THE SPANISH ECONOMIC AND BANKING CRISIS UNDER THE SPECTRUM OF THE U.S SUBPRIME MELTDOWN AND THE SECOND GREAT CONTRACTION

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ABSTRACT

It is an undeniable fact that financial crises do not constitute a new "phenomenon". In contrast, they exist since the development of money and financial markets. In addition, the historical frequency of banking crises is similar in high- and middle-to-low- income countries, with quantitative and qualitative parallels during the run-ups and the post-crisis period. Undoubtedly, banking crises strongly weaken fiscal positions in both groups, with government revenues invariably contracting, and fiscal expenditures often expanding sharply.

In the last twenty years Spain has experienced a period of rapid growth followed by a very deep crisis. Until 2007, it was named '**the Spanish economic miracle'** and now it is the country with the highest unemployment rate in the EU which has to deal with innumerable difficulties. The present economic crisis has brought severe problems to the economy and society of the country which are proving to be intractable. Spain has become a very relevant part of the European periphery and its debt problems, especially external debt, is considered as a key element for today's policies. All this process has been developed around, and cannot be dettached from, Spain's integration to the European Union and the Eurozone.

So, the purpose of this essay is to put emphasis on the Spanish economic and financial crisis as a consequence of the subprime mortgage defaults in the United States (which will be elaborated in detail), as well as on the factors that characterize the crises-periods and their aftermath. The structure and the analysis of this essay is based especially on a comparative research which was carried out by Carmen M. Reinhart and Kenneth S. Rogoff, as well as on various scientific articles and books.

INTRODUCTION

Beyond a shadow of a doubt, the international economy suffers the impact of the worsening crisis, with most countries and regions showing a renewed backwardness of activity. On the one hand, the United States has followed a path of relatively sustained growth, but shown little capacity to create professions. On the other hand, budgetary adjustments and the process of public- and private-sector deleveraging in the Eurozone have pushed the countries of the periphery back into recession and led the area to stagnation. Finally, the emerging economies are characterized by growth but have been affected and move towards an economic deterioration.[1]

It is an undeniable fact that the banking crises constitute a vital "phenomenon" for analysis. Firstly, because they make their appearance both in advanced economies and in emerging markets and secondly because they are characterized by a unique permanence in advanced economies, as time goes by. In particular, beyond a shadow of a doubt various now-advanced economies have succeeded in graduating from serial defaults concerning sovereign debt or very high inflation. However, the graduation from banking crises does not always seem to be feasible and possible. Indeed, the advanced economies presented serial banking crises during 1800-2008. On the other hand, until very recently it was believed that for advanced economies systemic and multi-country crises were just a "memory" of the past, but in reality banking crises have equally affected rich and poor countries. This is clearly proven by the **Second Great Contraction**, the global financial crisis that had a strong impact on the United States and Europe. Consequently, it becomes clear that banking crises are similar in both high income and middle-to-low income countries. Nevertheless, the undesirable consequences of the financial crises tend to strongly influence the world's financial centers: The United States of America, the United Kingdom and France.[2]

Of course, the comprehension of the notion of the **economic crisis** would be substantial for the further understanding of the banking crisis analysis. In particular, great importance should be placed on the types of the crises which characterize the economic system; **the inflation crises, the currency crashes and the currency debasement.** Concerning the inflation crises, they constitute a universal phenomenon with long historical importance. On the other hand, the currency crashes are dated by an approach of Frankel and Rose, who put emphasis on large exchange rate depreciations and "set their basic threshold as twenty five per cent per annum.[3]" Finally, the currency debasements was the precursor of modern inflation and foreign exchange rate crises, during the era in which the transactions were taking place through metallic coins. Of course, debasements were more frequent during wars when "drastic reductions in the silver content of the currency sometimes provided sovereigns with their most important source of financing."[4]

Undoubtedly, there are two more categories of crises which are important to be mentioned; **the External Debt Crisis and the Domestic Debt Crisis**. In the first kind of crisis there is the failure of the government to meet a principal or interest payment on the due date (or within the specified grace period). Moreover, despite the fact that the time of default accurately defined as a year of crisis, in most cases the final resolution with the creditors is not exact.On the other hand, the same criteria and factors exist in the case of a Domestic Debt Crisis but there is also the

[1] www.aebanca.es
[2] Reinhart, Rogoff (2009), 141.
[3] Reinhart, Rogoff (2009), 5.
[4] Reinhart, Rogoff (2009), 6.

stagnation of bank deposits and conversions of such deposits from dollars to local currency. Historically, it is very difficult these episodes to be dated and it is also impossible for the date of the final resolution to be ascertained.[5]

It would be important great emphasis to be placed on the types of the banking crises in order for their definitions to be comprehended. In particular, a banking crisis is defined by two events. On the one hand, bank runs, which entail the desire and tendency of individuals to withdraw their deposits from the banks that they have chosen because they have lost their confidence. As a result, this situation leads to the closure, merging or takeover by the public sector of one or more financial institutions, in other words there is a severe systemic banking crisis. On the other hand, under the condition that no bank runs, closure, merging, takeover or large-scale government assistance of an important financial institution, takes place, there is the beginning of a series of similar outcomes for other financial institutions in other words, there is a financial distress.[6]

It becomes clear that there is a strong connection between the bank runs and the banking crises. We could assume that banks are usually exposed to the "danger" of a bank run. In particular, banks' role in transforming short-term loans makes them vulnerable and susceptible to bank runs. In particular, banks borrow savings and demand deposits (which can be in principle withdrawn at short notice). At the same time, "they lend at longer maturities, in the form of direct loans to businesses as well as other longer dated and higher risk securities".[7] Moreover, banks try to have a surplus of liquid resources in order to be able to handle any deposit withdrawals. However, in case of a "run" depositors lose their trust and confidence in the bank and withdraw their deposits. Consequently, this "tendency" of withdrawal makes the banks to liquidate assets "under duress." As a result, the prices received are "fire sale" prices, especially if the bank holds highly illiquid loans (usually these loans are given to local businesses and the bank has better information than other investors). In addition, the need to liquidate at fire sale prices may have consequences on a broader range of assets during a systemic banking crisis because various banks often hold broadly similar portfolios of assets and if all banks decide to sell simultaneously, then the market is going to collapse. So, banks have to be really careful because assets which are liquid in normal times may become illiquid in periods that banks need them.[8]

Undoubtedly, banking systems have many ways to confront "bank runs". In particular, if a "run" affects a single bank then it can borrow from other private banks that effectively provide deposit insurance to one another. In other words, between the banks there is interdependence. However, if the run affects many institutions this path will not be a solution. An example of such a run is the **U.S subprime financial crisis** of 2007, which is going to be elaborated further down, because banks held mortgage assets. Moreover, "exchange rate crises as experienced by so many developing economies in the 1990s are another example of a systematic financial crisis affecting almost all banks in a country''[9]

[5] Reinhart, Rogoff (2009), 10.
[6] Reinhart, Rogoff (2009), 10-11.
[7] Reinhart, Rogoff (2009), 144.
[8] Ibid.
[9] Reinhart, Rogoff (2009), 145.

