

Spanish Banking Crisis That led to the Spanish Sovereign Debt Crisis during the Period (2009-2014)

Dina M. Mitkees

PHD student, Faculty of Economics and Political science, Cairo University



ABSTRACT

The problem of the research confined to analyze how the Spanish financial crisis led to the sovereign debt crisis. As Spain recently experienced the worst financial situation since it joined the EU. This paper analysis how the Spanish banking crisis caused by high exposure to construction sector during the housing bubble that turned to a sovereign debt crisis as consequence of both the Global financial crisis and the EU debt crisis. As the Spanish government interfered to save its financial sector so government debt increased to an extent it became difficult to manage. Then the paper explains how the crisis was handled by the Spanish government and EU institutions and the consequences of the reforms implemented by the Spanish authorities. As major banking reforms were implemented for both commercial and saving banks This study aims to identify the major deficiencies in the Spanish economy that led to the financial crisis and the action taken by the Spanish authorities that led to the sovereign debt crisis and how the crisis was handled. Lesson learned from the study that banks should not concentrate their portfolio in one sector, and central banks should intensify their supervision to the banking activities and governments should adopt balanced economic growth strategy driven by diversified sectors

INTRODUCTION

Spain is considered one of the major economic player in the world economy. It is classified among high income countries, the fifth largest economy in the EU and fourth in Eurozone. It has long history in adopting disciplined fiscal policy. It did not face any obstacles in meeting the convergence criteria for entering the Eurozone.

By 2008 when the financial crisis broke Spanish fiscal position was excellent even compared to Germany and France the largest Eurozone members. Its budget was running surplus of about 1.9 as a percent of GDP.

However, after 2008 global financial crisis and the housing bubble started to burst in the whole world major problem in the Spanish banking sector started to show significant signs. The problem in the Spanish banking sector are deeply rooted in the financial imbalances built up over the years and appeared once the global economies were vulnerable.

The banking sector expanded their credit to construction sector depending on easy money provided from Eurozone countries, so once they faced a financial problem Spanish government took radical actions to restore confidence in its banking sector that turned the banking debt problem to a sovereign debt problem. The paper content will be divided as follows: first section explaining the origin of the crisis and show how it was turned from being a banking debt problem into a sovereign debt crisis second section focus on action taken by the Spanish government to address the crisis the third concludes by summarizing the lesson learned from the crisis.

Objective of the research

Analyze the origin of Spain's debt crisis and how it was transmitted from banking sector to be government debt by answering the following questions

- 1- What are the major deficiencies in the Spanish economy?
- 2- How the crisis was handled and the stakeholders involved?
- 3- What are the suggested future preventive measures that should be taken?

Research Methodology:

The paper adopts the quantitative analysis methodology and post-positivist knowledge claim as data about the debt, inflation, deficit and bailout package will be collected and analyzed

Research Hypothesis:

The paper test the following two hypothesis:

- 1- Lack of banks supervision in Spain is one of the main deficiencies of the Spanish financial system
- 2- Spain crisis was a direct consequence of the Global financial crisis and EU debt crisis

Section one: Origin of the financial crisis in Spain

Spain for 14 successive years starting from 1994 had achieved excellent fiscal position with average annual growth rate of 3.7%. This happened for two main reasons: Joining the euro zone produced dramatic fall in interest rate, so investment and growth extremely expanded. Also, this was accompanied by expansion in the construction and tourism sectors and hence attracted 3.6 million immigrants during the period of (2000-2007) of which most of them were at the working age which enhanced the growth of GDP.

Even by the end of 2007 when the global financial crisis was showing signs, Spain was enjoying government budget surplus of 1.9% of GDP, however in reality, the case wasn't that perfect for Spain's economy. The global financial crisis hit the world's economy in 2008, then debt crisis started to attack the euro zone economies. The drawbacks of the internal financial imbalances in the Spanish economy started to appear.

The main financial imbalance in the Spanish economy was led by increasing the average annual inflation rate which was 2.7% during the period of (2000-2007) although the 3.7% average growth rate during the same period. As this growth rate wasn't expected compared to the projected growth rate which was 3%. Also the rate of inflation in Spain at that time was higher than the average euro zone's rate which was 1.8%. This relatively high rate of inflation coincides with low interest rate applied by ECB led the real interest rate for Spain to get close to zero.

