indeed, as we have seen in Chapter 3, in Spain, the banking oligopoly that had emerged at the beginning of the twentieth century led to a structure dominated by the so-called Big Seven banks that controlled 72% of total bank deposits by 1957. According to Pérez (1997), an influential group of economists based at the research department of the Bank of Spain gained prominence in the major parties and pursued macroeconomic policies strongly oriented to market mechanisms and private initiatives favored by the existing players—including the large banks. These banks formed a coalition with that group of economic reformers trained in the Research Service of the Bank of Spain under the Franco regime. These reformers, neoliberal technocrats closely connected with the Catholic lay organization Opus Dei, had emerged in the late 1950s and were able to secure a significant degree of control over the regime's economic policies, which led to the launching of the stabilization plan (a series of four-year plans) and the dismantling of the corporatist autarkist policies that had dominated the country until 1957 (see Chapter 3). The neoliberal technocratic reformers, although ideologically opposed to state intervention

and cheap credit, were interventionists at heart and used the state apparatus to reach an accommodation with the big banks to preserve their oligopoly and kept interest rates low to stimulate investment in certain areas and to preserve social peace. Following the transition to democracy, these reformers retained control over economic policy (Pérez 1997, p. 43). They took advantage of the unstable social and economic conditions of the 1970s, which shifted the balance of power in favor of that small network of reformers that had emerged around the Spanish Central Bank's research department and propelled them into leadership positions. These reformers opposed the traditional approach that subordinated monetary rigor and market discipline to the principles of state discretion, and sought to reverse the dominance of the dominant bureaucracy that supported planning as an instrument for development. In order to achieve their objectives, they pursued accommodation with the banking sector.

In other words, in the years that followed the democratic transition, the *Game of Bank Bargains* in Spain was marked by this interplay between state elites and the domestic banking sector, which helps explain monetary and banking outcomes. The interest of this coalition was served by a particular set of policies that had income distribution consequences and enriched the banking oligopoly. In the end, the new democratic government's attempts to dislodge the existing oligopolistic banking structure largely failed and ultimately led to the resignation of the prime minister, Adolfo Suárez, who blamed the banks and their opposition to his market-opening initiatives for his fall from power. Cheap credit provided a means to diminish social tensions and stabilize the new democratic regime at a time of worldwide recession. According to Pérez, the Spanish financial reforms that shifted away from interventionism were driven by state elites rather than economic actors. The way banking liberalization was carried out was the result of strategic choices on the part of anti-interventionist reformers (who sought to defeat the historical scourge of government interventionism in the country) for whom their first priority was to alter the institutional structure of Spanish policy-making to give greater influence and leverage to the central bank, and it was the result of a pattern of accommodation between state elites and the private banking sector that started at the beginning of the twentieth century. That development was instrumental in the shift away from interventionism and the neoliberal reforms of the 1970s and 1980s, as well as in prolonging the privileges

of the banking sector in Spain and in the primacy of monetary policy considerations over other economic objectives (Pérez 1997, p. 190).

Yet, even more surprising was that the election of a new Socialist government in 1982 (which had called for the nationalization of the banking sector) did not lead to a new coalition or new banking policies. On the contrary, the new Socialist government quickly broke its electoral commitment to nationalize the banks, and it appointed the same central banker reformers to key economic policy-making positions, who sustained the accommodative partnerships with the banks, allowing the Big Seven banks oligopoly to persist well into the mid-1980s while protecting them from strong competition (as part of Spain European Community [EC] membership, they negotiated a transition period of seven years for the banks, which sheltered the banking sector from significant external competition, at precisely the same time that other sectors of the Spanish economy were exposed to brutal EC competition). While Lukauskas (1997) attributed the Socialists' banking policies to an electorally based desire to secure economic outcomes, such as growth, and please the median voter, Pérez (1997) offers a largely political explanation for the ability of Spain's large banks to maintain that state of affairs. According to her analysis, the main political actors in post-Franco's Spain choose to accept the power of the large banks or the economic consequences of that banking system (Pérez 1997, p. 149), as Spanish economic policy-makers quickly turned their emphasis to the effort to fight inflation (Pérez 1997; Royo 2000). Furthermore, the Socialist government under Felipe González maintained generally friendly relations with the large private banks for the thirteen years in which he was in power, and avoided any sustained public-ownership role of banks, going as far as even re-privatizing the nationalized *Rumasa* banks, as we noted in Chapter 3. His first two finance ministers, Miguel Boyer and Carlos Solchaga, were intimately linked to the network of academic reformers of the Bank of Spain and they supported a long-term strategy of boosting competitiveness, profitability, and growth through macroeconomic rigor, fiscal consolidation, and wage moderation, seeking to raise the rate of public savings and to shift resources away from social transfers into capital investment in infrastructure (Boix 1995, p. 2).

It is important to note, however, that this accommodation took place in the context of a democratic transition defined by efforts to avoid confrontations that would bring back the memories of the Second Republic and the Civil War, as well as by the need to avoid the perceived danger

of socioeconomic over-reaching and to achieve left-right accommodation (Fishman 2010; Linz et al. 1981; Linz and Stepan 1996). In the end, the transition to democracy in Spain minimized the political relevance of social protests and the relative openness of policy-makers to such pressures (Fishman 2010). At the same time, the relatively hierarchical and centralized nature of the PSOE and its growing distance from the union movement (in the 1980s, they came to see union power as an obstacle to the liberalizing policies they favored), combined with the favored approach of the Socialist economic team, which relied largely on market pressures and competition for growth and the revival of employment, led the Socialist government toward neoliberal labor market and macroeconomic policies (Royo 2000). In this context, it is not surprising that they abandoned their commitment to bank nationalizations or that they failed to assign any significant role to state-owned banks into credit creation for small businesses, relying instead on market competition and labor contract flexibilization.

Subsequently, as we discussed in Chapter 4, throughout the 1990s and 2000s, this pattern continued and became the predominant tendency, as Spanish policy-makers from both major parties avoided any significant challenge to the large banks and continued relying heavily on market-based mechanisms and liberalization as strategies to generate growth and employment. And this approach even persisted under the more progressive Socialist government of Rodríguez Zapatero, widely considered the most leftist prime minister since the Second Republic (Fishman 2010).² In this regard, Fishman has argued that the dispositions of relevant policy-makers in Spain, and their approach to forging state policies, were conditioned by the country's path to democracy, and that the political handling of banking and financing for SMEs has been reflective of that broader pattern. According to him, Spanish policy-makers' economic approach has been shaped by their limited sensitivity—or even closure—to social pressures from below and their lack of receptivity to policy advice promoting, or discouraging, state involvement in the economy. These tendencies were put in place during the regime democratic transition and they continue to make their mark on policy-making.

²Fishman highlights the fact that in 2009 when a government minister offered critical words against the banks because of their reluctance to make credit available for firms, a more powerful member of the PSOE quickly issued a public statement friendly to the banks. *El País*, February 5, 2009, p. 17.

Those choices, however, have had consequences. The structure of the Spanish banking system produced significant (negative) economic consequences. Indeed, there is growing consensus that in order to promote economic growth and employment creation, systems of finance need to meet the credit needs of small and medium enterprises (SMEs), and that a strong state role in banking has positive consequences for SME financing (Stallings 2006). Spain came short in that regard. Emphasizing the oligopolistic nature of the sector, Pérez has argued that as a result of that characteristic of the country's financial system, "Spanish banks had far higher cost, interest and earning margins than other West European countries," and she contends that this feature of the system generated significant costs for Spanish firms outside the finance sector (Pérez 1997, p. 20). The elimination of the credit controls that had kept the real interest rates low in the 1960s, and the establishment of tight-credit policies to address the oil-shocks of the 1970s, allowed banks to increase real credit rates significantly and therefore led to higher profit margins for them at the time in which the public and industrial sectors were undertaking a brutal restructuring (which led to a then record unemployment of 21%). Yet, the combination of credit deregulation and oligopolistic control of financial and capital markets led to high interest rates that intensified the recession and adjustment process in the 1980s, and limited access to credit (Pérez 1997). It was only EC membership that led to a policy shift and dislodged the oligopoly of the Big Seven banks.³

The 2008 Banking Crises

The crisis of 2008 reaffirmed the instability and crises proneness of the Spanish banking system. Indeed, the latest banking crisis in Spain confirmed a long-standing tenant: Banks or banking systems collapse when they meet two conditions: They take on too much risk in their loans and investments, and they do not have sufficient capital on reserve to absorb the losses associated with their risky investments and loans (Calomiris and

³Foreign bank ownership had several advantages: They would contribute to the recapitalization of the banking system; since they did not own nonfinancial companies they would not be tempted to finance their losses; they would not be expected to be bailed out by Spanish taxpayers in the case of insolvency; and finally, they would be subject not just to Spanish regulators, but also to shareholders and regulators from their own countries. See Calomiris and Haber (2014, pp. 385–86).

Haber 2014, p. 207). Indeed, the cause of the 2008 crisis in Spain was rooted in policies that eroded underwriting standards and weak prudential regulation. Populists formed coalitions with technocrats and bankers, and then enacted banking policies to their liking.

As we have seen in Chapter 6, with a few relatively small exceptions, the Spanish financial crisis was a crisis of the *cajas*. The three most problematic Spanish *cajas*: *Bankia*, *CatalunyaCaixa*, and *Novagalicia*, had capital deficits (that have been covered partly or fully by the taxpayer) of €54 billion—the equivalent of over 5% of Spanish GDP. These institutions borrowed short term from depositors and then lend long term on fixed-rate mortgages. However, by the mid-2000s, the context in which these institutions operated had changed markedly and they were particularly vulnerable on wholesale funding. Yet, as part of the banks bargains that we have examined throughout the book, governments' protection of *cajas* had insulated them from the consequences of their own risk-taking and facilitated the reckless decisions that led to their downfall. When the real estate market collapsed after 2007, wholesale funding dried up and their funding costs skyrocketed, which caused significant problems because they had to pay more for capital, and they held mortgages (many of which went into default as a result of the crisis) that still earned only low fixed interest rates of return. This brought several of them to the point of insolvency, and many of them tried to cover up their losses reclassifying, refinancing, and extending loans during 2008, 2009, and 2010 (Cuñat and Garicano 2010). Other research has also shown that there was a clear cyclical pattern in nonperforming loans (NPL) recognition: They increased sharply in the first two months of each quarter and then became systematically negative in the third one, when the numbers had to be reported (Coterill 2010). And this happened while the stock of real estate developer loans, which represented 32% of Spain's GDP, was still growing through that period in spite of large bankruptcies in the sector, which suggests that many loans were being informally restructured or refinanced (Garicano 2012).

If the *cajas*' vulnerability, driven by their high reliance on the real estate market and wholesale funding, and their (often fraudulent) attempts to cover up their losses had been recognized and addressed in the years prior to the crises through *cajas*' closures, shrinkage, or consolidation, the crisis for the *cajas* sector would have been significant but not as devastating as it ended up being. As losses started to pile up the Spanish government, supervisory agencies should have shut down insolvent

ones or forced them to raise additional capital. Yet, as we have seen, they ignored or minimized the signs and looked the other way, postponing the day of reckoning. But in doing so they ended up ensuring that the final outcome would be much worse. In many ways, the *cajas*' crises were a failure of risk management, which led to an increase in risky lending and to inadequate levels of capital cushions. But, it was not just merely a management problem.

What were the true reasons for the extent of the crisis? How was it that so many cajas ended up making so many risky loans while maintaining insufficient capital to protect themselves against insolvency? What were the processes by which cajas' portfolios became increasingly risky? And, why increased risk in their assets was not adequately matched by increasing amounts of capital in reserve?

In response to those questions, this book has argued, following Calomiris and Haber (2014), that institutional and regulatory frameworks favored both the government and other privileged actors' access to finance at the expense of an environment conducive to a stable banking system. Indeed, political institutions have structured the incentives of bankers, as well as political and economic actors to form coalitions that shaped regulations and policies in their favor. This institutional framework was the result of political choices that made it vulnerable, because prudent lending practices continued being influenced by the desires of the groups that were in control of the government, who often channeled credit to groups that were considered politically crucial. Therefore, it is not surprising that Spanish banks/*cajas* have been fragile and crises prone.

Furthermore, the existing regulatory framework for the *cajas* encouraged excessive risk-taking at the taxpayer's expense: In the absence of appropriate regulatory oversight and with the government's implicit guarantee of their debts, it was not surprising that their managers, who had little at stake, had strong incentives to lend with borrowed money and little equity capital. This was compounded by weak underwriting standards that anyone could take advantage of, which opened the doors to riskier mortgages, and increase the leverage of Spanish families. The crisis and the subsequent loss of employment (unemployment reached over 26% at the peak of the crisis) pushed thousands of them into default.

In the end, the collapse of housing prices and a recession that led to reduced employment for overindebted homeowners were enough to start a major financial crisis. However, although risky housing lending was the fuel for the financial crisis, it was weak prudential regulation (i.e., the role

that regulators play to ensure the safe operation of the financial system) that made that fuel explosive. While these two factors may be perceived as independent from each other, both of them were symptoms of a larger problem: an underlying political culture that allowed for higher risk tolerance. Regulators could have imposed higher capital ratios on banks and *cajas*. Yet this decision would have met resistance from bankers and voters, because they would have increased the costs of mortgages and made it less likely for banks and *cajas* to supply risky mortgages.

In other words, stronger prudential regulation would have subverted the goals of providing cheap credit and expanding home ownership, which was a central tenant of the *banks bargains* among bankers (particularly the managers of the *cajas* who were political appointees and had strong links with the political parties), voters, regulators, and politicians. Managers were able to borrow massively in wholesale markets because the creditors took for granted that their debts would be assumed by Spanish taxpayers. This assumption proved to be correct when they were bailed out. Since this money did not belong to their 'shareholders,' it made it even easier for them to lend recklessly and invest in questionable real estate projects. This perpetuated an environment in the years that preceded the crisis in which risk-taking with borrowed money became the norm, and in which many bankers "threw any caution to the wind" (see Calomiris and Haber 2014, p. 257).