All in all, Bank runs denote fragility of powerful public and private borrowers. As it will be analyzed the "recession" of the U.S financial system during 2007-2008 was the outcome of the fact that **this time was not different** because the superiority of the U.S financial system was proved false. As a result, many financial firms which did not belong to the regulated banking sector, financed their illiquid investments through short term borrowing. Of course, there was a "domino effect" concerning the banking difficulties. In other words, almost all countries in the Eurozone experienced and continue to experience banking crises, one of them is Spain. The downturn of one of the cohesion countries is worth analyzing.[10] Spain started to have an economic downturn in 2008 due to the collapse of its housing market, and economic conditions worsened when it became clear how entrenched the country's unregulated savings banks were in the real estate market. Finally, the more the public profits of the country the higher the government's expenditures thus, government debt increased tremendously and the investors hesitated to rely on Spain. Consequently, the Spanish economy has become witness of a remarkable economic and financial decline.[11]

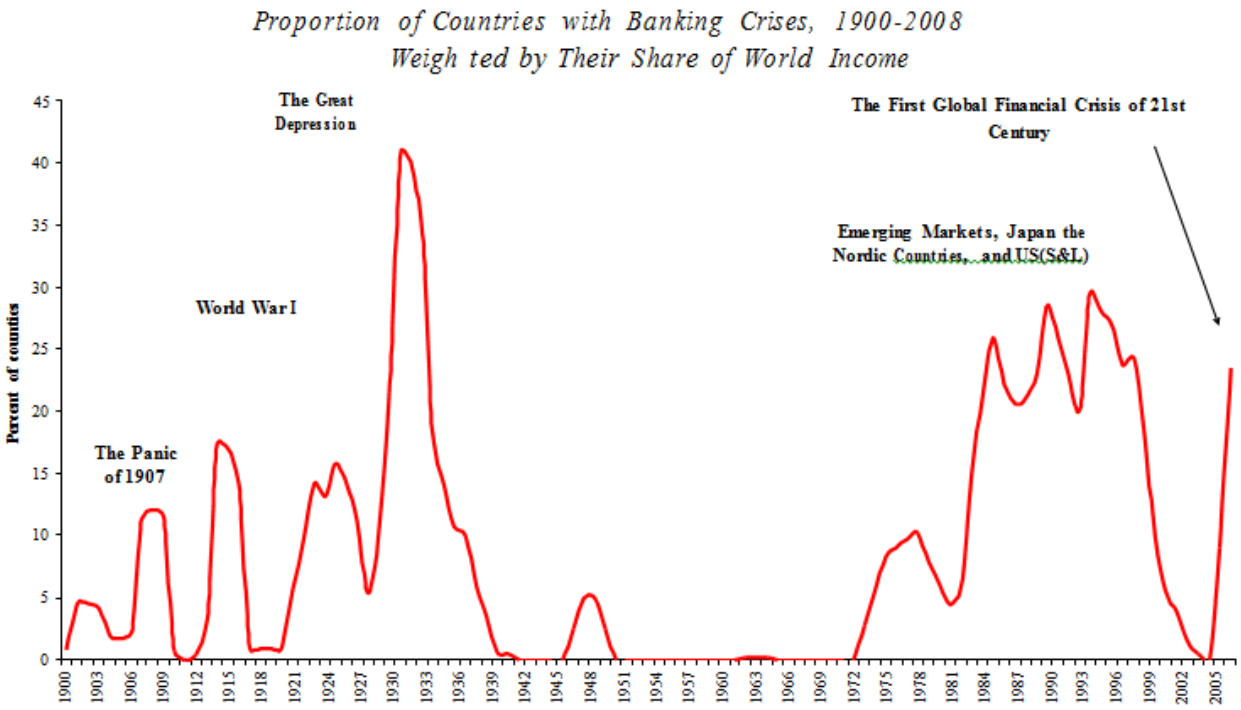
[10] Reinhart, Rogoff (2009), 15.
[11] Harrington (2011), 1.

PART ONE

BANKING CRISES: AN EXTENDED ANALYSIS OF THE NOTION

Banking and Sovereign Debt Crises

It is an undeniable fact that individual banking crises have a great influence globally. Indeed, it becomes obvious by the following figure, which shows the incidence of banking crises among the countries considered as our sample (which account for about 90 percent of world GDP). Specifically, the figure shows the percentage of all independent countries during 1900–2008 having a banking crisis in any given year. The tally weighs countries by their share of global GDP. However, the crises that affected the United States and Germany have a much higher weight than a crisis in Angola or Honduras, all of which are part of our 66-country sample.[12]



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[12] Reinhart, Rogoff (2008), 6.

[13] Sources: Bordo et al. (2001), Caprio et al. (2005), Kaminsky and Reinhart (1999), Jácome (2008), Maddison (2003), and additional sources listed in Appendix II, which provides banking crises dates.

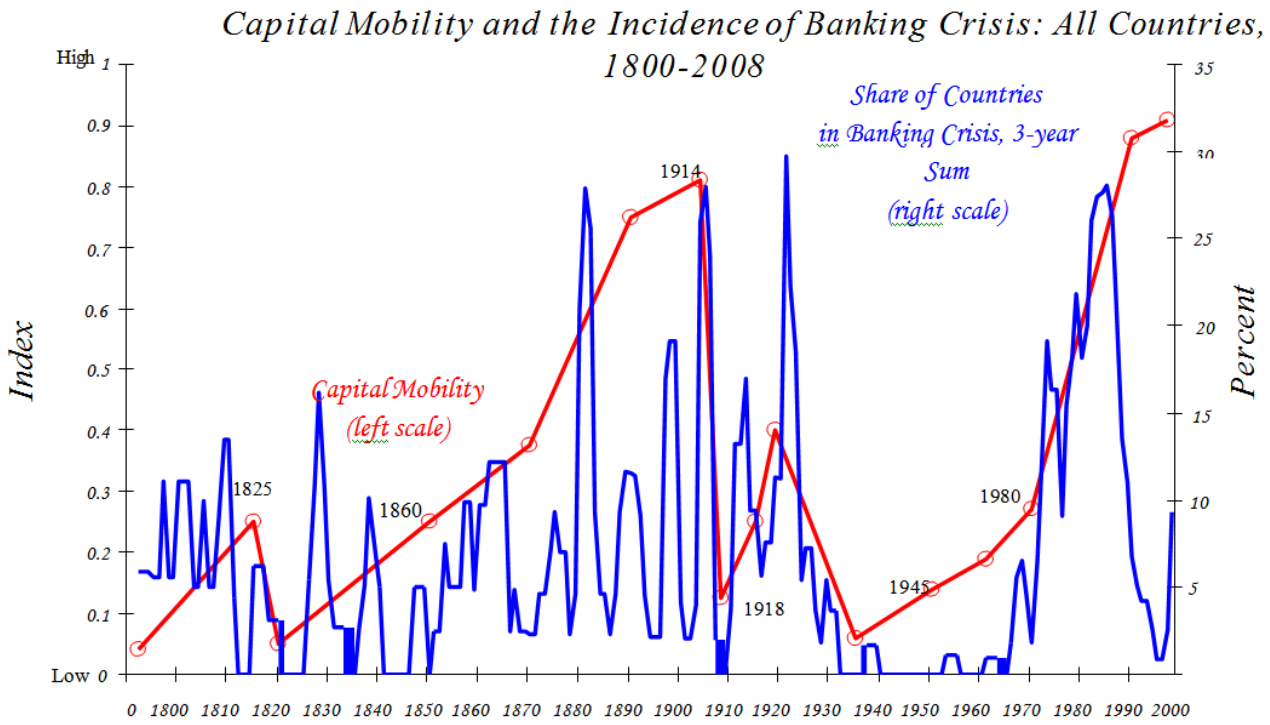
"It is clear that the worldwide Great Depression of the 1930s posts the highest readings Of banking crises during this 109-year stretch. Earlier, less widespread, "waves" of global financial stress are evident during and around the Panic of 1907 that originated in New York, as well as the crises accompanying the outbreak of the First World War. Another striking feature of the Figure is the relative calm during the late 1940s to the early 1970s. This calm may be partly explained by booming world growth, but perhaps more so by the repression of the domestic financial markets (in varying degrees) and the heavy-handed use of capital controls that followed for many years after World War II"[14]

[14] Reinhart, Rogoff (2008), 7.