Given the relatively higher inflation that was accompanied with average households wages increase together with prevailing zero real interest rate it had made the perfect timing for household to buy houses especially with the increasing inflow of immigrants who need to buy houses. As a result the annual increase in mortgage reached 32% at the time where real GDP was growing by 6.5% (mortgage was growing almost 5 times as much as the GDP growth rate)

inflation rate in Spain

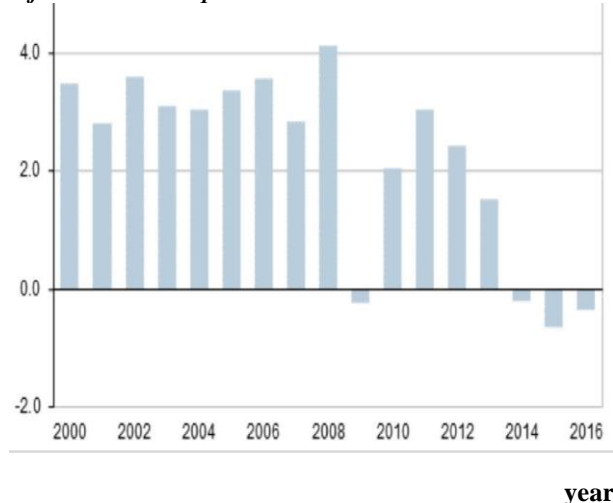


Figure1. Inflation Rate in Spain
Source: www.Focus- economics.com

Also, there was large speculative investment flow in houses. Speculators were buying houses before it was built and selling it when it was finished, as of this the Spanish investors generally earned a huge return however they heavily contributed to the housing bubble. So, the obvious consequences were booming in construction sector reaching 16% of GDP, employing around 20% of total employment (Dehesa, 2012, pp109-125).

Actually, The Spanish government did not work on slowing down the construction development trend for several reasons namely 1) construction sector development is labor intensive activity so they can reduce the problem of unemployment and preserve the public support for successive governments 2) construction sector became the main source of tax's revenue.

The problem transmitted to the banking sector through credit finance to both construction sector which witnessed average annual growth 24.6% during (2004-2007) period and the overall real estate sector which witnessed average growth 43.1% during the same period

Prices of houses in Spain witnessed unprecedented increasing trend from 90's until 2007 the average housing prices in Spain rose by 115% during the ten years before 2007 thereafter the housing bubble started to burst gradually from 2007-2010 which was directly reflected on high rate of non performing loans in the banking sectors since they are highly exposed to construction and real estate sectors.

Until 2010 the problem facing Spain was banking financial while other European countries were experiencing sovereign debt crisis .At that time Spanish public debt was 65.1% of GDP far below Eurozone average that was 85%. However the main issue was centered on the huge private debt level that reached 224% (Cruz 2011, PP313-318).

Spain debt in 2009 reached Euro5274 bn which represented 502% of GDP of which external debt represent 165% of GDP compared to the public debt that limited to 13% of the total debt. The Spanish government found that there is no option to preserve the financial market stability and avoid economic turmoil but to bailout banks and enhance its capitalization capacity which led to the sovereign debt crisis in Spain later on .Spain debt was over 100% of GDP (Lane,2012, p55)

Spain Debt

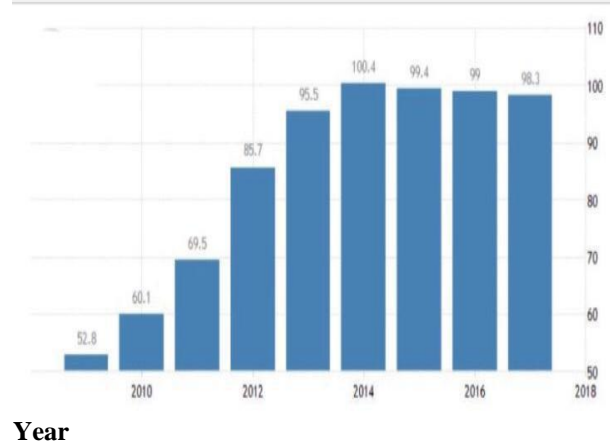


Figure 2. Spain government Debt
Source: www.Statista.com

Section 2: Action taken by Spanish government to handle the crisis

Spain's financial crisis is a unique case for two main reasons:

First: Spain's GDP represents on average 8% of European union total output so any financial problem occur to the Spanish economy will threaten the whole EU economies.