In the end, the examination of the Spanish banking crisis confirms that the crisis was the outcome of a *political bargain* (see Calomiris and Haber 2014, pp. 280–81). In the *cajas* sector, populists formed coalitions with bankers, and they enacted banking policies that allowed them to grow and assume unsustainable levels of risks in the years prior to the crisis, and during the crisis to avoid the actions of regulators and scape their troubles (for instance, covering their losses with disastrous mergers). As we have seen in Chapter 7, Spanish *cajas* were allowed to grow and expand, which afforded them economies of scale and scope, as well as increasing market share and market power, and thus a larger too-big-to-fail protection. In exchange, however, they had to share some of their rents with other groups, in this case new homeowners eager for cheap credit to buy their homes; politically influential developers, real estate and construction companies; as well as their local and regional governments. These groups used their influence with local, regional, and national politicians to appoint political (and often uneducated and unskilled) managers to the *cajas* to do their bidding, and they pushed to loosen underwriting

standards and to maintain low capital requirements. For their part, policy-makers and regulators, although they knew what was happening, chose to acquiesce and to go along because they also accrued electoral and often personal and/or financial benefits from this game, or they simply did not want to pay the political and/or personal price to try to stop them.

Moreover, the failure of prudential regulation was manifested by the unintended (and perverse) role of safety nets, in the form of deposit insurance, or implicit too-big-to-fail guarantees of bank debts not covered by deposit insurance. These safety nets can be considered subsidies and their value changes according to two criteria: the size of the bank/*caja* (the larger it is, the larger the value of the safety net, and vice versa) and the amount of debt (the more the debt vis-à-vis capital, the larger the value of the safety net). As a result, the higher the leverage (or the larger the institution), the stronger the protection and the higher the default risk assumed by the government that protects the debt. Hence, the government's decision to push for the consolidation of the *cajas* paradoxically intensified moral hazard because it expanded the size of the safe net/subsidy. In other words, the reckless managers of these institutions had an incentive to build their strategies trying to maximize the value of their safety-net provisions by growing and expanding as much as they could with borrowed money, and/or by maintaining as little equity capital as possible to fund their operations. Still, as in other countries, they "were rewarded by the government safety net for having as little skin in the game as possible" (Calomiris and Haber 2014, p. 259). They, of course, also embraced the push for mergers and consolidation from the regulators and regional governments, a process as we have seen that was largely politicized and led to the creation of larger institutions, like *Bankia*, that created a larger systemic risk and intensified moral hazard.

In addition, regulators were "asleep in the wheel" when they allowed these *cajas* to keep inadequate capital cushions. Once again, the reason for the inadequate capital ratios was also the outcome of political bargaining: *Cajas* expanded mortgage lending in exchange for lower capital requirements and weak regulatory oversight (or larger safety-net subsidies). But the problem was not so much lack of regulation but ineffectual regulation. For instance, capital requirements for mortgages had not been determined for a new world in which borrowers would not put any money down in their new houses, or in which there was much lesser oversight of risk when approving loans. The question remains, *did they see these changes and refused to act for their own interests? Or did they lack*

the power to do anything about it? The fact is that, despite ample warnings about the scope of the problem and the increasing building up of risk in many of the *cajas*, and despite the ample power to intervene by rejecting banks’ decisions regarding their own risk or by imposing higher capital ratio requirements, the Spanish regulators (as it happened in many other countries, see Calomiris and Haber 2014, pp. 265–66) failed to control and minimize risk and did not increase capital requirements to limit banks/*cajas*’ investment in risky assets.⁴

In other words in their failure to take action to limit the potential systemic consequences of the risky mortgage investment by *cajas* and banks, they chose to “hear no evil, and see no evil.” Concerned that a decision to increase capital requirements may have led to a credit crunch with significant impact on the supply of mortgage credit, and aware that such decision would have been heavily resisted by banks and *cajas* (who would have fought to the bitter end to keep low capital requirements because they allowed them to generate higher rates of return), they sat idle. In the end, it was easier to stay put than to fight a bitter battle because the regulators did not want to confront the political coalition that underpinned these policies (which included not just bankers, but also governments who benefitted from the support of happy new homeowners, and happy new homeowners who finally had access to cheap credit to buy a house), and instead chose the path of least resistance and failed to act. Indeed, the main explanation for the supervisory failure of the Bank of Spain has to do with the political control of the *cajas*: Confronted with powerful and well-connected actors, it decided that it was easier to look the other way (Royo 2013a).

Indeed, the inaction from the Bank of Spain has been widely criticized, as we examined in Chapters 6 and 7 (for contrasting views, see Ekaizer 2018; Fernández Ordoñez 2016). While no evidence of corruption has been unveiled (so far), its reluctance to recognize and uncover its own previous mistakes (although some inspectors tried to do it as we have seen); the absence of an appropriate resolution framework at that

⁴Calomiris and Haber (2014, pp. 266–68) explain how regulators compounded their failure by subcontracting regulation to private firms, like the rating agencies, and undermining the incentives that those agencies had to provide accurate ratings. In the United States, the loose monetary policies of the Fed between 2002 and 2005 further intensified the lower pricing of risk.

time (it was created in the summer of 2012); plus the Bank's overly confidence on the dynamics provisions that forced banks to increase provisions without reference to any specific loan (which, as we have seen in Chapter 5, worked as intended in the initial stages of the crisis) help partially to explain the Bank's inaction. But the consequence of this inaction, as noted before, was that it "allowed the reality to be hidden in plain sight for longer than it would have been otherwise possible" (Garicano 2012) or desirable. In the absence of those provisions, the *cajas'* losses would have become visible much earlier and would have forced action from the supervisor.

But as noted by Garicano (2012), the main explanation for the supervisory failure had to do with the political control of the *cajas*. As we examined in Chapter 6, governance played a critical role in the development of the crisis. The Bank of Spain confronted with powerful and well-connected ex-politicians decided to look the other way in the face of obvious problems. As we have seen on Chapter 6, Cuñat and Garicano (2010) have shown how the political connection of the managers of the entities was a good predictor of poor management and subsequent problems of the *cajas*. They show that *cajas* with chief executives who had no previous banking experience, no graduate education, and were politically connected did substantially worse in the run-up to the crisis, granting more real estate developer loans, and during the crisis with higher nonperformance loans. Hence, it is not surprising that *Bankia*, which turned out to be the worst in terms of the losses imposed on taxpayers (it needed a rescue of 22,242 million euros), was the most politicized of the *cajas*. For instance, the appointment of its CEO, Rodrigo Rato (a former minister of finance in Spain under the Aznar government and a Manager Director of the International Monetary Fund (IMF) between 2004 and 2007) was the result of a formal but secret pact between the Popular Party (PP) (of which he had been a main leader for years) and the major leftist trade union, *Comisiones Obreras* (CCOO), in 1986. In February 2017, Rato was found guilty of embezzlement and sentenced to four and a half years' imprisonment. At the time of writing (January 2020) after ten months of trial, Rato and 31 other *Bankia* managers (plus *Bankia*, BFA, and Deloitte) are still waiting for the sentence on the *Bankia* case. They have been accused of falsifying the bank accounts and scam investors when the bank went public and entered the stock market.

Furthermore, the politization of the *cajas* was also crucial in diluting the role of the supervisor after the crisis started, because the *cajas'*

insiders used their political connections to try to escape their troubles and avoid the wrath of the regulator. For instance, as noted above, these political connections were instrumental in the mergers that we discussed in Chapters 5 and 6, which were mostly decided based on political and geographic criteria, rather than economic rationale. The *cajas* controlled by PP politicians merged together, which meant that two of the most problematic *cajas* (*Bancaja* and *Caja Madrid*) from regions in which the PP was in power (Valencia and Madrid) were merged and led to the creation of Bankia with the results that we know. The same happened in other regions like Galicia or Catalonia with similar disastrous results. Yet again, while the Bank of Spain had reservations and was cognizant of the risks, it failed to confront the politicians (Garicano 2012).

In addition, while many analysts have blamed the European Central Bank's (ECB) policies prior to the crisis, which led to a sharp decline in the cost of capital for peripheral countries (real interest rates were negative during part of the boom, which intensified the bubble) (see Jiménez et al. 2014), it is important to emphasize again that monetary policy alone did not cause the crisis. First, because the initial growth of mortgage risk and the decline in prudential regulation preceded the loose monetary policies of the ECB. In addition, the Spanish Central bank could have countered the effect of the ECB loose monetary policies by increasing capital requirements from banks and *cajas*. Finally, although monetary policy can contribute to the overpricing of assets, notably real estate ones, and may lead to the development of bubbles, it is important to stress, as noted by Calomiris and Haber (2014, p. 271), that banking crises require that banks invest in those overpriced and risky assets and that they back those investments with insufficient capital. Therefore, it is not enough just to account for weaker lending standards and prudential regulatory failures, but also to explain differences among banks/*cajas*.

Indeed, the fact that banks and *cajas* had the opportunity to gamble and assume huge risks does not mean that they had to, and not all did (a notable example was the Basque's *Gipuzkoa Donostia Kutxa*—the Savings Bank of Gipuzkoa and San Sebastián). They all faced a choice: They could maintain high-quality lending standards, limit their risk exposure, and maintain appropriate capital cushions; or alternatively, they could exploit the lower regulatory environment assume higher risks and lower their capital cushions. In Spain, there is evidence that this choice was also conditioned by the education level of the managers of the *cajas*, as well as by how they were appointed to these positions, both an integral

part of the *bank bargains* that took place in the country. As noted before, Cuñat and Garicano (2010) have shown that the main difference between banks and *cajas* was not so much the *cajas*' political nature but the lower level of professionalization of their managers: Only 31% of their presidents had postgraduate degree, and half of them had occupied political positions before becoming presidents. This evidence shows that bankers' abilities and the nature of their appointments may have encouraged them to assume exceptionally high risks. Hence, given the strong connections between the managers of the *cajas* and political leaders, it cannot be a surprise that regional and local governments encouraged the *cajas* to lend to local firms in order to encourage local/regional employment growth and also used their power over the *cajas* to generate employment in order to maximize their chances of winning elections.

As in other countries (see Calomiris and Haber 2014, pp. 276–78), another factor that helps explain which banks and *cajas* were worst affected by the crisis was *variations in the franchise value of banks* (i.e., the ability of banks management teams to develop strong client lists to provide potentially profitable investment opportunities). There is some evidence that differences in risk-taking prior to the crises reflected differences in franchise value: Banks with higher franchise value and with stronger risk-management systems tended to be more Conservative prior to the crisis and took on lower risk relative to their capital. They had a stronger institutional commitment to risk management, which conditioned their risk management decisions and prevented their senior management from taking unnecessary risks (see Ellul and Yerramilli 2010). Unsurprisingly, these banks, like Santander and BBVA, did not require bailouts during the crisis. On the contrary, those banks and *cajas* with weaker risk-management systems and weaker franchises were more tolerant of risk and assumed larger risks, which in some cases led to their default. Again, this may be another instance in which bankers' institutional capabilities may have encouraged them to assume (or may have prevented them from taking) exceptionally high risks.

The structure of the Spanish banking system and differences in the regulatory frameworks for banks and *cajas* also help account for the differential impact of the crisis. The Spanish banking system is composed of a small number of very large banks with nationwide branches. Although it is true that before the late 1980s, as noted in the previous section, when EC integration forced Spanish banks to compete with international ones

and the banking system was dominated by the Big Seven, such a concentrated system undermined competition among banks and resulted in less credit at higher prices for Spanish consumers and companies, since then this structure has allowed banks to diversify, as well as to capture economies of scale and scope, while heavily competing among themselves for market share.

Furthermore, although banking regulations centralized authority in the national government and national regulators, this was not the case for the *cajas*, which were also overseen by the regional governments. This distinction had far-reaching implications for banks and *cajas*. For the *cajas*, prior to the crisis, decision making and regulation were fragmented at the regional level allowing local and regional coalitions to shape policies. These coalitions pushed for strategic decisions to expand and grow, even outside of their traditional regional markets, and for reckless lending. Spanish banks, on the contrary, were subject to centralized authority from the beginning (similar to Canada, see Calomiris and Haber 2014, pp. 297–98), which in effect meant that any political bargaining among coalitions had to take place at the national level, and at that level, all interests are aggregated, which facilitates the taking into account of rules for nationally organized constituencies. Centralized control over the banks and banking policy made it harder for populists to form coalitions with the bankers to enact policies to their liking, as it happened with the *cajas*. And the political system proved much more resilient at the national level (than the regional or local one) against pressures from *cajas* in the interest of preserving a strong regulatory supervision and competition.

While *cajas*' lax risk management reflected the inadequate oversight of regulators, the far more Conservative risk management from some of the banks reflects the appropriate oversight of regulators. Banks understood that failure to abide by the regulations would cause the loss of valuable privileges and they want to avoid at all costs getting on the wrong side of the government and the Bank of Spain. Their problems emerged as a result of their decision to fund much of their lending with money that they borrowed from wholesale markets, rather than holding onto their traditional depositors. This fateful decision made them more vulnerable because they relied on volatile wholesale markets.

Despite the perception that Spanish banks operate in a cozy oligopoly, the reality is that for the last couple of decades Spanish banks have operated in a more competitive environment than the *cajas*, despite a restrictive regulatory environment (that allows them to operate national

branch networks: The country has a very large density of per capita bank branches). At the same time, they had been able to make more money than the *cajas* because they have been able to capture economies of scale in back-office operations and deploy capital more efficiently. Moreover, their national network and international expansion allowed them to distribute credit efficiently across the country and beyond (i.e., rural areas are well supplied with bank facilities and with costs of credit similar to the urban ones); lower information costs have facilitated transactions and economized the costs of credit; and international expansion allowed them to diversify their portfolio of risk and achieve large economies of scale. Finally, Spanish banks have been more efficient in managing risk than the *cajas* and have been able to achieve lower risk of default on their debts.