BANKING CRISES, CAPITAL MOBILITY AND FINANCIAL LIBERALIZATION

It is an undeniable fact that since time immemorial there was a strong relation between the capital mobility and the banking crises. In other words, periods that were characterized by high international capital mobility, produced banking crises. " The figure plots a three-year moving average of the share of all countries experiencing banking crises on the right scale. On the left scale, there is the index of capital mobility."[15]

[16]



[15] Reinhart, Rogoff (2008), 9.

[16] Sources: Bordo et al. (2001), Caprio et al. (2005), Jácome (2008), Kaminsky and Reinhart (1999), Lindert and Morton (1989), Macdonald (2003), Maddison (2003), Purcell and Kaufman (1993), Reinhart, Rogoff, and Savastano (2003), Suter (1992), and Standard and Poor's (various years).

EQUITY- HOUSING PRICE CYCLES AND BANKING CRISES

Undoubtedly, banking crises are related to the real housing prices. In other words, "a boom in real housing prices in the run-up to the crisis is followed by a marked decline the year of the crisis and in subsequent years". According to Bordo and Jeanne (2002), "the advanced economies during 1970–2001, find that banking crises tend to occur either at the peak of the boom in real housing prices, or right after the bust". On the other hand, Gerdrup (2003) puts emphasis on the relation between the three Norway bnking crises (1890s-1993) and the fluctuations in housing prices. So, the table further down presents the magnitude and duration of the downturn in housing prices that has historically accompanied major banking crises in both advanced and emerging economies.[17]

[18]

Real Housing Price Cycles and Banking Crises

Country	Crisis date	Peak	Trough	Duration of downturn	Magnitude of decline
			(in percent)		
			Advanced economies: The Big 5		
Finland	1991	1989:Q2	1995:Q4	6 years	–50.4
Japan	1992	1991:Q1	Ongoing	Ongoing	–40.2
Norway	1987	1987:Q2	1993:Q1	5 years	–41.5
Spain	1977	1978	1982	4 years	–33.3
Sweden	1991	1990:Q2	1994:Q4	4 years	–31.7
			Asian Crisis: The Big 6		
Hong Kong	1997	1997:Q2	2003:Q2	6 years	–58.9
Indonesia	1997	1994:Q1	1999:Q1	5 years	–49.9
Malaysia	1997	1996	1999	3 years	–19.0
Philippines	1997	1997:Q1	2004:Q3	7 years	–53.0
South Korea	1997		2001:Q2	4 years	–20.4
Thailand	1997	1995:Q3	1999:Q4	4 years	–19.9
			Other emerging		
Argentina	2001	1999	2003	4 years	–25.5
Colombia	1998	1997:Q1	2003:Q2	6 years	–51.2

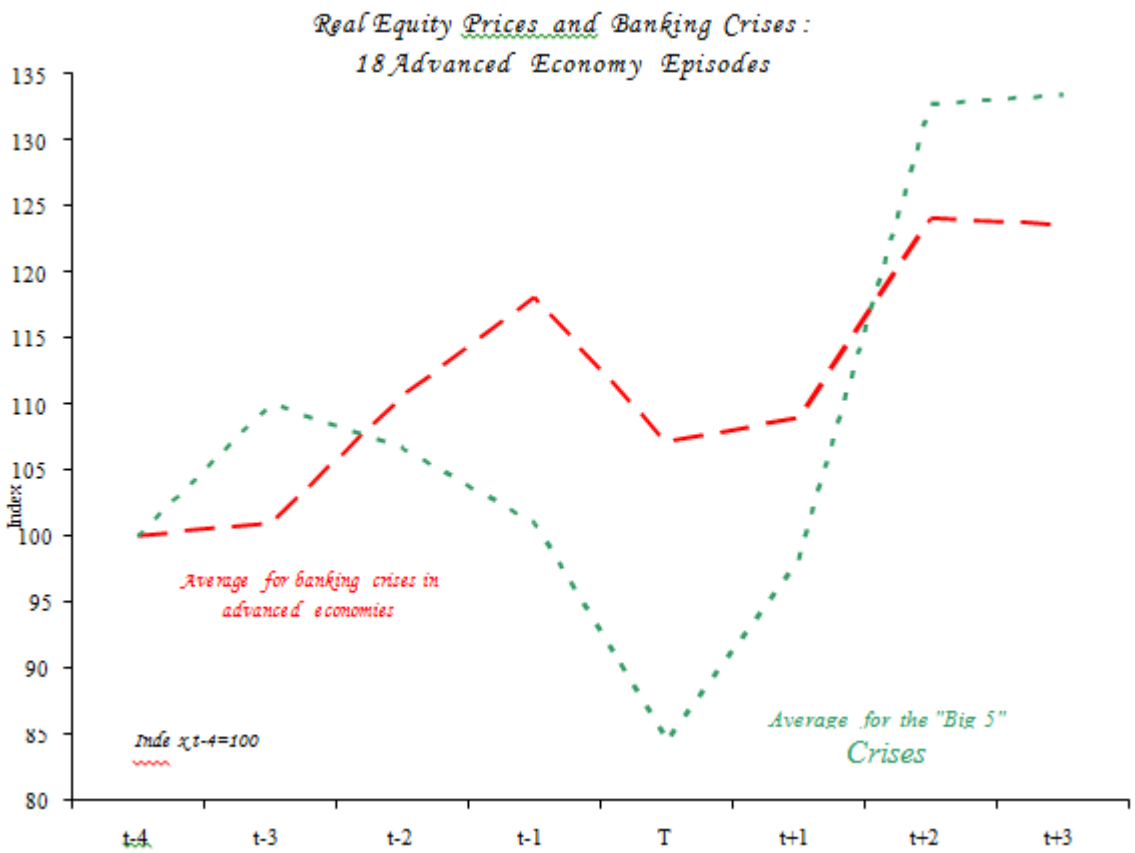
[17] Reinhart, Rogoff (2008), 27-28.

[18] Sources: Bank of International Settlements and the individual country sources described in the Data Appendix.

		Historical episodes			
Norway	1898	1899	1905	6 years	–25.5
US	1929	1925	1932	7 years	–12.6
		Current cases			
Hungary	2008	2006	Ongoing	Ongoing	–11.3
Iceland	2007	November 2007	Ongoing	Ongoing	–9.2
Ireland	2007	October 2006	Ongoing	Ongoing	–18.9
Spain	2007	2007:Q1	Ongoing	Ongoing	–3.1
UK	2007	October 2007	Ongoing	Ongoing	–12.1
US	2007	December 2005			–16.6

In advanced and emerging economies magnitudes of the declines in real housing prices around banking crises from peak to trough are almost the same.