Second: Spain has a history of adopting disciplined fiscal policies that maintained its public debt level prior its financial crisis within the range of 60% of GDP that was stated in the growth and stability pact.

The main issue at that time was burst of the housing bubble so Spanish government was obliged to spend large amount of money for bailing out the Spanish banks while at the same time its public revenues deteriorated because of the burst of the housing bubble the main source of taxes revenues. So Spanish government started to experience budget deficit as shown below public debt had accumulated since then.

Evolution Spanish Government Balance. Surplus (+) / Deficit (-)

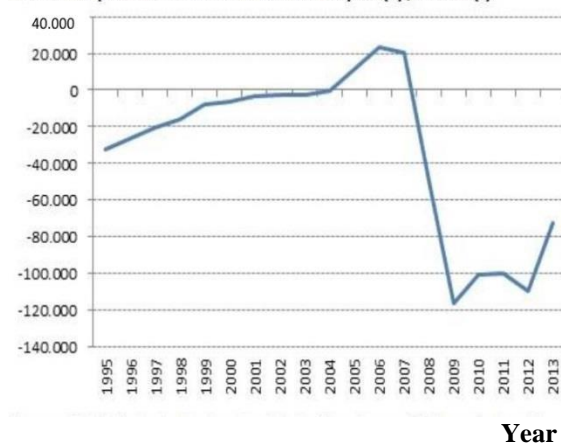


Figure 3. Spanish Government balance
Source: www.economichelp.org

The option of bailout to handle the Spanish sovereign debt crisis was at the beginning excluded totally by the Spanish authorities because Spain was perceived too big to be bailout. However world experience of handling debt crisis has shown that in such cases asking for bailout is indispensable. Spanish government adopted the following strategy to handle the crisis; firstly, it began by

embarking austerity policies and measures, secondly by adopting banking reform program that it was the main reason for the financial crisis, thirdly while reforming its bank Spanish government found that it has no option but to ask for a bailout to prop up its banking sector which was supported with more strong banking reforms, In the light of this the paper will discuss the strategy of the Spanish government to handle the crisis by adopting stringent reform packages as follows:

- 1) Austerity measures & Structural reforms
- 2) Banking reform before asking for assistance.
- 3) Banking reform strategy after receiving bailout package.

1) Austerity measures & Structural reforms:

Spain used to adopt expansionary fiscal policy till 2009. however, such policy became no longer applicable starting from 2010 and beyond, Since then several austerity measures were implemented to bring budget deficit down to 6% by 2011, Notwithstanding the target wasn't achieved as deficit increased to reach 8.5 % of GDP in 2011 therefore more measures were adopted .Spanish government took several actions to formalize its strategy regarding fiscal discipline. In September 2011, the Spanish parliament approved a reform of Spanish constitution to strengthen the principle of budgetary stability consequently in April 2012 budgetary stability law was passed and accordingly an independent institution was created "Independent fiscal responsibility Authority" (AIREF). Its role is advisory and monitoring the government's compliance with the principle of budgetary stability. The above mentioned actions reflected the Spanish government long term strategy toward achieving rational fiscal policies as amendments embodied in the constitution itself as long lasting actions to handle the crisis.

Actions were taken in the following areas, The value added tax(VAT) was increased from 16% in 2010 up to 21% in 2012 together with increases on the income tax targeting high income groups, actually VAT and income taxes were the main source of government's revenue. On the expenditure side, government took very aggressive action in regard of cutting spending on a public service. Spanish government adopted number of initiatives to reform public administration with an aim to eliminate duplication among tiers of public administration and to simplify the relevant process.

Pension system reforms also took place. Spain like most of the European countries has a demographic aging problem where the average high ages of its citizens is growing steadily .The aging population is considered a burden on its spending. In this regard reforms took place were first to increase retirement age from 65 to 67 years. In addition to passing a new law to link pensions increases with certain index based on number of criteria such as life expectancy, inflation and the balance(deficit or surplus)of social security system (Marti, Perez,2016, pp13-20).