The stickiness and persistence of the coalitions that have underpinned the banks bargains examined in this book underscore the difficulties to change the system. While there have been changes to the elite power networks that have ruled the country and dominated its economy, there have also been substantial continuities. According to some studies, there is a relative small elite with very specific characteristics that still rules the country (Villena Oliver 2019): Their positions of influence and power are largely inherited as many of the members proceed from families that have been in these positions for decades; they are deeply interconnected through persisting links that have different origins/sources (family, schools, professional, social, business...); there is a division of labor that places members of the elites in different positions of power (the traditional division whereby a son was a priest, a second a soldier, and a third was in charge of the family's patrimony has now been replaced by a more modern distribution in which some are in the public administration, others in business, and others in politics or public institutions with the additional novelty that these positions can be interchanged throughout their careers); these elites are not only involved in politics but also in the economy, media, and all other decision-making institutions; and their intervention in the country's economic, social, and economic life is not based merely anymore on ideological considerations (on the contrary, many of these networks are represented across the political spectrum), but rather on their interests. These networks work hard and skillfully to retain their positions of privilege in order to advance their interests, guarantee their immunity, and to ensure that they may be displaced. Villena shows that rather than a traditional perceived revolving door between the public and private worlds, what we have are dense networks that have representatives

on both worlds, but also that whenever necessary they co-opt external allies in public institutions (like the *cajas* or the Bank of Spain) to carry out their interest in exchange for benefits. These networks have proved to be not only compatible but also substitutive (for instance, between the PP and the PSOE). This would help explain, for instance, the significant consistency in economic policy-making (as noted in Chapter 4) that has characterized the country for the last three decades regardless of whether the PP or the PSOE was in power. According to Villena, elections have become merely a formal medium that has helped perpetuate the power of these networks that extend their influence across all sectors by virtue of their access to the budget and control of regulatory power and the judiciary. Political leaders are so indebted to these networks that they have very limited room for maneuver in policy-making. Regardless of the merit of this interpretation, Villena's perception is shared by millions of Spaniards and helps account for the crisis of representation that was referenced in Chapter 7, as well as the coalition formation that has been the focus of the book.

While everyone understood the risk that a potential collapse of the banking system would present to the Spanish economy, there was a strong sense of complacency because the country has weathered relatively unscathed the first couple of years of the global financial crisis. However, the problem preceded the crisis. Public officials (from the central government, congressmen and senators, regional congressmen, local authorities, bank supervisors, and regulators) understood the risk, but they had little incentives to change the existing rules of the games. As in other countries, the "success" of the political coalitions was marked by their ability to get a public official to go along with "something that he knows is not in the long-run public interest because it is in his own short-term interest" (see Calomiris and Haber 2014, p. 212).

In other words, the costs of their decisions would be in the future but the benefits were immediate. Public officials should have known the outcome of those decisions but they chose to sit on the sidelines and do little to prevent it. This is an important consideration because a typical reaction to the crisis has been the attempt to try to blame particular actors (bankers, central bankers, politicians, regulators...) for it. This misses the larger point, which is that people typically pursue their self-interests, and in democratic countries one of the ways in which they do that is by exercising their voting rights,

and building coalitions with politicians to pursue their mutual interests and benefits. Hence, as Calomiris and Haber (2014, p. 213) suggest, no individual should be “blamed for what happens as a result of that coalition.” That distracts us from examining the real problem: *How do our political institutions encourage (and often reward) the formation of such costly coalitions?*

In sum, the 2008 financial crisis in Spain was the result of macroeconomic factors, the monetary policies of the ECB, inadequate supervision, the underestimation of risk, and political interference. Yet, as we have seen throughout the book, while the banks/*cajas* managers blamed the real estate bubble for the problems of their institutions, in reality these very deficient managers took advantage of the *bank bargains* that we have described (and of the inadequate and insufficient supervision from the Bank of Spain) to assume risks that not only led to the collapse (or near collapse) of many of their institutions, but also created a systemic risk for the Spanish banking system overall that led to a financial bailout and put the whole Spanish economy at risk. This outcome was not predetermined. As we have seen, other institutions faced a similar environment and made the right choices. The *banks bargains* led to the appointment of bad managers as well as the establishment of a supervisory framework characterized by lack of adequate supervision and controls (for instance, when nonperforming loans were hidden by these banks as refinanced loans, or when these banks approved loans without even appraising the real estate properties) and regulatory lapses (for instance, regarding capital provisions, which were inadequate, or when these banks passed their stress test and shortly afterward they had to be intervened), and both factors were also central to explain the recent crisis.

SPANISH BANKING IN THE AFTERMATH OF THE CRISIS

According to the IMF, the implementation of the financial bailout program was “steadfast,” and all of the program’s specific measures had been completed by 2014, including identifying undercapitalized banks; requiring banks to address their capital shortfalls; boosting liquidity; adopting plans to restructure or resolve state-aided banks within a few years; reforming the country’s frameworks for bank resolution, regulation, and supervision to facilitate a more orderly cleanup and promote financial stability and protect the taxpayer. All these efforts reduced threats emanating

from banks to the rest of the economy and strengthened the system’s capital, liquidity, and loan-loss provisioning. Notwithstanding this substantial progress, the IMF still stressed the challenges remaining for the financial sector, including the decline in core pre-provision profits, the continuing rising NPL ratio, and the challenges from the private-sector deleveraging and fiscal consolidation (see IMF 2014).

The costs in financial aid to the financial sector since the crisis, according to the latest data from the Bank of Spain, had reached €65,725 million through December of 2018. This amount included €42,561 million provided by the state through the *Fondo de Reestructuración Ordenada Bancaria* (FROB), and an additional €23,164 million provided by other Banks through the *Fondo de Garantía de Depósitos* (FGD). Of this amount, only 22.5% (or €14,785 million) have been recovered so far, but there is hope that the eventual privatization of *Bankia* will lower the total costs (see Table 8.1). The first institution that collapsed was CCM in March 2009 with a cost to the estate of €2475 million. It was infamous for its ruinous investment on project like the building

Table 8.1 State aid to banks ten years after the crisis (FROB, FGD and support to Sareb)

	<i>Amount (million euros)</i>	<i>Percentage over assets</i>	<i>Percentage over risk-weighted assets</i>
BFA-Bankia	22,424	7.5	12.3
Catalunya Bank	12,599	16.6	25.9
CAM	12,474	18.5	29.6
NCG	9404	14.1	18.2
B. Valencia	6103	25.9	37
CCM	4215	16.2	24
Sareb	2192		
Unnim	1997	10.2	17.2
BMN	1645	2.4	4.1
Ceiss	1559	3.4	6.2
CajaSur	1192	7.7	11.3
B. Cívica	977	1.4	2.1
Caja 3	407	2	3
B. Gallego	245	5.4	7.8
Liberbank	124	0.2	0.4

Assets’ data as of December 31, 2010

Source Bank of Spain

of a new airport in Ciudad Real, which has been barely used. That one institution used all the deposit guarantees funds that the banks, *cajas*, and cooperatives had accumulated during the previous two decades. It was purchased by *Liberbank*.⁵

In December of 2019, the FROB (now renamed the *Autoridad de Resolución Ejecutiva* or the Executive Resolution Authority) celebrated its tenth year anniversary and it issued a full report of its activities since the crisis. According to that report, while *Bankia* is the bank that has received the largest amount of state aid (€22,424 million), other entities received much more support in proportion to their size, particularly *Banco de Valencia* (which was at some point a subsidiary of *Bankia*) and the *Caja de Ahorros del Mediterraneo* (CAM). Four examples will illustrate the magnitude of the problem: *Banco de Valencia* needed aid for the equivalent of 25.9% of their total balance sheet, and for 37% of its assumed risks, in other words, one of three loans could not be recovered and lacked sufficient capital to cover the risk. In the end, the Bank of Valencia received €6103 million and the state only recovered €42 million (it was sold to *CaixaBank* in November 2012 for one euro, and the bank faces 11 judicial proceedings still pending, as of January 2020, on Spanish courts). *Novagalicia Banco* accumulated 18.2% of loans that could not be recovered and received €9404 million of which only €873 have been paid back by *Abanca* after it bought it. Furthermore, at the CAM, the percentage of loans over risk-weighted assets that could not be recovered reached 29.6% of all their loans, and in this case, the FGD (e.g., the other banks) had to assume those losses. The accumulated losses have already reached €7386 million (€693 more than what the FROB expected). The CAM was sold to the *Banco Sabadell* in November 2011 for one euro. Finally, *Catalunya Banc* needed €12,599 million of which only €881 have been recovered, mostly paid by the BBVA, which purchased it. All these banks have achieved dubious recognition for their immense losses that placed the Spanish economy at risk and cost millions of euros to Spanish taxpayers. According to the FROB report, as of June 2019, the FROB was participating in 24 criminal proceedings against managers from all these institutions and was claiming €3705 million.⁶

⁵For the reforms in the Spanish financial system after the crisis, see IMF (2014).

⁶From “El Banco de Valencia y la CAM, peores que Bankia,” *El País*, Sunday, January 12, 2020, p. 43.

Moreover, while the overall health of the banking sector is not questioned (as of January 2020), significant challenges remain. Spanish banks are being dragged by low interest rates (see Fig. 8.1), low profitability, reputational damage, adverse judicial decisions (mostly around the contractual conditions of some mortgages), and a digitalization process that threaten to reduce even more profit margins. All these obstacles are impacting the performance of their stock: Eight Spanish banks publicly traded (*Santander*, BBVA, *CaixaBank*, *Bankia*, *Bankinter*, *Sabadell*, *Unicaja*, and *Liberbank*) have lost almost a quarter of their stock market capitalization between August 2018 and August 2019, reducing their value in €40,000 million in that period, from €156,000 million to €116,000 million. Consequently, they have embarked in a process to reduce costs: They eliminated 5473 jobs in 2018, and since September of 2008, they have closed 43.1% of their offices, from 45,707 to 26,011 offices. Since 2009, there has been a 30% reduction in the number of banking entities, yet the banking sector remains very competitive according to the Bank of Spain. And the consolidation process continues as banks continue to seek to reduce costs (one of the few levers that they still have available to improve their financial results): There are questions about a possible merge between Bankia and BBVA, *Unicaja* and *Liberbank* have been in discussions to merge (they announced it in January of



Fig. 8.1 Short-term interest rates. Total, % per annum, Jan 2011–Feb 2020
(Source OECD Main Economic Indicators: Finance)

2019 but later retracted it), and further mergers are expected. The Bank of Spain is demanding that any new fusion “generates synergies, and that the potential partners present a viable business plan, that is coherent and credible.”⁷

*Has Sareb Succeeded?*⁸

As part of the rescue deal, Sareb (*Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria*, or *Company for the Management of Assets proceeding from Restructuring of the Banking System*), a ‘bad bank’ owned by Spain’s banks and the state bailout fund FROB, took over more than 50 billion euros (\$57 billion) in real estate and other toxic assets from nine Spanish savings banks in 2012. It took on 200,000 assets for more than 50 billion euros, 80% of which were loans buying the value of loans and foreclosed assets at the time at an average discount of 46 and 63%, respectively.

When Sareb was established, it targeted a return on equity of around 14–15%. However, contrary to other ‘bad banks’ set up in Europe after the financial crisis, such as in Britain and Ireland where property markets have rebounded,⁹ Spain’s Sareb has been struggling due to a slump in Spanish real estate prices, which has depressed the value of the loans and foreclosed assets it took on. Consequently, by the end of 2018, it had only managed to sell a third of its real estate and financial assets since it was established and has repaid less than a third of its senior debt.

By the end of 2018, Sareb’s assets were worth 34 billion euros of which 12.4 billion euros were in real estate assets. Since it is easier to sell real estate development than to directly sell loans, Sareb decided in 2019 to join other real estate funds and swaps loans for property to try to limit losses on toxic assets it took on during the financial crisis. With this plan,

⁷According to the Deputy Governor of the Bank of Spain, Margarita Delgado, as of January 2020 “the banking environment remains extremely competitive,” and she considers that “there is a worrying competition that makes the profit margins are super narrow.” See “El banco de España cree muy ‘preocupante’ la alta competencia bancaria,” *El País*, Tuesday, January 14, 2020.

⁸From: <https://www.reuters.com/article/us-spain-badbank-analysis/spains-bad-bank-transforms-into-real-estate-fund-as-it-tries-to-stem-losses-idUSKCNITQ1XH>.

⁹Britain’s ‘bad bank’ set up to manage more than 100 billion pounds (\$127 billion) of assets repaid the last of its government loans in June 2019 and Ireland, NAMA’s 32 billion euro deleveraging program was 94% complete at the end of 2018.

they were trying to get more liquidity on those assets by transforming up to 18 billion euros (from a total of 22 billion euros) in outstanding loans to real estate developers into assets in order to gain access to the collateral and be able to sell it afterward. As part of this plan, Sareb is planning to speed up filing lawsuits against those who don't fulfill their payments, targeting a total of around 8 billion euros in loans. So far, Sareb says it has transformed 5.8 billion euros into assets. It is also shedding assets since 2017, with discounts ranging from 50% on foreclosed assets to over 70%.

Nevertheless, market conditions in Spain will most likely mean that the lender will not be able to deliver a positive return. In 2018, Sareb reported a loss of 878 million euros, while revenues fell by 5%. Even before the COVID-19 crisis, the ratings agency S&P anticipated a slow-down in the Spanish real estate market, from an estimated 4.5% rise in house prices in 2019 to 3.4% in 2020. Hence, few expect that Sareb will be able to offload its assets by the end of 2027, as planned.