The prolonged housing price downturns following financial crises are in stark contrast to the behavior of real equity prices, as illustrated in the following Figures in which the pattern of decline and recovery is more v-shaped.[19]

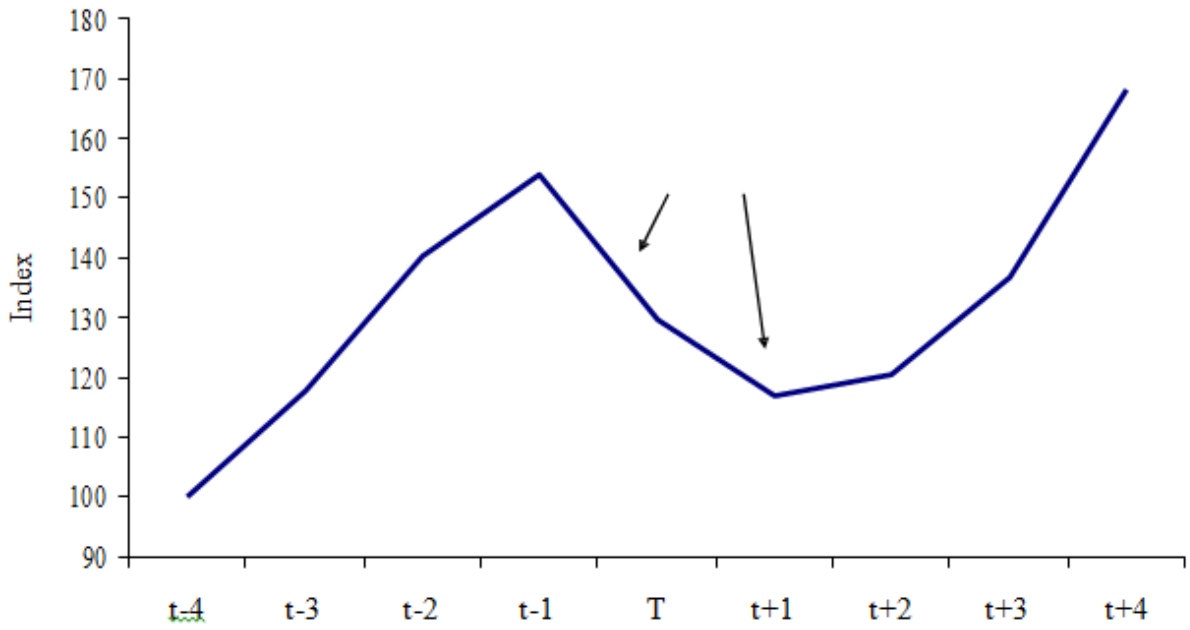


[19] Reinhart, Rogoff (2008), 31.

The Big 5 crises are: Spain (1977), Norway (1987) Finland (1991), Sweden (1991) and Japan (1992).

[20]

Equity Prices and Banking Crises: 40 Emerging Market Episodes



"These figures show the evolution of real equity prices from four years prior to the crisis to three years afterwards for emerging and advanced economies separately. As the figures make plain, equity prices typically peak before the year of the banking crisis and decline for 2–3 years as the crisis approaches and, in the case of emerging markets in the year following the crisis. However, the pattern tends to be v-shaped and the recovery complete, in the sense that three years after the crisis real equity prices are on average higher than the pre-crisis peak. One can conjecture that one reason why major banking crises are such protracted affairs is that these episodes involve the real estate market's persistent cycle in a way that "pure stock market crashes" do not." [21]

[20] Source: Global Financial Data
[21] Reinhart, Rogoff (2008), 33.

PART TWO

THE BACKGROUND OF THE GLOBAL FINANCIAL CRISIS OF THE LATE 2000
(What made people get deceived)

Beyond a shadow of a doubt, the global financial crisis of the late 2000s whether measured by its depth, by its duration or by its effect on asset markets, could be characterized as the most serious and remarkable financial crisis since the Great Depression. Without the slightest doubt, this crisis represents a period of passage in global economic history whose final outcomes will have a great effect on politics and economics for at least a generation. However, this crisis was really influential for the United States. So, the "debate" before the appearance of the crisis would be substantial in order for the recession to be fully comprehended.[22]

According to the U.S Federal Reserve Chairman Alan Greenspan, the burgeoning U.S account deficit of that time was really "perilous" for the economy. In particular, Greenspan argued that this gaping deficit, which reached more than 6.5 per cent of GDP in 2006 (over 800million) "was simply a reflection of a broader trend toward global financial deepening that was allowing countries to sustain much larger current account deficits and surpluses than in the past." Indeed, in his 2007 book, Greenspan characterized the sustained U.S account deficit as a trivial issue that did not have any risks. As a result, it should not have caused any doubts among U.S policy makers during the run-up to the crisis that began in 2007. On the other hand, Ben Bernanke who was Greenspan's successor famously described the tendency of U.S borrowing as the product of the strong desire for savings. In other words, he described that tendency as a "global savings glut." This "trend" existed thanks to various and different factors. In particular, many emerging markets wanted to be safe towards possible future economic crises after the crisis in Latin America and Asia in 1990s and early 2000s. At the same time, Middle Eastern countries had found ways to use their oil earnings and countries with underdeveloped financial systems such as China, had wanted to diversify into safer assets. Bernanke argued that it was natural for some developed economies such as Japan and Germany to have high saving rates in the face of rapidly aging populations. As a result, all these factors led to the United States, which was a safe and solvent place for the savings.[23]

It becomes clear that as The United States were "the place where the money were accumulated", U.S Financial firms and investment banks as Goldman Sachs, Merrill Lynch, as well as large universal banks (with retail basis) such as Citibank, had great profits. Moreover, The size and the efficiency of the U.S Financial sector (including banking and insurance) "more than doubled , from an average of roughly 4 percent of GDP in the mid-

[22] Reinhart, Rogoff (2008), 208.
[23] Reinhart, Rogoff (2008), 209.

1970s to almost 8 percent of GDP by 2007. In addition, the top employees of the five largest investment banks divided a bonus pool of over 36$billion in 2007. Leaders in the financial sector argued that in fact their high returns were the result of innovation and genuine value-added products and they tended to glossy understate the latent risks their firms were taking." According to them, financial innovation was a vital factor that allowed the United States to effectively borrow much larger quantities of money from abroad than might otherwise have been possible. For example, innovations such as securitization allowed U.S consumers to convert their previously illiquid housing assets into ATM machines which represented a downturn in precautionary saving.[24]

It would be of paramount importance emphasis to be placed on the dangers of the account deficit of that time. Undoubtedly, there were various and different opinions. According to Obstfeld and Rogoff the outsized U.S account was currently unsustainable. In particular, "they observed that if one added up all the surpluses of the countries they were net savers (countries in which national savings exceed national investment, including China, Japan, Germany, Saudi Arabia and Russia), the United States was absorbing more than two out of every three of these saved dollars in 2004-2006. Thus, eventually the U.S borrowing binge would have to unwind perhaps quite precipitously, which would result in sharp asset price movements that could severely stress the complex global derivatives system." At the same time other specialized individuals expressed a similar opinion. "For example, in 2004 Nouriel Roubini and Brad Setser projected that the U.S borrowing problem would get much worse, reaching 10 percent of GDP before a dramatic collapse". On the other hand, the nobel winner Paul Krugman argued that there would inevitably be a "Wile E. Coyote moment" when the unsustainability of the U.S current account would become obvious to all, and suddenly the dollar would collapse. [25]