Labor market reform took place as Spanish labor market had an old reputation of being very protective for old workers who are very highly paid. The case is different for younger generations several reforms took place like reducing compensation of objective dismissal, the extension of workers that can be hired through contracts of employment promotion with greater ease and lower cost of dismissal in

addition to the introduction of new restrictions on temporary hiring (Croz, 2011, p.322).

2) Banking sector reform before asking for financial bailout assistance

There was general consensus among experts in Spain concerning the need of banking sector reform however, actions weren't taken on timely order to avoid the occurrence of the financial crisis.

The Spanish authorities had worked on that direction first on its own initiative before bailout package to reform both commercial and saving banks. Among the major actions taken by the Spanish authority was the creation of fund for orderly bank restructuring (FROB), was created with an aim to supporting troubled entities to avoid the use of public resources.

Other measures were taken to regain market confidence in the Spanish banking system, in this regard reform of saving banking law was approved in 2010, several measures were taken to increase transparency, bank of Spain raised the minimum capital requirements up to 10% for risk weighted assets, and increasing provisioning requirements for real estate loans. Several merger and acquisition took place. As the aim of the Spanish government was mainly reorganization, recognition of losses and capitalization. In order to do so, banking industry recognized losses in assets equivalent to 9% of GDP, so specific and general provisions were established amounted 69,000 million Euros and in order to achieve their aim of re capitalization, capital increased by amount equivalent to 3.7 of the GDP through the available reserve of the country (Croz,2011, pp320-322).

Actually, the amount needed to achieve the required reforms was beyond the Spanish authority's capability. Therefore they asked for assistance because it became no longer an option,

3) Banking reform strategy after bailout package

In June 2012, Spanish government requested for EU financial assistance of 100 bn Euro to recapitalize its banking sector was approved, however, the actual disbursed amount was 41.5 bn Euro (Marti, Perez, 2016, p.14).

The approved package was granted through the European stabilization mechanism under this scheme European Commission is allowed to raise up to 60 Billion Euros on the money market at low interest rate by issuing bond using the EU's annual budget as collateral, So as to lend highly indebted EU countries. This mechanism could be activated without the approvals of the parliaments in addition to European financial stabilization facility which have up to Euro 440 BN available for EU troubled members (Lapavitsas *et al*, 2012, p108).

The approved financial assistance was concluded after signing what was called memorandum of understanding (MOU).The main conditions stated in the MOU were:

- The identification of individual needs of capital after complete bank by bank stress tests.
- The recapitalization, restructuring or resolution of weak banks.
- Reform of supervisor's framework of financial sector.
- Legal framework allows banks with problematic real estate related assets (REDS) to segregate those assets

to external asset Management Company for asset arising from the bank restructuring (SAREB). (Carlos *et al.*,2019)

A) Commercial banks reform

Actually, in September 2012 as planned independent stress test of the Spanish banks' balance sheets was conducted and identified 10 banks that are facing capital shortfall according to the set of benchmark. The amount of capital shortfall that was identified totaled 56bn Euros. Public capital injection filled 70% of the amount, 23% was filled by bailing out junior debts and 6% by private capital injection.

A new law was adopted in August 2012 in order to strengthen the state power to recapitalize, restructure and resolution of troubled banks in a way that minimize the burden on tax payers according to the law authority can interfere quickly in troubled bank. FROB for example can recapitalize troubled bank through emergency procedures and transfer problem assets to asset Management Company. In addition, FROB was given temporary power to impose losses on holders of hybrid capital of banks that accessed public financing emphasizing burden sharing concept in order to reduce fiscal cost.

Supervisory power of Banco de Espana (BdE),(Central bank of Spain) it was strengthened by gradual transfer of sanctioning and licensing power to it. In addition of BdE intensified its effort regarding continuous onsite monitoring to all Spanish bank.

Regarding segregation of state-aided banks REDS(Real Estate development loans) and foreclosed assets. These assets were transferred to SAREB amounted in number 200,000 with asset value of 51 bn Euro in exchange for government guaranteed senior bonds with the aim of providing liquidity to those banks as SAREB's bonds can be used as collateral either in Spanish financial market or European market. In addition, segregation of such assets enables the management of state aided banks to focus on core business and avoid future mistakes (IMF, 2014, pp8-15).