The Crisis of Banco Popular

When everyone thought that the worst was behind, *Banco Popular* (Popular Bank), Spain's fifth-largest bank with 91 years of history, with over \$100 billion in loans, collapsed in June 2017, forcing it into the arms of its rival, *Banco Santander*, which purchased it for the nominal sum of one euro after depositors withdrew money massively and the bank's stock price plunged.¹⁰ The root of the problem was, yet again, the nonperforming loans on the bank's books, which were a major cause of its collapse. They can be traced back to the real estate bubble of over a decade ago, as toxic home loans had been festering on its books for years. As a result, *Popular's* stock had lost 95% of its market value over the previous five years, weighed down by its toxic real estate portfolio (see ECB 2017).

Popular's collapse was not merely a problem of lack of liquidity, the capital increases that took place in 2012 and 2016 were insufficient to cover the losses from the real estate mortgages, and they just served to gain more time. The experts (*peritos*) agreed that the bank was solvent when it collapsed but it was very close from falling below the minimum capital requirements. In the end, liquidity problems, combined with

¹⁰ See Gretchen Morgeson, "Lessons from the Collapse of Banco Popular," *New York Times*, June 23, 2017.

governance problems and severe management mistakes (like the decision from the bank's chairman, Emilio Saracho, during the August 2017 shareholders' meeting to announce that the bank needed additional capital, which precipitated a run on the bank deposits and a 10% drop of the bank's stock), ultimately led to its collapse.¹¹

The collapse of *Popular* illustrated, yet again, the limits of supervision and safeguard instruments, as the stress tests that had been designed by regulators to assess how resilient bank balance sheets will be during downturns failed. Indeed, in 2016, *Banco Popular* conducted a stress test in cooperation with the European Banking Authority. Based on the results of the tests, *Popular's* common equity Tier 1 capital stood at 10.2% of assets, which was below the 12.6% average among 51 big European banks, but not the worst on the list, and even in an adverse scenario, according to the stress tests *Popular* would still have excess capital of 6.6%. In April of 2017, that capital cushion vanished almost overnight, when top *Banco Popular* officials said they needed to raise capital and the institution began to experience a run. In early June, the bank received \$4 billion in emergency assistance from the Bank of Spain but this aid was consumed in two days, and the deal with *Santander* quickly followed.

While there was a sense of comfort based on the fact that the mechanisms that were created after the 2008 crisis worked and no taxpayer money was involved in the takeover, there were significant losers including investors in both the bank's stock and in the \$1.4 billion in debt-like instruments *Banco Popular* issued prior to its collapse to provide a capital cushion (thousands of judicial demands are still pending in Spain, Belgium, and the United States), as well as *Santander's* shareholders because their holdings were diluted by the bank's decision to raise \$7.9 billion in equity to shore up its balance sheet.

The *Popular's* collapse showed the limits of stress tests and reaffirmed the need for regulators to require banks to maintain higher leverage ratios. According to the 2016 tests, *Popular* had a leverage ratio of 5.68%. Under the stress scenario, it was supposed to be 3.99%. Yet, the bank's capital proved inadequate.

Two years after the *Popular's* collapse, the judicial process is still pending with a number of demands from all parties involved. It will be an

¹¹ Saracho had replaced Angel Ron as chairman of *Popular* in February 2017, a few months before the bank collapsed. Ron, who became chairman of *Popular* in 2004, was forced to step down in the face of an intense backlash from investors and analysts.

incredibly complex process that will take place in several countries and will involve shareholders, investors, auditors (PwC), the bank managers (for their management of the bank and their compensation¹²), bondholders, regulators (for intervening in the bank), and even *Santander*. So far, there have been 1063 claims and 262 appeals against the FROB.

In the end, the new complex resolution rules that had been established after the crisis in the EU did not protect the system from the *Popular's* collapse. Now, it will be up to the pending trials to determine if it was just an issue of poor management or there was also malfeasance, and whether the regulators (including the supervisor Bank of Spain) and the PwC auditors did their job.

LESSONS FROM THE SPANISH EXPERIENCE

Financial Stability Cannot Be Divorced from Economic Policy

As we have seen throughout the book, the Spanish government (and the ECB) failed to cope with the asset bubble and its imbalances. Hence, the Spanish experience shows that financial stability cannot be divorced from economic policy and macroprudential supervision; while regulation matters, macroeconomic factors do too. The recurrent excuse from politicians and regulators that their hands were tied up because monetary policy was in the hands of the ECB (which was true) was a convenient justification for their inaction. They had other options to curve the bubble: For instance, the government should have eliminated housing tax breaks and/or established higher stamp duty on property sales, or higher capital gains tax on second properties; and the Bank of Spain could have imposed higher provisions and/or capital requirements. Those options, however, would have been politically costly, and it was easier to stand still.

Moreover, the Spanish experience provides an interesting insight into the pitfalls of integration into an incomplete monetary union (one not backed by a political union): Lower interest rates and the loosening of credit will likely lead to a credit boom, driven by potentially overoptimistic expectations of future permanent income, which in turn may

¹²Ron was paid €1.47 million in 2016, the same as the year before, and he retired on a pension worth €1.1 million a year, and Saracho was hired with a \$4.5 million hiring bonus. See "Mission Impossible: Saving Banco Popular Too Much for Saracho," *Bloomberg*, June 8, 2018 and "Emilio Saracho Replaces Angel Ron as Banco Popular Chairman," *Financial Times*, February 20, 2017.

increase housing demand and household indebtedness, as well as lead to overestimations of potential output and expansionary fiscal policies. The boom will also lead to higher wage increases, caused by the tightening of the labor market, higher inflation, and losses in external competitiveness, together with a shift from the tradable to the non-tradable sector of the economy, which would have a negative impact on productivity (see Royo 2013). In addition, the crisis also showed that fiscal discipline matters in a monetary union, but it is not enough. Indeed, prior to the crisis as we examined in Chapter 3, Spain was perceived as one of the most fiscally disciplined countries in Europe, and initially, fiscal surpluses allowed the country to use fiscal policy to be used in a countercyclical way to address the global financial crisis. However, although Spain entered the crisis in 2008 in an apparent excellent fiscal position, the country's structurally or cyclically adjusted deficit turned out to be much higher than its actual deficit. As a result of the crisis, as we examined in Chapter 3, the country's fiscal performance collapsed by more than 13% of GDP in just two years. This shows that Spain's structurally or cyclically adjusted deficit was much higher than its actual deficit, and illustrates how difficult it is to know the structural position of a country.

In order to avoid these risks, countries should develop stringent budgetary policies in the case of a boom in demand and/or strong credit expansion. At the same time, they should guard against potential overestimation of GDP and measure carefully the weight of consumption on GDP, because they may inflate revenues in the short term and create an unrealistic perception of the budgetary accounts, as in the case of Spain. It is also important that they use fiscal policies in a countercyclical way to be prepared for recessions. Finally, higher revenues, as in Spain prior to the crisis, should not drive budget surpluses. On the contrary, governments need to address the structural reasons for the deficits and avoid one-off measures that simply delay reforms but do not address the long-term budgetary implications.

Furthermore, to avoid unsustainable external imbalances, countries should also carry out the necessary structural reforms to increase flexibility and productivity, as well as improve innovation in order to allow their productive sectors to respond to the increasing demand and to ensure that their economies can withstand the pressures of increasing competition. They should also set wages based on Eurozone conditions to ensure wage moderation, instead of on unrealistic domestic expectations and/or domestic inflation (Abreu 2006, pp. 5–6). Countries should also take the

opportunity presented in boom years to move into higher value-added and faster growth sectors toward a more outward-oriented production structure.

However, the crisis also showed that the economic reform process is a domestic responsibility that countries need to undertake to fully adapt to the challenges (and opportunities) of a single market and a monetary union. Somehow there was an expectation that membership on its own would force structural reforms, and this (naturally) did not happen. On the contrary, the years prior to the crisis showed the limits (and also adverse incentives) of EU/EMU membership in imposing institutional reforms in other areas (e.g., the labor market, the financial sector, or competition policy) and to balance domestic and external economic objectives. Since the crisis, while the EU has gained some leverage to force countries to act in the case of bailouts (as it happened to Spain and other countries that received financial assistance), that leverage is limited once the countries exit the bailout. This remains a domestic process that has to be undertaken at the national level (see Royo 2013).

Moreover, in the context of a monetary union, it is also crucial that countries address current account deficits and losses of competitiveness. During the Eurozone crisis, the focus was largely on the fiscal challenges that countries faced. Yet, it is essential to note that we were also dealing with a crisis of competitiveness. In Spain, EMU membership fostered a false sense of security among private investors, which brought massive flows of capital to the periphery. As a result, costs and prices rose, which in turn led to a loss of competitiveness and large trade deficits. Indeed, below the public debt and financial crisis, there was a balance of payment crisis caused by the misalignment of internal real exchange rates.

Indeed, between 2000 and 2010, there was a significant deterioration of competitiveness in Spain vis-à-vis the Eurozone: 4.3% if we take into account export prices, and 12.4% if we take into account unitary labor costs in the manufacturing sector. In this regard, the experience of Spain within EMU showed that there were lasting performance differences across countries prior to the crisis. These differences can be explained at least in part by a lack of responsiveness of prices and wages, which did not adjust smoothly across sectors, and which, in the case of Spain, led to accumulated competitiveness losses and large external imbalances (see Fig. 8.2). While Germany (and other EMU countries) implemented supply-side reforms in the first years of EMU to bring labor costs down, through wage restraint, payroll tax cuts, and productivity increases,

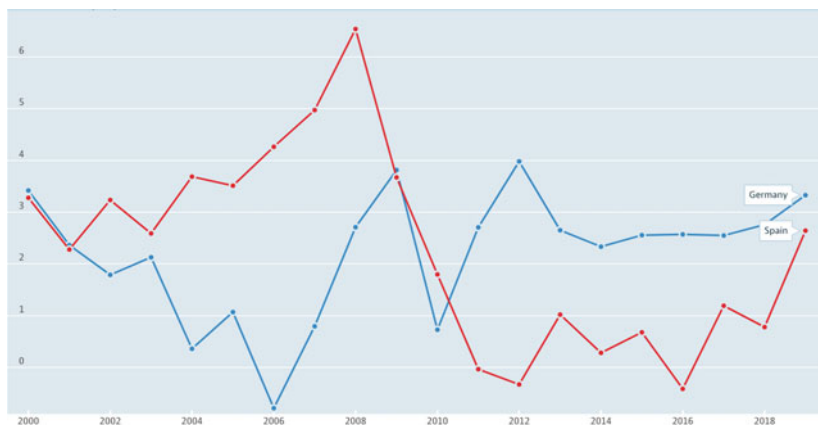


Fig. 8.2 Labor compensation per hour worked in Spain and Germany. Total, Annual growth rate (%), 2000–2019 (*Source* OECD Productivity Statistics: GDP per capita and productivity growth)

making it the most competitive economy with labor costs 13% below the Eurozone average, Spain continued with the tradition of indexing wage increases to domestic inflation rather than the ECB target, and it became one of the most expensive ones with labor costs going up to 16% above average (Portugal led with 23.5%, Greece with 14%, and Italy with 5%).¹³ Hence, a lesson for EMU members has been that it is critical to set wages based on Eurozone conditions, and not on unrealistic domestic expectations, to ensure wage moderation (Abreu 2006, 5–6).

Indeed, a crucial problem for Spain was the dramatic erosion of its comparative advantage. The emergence of major new players in world trade, like India and China, as well as the Eastern enlargements of the EU, was damaging some European economies like Spain because those countries have lower labor costs and compete with some of our traditional exports (as exporters of relatively unsophisticated labor-intensive products), leading to losses in export market shares (aggravated by the appreciation of the euro and the increase of unit labor costs relative to those in its trading competitors). Yet, while this was particularly true for

¹³Stefan Collignon, “Germany Keeps Dancing as the Iceberg Looms,” *Financial Times*, January 20, 2009, p. 13.

other countries such as Portugal, Italy, and France, in Spain the problem was compounded by the fact that too few companies exported prior to the crises, and that those that exported had differentiated products because they were the large multinationals. At the same time, Spain's attempt to specialize in medium- and higher-technology products was also hindered by the accession of the Eastern European countries into the EU, which were already moving into those sectors specializing in these products.

Furthermore, in order to avoid unsustainable external imbalances, countries should also carry out the necessary structural reforms to increase flexibility (particularly internal flexibility which may be even more important for companies to allow them to deploy effectively their human capital, than the external one, despite the traditional fixation in Spain on dismissal costs) and improve productivity. This would be the most effective way to allow countries' productive sectors to respond to increasing demand and to ensure that their economies can withstand the pressures of membership to a single market. Finally, countries should also take the opportunity presented by the boom to move into higher value-added and faster growth sectors, toward a more outward-oriented production structure.

Last, in regard to economic policies, much has been said about the response to the crisis and the focus on austerity (see Royo 2013; Blyth 2013; Alesina et al. 2019). Suffice to say here that the aftermath of the crisis has shown that discipline and austerity are not enough. The response to the crisis was a real-life experiment to try to prove that an expansionary fiscal contraction can work, and in the end, the obsession with austerity had painful consequences across the European periphery. The problem for countries like Spain was the feeble outlook for growth, as austerity further contributed to the contraction of the Spanish economy and deteriorating fiscal conditions. As a result, Spain's sovereign debt was repeatedly downgraded throughout the crisis; unemployment reached record levels at over 24%; public debt grew from 36% in 2007 to nearly 100% in 2020. The country was trapped in a so-called doom loop: a negative spiral that happens when banks hold sovereign bonds and government bailout banks. Bailing out banks puts pressure on sovereign bonds as investors, concerned about a possible default, sell them. That pressure in turn leads to increase in interest rates, making it more expensive for countries to fund their deficits/debt, which in turn worsens the fiscal outlook for the country and makes a default more likely. Yet, if they do not bail out the banks,

countries risk a financial meltdown. This was a trap countries in the European periphery (Greece, Portugal, Ireland, and Spain) found themselves in, which ultimately precipitated their bailouts.