Richard Cooper, the famous Harvard economist argued that the current account deficit was not so dangerous as to cause caution and negative thoughts. Indeed, he stressed the powerful and primary position of the United States in the global Financial and security system and the extraordinary liquidity of U.S financial markets as well as its housing markets, in order to support his argument. It should be noted that others, such as Ricardo Hausmann and Federico Sturzenegger of Harvard University's Kennedy School and Government expressed a totally different opinion by saying that t U.S foreign assets were not measured properly. Concerning the debate about the U.S borrowing from abroad economists put emphasis on the policy maker's role in the explosion of the housing prices that was taking place widely in the United States. "But again top policy makers argued that high home prices could be justified by new financial markets that made houses easier to borrow off and by reduced macroeconomic risk that increased the value of risky assets".So, Both Greenspan and Bernanke shared the opinion that not much emphasis should be placed on the housing prices since they did not affect the primary goals of the Central Bank:

[24] Reinhart, Rogoff (2008), 210.
[25] Reinhart, Rogoff (2008), 211.

growth and price stability. Moreover, Bernanke strongly argued that the housing price bubble was a matter of regulatory policy instead of monetary policy. But, then appears the question of what is going to happen if regulatory policy is not appropriate to respond to an asset price bubble. Indeed, it was precisely the huge capital inflow from abroad that gave a boost to the asset price inflation and low interest rate spreads that ultimately created risks from both regulators and rating agencies.[26]

Concluding, the deterioration of the situation was caused by the mortgage loans made to "subprime" or low- income borrowers. Also, "Advances" in securitization, as well as the continuous rise to housing prices, allowed people to buy houses that they never imagined that they could do so. Unfortunately, many of these borrowers depended on loans with variable interest rates and low initial "teaser" rates. As a result, when the need for the reset of the loans appeared, it was impossible for them to meet their mortgage obligations due to the deteriorating economy and the high interest rates. So, the financial deterioration began. Finally, it becomes understandable that the U.S conceit, which represented the dogma that **this time is different** because of the superiority of the U.S regulatory and financial system to handle massive inflows on a sustained basis without any implications, led to the financial crisis of the late 2000.[27]

Many factors led to the conception that this time was different. First and foremost, the United States was the most solvent and innovative system of financial regulation, with political stability and with one of the world's special, largest and most liquid capital markets that could definitely handle capital inflows. Secondly, rapidly emerging developing economies needed a safe place in order to invest their funds for diversification purposes. Finally, the United States boasted about their powerful monetary policy institutions and monetary policy makers and at the same time their innovative financial instruments let new borrowers to make mortgage transactions and enter mortgage markets.[28]

THE U.S. SUBPRIME CRISIS.

Post War Bank-Centered Financial Crises: The Data

According to many analysts the remarkable increase in U.S housing prices was not a bubble, on the contrary it was characterized by a financial innovation and by the steady inflow of capital from Asia and petroleum exporters. Moreover, "the huge run-up in equity prices was similarly argued to be sustainable thanks to a surge in U.S. productivity growth a fall in risk that accompanied the "Great Moderation" in macroeconomic volatility". On the other hand concerning the outsized U.S current account deficits, (which at their peak accounted for more than two- thirds of all the

[26] Ibid.
[27] Reinhart, Rogoff (2008), 213.
[28] Reinhart, Rogoff (2008), 214.

world's current account surpluses), they were justified by innovative elements of the global economy. As a result, the United States were characterized by a flexible and innovative economy that would allow them to have long term productivity growth and higher returns on physical and financial investment than the foreigners could expect in the United States.[29]

The reality was not pleasant in the case of the United States. In particular, in the summer of 2007, the United States was characterized by a tremendous reduction in wealth, increase in risk spreads and difficulties in credit market functioning. In order for the U.S sub-prime crisis to be comparatively understandable, it would be essential information to be presented on the eighteen bank-centered financial crises from the post-War period. Particularly, according to Kaminsky , Reinhart, Geragd Caprio and Andrew Mullineux great emphasis should be placed on: the Financial Crises in Australia (1989), Canada (1983), Denmark (1987), France (1994), Germany (1977), Greece (1991), Iceland (1985), Italy (1990), New Zealand (1987) and United Kingdom (1973, 1991,1995) and United States(1984).[30]

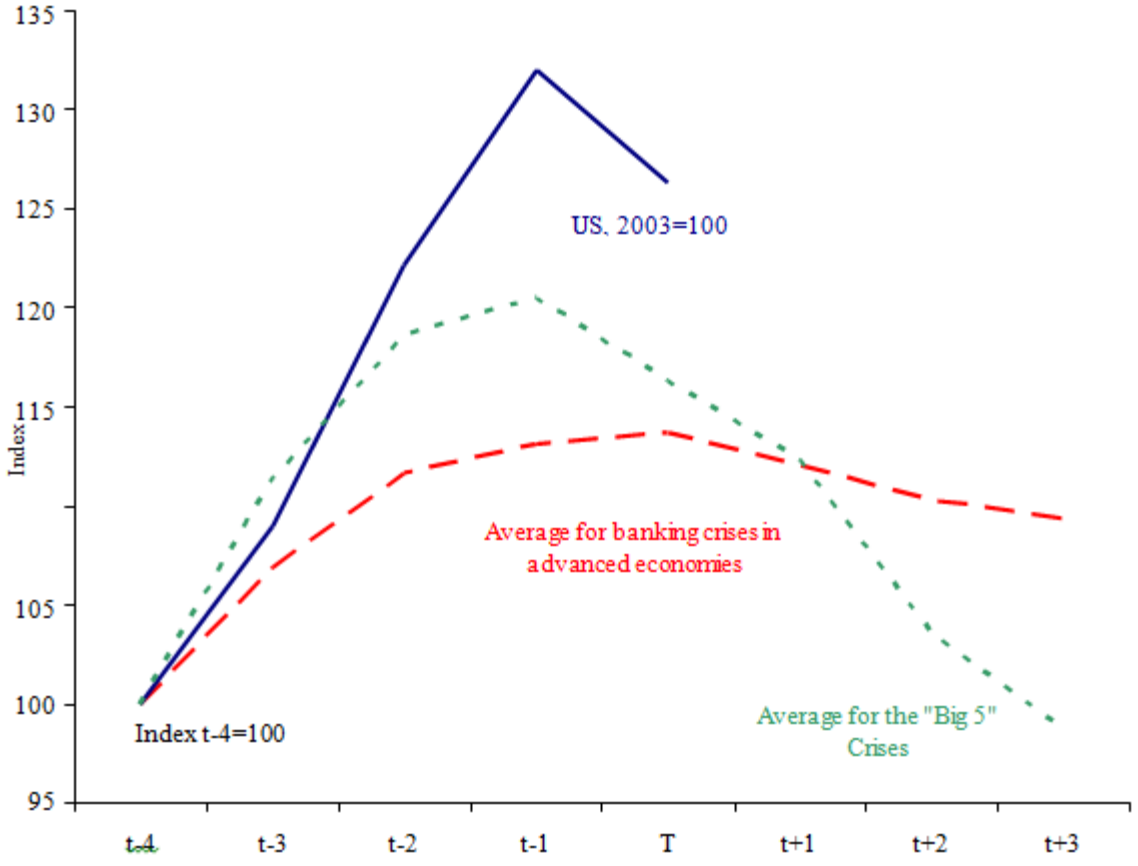
[29] Reinhart, Rogoff (2009), 215.
[30] Ibid.