B) Saving banks reform

Although banking sector as a whole witnessed series of drastic reforms as mentioned before according to MOU. Saving banks in particular witnessed more stringent reforms.

Before discussing the saving banks reforms, The paper will start by giving an overview of the history of saving banks in Spain and how they turned to be the core of the current crisis and hence to understand the logic behind the taken actions.

Saving banks were organized in the 19th century in Europe to hold fund of individuals' depositors in interest bearing accounts and to provide long term investment. Spanish saving banks is known as cajas. History showed that saving banks in Spain were very disciplined in running their activities. As they specialized in mortgage loan and short-term personal loan their source of fund comes mainly from time deposits and accumulated reserve they never used to depend on domestic or international markets to finance their assets strictly stuck to the principle of territoriality, so they never asked for rescue operation even when crisis affected commercial and investment banks between 1800-2000.

So, if this was the case, why saving banks started to deviate from the model they were adopting. Since the late 70's they started to liberalize their range of activities. They were allowed to open branches all over the country, the territoriality principle was no longer valid. Several changes occurred like increasing the number of government representatives in the board members. Political parties and trade unions were controlling the governing bodies. Therefore appointment of senior executives witnessed corruption and nepotism.

The crisis occurred when they started expanding their activity in a way that removed all differences between saving and commercial bank. Number of branches almost tripled between 1979-2009. Total credits granted by saving banks quadrupled between 2001-2007. Which was directed mainly to building and construction sector. Share of granted loan to those sectors was 50% of their portfolio. To finance such expansion their own resource became insufficient so they resorted to the international financial market. Moreover, they were engaged in securitization activity to refinance mortgage portfolio, so when the bubble burst financial crisis occurred. The first sign of saving banks problem was in March 2009 when bank of Spain rescued the first saving bank Caja De Castilla.

Several actions were taken since 2009 to limit the activities of saving bank in order to handle the current crisis and to return back to their previous model or to shift to be ordinary commercial bank. First in order to handle the crisis FROB in July 2009 put into motion consolidation process. Accordingly, 43 out of 45 saving banks have been part of the process. Institutional Protection Scheme (IPS) was followed in the merging process. According to IPS saving banks maintained their legal personality and retail business but they had to sign long term agreement for the creation of a central unit and strong mutual solvency guarantees between members. The outcome of the consolidation process was 22 saving banks were involved in formation of 5 IPSs, number of branches reduced by 43.9% and work force reduced by 38.6% (Acena,2013, pp85-94). second in order to limit the activities of saving banks in the future and to bring it back to their original functions in accordance with the banking foundation law saving banks will limit their activity to one autonomous region or maximum 10 neighboring provinces, their activity will be limited to deposit taking and lending, neither political parties members nor trade union and professional associations' members are allowed to be members of management body of saving banks. Moreover, any saving bank holding assets over 10 billion Euros or preserve market share over 35% of its autonomous region shall transfer its financial activity to a credit entity (Carlos *et al.*, 2018, p.5)

Spain exit bailout program with signs of recovery

In January 2014 Spain graduated smoothly from bank bailout program. With good signs for recovery foreign investors started to restore their confidence in the Spanish economy with risk premium below 200 basis point, economic growth expanded by 3% in 2015, Austerity measures started to be eased, deficit decreased by 1% in 2014, employment risen strongly by 2014 but was still 14% less than pre-crisis (Tilford,2015, pp2-6).

CONCLUSION

Spain was doing fine during prosperity years but the recent crisis showed main deficiency in Spanish economy that should be taken into consideration for any country seeking to achieve economic growth. This deficiency represented in depending on construction sector only as a driver for economic growth and main source for taxes' revenue so when the sector faced crisis the whole country became in trouble.

In Addition banking sectors was very highly exposed to construction sector without appropriate supervision which led to major turmoil in the whole economy, the cost of handling the crisis was huge and it was not affordable by the Spanish government, so it was obliged to ask for assistance from the EU to be directed for special purpose which is banking reform. EU was keen on saving Spain as it is the fifth largest economy in the EU so any vulnerability in the Spanish economy threaten the whole union .