In this regard, the contrast with the United States was striking. Between 2007 and 2010, the US Congress passed the equivalent of three stimulus bills:

- A bipartisan \$158 billion package of tax cuts signed by President George W. Bush in early 2008.
- A \$787 billion bill pushed by President Obama as he took office in 2009 in the wake of the financial system's collapse.
- A tax cut and unemployment fund extension agreement reached by President Obama and Congressional Republicans in December 2010.

Many studies show that these measures were a key reason why the unemployment rate did not reach double digits in the United States (see Prasad and Sorkin 2009).

Macroprudential Instruments Are Important to Ensure Financial Stability

One of the important lessons from this crisis is that a microprudential approach, even when combined with stable output and inflation, is not enough to ensure financial stability. We still need macroprudential instruments, because they help bolster financial stability and mitigate systemic risk. These instruments have been used more extensively following the crisis, including the use of contemporaneous financial variables as proxies for systemic risk; the use of early warning indicators to gauge financial risks; measures of credit, house prices, and bank balance sheets (e.g., capitalization, profitability, maturity, and currency mismatches); monitoring the financial health of borrowers using detailed firm- or consumer-level data; using housing price and asset-pricing models, as well as a statistical analysis to assess overvaluation in the housing market.

Stress tests also stand out as a systemic risk indicator. They are particularly helpful, because they are forward-looking and can consider various extreme scenarios. However, the Spanish financial crisis also shows the shortcomings of these tests, as macrostress tests carried out prior to the

financial crisis did not point to any significant risk in the banking sector (nor did they prevent the collapse of *Banco Popular* in 2017).

Furthermore, additional work remains to be done in this area as no consensus exists about the definition of a “macroprudential policy stance,” nor regarding the best methods used to measure it. On the one hand, this policy stance can be viewed as the values taken by macroprudential instruments, irrespective of current financial conditions. Alternatively, we could also define the policy stance as conditional on financial developments, e.g., how binding the instruments are at a given time. In addition, it is challenging to determine the best methods to measure it, as it is difficult to aggregate different instruments with potentially very different effects on financial risk.

Finally, some studies have shown the limits of these macroprudential tools. For instance, Montalvo and Raya (2018) have shown that, contrary to other countries, the introduction of regulatory penalties on high loan-to-value (LTV) ratios (one of the most frequently used tools of macroprudential policy) for residential mortgages used by Spanish banking regulators before the onset of the housing crisis of 2008 did not reduce the feedback loop between credit and house prices. The reason was that in Spain appraisal companies were mostly owned by banks, which led to a situation in which the LTV limits were used to generate appraisal values adjusted to the needs of the clients, rather than trying to appropriately represent the value of the property. This caused a tendency toward over-appraisals, which in turn produced important externalities in terms of a higher than otherwise demand for housing, and the intensification of the feedback loop between credit and house prices.

Address EMU’s Institutional Deficiencies

While EMU is not the focus of this book, it is important to note that the crisis exposed institutional deficiencies in the European Monetary Union that still need to be addressed. Indeed, the crisis showed that the EMU is a flawed construction. Mario Draghi, president of the ECB, acknowledged as much when he noted that it was like a “bumblebee” and declared “it was mystery of nature because it shouldn’t fly but instead it does. So the euro was a bumblebee that flew well for several years.” It has not been flying well, and according to him, the solution should be “to

graduate to a real bee.”¹⁴ The crisis in Spain further illustrated the EMU’s institutional shortcomings: Spain had a huge bubble that crashed with the crisis. The “bumblebee” flew for a while and convinced investors that they could invest (and lend) massively within the country; thus, money poured into Spain. However, when the crisis hit, the country could not count on the EU support to guarantee the solvency of its banks or to provide automatic emergency support. And when unemployment soared and revenues plunged, the deficits ballooned. As a result, investors’ flight followed and drove up borrowing costs. The government’s austerity measures and structural reforms contributed to deepen the country’s slump. If anything, the crisis exposed the shortcoming of EMU institutions and showed the fragility of an institutional framework that tried to balance fiscal sovereignty with a monetary union. This model failed to combine flexibility, discipline, and solidarity. Fear has been largely what is keeping it all together. But is fear enough to hold it together in the long term?

Be Humble: This Time It May Not Be so Different

The experience of Spain showcases the need to address deficiencies in the policy-making process and to challenge the dominant paradigm. As we examined in Chapter 4, prior to and during the crisis, there was strong consensus in Spain among economic elites, as well as among Conservatives and Socialists leaders, regarding fiscal consolidation and the balanced budget objective. Indeed, prior to the crisis, Spain presented itself as the model of a country applying the budget surplus policy mantra. This consensus may have worked well in the short term, as it contributed to the credibility of the government policies and allowed the country to become a founding member of EMU, but a more accommodating policy stance would have positively contributed to upgrading the productive base of the country with investments in necessary capital infrastructure and human capital that would have contributed to a faster transition from an economic growth model based largely on low costs, toward one based more on higher value-added and higher productivity, as well as reduced dependency on the construction sector. These investments would have contributed to change the growth model, diversify the economy, and regain

¹⁴Paul Krugman, “Crash of the Bumblebee,” *The New York Times*, July 30, 2012.

competitiveness, thus preparing the Spanish economy to better confront the crisis.

Furthermore, more humbleness would have gone a long way in overcoming the overconfidence on the strengths of the Spanish banking sector that was so pervasive during the initial stages of the global financial crisis. Indeed, the Spanish banking crisis also shows that systemic crisis does not only originate from problem of large financial institutions. We also need to pay close attention to the performance of smaller institutions (Garicano 2012). It was precisely the strength of the largest banks (e.g., *Santander*, BBVA, and *La Caixa*) that created a lull and a false sense of overconfidence during the initial stages of the crisis, while the problems of the small institutions, like the *cajas*, were minimized. As we have seen, the Spanish *cajas* sector proved to be the canary in the coalmine. Had more attention been paid to the *cajas*, the regulator would have been able to anticipate earlier the systemic problems and act more timely and decisively.

In addition, the country also overestimated the strengths of its regulatory system based on the countercyclical policies and the dynamic provisions of the Bank of Spain. The crisis exposed the shortcomings of that system, particularly its inability to withstand the political pressures that were at that heart of the "bank bargains" examined throughout the book, and it illustrates the need to build institutional mechanisms that allow the supervisor and regulators to stand up to politicians. As we have seen, regulators in Spain failed to challenge regional politicians, political parties, and unions. This proved to be disastrous. Regulators not only need the supervisory instruments, access, and authority to know the ins and outs of banking institutions, but also they need to courage to be as intrusive as necessary. While individual actors may matter in shaping outcomes because of their ability to act decisively or identify opportunities, we should not just rely on individual actors, but rather develop institutional mechanisms that limit the rent-seeking interest of populist coalitions (like the ones that took over most of the *cajas*).

Moreover, the complacency about the strength of the financial system and its ability to weaver the crisis proved to be disastrous and it prevented the country from taking decisive action earlier, which would have mitigated the impact of the crisis. Indeed, the timing of the decisions is also crucial: Dynamic provisioning worked initially as expected, but it delayed decisive action thus making the crisis larger and deeper than it should have otherwise been. As we have seen, during the initial stages of the global financial crisis, there was consensus in Spain that the stern regulations of

the Bank of Spain played a key role in the initial positive performance of Spanish banks, because it forced banks to set aside during the good years “generic” bank provisions in addition to the general provisions for specific risks. In addition, it made it so expensive for them to establish off-balance sheet vehicles that Spanish banks stayed away from such toxic assets. But this consensus led to complacency and hubris. Indeed, the provisions’ size—3% of GDP at their highest point (2004)—was simply not of a magnitude commensurate with the credit losses accrued during the crisis. The experience of the Spanish financial sector shows that it is impossible for banks not to be affected from a collapsing bubble in real estate (the Bank of Spain announced in 2012 that bad loans on the books of the nations’ commercial banks, mostly in the real estate sector, reached 7.4% of total lending). In the end, Spain suffered a property-linked banking crisis exacerbated by financing obstacles from the international crisis and the delay in taking action proved to be very damaging.

Finally, we should not think that ‘this time is different’ (Reinhart and Rogoff 2009) and we should be prepared to learn from traditional financial crises. As we have seen, the financial crisis in Spain did not involve subprime mortgages, collateralized debt obligations, structured investment vehicles, or even investment banks. In many ways, some of the main lessons from the Spanish financial crisis are not be so different from those from a traditional banking crisis. First, as noted above, monetary policy has to address asset bubbles and central bankers should be proactive in bursting the bubbles before it is too late. The global financial crisis showed that financial stability will not follow automatically if monetary policy delivers steady growth and low inflation. On the contrary, central banks should try to prevent bubbles from inflating. The crisis has finally shown that it is far more expensive and painful to ‘clean up’ after asset price bubbles that have burst. At the same time, banks should not lend excessively to property developers and governments. Second, bankers should recognize that retail banking is not a low-risk activity and should avoid overconcentration in property loans, and finally, governments and central bankers should avoid any complacency (as it happened in Spain) and instead need to be vigilant and proactive to avoid the mistakes of the past and to anticipate all possible scenarios, including the most negative ones. In Spain, as noted before, the misplaced and excessive confidence on the strength of the financial sector, and the almost unquestioned belief in the regulatory and oversight prowess of the Bank of Spain, led to hubris.

In sum, in Spain, the collapse of the real estate markets eventually led to a traditional banking crisis fueled by turbocharged lending (largely from international wholesale funding). When the crisis hit, international and wholesale funding dried up and it affected bank lending. In this regard, the main “toxic” assets held by Spanish banks were domestic bad loans and mortgages. In this sense, the Spanish banking crisis has been labeled as a traditional bank crisis. This time it was not so different!

It Is the Politics, Stupid

Throughout the crisis, the focus for most analysts was largely on the economic dimension of the crisis, as well as on its economic causes and consequences. As we have seen, however, it would be a mistake to underplay the political dimensions of the crisis, and not just at the Spanish national level, but also at the European and global ones. This was as much a political crisis as an economic one, and as much a failure of the markets, as a failure of politics. Indeed, political decisions led to the crisis and marked the course of the crisis.

A central argument of this book has been that politics matter, and that political factors are central to understanding why Spain has suffered repeated banking crises. Politics influence bankers’ decisions, their operations, and the regulatory framework in which they operate. And political institutions and politics structure the incentives of actors involved in banks, from bankers to shareholders, depositors, debtors, to regulators.

Indeed, political circumstances influence *bank banking bargains*, and they in turn define the types of banks that emerged in any given country (see Calomiris and Haber 2014). As we have seen throughout the book, banking systems are an outcome of politics, and the interplay between politics and banking has been crucial to account for the performance of the Spanish banking system. At the same time, while banking systems shape politics, they also influence the coalitions that bargain and affect the bargaining power of the parties that participate in the bargain. Finally, political circumstances shape the development of new financial services and instruments.

Ensure Conservative Risk Management

The Great Recession of 2008 made it clear that Conservative risk management will be crucial, and hence, banks must be required to manage

their risk prudently, hold sufficient levels of capital, and recognize losses in a timely manner. Furthermore, they should be prevented from free riding on safety-net/too-big-to-fail protection. Bankers should also stress the need to be obsessive about credit quality, they should largely avoid non-core activities such as commodities trading, they should absorb past experiences, and they should learn that geographical diversification may help limit the banks' exposure to the weak economic performance of a particular market.

Hence, some of the main lessons from the crisis are old lessons that banks should have already heeded: Banks need to maintain lending standards to ensure banking stability; they need to maintain sufficient provisions and capital to cover expected and unexpected losses; and they have to ensure alignment between the incentives of managers, shareholders, and stakeholders (including taxpayers and deposit guarantee funds). Moreover, supervisors and regulators need to enforce intrusive supervision and ensure that financial institutions do not engage in unsustainable business models/initiatives (see Roldan and Saurina 2012).

In addition, the 2008 crises also showed that safety nets can be destabilizing because they intensify moral hazard: The more the generous, the more unstable the banking system (Calomiris and Haber 2014, pp. 461–62). The most stable banking systems combine a credible system of prudential regulation based on accounting transparency, substantial capital requirements, and limited safety-net protections. And paradoxically safety nets, such as deposit insurance, which are outcomes of political bargains, tend to destabilize banking systems. In Spain, those guarantees and the expectation of bailouts promoted (and even rewarded) the reckless behavior that led to the collapse of so many *cajas*. Hence, it is crucial to overcome political resistance to stricter capital requirements.

Implement Financial Reforms (While Recognizing How Difficult That Process Will Be)

We still need further financial reforms at the national and international level to ensure increasing financial stability. Yet, we need to recognize that reforms are difficult because the coalitions that underpin the “banks bargains” described throughout the book are entrenched, and we cannot simply expect incumbent politicians or regulators to prevent the next banking crisis because they are likely part of the coalition that may cause

it (Calomiris and Haber 2014, pp. 278, 281). For this reason, improvements in banking systems would be more lasting if they take place in the context of broader reforms of the political system, fiscal policy, trade policy, industrial policy, and corporate governance that reduce corruption.

As noted by Calomiris and Haber (2014, p. 504), the implementation of reforms hinges on the ability to assemble a winning coalition, and even more importantly, we need *persistent support for good ideas*. Crisis offers windows of opportunity to effect change. However, more often than not, powerful interests succeed in using moments of crisis to strengthen their power. For instance, despite the establishment following the crisis of resolution mechanisms, dynamic provisioning, increasing capital requirements, and other safeguards, moral hazard remains a significant problem across the Western world in the aftermath of the recent Great Recession. Indeed, one of the main outcomes of the crisis in Spain and other countries has been the greater concentration of national banking systems (yet another instance of the political bargains that shape banking), which has only aggravated the risk of ‘too-big-to-fail.’