COMPARING THE U.S CRISIS

"Comparing the run-up in housing prices. Period T represents the year of the onset of the financial crisis. By that convention, period T-4 is four years prior to the crisis, and the graph in each case continues to T+3, except of course in the case of the U.S. 2007 crisis, which remains in the hands of the fates. Undoubtedly, the chart confirms the fact that the increase in housing prices existed before the financial crisis. Finally,it becomes obvious that the run-up in housing prices in the United Sates is higher that this in the case of the "big five""[31]

[32]

Real Housing Prices and Banking Crises



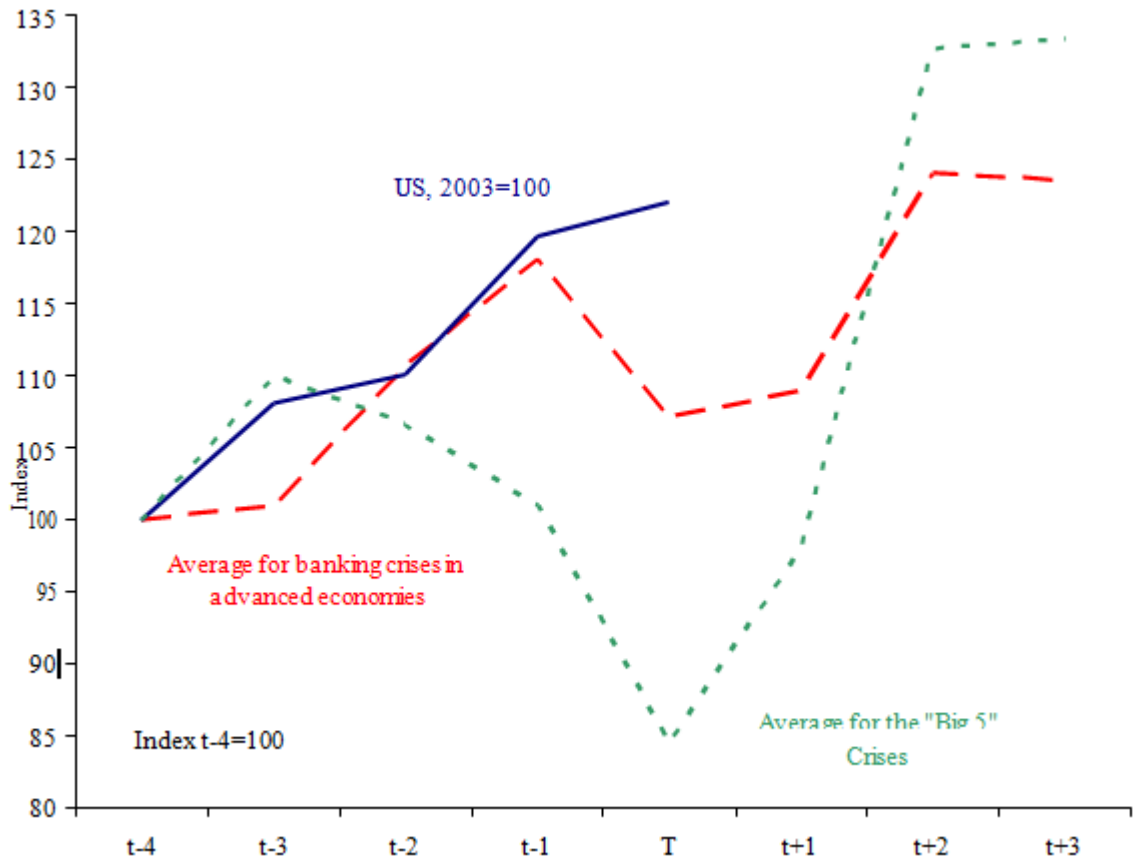
[31] Reinhart, Rogoff (2009), 217.

[32]Sources: Bank for International Settlements (2005); Shiller (2005); Standard and Poor's; International Monetary Fund(various years), International Financial Statistics; Rogoff's and Reinhart's calculations.

Observing the real rates of growth in equity market price indices, the United States looks like the archetypical crisis country. On the other hand, the Big Five crisis countries were characterized by equity price falls earlier on than the United States.[33]

[34]

Real Equity Prices and Banking Crises

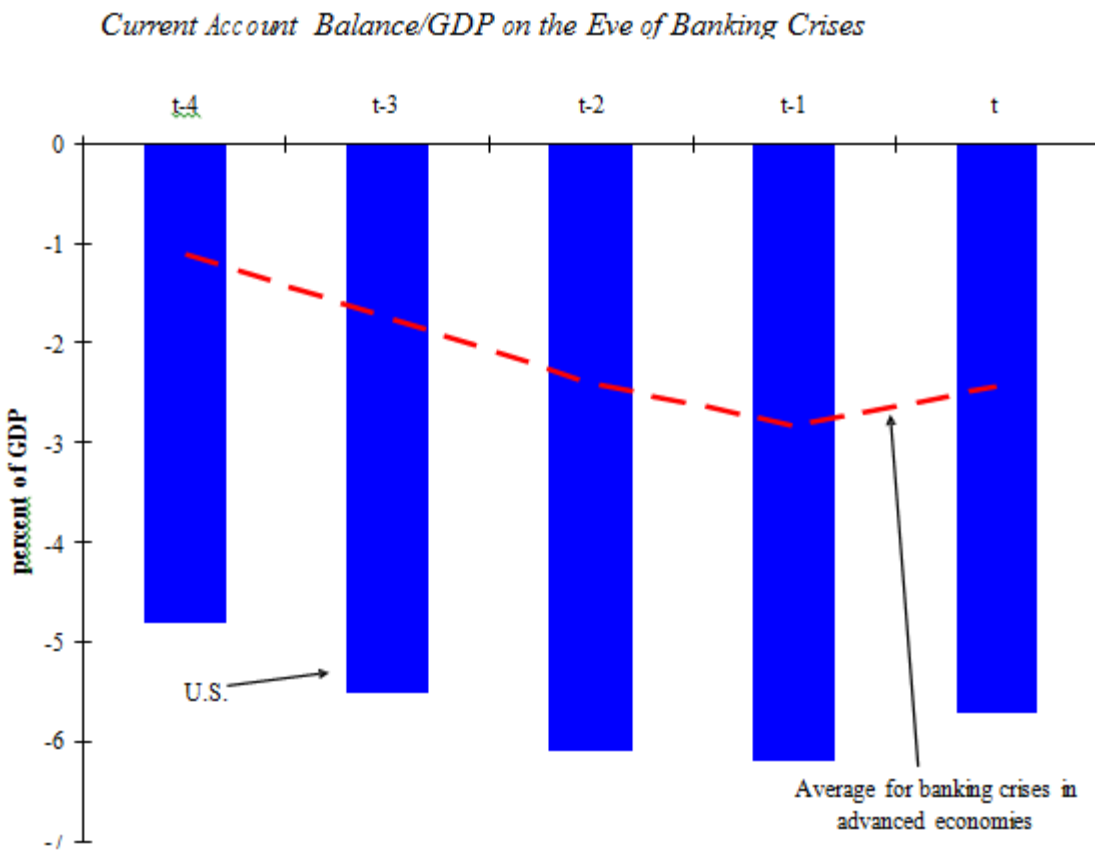


[33] Reinhart, Rogoff (2009), 218.