Spain by 2014 managed to graduate safely from bailout program with good sign of recovery but still with very high unemployment rate and government debt around 90% ore effort should be done in order to achieve economic growth based on diversified sectors with competitive advantage to be able to compete within the EU.

Learned Lessons

- 1-The unbalanced growth of credit to certain sector leads to concentration of risk which expose the banking sector to vulnerability that affect the whole economy.
- 2- Central banks should intensified their supervision to the banks' activities in order to preserve diversification of risk to avoid exposing the countries to financial turmoil. Not to depend on self-regulation policy, close monitor to

bank's activity should be implemented.

- 3- While trying to achieve economic growth countries must adopt balanced strategy driven by diversified sectors to avoid such intensified risk. Spain must work on creating its own competitive advantage aiming to adopt export oriented growth approach to benefit fully from being an active member in the EU

REFERENCES

- Acena, Publo (2013) "The saving banks crisis in Spain when and how", world saving and retail banking institute, Bruxelles
- Carlos etal (2019) "The banking regulation review"
- Cruz, Francisco (2011) "Cause and consequences of the Spanish economic crisis: why recovery is taken so long?", university of Minho, Portugal
- Dela Dehesa, Guillermo (2012) " Spain and the Euro area sovereign debt crisis" in cline R. and Wolff B. (eds) resolving the European debt crisis, versa press, Washington Dc, pp 109-130
- <http://Thelawreview.co.uk/edition/the-banking-regulation-review-9/1168403/5>
- IMF (2014) "Spain: financial sector reform-final progress report" IMF country report No 4/59
- LaneR., Philip (2012) "The European sovereign debt crisis" Journal of economic perspective, volume 26 no 3, American economic association
- Lapavitsas *et al* (2012)"Crisis in Euro Zone",Verso,London
- Tilford, Simon (2015) "Gain or more pain in Spain?" Center of European reform, UK
- www.economicshelp.org
- www.focus-economics.com
- www.statista.com

موجز الدراسة أزمة البنوك في اسبانيا التي أدت الى أزمة ديون سيادية خلال الفترة (٢٠٠٩-٢٠١٤)

دينا محمد ميتكيس
كلية الاقتصاد والعلوم السياسية-جامعة القاهرة

تتصدر مشكلة الدراسة في كيفية تحول الأزمة الإسبانية من ازمه قطاع مصرفي الى أزمة ديون سيادية اسبانيا واجهت أسوأ وضع اقتصادي منذ انضمامها الى الاتحاد الأوروبي. في هذه الدراسة تم استعراض أزمة البنوك في اسبانيا بسبب التوسع في اقرضات قطاع الإنشاءات و التمويل العقاري حيث ان أسعار العقارات شهدت ارتفاع غير مسبوق و لكن مع اندلاع الازمه العالمية في 2008 ثم أزمة الديون في الاتحاد الأوروبي أخذت أسعار العقارات منحى تنازلي مما أدى الى وجود أزمة في القطاع المصرفي . تدخلت الحكومة الإسبانية بقوة لإنقاذ القطاع المصرفي الإسباني و لكن حجم الديون كان يفوق قدرة الحكومة الإسبانية على تحملها منفردة لذلك اضطرت لطلب مساعدة من الاتحاد الأوروبي لإعادة هيكلة القطاع المصرفي بذلك تحولت ديون البنوك الإسبانية الى ديون سيادية . و تهدف الدراسة الى التعرف على الاختلالات في الاقتصاد الإسباني التي أدت الى أزمة القطاع المصرفي التي تحولت فيما بعد الى أزمة ديون سيادية و الاجراءات التي اتخذتها الحكومة الإسبانية للخروج من الأزمة . و يستفاد من هذه الدراسة أولاً ان البنوك يجب ان تتوسع من محفظة القروض لتجنب تركيز المخاطر في قطاع واحد ثانياً ان الحكومة يجب ان تستهدف استراتيجية نمو اقتصادي معتمدة على عدة قطاعات ثالثاً على البنوك المركزية اتباع سياسه مراقبة أكثر حزماً لتجنب تعرض البلاد لمثل هذه الأزمات.