Supervision and an appropriately tough resolution regime must go hand in hand. But it is also important to recognize that smart regulation alone cannot count for a country’s banking success. If that was the case, it could be easily replicated. The initial complacency regarding the strength of the dynamic provisioning system that we examined in Chapter 5 proved to be unwarranted in light of the subsequent crisis. On the contrary, banking success is based on the “*bank bargains*” that we have examined throughout the book, and those are much harder to emulate. Countries with stable banking systems that provide abundant credit (i.e., Australia, Canada, New Zealand) have the following characteristics: They were part of the British Empire; they have long-standing democracies; and they have institutions “that limit the opportunities for bankers and populists to form rent-seeking coalitions” (Calomiris and Haber 2014, p. 459). The Spanish experience confirms that premise. Indeed, one of the main lessons from Spain is that in order to avoid banking crises it is crucial to develop strong institutional mechanisms that limit rent-seeking. In Spain, an apparently robust regulatory and institutional framework that was supported by a dynamic provisioning regime was undermined by a coalition of bankers and populists (particularly in the *cajas*’ sector) that prioritized their own rent-seeking interests, at the expense of the stability of the system.

Furthermore, we need to accept the premise that banking systems are the result of political compromises. Hence, they can be used as instruments of redistribution and have often provided politically palatable options to governments to avoid harder choices. Governments essentially have three main ways to redistribute income (Calomiris and Haber 2014, p. 445): They can change the tax burden; they can transfer resources to the poor; or they can use subsidized lending through the banks to effect implicit transfers to the poor. Sometimes governments use all three, but this choice has enormous implications for the stability of banking system. Countries cannot expect a ‘free lunch.’

Finally, it is also necessary to acknowledge that although political pre-conditions impact banking-system outcomes, these outcomes can also have very significant political consequences, and sometimes these effects are unintended and/or unanticipated. For instance, governments can resort to inflation-tax banking to avoid increasing taxes, but this may eventually undermine the legitimacy or electoral support of that government and lead to a political change.

Be Wary of Capital Inflows

While capital inflows have many benefits for countries because they provide funding for infrastructure and investment, or help offset trade deficits, they can also be a source of instability because they may trigger a boom, as it happened in Spain, which caused an asset price bubble that led to an erosion of Conservative risk management from banks when the drop in interest rates from the ECB led to a search for higher yields. This has led many authors to emphasize the negative impact of global capital and to attribute financial crises to capital inflows (see Chinn and Frieden 2011). In Spain, the real estate market boomed in the year that preceded the 2008 financial crisis, and this led to higher commodity prices and record stock market yields. Most banks tried to capitalize on this bubble and made choices that they came to regret. While capital controls have a mixed record in terms of effectiveness and would not be desirable, capital flows can contain early warning signals of an upcoming crisis; hence, it makes sense for the European Stability Mechanism (ESM), as the crisis resolution mechanism, of the Eurozone to carefully monitor these data.

However, it is important to recognize that not all foreign capital is destabilizing for the banking sector. While countries like Spain, the UK, and the United States experienced large current account deficits in the

years prior to the 2008 global financial crisis, other countries, as we mentioned in Chapter 1, like Australia or New Zealand did as well, but did not experience financial crises. This puzzle has to be explained. According to Copelovitch and Singer (2020), while foreign capital inflows can be the fuel for a destabilizing financial boom that can end in a financial crisis, and large international capital inflows are strongly correlated with banking crisis, the key conditioning variable is the domestic financial market structure. It is the relative degree of competition between banks and securities markets, measured by the ratio of stock market size to bank credit that determines the risk proneness of financial systems. This is so because when banks face competition from large, well-developed security markets they take on more risks and these risks are magnified by capital inflows. In other words, they show that capital inflows in countries with more securitized financial markets affect the quality of bank lending and the composition of balance sheets (not necessarily the volume of bank credit) (p. 44). Therefore, it is crucial to examine the size and depth of securities markets in order to understand (and prevent) financial crises.

Consider the Size and Depth of Securities Markets

As we outlined in Chapter 1, Copelovitch and Singer (2020) focus on the political decisions that shape the structure of financial markets and the international capital flows that make some countries more vulnerable to financial crises. They recognize that capital inflows amplify this risk and increase the chance of a banking crisis but argue that banks engage in riskier behavior when they compete alongside well-developed national securities markets. They examine the political origins of financial market structure, looking at the key political decisions that define the structure of these financial markets (from the process of granting and operating license to banks to the rules that determine their operations; to the rules that establish the terms to disclose information, fraud, supervision, and exchange for securities). According to them, banks in countries with large financial markets are likely to feel more pressure to take on more risk to maintain their market share and profits. In other words, their Conservative bias will be eroded as security markets get stronger in their countries. From this perspective, the size and depth of securities markets are key for bank stability and have important implications of risk management. Hence, in order to understand financial crises, we need to delve into the structure and characteristics of national financial markets, which varies

significantly from country to country: from universal banks to specialized banks; from developed to underdeveloped securities markets; from national to regional banks; from fragmented to centralized...

However, it is important to recognize that changing the structure of financial markets will not be easy because they are historically contingent and thus difficult to change. Indeed, their development is marked by path-dependent financial trajectories and stickiness (Thelen 2004), which, for instance, makes it harder for countries with underdeveloped securities markets to develop new and riskier financial products whereas it is easier for those with well-developed securities markets, and thus amplifies the risk of financial crises.

This is an important finding that fell outside of the scope of this book's analysis, but it still needs to be explored further and should be in the agenda for future research. As Copelovitch and Singer (2020) show, differences in the size and structure of securities markets and the behavior that they have on banks have also impacted the stability of the Spanish financial system. While this book has focused largely on the structure of the Spanish banking sector and the rules for allocating credit as the key explanation for banking instability in Spain, it has overlooked the role of securities markets in explaining the incidence of financial crises in Spain. Indeed, more work needs to be done to analyze the relationship between banking systems, securities markets, and financial stability in Spain. In particular, it would be important to examine carefully the historical policy decisions and political bargains that helped to determine the relative strength of traditional banking versus securities markets in the country, and analyze in great detail the relationship between banking and securities markets. These political decisions have shaped Spanish financial markets over the long term by allowing room for securities markets to mature, which in turn have made the country more vulnerable to financial crises. This is an omission of broader aspects of Spanish financial markets that still needs to be addressed.

SPANISH BANKING IN COMPARATIVE PERSPECTIVE

Some have compared the Spanish case with the experience of Japan (Kamikawa 2013). Is Japan the future of Spain? While there were some similarities on the assets and liabilities side, there were also key differences; in Spain, the purchase of sovereign bonds depended to a significant degree on international markets (this was not so much the case in Japan,

where domestic savings were a major source of funding). In Japan (unlike Spain), during the lost decade citizens still invested in banks despite the bubble, and there was limited capital flight. Finally, Spain has a much larger funding gap, hence a larger dependence on wholesale markets.

Others have compared Spain to Ireland (Dellepiane and Hardiman 2011). Fortunately for Spain, its real estate bubble was smaller than in Ireland: Property prices rose about three times in Spain in the mid-1990s, compared with 4.5 times in Ireland, and real estate loans peaked at 77% of the Irish economy, compared with 29% in Spain. Moreover, the crisis largely affected the second tier of Spanish banks. Santander and BBVA far more diversified and with major international operations, were affected to a far lesser degree. At the same time, Spain unlike Ireland had established a recapitalization instrument and process based on the FROB. The problem, of course, is that it lacked enough funds, which led to a financial bailout in June 2012 (see Chapter 1). However, the Spanish bailout was also 9% of its economy, compared with 63 billion euros, or 43%, in Ireland.

In the end, the Spanish government (as well as the BoS and the ECB) failed to cope with the asset bubble and its imbalances. Hence, the Spanish experience shows that financial stability cannot be divorced from economic policy; while regulation matters, macroeconomic factors do too. As late as 2012, Spanish banks were still dealing with their toxic assets. They should have heeded the lesson from other countries who acted more decisively to clean them up, not just merged into a bigger problem. Bankia is a perfect example of that failure. In the end, Spain did not heed the lessons from previous crises: do not lend excessively to property developers; burst the bubble before it is too late; recognize that retail banking is not a low-risk activity; avoid over-concentration in property loans; and remember what happened before.

Theoretical and Normative Implications

From a theoretical standpoint, the Spanish financial sector's response to the global financial crisis during the crisis shows that cross-national differences persist. While financial capitalist states have converged as a result of the combined processes of globalization and European integration rendered the "Mediterranean" financial model far less distinct from other models than before, in the case of Spain, the crisis led to extensive regulatory intervention that served to reinforce the pre-existing model;

changes in the years immediately preceding the financial crisis have not been reversed (see Hall 2016).

The analysis of the Spanish case shows that institutions do not stand still. On the contrary, they evolve through their ongoing adaptation in response to changes in the political, social, economic, and international (i.e., the EU) environments. These changes have illustrated the ways in which the functions and roles of these institutions have evolved over time. Yet, it calls into question the presumption that increasing economic integration into EU/EMU will force the institutions of member states into convergence on a common model. Indeed, Spanish institutions have proved to be remarkably resilient in the face of significant exogenous shocks and EU/EMU membership did not radically reshape or disrupt previous patterns. Nor it did generate the degree of institutional innovation that could have been expected. The financial bailout forced significant reforms but since 2015 the political paralysis and fragmentation have led to stagnation and complacency. To understand why, future research should explore further, as we have tried in this book for the banking sector, the political coalitions under which these institutions have evolved.

Furthermore, the focus of the VoC literature has been on how national institutional differences condition economic performance, public policy, and social well-being; and whether national institutions will survive the pressures for convergence generated by the crisis. This book contributes to this literature by highlighting how national institutions have conditioned economic performance in Spain (see Royo 2008).

The initial response to the global financial crisis showed that cross-national differences persisted. While financial capitalist states converged as a result of the combined processes of globalization and European integration rendered the “Mediterranean” model far less distinct from other models than before, in the case of Spain, the crisis initially led to extensive regulatory intervention that served to reinforce the pre-existing model, and changes in the years immediately preceding the financial crisis were not reversed. However, it is likely that the recent restructuring of the Spanish financial system and labor regulations will accelerate its convergence towards a more liberal market economy model, more based on the markets.

Moreover, despite the grouping of Spain in the ‘Mediterranean’ variety of capitalism, there are important differences in how the crisis played out among those countries. A coherent variety of Mediterranean capitalism is missing and certain domestic political economy institutions—namely,

banks—are key to explain the outcome of the sovereign debt crisis. In light of recent events, the literature on varieties of capitalism, and the literature in political economy more generally, should pay more attention to banks and national banking systems (Quaglia and Royo 2015).

Yet, it is important to stress that the process of institutional change is not linear and that there is also strong path dependency; therefore, it is still too premature to confirm any definitive outcomes (Hall 2016). In addition, the analysis of the Spanish experience with the crisis confirms the thesis that coordination is a political process and that strategic actors with their own interests design institutions (Thelen 2004). Institutional change is a political matter because institutions are generated by conflict, they are the result of politics of distribution, and, hence, they are politically and ideologically construed and depend on power relations. In other words, institutional change is driven by politics. In this regard, the crisis is having a profound effect on power relations and the interests of actors. The (yet undetermined) outcome(s) of these changes will, in turn, influence the process of institutional change. But it is still too premature to make definite conclusions, and that is a limitation of this book.

The implications of policy-making are also significant. The experience of Spain shows that economic convergence is not sustainable in the absence of institutional convergence. This casts the fundamental challenge of policy-making in a new light, suggesting that policy-makers should not only focus on policy reform, but also on institutional one, as well.

The creation of the Single Monetary Union and the conferral of monetary powers to the ECB were not accompanied by the centralization of prudential institutions in the Eurozone area, which apart from regulatory efforts to harmonize prudential requirements in the internal market largely remained in the hands of national supervisors. As we have seen, the financial crisis brought to the fore the vulnerabilities of the European banking system and had a great impact on prudential supervision of credit institutions (Lo Schiavo 2017). As a result, in 2014, European institutions established a new framework of banking supervision for the Europe area: the Single Supervisory Mechanism (SSM), which places considerable supervisory powers in the hand of the ECB including bidding supranational macroprudential powers (including the power to 'apply higher requirements for capital buffers' and also 'apply more stringent measures aimed at addressing systemic or macroprudential risks at the level of credit institutions,' which could be higher than the requirements applied by national

governments of the member states in which the banking institutions are established) under certain conditions (art. 5 of the SSM Regulations).

These regulatory changes go a long way in addressing Schoenmaker's financial stability trilemma (2011), according to which financial stability, financial integration, and national financial policies are incompatible. Any two of the three objectives can be combined but not all three; one has to give. As we have seen throughout the book, Spain tried to achieve all three and failed. The establishment of a European-based system of financial supervision that moves powers for financial regulation, supervision, and stability, as well as crisis management operations to maintain financial stability further to the European level, helps address the balance between financial integration and national financial autonomy (e.g., as financial integration increases national policies become less effective) (see Goodhart and Schoenmaker 2009). This development would have had a tremendous impact on the "bank bargains" described throughout the book, as the locus of decision making would have been transferred to European institutions, thus making it far harder for the coalitions that underpinned those bargains to get their way. This new framework of banking regulation will likely set a new structure for the emergence of new supranational coalitions and new "bank bargains." Yet, it is still important to highlight that so far there has been limited progress toward a banking union and much remains to be done.

Finally, the crisis also exposed the weaknesses of the EMU design, as well as the absence of adequate instruments to correct asymmetries among member countries, particularly persistent current account deficits in a monetary union that lacks a fiscal union. If anything, the crisis has shown that we need a more balanced response to any crisis at the EU level. The lack of coordination may have lessened the effects of the measures taken to deal with the crisis.