[34] Sources: Global Financial Data; International Monetary Fund (various years), International Financial Statistics; Rogoff's and Reinhart's calculations.

"The current account as a share of GDP: in the United States the capital inflows were really high to the eve of the crisis. Indeed, the U.S. deficits were more severe, reaching over six percent of GDP."[35]

[36]

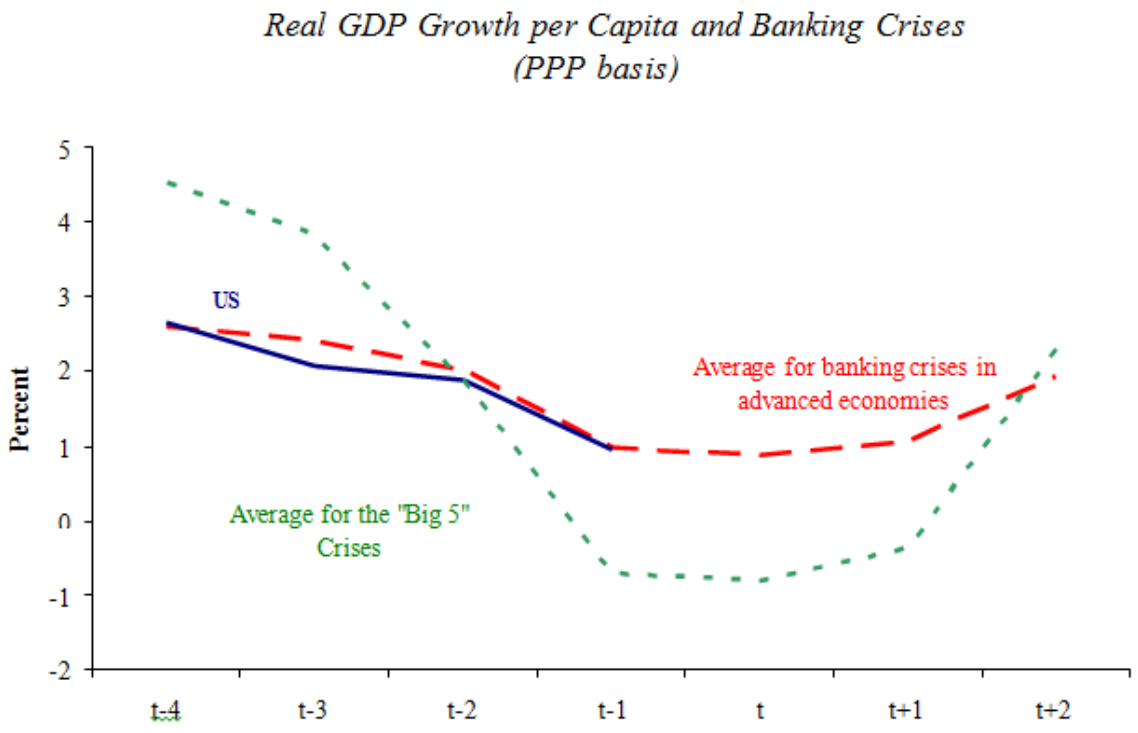


[35] Reinhart, Rogoff (2009), 219.

[36]Sources: International Monetary Fund (various years), World Economic Outlook; Rogoff's and Reinhart's calculations.

Real per capita GDP growth in the run-up to debt crises is illustrated in the following figure. The United States 2007 crisis follows the same inverted V shape that characterizes the earlier episodes. Growth momentum falls going into the typical crisis, and remains low for two years after. In the more severe "Big Five" cases, however, the growth shock is considerably larger and more prolonged than for the average.[37]

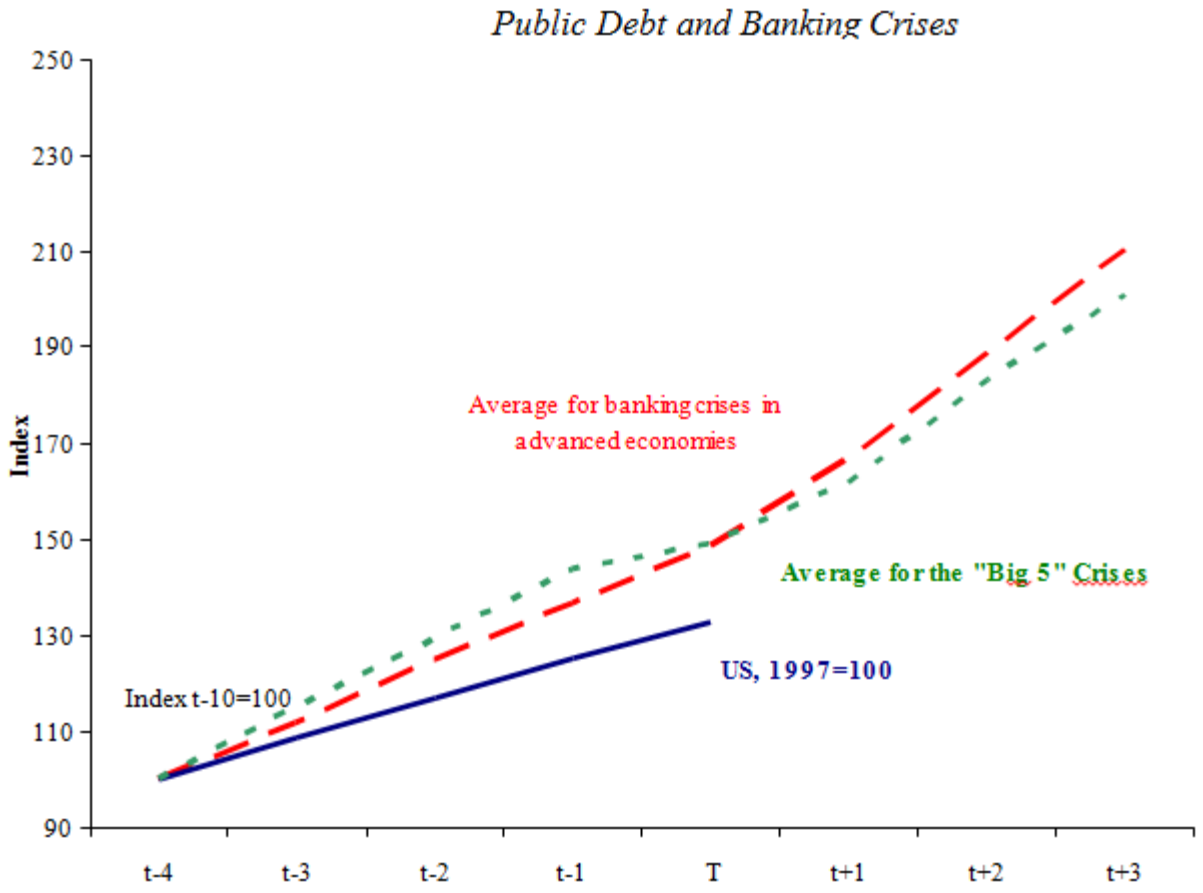
[38]



[37] Reinhart, Rogoff (2009), 220.