CHALLENGES FOR SPAIN

The last ten years of Spain's history (2009–2019) have been a period of brutal lows during one of its worst crisis in modern history, but also some impressive highs as the country emerged from it. Those who still argue that the economic crisis in Spain was caused by EMU's institutional deficiencies, the subprime crisis in the United States, neoliberal policies, or deregulation fail to take into account the domestic institutional dimension. As we have seen, the crisis exposed an unsustainable

economic model that had no long-term prospects. The emperor had no clothes (see Muñoz Molina 2013). While Spaniards were rightly outraged by the actions of bankers and politicians, and by the amorality of the whole situation and the complete disregard from the majority of the country's elite of the impact that their actions could have on people, most people had a sense of what had been going on and tolerated it. As noted on Chapter 7, there seemed to be a complete disconnect between actions and consequences. The Spanish ruling class largely remains a community interwoven by personal and/or financial connections that have worked to their advantage, often at the expense of regular citizens. That interweaving generated clientelistic networks that have provided protection and a safety net that did not let them fall. Elites became complacent, they had been coasting for a long time, and they could not grasp the unsustainability of their course of action. Their own success skewed them in an optimistic direction and kept them from seeing what was happening around them. For them, actions and consequences did not apply. They did not seem to appreciate that their actions could make any difference, or that they had responsibilities over the consequences of their actions.¹⁵ When the crisis hit the country, they were out of answers. Their complacency took the place of serious thinking about the country's future.

At the time of writing (January 2020), Spanish citizens still demand answers. The economic crisis has been followed by a political crisis that has made it harder to act: The country has experienced four general elections in four years between 2015 and 2019, and regional tensions have intensified as a result of the crisis in Catalonia, where divisions over the illegal independence push in 2017 and the nationalist backlash that it triggered in the rest of the country have intensified the effects of political fragmentation and polarization. Not surprisingly, as we have seen in Chapter 7, Spanish citizens are still upset about the corruption and impunity, the consequences of the severe budget cuts, the taxes, the dramatic increase in unemployment, the pessimism, and desperation that has spread across the country following the crisis. But it would be too easy to just blame the political and economic elites. That account leaves aside the responsibility of people who were not part of the political elite, but also invested in the property pyramid scheme that fueled the bubble. They also seemed to forget that their actions had consequences.

¹⁵ See "The Psychology of and Irish Meltdown," *The New York Times*, July 27, 2013.

Indeed, a central problem has been the lack of accountability: In the years prior to the crisis, there was (in Spain and many other countries) a feeling of impunity that came from non-punishment. As of 2020, the list of those who have been sent to jail for their part in the housing bubble and all that followed it is remarkably thin. The result of the *Bankia* trial, in which its main administrators have been accused of embezzlement and falsifying accounts, is still pending at the time of publishing, and just a handful of corruption cases have resulted in convictions or reached any conclusion to date. Certainly, if there is nothing criminal in the conduct of the managers and/or the regulators, it must be because the criminal law is defective in that area.

It is essential that the culture impunity that characterized the years prior to the crisis changes. In this regard, one of the few positive outcomes of the crisis seems to be that Spanish society seems to be less tolerant of corruption. This will be crucial to prevent future crisis: Bankers and politicians must know that if they break the rules they could go to prison. The country needs simple rules, timely judicial decisions and strong enforcement, and accountability must also extend to politicians. Yet, while Rajoy's government was toppled in 2018 over the corruption of the PP, trials still take way too long, few people are convicted, and the prison terms and/or financial penalties are not always severe or come too late.

Spain seems to conform to Mancur Olson's institutional sclerosis thesis (1982), according to which over time all political systems succumb to sclerosis because of rent-seeking activities by organized interest groups, which lead to cronyism and corruption, and thus an erosion in the rule of law. The solution, therefore, must come from civil society. Indeed, civil society needs to be strengthened. Historically, Spaniards (as other continental Europeans) have preferred equality to liberty, which led to the development of strong states, but conversely weak civil society (Ferguson 2013). We need a better balance.

Furthermore, deep-seated structural weaknesses are still holding back growth in Spain and weighting on market assessment: overregulated product and labor markets, poor productivity, and low education achievement in international tests. Spain still has much ground to cover vis-à-vis its wealthiest European counterparts (see Fig. 8.4). In the absence of devaluations, Spain still needs further structural reforms to improve productivity and move toward a higher value-added model. The crisis has

shown that ‘internal devaluations’ through a decrease in prices and salaries are not politically sustainable in the long term and too costly socially.

Indeed, while Spain has regained competitiveness after the crisis, it did so through a very painful internal devaluation with enormous social costs. Carabaña (2016) shows that Spain had roughly the same inequality in 2016 than in 1993: a Gini coefficient of disposable income of around 0.34 (see Fig. 8.3). In comparative perspective, Spain’s inequality got closer to the EU-15 average at the peak of its real estate bubble in 2006–2007 but it fell back again in the aftermath of the crisis. In constant 2013 euros, the average income for the very poor went from 1,443 euros in 1993 to 729 euros in 2012, with even negative incomes between 2007 and 2009. This is also reflected in the distribution of overall income in Spain. In 1994, the poorest 20% of the population received 7% of the income; in 2013, this share was just 5.9% (Otero-Iglesias 2019). And the crisis was particularly brutal for young people, and they have not yet fully recovered: A head of family younger than 35 had in 2016 (the last available data) an income 18% lower than someone of that age in 2010 (27,700 euros in 2010 vs. 22,800 euros in 2016), and this despite the fact that by 2016 all overall incomes had recovered the level of 2010. But governments have other options, including the reduction of Social Security contributions

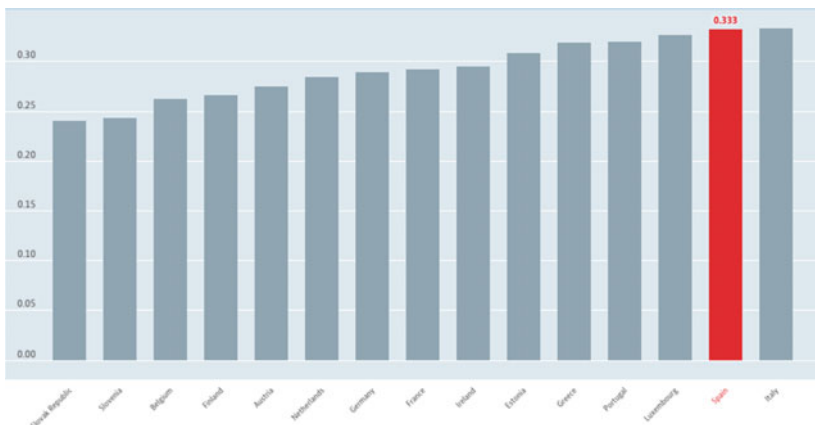


Fig. 8.3 Income Inequality. Euro Area (2017) Gini coefficient, 0 = complete equality; 1 = complete inequality (*Source* OECD Social and Welfare Statistics: Income distribution)

and/or the increase in the value-added tax; the reduction of other non-salary costs such as the energy and infrastructure ones; and the increase in productivity and labor quality.

As of January 2020 (the time of writing), a new leftist government coalition between the Socialist Party and the leftist populist *Unidas Podemos* that emerged from the November 2019 election is coming to power with a progressive agenda that, while committed to fiscal discipline, seeks significant tax increases for the wealthy, higher corporate taxes, the establishment of a basic income and a labor reform to eliminate some of the more neoliberal provisions of Rajoy's 2012 labor reform. This is the first coalition government and the first time in which the Communist Party is part of a coalition government since the 1930s. It comes to power with a very slim and fragile majority in Congress (it won the tightest of investiture votes in history—167 vs. 165) and at a time in which the country has slipped back to the polarization and personal animosity that had characterized other dark periods of Spanish modern history (Fig. 8.4).

Yet, the 2008 crisis has resulted in significant shifts in the business sector and the economy as a whole (see Table 8.2), and prospects for the country seem positive despite challenges. On the one hand, the last election that took place in November 2019 produced an inconclusive result, unemployment remains stubbornly high at 14% (still about half the rate of

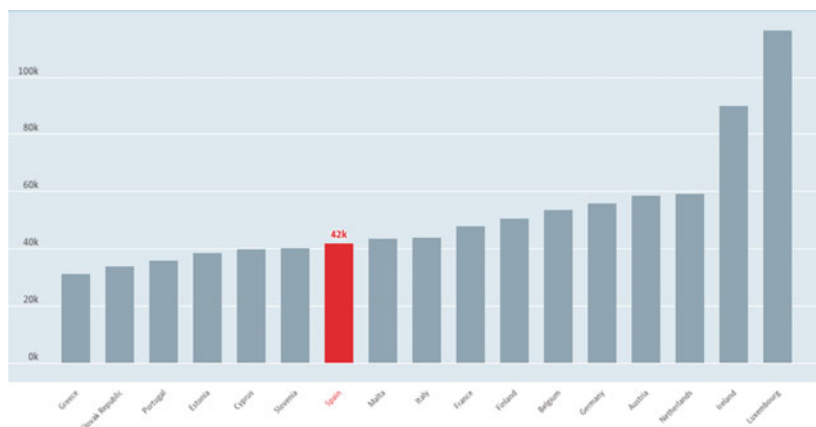


Fig. 8.4 Gross Domestic Product (GDP) Total (US dollars/capita, 2019) (Source OECD. Aggregate National Accounts, SNA 2008 [or SNA 1993]: Gross domestic product)

Table 8.2 Economic performance Spain. 2014–2020

<i>Subject Descriptor</i>	<i>2014</i>	<i>2015</i>	<i>2016</i>	<i>2017</i>	<i>2018</i>	<i>2019</i>	<i>2020</i>
GDP, constant prices. % change	1.4	3.7	3.2	3.0	2.6	2.2	1.8
GDP, current prices. US dollars	1379.1	1199.7	1238.0	1317.1	1427.5	1397.9	1440.4
Total investment. % of GDP	19.5	20.4	20.4	21.1	21.9	22.2	22.3
Gross national savings. % of GDP	20.5	21.6	22.7	22.9	22.9	23.1	23.3
Inflation, avg. consumer prices. % change	−0.2	−0.5	−0.2	2.0	1.7	0.7	1.0
Volume of exports of goods and services. % change	4.3	4.2	5.2	5.2	2.3	2.4	3.3
Unemployment rate. % of total labor force	24.4	22.1	19.6	17.2	15.3	13.9	13.2
General government structural balance. % GDP	−1.9	−2.4	−2.8	−2.5	−2.3	−2.3	−2.3
General government gross debt. % of GDP	100.4	99.3	99.0	98.1	97.1	96.4	95.2
Current account balance. % of GDP	1.1	1.2	2.3	1.8	0.9	0.9	1.0

Source International Monetary Fund, World Economic Outlook. October 2019
 Estimates after 2018

the peak of the crisis), job security is still an issue with more than a quarter employees on temporary contracts, the quality of many jobs and the level of some wages leave much to be desired, and the country is already experiencing lower rates of growth: The economy is no longer expanding at the 3% rate of 2015–2016, but is expected to reach about 2% in 2019, still above the EU average, which has already slowed down job creation from an annual rate of 3.2% earlier in 2019 (596,900 new additional jobs) to 1.7% by the end of the year (346,300 jobs). Still, the main concern is the dysfunctional state of the country's politics: The dispute between Catalan separatists and the rest of the country remains tense, and four elections in four years have produced inconclusive results and weak governments that have not lasted long. Political fragmentation seems entrenched: The fourth general election in as many years resulted, yet again, in an inconclusive result in November 2019 that made the formation of a stable government even more difficult.

However, there were good reasons for optimism prior to the COVID-19 crisis.¹⁶ Following the 2008 crisis, Spain moved away from an economy that was overly dependent on residential constructions and adjusted magnificently to an export-oriented economy. Indeed, despite political uncertainty, innovation and exports were flourishing and the country was experiencing an expansionary cycle with a positive current account cycle (something quite exceptional in recent history as Spain experienced current account deficits of over 10% prior to the crisis). Indeed, Spain is still benefitting from its extensive connections abroad, particularly in the EU and Latin America, and it is capitalizing from cost advantages compared to other Western European countries, as well as from an impressive infrastructure network that includes the EU's most extensive high-speed train, motorway, and fiber-optic networks. The crisis led a massive deleveraging of the private sector and the reforms that followed the crisis (including a labor reform that further liberalized the labor market and shifted away from sectoral wage bargaining) have resulted in competitiveness gains driven by lower costs and wages (labor costs are between 20 and 40% below France, Germany, and the UK, the outcome of a brutal internal devaluation) (see Fig. 8.5), which have led to a surge of exports (cars, chemicals, industrial equipment, food products) in the last decade, from 22% of GDP to 35%. While Spanish workers bore the brunt of the crisis, salaries are finally growing again: In 2019, salaries negotiated in collective bargaining agreements have grown 2.3%, public salaries have also increased 2.5%, and the government increased the minimum wage of 22.3% to 900 euros (the highest increase since the establishment of democracy in the country). All this has led to an average wage increase of approximately 2% (1876.95 euros).

The new leftist coalition government, which came to power in Spain in January 2020, is in uncharted territory, as the country has never had a coalition government since the transition to democracy more than four decades ago, plus they do not have enough votes in parliament and will need to support from other parties to pass legislation. Moreover, its leftist agenda has raised some alarms among markets and investors. The two parties have agreed to higher taxes, swifter reductions in carbon emissions, and a return to sector-level collective bargaining (from firm-level

¹⁶ See "Companies Ride Out Political Turbulence," *Financial Times: Spain Business and Innovation*, Tuesday, December 10, 2019, pp. 1–2.

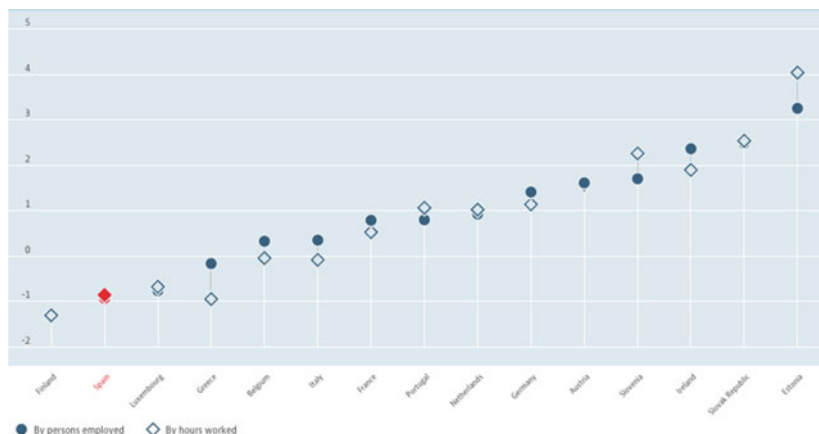


Fig. 8.5 Unit labor costs by persons employed/by hours worked, Percentage change, previous period, 2016 (*Source* OECD. Labor: Unit labor cost—quarterly indicators—early estimates)

wage bargaining). The government is also committed to engage in dialogue with the pro-independence Catalan leaders (in exchange for the most pragmatic of Catalonia’s secessionist parties, *Esquerra Republicana de Catalunya*, ERC’s abstention in the investiture vote) to try to ease tensions and mend divisions (for which he has been accused of treachery by the Conservative parties). Yet, there are concerns that these policies will deny Spanish companies the ability to adapt swiftly to new market conditions and opportunities, and that raising corporate taxes of bigger groups may deter the investment that the country desperately needs to raise productivity (although the recent data in productivity growth is promising, see Fig. 8.6). Finally, the new government faces significant fiscal constraints as public debt is hovering at around 100% of GDP, and it comes to power at a time when the Spanish economy has cooled and it has to reconcile its spending promises with the EU demands for Spain to rein in its structural deficit (and it lacks a majority in parliament to pass a budget). The implosion of the COVID-19 crisis, which took place as this book goes to the publisher in March 2020, with its devastating costs in lives as well as its social and economic consequences, will make things extraordinarily harder.

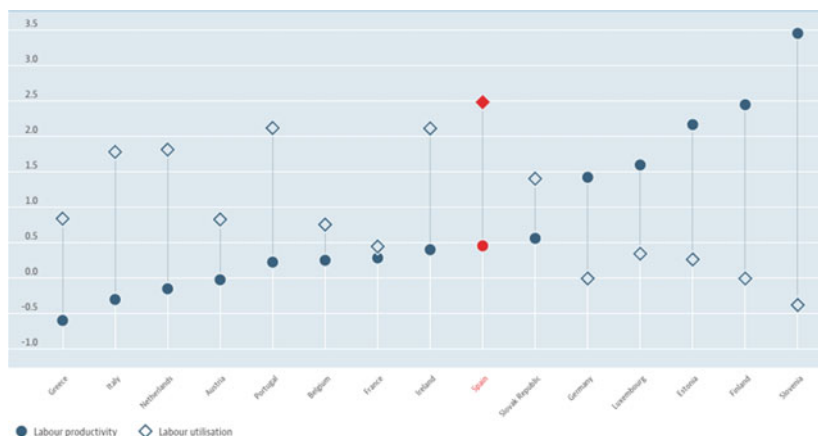


Fig. 8.6 Labor productivity and utilization. Labor productivity/Labor utilization, Annual growth rate (%), 2016 (*Source* OECD Productivity Statistics: GDP per capita and productivity growth)

However, the recent experience of Portugal shows that a government committed to reform and fiscal discipline can turn around investor sentiment. Indeed, while the degree to which the Portuguese Socialist government that came to power in November 2015 overturned austerity was not dramatic, small policy changes that sought to combine fiscal discipline with a fairer distribution of the economic costs and benefits were enough to restore market confidence and increase growth because they lifted confidence, the great driver of economic recovery, thus propelling economic activity. Prime Minister Costa challenged the prevalent austerity dogma based on the imposition of deflationary policies that ended up deepening recessions and increasing unemployment and the probability of defaults. His policies have shown that it is possible to respect common rules on deficit and public debt, while achieving a fairer distribution of economic benefits and promoting economic growth to reduce unemployment and increase people's incomes.

THE IMPLICATION OF *BANK BARGAINS* FOR DEMOCRATIC POLITICS

At a time in which there are growing calls in many countries for further deregulation and the undoing of some of the safeguard mechanisms that emerged after crisis (dynamic provisions, greater capital requirements, resolution mechanisms, stronger supervision, the Volcker Rule...), it is important to emphasize again the crucial role of *bank bargains* in banking systems. Not only governments have been historically the largest demanders of credit, but they also define the property-right systems that structure banking; establish and regulate banks; enforce credit contracts; and allocate losses among creditors in the case of bank failures. This book has emphasized the political deals that determine which banking rules are passed and which groups are in charge, and it has shown that banking systems are the result of a partnership between governments and bankers that is shaped by the institutions that determine the distribution of power in the political system. The supervision and regulation of banks may be based on technical criteria, but those criteria are the outcome of a political process of deal making, Calomiris and Haber's *Game of Bank Bargains*. While the rules that determine who is part of the government-banker partnership are set by political institutions, coalitions among the actors determine the rules governing bank entry, access to credit, and the allocation of profits and losses. And these decisions are not merely technical decisions based on some efficiency criterion, but rather the outcome of political deals that are guided by the logic of politics (Calomiris and Haber 2014, p. 13) and had substantive economic and political consequences.

Democratic governments in Western Europe and the United States responded to the 2008 *Great Recession* by bailing out failed financial institutions, and most of them did it while they were implementing severe austerity policies that were exceptionally painful for millions of their citizens. And this happened while there was limited accountability (if any) against the leaders of those financial institutions who were also responsible for the crisis. These governments' inadequate responses to that crisis have had disastrous social, economic, and political consequences, and it has made the allocation of losses among creditors in the event of bank failures one of the most contentious issues of the day and a challenge to our democratic politics. To this day, we are still suffering the consequences of those decisions.

The crisis provided a window of opportunity to address the self-interested policies that had led to such catastrophic consequences for many banking systems (and their citizens!). But we seem to have quickly forgotten the terrible consequences of previous policy choices. It is important to emphasize the political nature of this process because at this precise time, powerful self-interested coalitions in countries across the world are looking for opportunities to reversing the safeguards established after the crisis and lower, again, underwriting standards.

Indeed, while in the nineteenth and early twentieth century governments responded to systemic banking crisis with either minimalistic policies or simply stayed aside, the increasing financialization of the last few decades has led to governments' public-funded bailouts in the most recent financial crises of 2007–2008. As Chwiero and Walter (2019) show, democratic institutions have not been able to constraint governments' propensity to implement taxpayer-funded rescues of the financial system, which now seem to have become the norm. According to them, this may reflect the evolving interest of middle-class voters, who are exercising pressure from below and 'forcing' governments to implement those bailouts to ensure electoral success.¹⁷ This era of growing financialization has increased the middle class's expectations that their governments will act to protect their wealth, which has enlarged the constituency supportive of bailouts.

However, the most recent crisis has shown the limits of this approach as governments have been finding it increasingly difficult to meet the demands of that middle class (whose investment interests largely align with those of the elites) for costly taxpayer-funded bailouts while mitigating the impact of the crisis on the majority of the population, because these bailouts have had an asymmetric impact on the distribution of wealth. They contribute to larger fiscal deficits (and to less resources to support those adversely impacted by them) and to rising economic volatility and lower growth (Reinhart and Rogoff 2009, pp. 145–47). Moreover, they inherently increase moral hazard and in turn foster greater financialization and leveraging, thus making financial system more fragile.

¹⁷ Yet, less than 14% of American households own corporate stock directly and the middle class only owns 8% of all stock (by comparison, the top 1% owns almost 40%) (Wolff 2017; Holmberg 2018); and the share the middle-class shares are decreasing even as incomes overall are rising in most Western European countries at the U.S. (Kochhar 2017).

The result of the crisis (amplified by the continued impact of globalization and technological change) has been rising inequality, job losses, and lower quality of jobs. The entrenched perception among millions of citizens is that these bailouts have left middle class and poorer households relatively worse off. All this, in turn, has been turning citizens against traditional parties (particularly leftist parties who have intervened in favor of the financial sector, as it happened to Zapatero's Socialists in Spain, see Rodríguez Zapatero 2013) and democratic institutions, and has contributed to the growth of populism and anti-system parties across the world (Pappas 2019). This presents a growing dilemma for our democratic politics because financialization and financial instability are likely here to stay.

Growing populism has not been a unique Spanish development. On the contrary, it has become a global phenomenon emerging all over the world. As we have seen, the *Great Recession* was a return to zero-sum politics, and one of its main consequences was the erosion of collective interest, solidarity, and cooperation, as well as the re-emergence of a new age of nationalism. The new politics of the day have been mostly marked everywhere by transactional arrangements and not enlightened self-interest. While societal upheaval was driven by social change, as well as technological and economic disruptions, the crisis led to the growth of populism because the traditional elites did not have effective solutions. Indeed, the liberal regimes failed to address the economic and social consequences that arose from liberal policies like tax cuts, deregulation, or fiscal consolidation. Those policies resulted in financial instability, inequality, deteriorating living conditions for low income people and stalled social mobility and wages across the world. And the response from the traditional elites to the crisis was largely austerity *rather* than accountability. Indeed, their obsession with austerity only intensified the resentment and the anger against the elites and their policies. That sense of insecurity was intensified by immigration, as well as low trust and low expectations for the future. All this provided a fertile ground for the emergence of populism in Spain and elsewhere.

What can we learn from this experience? History has shown that the main political drivers for people are fear and hope. Indeed, history moves by stories of identity, sovereignty, and self-respect, not just economic factors or rationality. While technological changes and automation have been crucial in the dislocations experienced by our societies, the growing inequalities are fueling a fury that is seeking someone to blame: elites

and immigrants; and the *Great Recession* has made social, economic, and geographical disparities and living conditions intolerable. Foa and Mounk (2016) have shown that as inequality rises, citizens are less likely to believe that their government is democratic, which undermines the legitimacy of the system. There is an enormous fear of losing control over the future and losing status vis-à-vis one's neighbor, which generates a backlash. At the same time, the traditional monopoly of elites over access to elected office has been eroded by new technologies that open up communication and fundraising (Levitsky and Zibblatt 2018). Finally, we need to heed the lessons from the past: As Paxton (2004) has eloquently shown, the rise of extremism in Europe was aided by businesses worried more about the possibility of wealth redistribution than about the threat of political extremism. Indeed, fascist parties would not have been able to approach power without the complicity of Conservatives willing to sacrifice the rule of law for security. That trade-off was disastrous and cannot be repeated. Passivity against current challenges is not an option.

We are living in a context in which the politics of destruction are increasingly defined by opposition: to the status quo, to the establishment, and to the other side. There is growing polarization, partisan rancor, intransigence, tribalism, distrust of institutions, and destructiveness across the world; and more instability driven by fractures within political parties, fragmentation, and elections that reject incumbents. This is all leading toward a growing tear-it all-down ethos characterized by *negative partisanship* (Abramowitz and Webster 2016) in which people vote based on fear and distrust of the other side, rather than support for one's side. This empowers those who want to destroy the other side and make crisis of governability more common, thus making the sense of political powerlessness more pervasive. In this context, outrage and distrust dominate our politics.

In this challenging environment, *how do we respond to the populists' fears?* Two important lessons from the past decade are that moderation and gradualism will not be enough, and also that institutions alone will not contain this threat. We must address urgently and effectively the forthcoming challenges, such as the threats (and opportunities) that will arise from artificial intelligence; the increasing inequality and poverty; racism; or the economic dislocations of climate change. And all this will be much harder after the extraordinary dislocations and pain caused by the COVID-19 crisis throughout the world (in Spain in less than a month, the crisis had led to the destruction of 304,000 jobs!).

This will require credible plans to address the security and economic concerns of our citizens. And in order to deliver and implement them, we need to overcome the growing fragmentation and polarization, and take effective action. For this, we need a politics built on hope to fill the vacuum, and we also need to develop a positive narrative that focuses on opportunities to address the fears of the day. In sum, we need to offer real solutions to citizens' problems that will allow our citizens to regain their confidence, while embracing diversity and the larger identities that emerge from engaging with one another.

In order to escape this dilemma, we need to engage the public at large to regain faith in our democratic institutions and ensure that they fulfill their solemn obligation to the public interest. This is something that we seemed to forget in Spain in the previous decades when our institutions rather than constraining the vices and treacheries of people within them seemed to encourage it and mask it. This institutional dereliction converted many Spanish institutions into platforms for prominence and enrichment. Instead, institutions must play a formative role shaping the people who populate them to serve the public interest and be trustworthy. And we need to leave behind the tendency to look to the other side and/or blame others, because we all have a role to play in our institutions to ensure they are trustworthy. Rather than using them for our own personal gain, we need to serve them to rebuild the bonds of trust that are so crucial to our societies.¹⁸ We also need to build new institutions that can integrate all citizens into decision making.

Finally, in the financial realm, which is the main focus of this book, we must learn from previous crises and work to bolster support for democratic institutions that shape partnerships between governments, bankers, and citizens that will limit the emergence of populist coalitions that have proved to be so detrimental to the establishment of stable banking systems, and that will rather work to establish robust banking regulations that avoid banking crises and implement policies that will make countries less vulnerable to crises. This is not an impossible task or a lost cause. Countries such as Canada have been able to do it. We should hope that participants in the game identify ways to build better-suited coalitions and institutions to make beneficial changes happen. Too much is at stake.

¹⁸ See Yuval Levin, "How We Lost Faith in Everything," *The New York Times*, January 19, 2020, p. 4.

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