[38] Sources: International Monetary Fund (various years), World Economic Outlook; Wall Street Journal.

The following figure presents the public debt as a share of GDP. Rising public debt is a near universal precursor of other post-war crises, not least the 1984 U.S. crisis. It is notable that U.S. public debt rises much more slowly than it did in run-up to the Big Five crisis. However, if one were to incorporate the huge buildup in private U.S. debt into these measures, the comparisons would be notably less favorable.[39]
[40]



Concluding, beyond a shadow of a doubt each financial crisis is special, however there are important similarities among the various financial crises, such as in the rise of asset prices, in the debt accumulation and in the current account deficits. Moreover, the majority of the past crises were characterized by financial liberalization (Kaminsky and Reinhart, 1999), nevertheless, in the U.S crisis there was not a de jure liberalization but a de facto liberalization, in which innovative unregulated financial entities play a major role in the financial system by contributing to the stability against various possible shocks and increasing insecurities against others.[41]

[39] Reinhart, Rogoff (2009), 221.
[40] Sources: International Monetary Fund(various years), U.S Treasury Departmant, International Financial Statistics, Rogoff's and Reinhart's calculations.
[41] Kaminsky, Reinhart (1999), 473-500.

THE CAUSES OF THE U.S FINANCIAL CRISIS[42]

Without the slightest doubt the current financial crisis made financial stability to be replaced by inflation. There are various fundamental causes for this crisis, which seems to have made their appearance not in the near past.

Causes	**Elaboration on the causes**	**Supplementary Arguments**
Inadvisable and relaxed Mortgage Lending	The financial crisis was a result of combination of factors. In particular, the coexistence of the low interest rates and the increased house prices led to the financial crisis. As a result, there was a relaxed lending policy so people bought houses they couldn't afford. However, when the house prices began to fall people stopped preferring the loans or they could not pay them back and they started not to spend much money in the market. As a result, a severe shock was created to the financial system due to lack of money circulation.	"Imprudent lending certainly played a role, but subprime loans (about $1-1.5 trillion at the peak) were a relatively small part of the overall U.S. mortgage market (about $11 trillion) and of total credit market debt outstanding (about $50 trillion)."
Housing Bubble	The Federal Reserve followed a relaxed monetary policy, so housing prices rose to unsustainable levels. It becomes clear that the crisis was created by the bubble bursting	
Global Imbalances	Global financial situations have been characterized in recent years by an unsustainable pattern: some countries (China, Japan, and Germany) have large surpluses every year, while others (like the U.S and UK) have deficits. Indeed, the U.S. external deficits have influenced the internal deficits in the household and government sectors As a result; there are the current financial disruptions.	Factors that would change or obliterate the global imbalances, haven't taken place yet. For example, such a factor would be a sharp fall in the dollar's exchange value.

[42] Jickling (2009), 3-8.

Causes	Elaboration on the causes	Supplementary Arguments
Securitization	"Securitization fostered the "originate-to-distribute" model, which reduced lenders' incentives to be prudent, especially in the face of vast investor demand for subprime loans packaged as AAA bonds. Ownership of mortgage-backed securities was widely dispersed, causing repercussions throughout the global system when subprime loans went bad in 2007".	It is of paramount importance the fact that mortgage loans that didn't follow the "procedure" of securitization but kept on the originating lender's books, have also done poorly.
Lack of Transparency and Accountability in Mortgage Finance	"Throughout the housing finance value chain, many participants contributed to the creation of bad mortgages and the selling of bad securities, apparently feeling secure that they would not be held accountable for their actions. A lender could sell exotic mortgages to home-owners, apparently without fear of repercussions if those mortgages failed. Similarly, a trader could sell toxic securities to investors, apparently without fear of personal responsibility if those contracts failed. And so it was for brokers, realtors, individuals in rating agencies, and other market participants, each maximizing his or her own gain and passing problems on down the line until the system itself collapsed. Because of the lack of participant accountability, the originate-to- distribute model of mortgage finance, with its once great promise of managing risk, became itself a massive generator of risk."	
The excessive role and impact of the Rating Agencies	The credit rating agencies gave AAA ratings to numerous issues of subprime mortgage-backed securities, many of which were subsequently downgraded to junk status. According to the critics there was lack of advisable economic models, conflicts of interest and ineffective regulation, as reasons for the rating agencies' failure. Of course another factor was the excessive confidence in the ratings, which has been imposed by numerous laws and regulations that use ratings as a criterion for permissible investments or as a factor in required capital levels.	

Causes	Elaboration on the causes	Supplementary Arguments
Mark-to-market Accounting	"FASB standards require institutions to report the fair (or current market) value of securities they hold. Critics of the rule argue that this forces banks to recognize losses based on "fire sale" prices that prevail in distressed markets, prices believed to be below long-term fundamental values. Those losses undermine market confidence and exacerbate banking system problems. Some propose suspending mark-to-market; EESA requires a study of its impact."	.
Deregulatory and ineffective Legislation	Laws such as the Gramm-Leach-Bliley Act (GLBA) and the Commodity Futures Modernization Act (CFMA) permitted financial institutions to participate in risky transactions. Moreover, the laws were driven by an excessive faith in the robustness of market discipline, or self-regulation.	GLBA and CFMA did not permit the creation of unregulated markets and ineffective, risky activities; they simply codified existing markets and practices. ("There is this idea afloat that if you had more regulation you would have fewer mistakes," [Gramm] said. "I don't see any evidence in our history or anybody else's to substantiate it."[43]
Off-Balance Sheet Finance	"Many banks established off-the-books special purpose entities (including structured investment vehicles, or SIVs) to take part in insecure and risky investments. This allowed banks to make more loans during the expansion, but also created contingent liabilities that, with the onset of the crisis, reduced market confidence in the banks' creditworthiness. At the same time, they had allowed banks to hold less capital against potential losses. Investors had little ability to understand banks' true financial positions."	
Government-Mandated Subprime Lending	Federal mandates in order to help low-income borrowers (e.g., the Community Reinvestment Act (CRA) and Fannie Mae and Freddie Mac's affordable housing goals) forced banks to get involved in risky imprudent mortgage lending.	.

[43] Lipton, Labaton (2008).

Causes	Elaboration on the causes	Supplementary Arguments
Failure of Risk Management Systems	"Some firms separated analysis of market risk and credit risk. This division did not work for complex structured products, where those risks were indistinguishable. "Collective common sense suffered as a result."	.
Financial Innovation	New instruments and institutions had a great development in a short period of that market infrastructure and systems were not prepared when those instruments came under stress and pressure. So, it is said that markets in new instruments (accountants, rating agencies and settlement systems) and under financial innovation should be given time to mature and to adjust before they are permitted to attain a systemically significant size.	
Complexity	"The complexity of certain financial instruments in the heart of the crisis had three effects: (1) investors were unable to make independent judgments on the merits of investments, (2) risks of market transactions were obscured, and (3) regulators were baffled."	Standard economic theory assumes that investors act rationally in their own self- interest, which implies that they should only take risks they comprehend and have under their control.
Human Frailty	According to behavioral finance investors do not always make optimal choices they are not completely rational and suffer from self-control. Regulators ought to help people manage complexity by encouraging financial prudence.	
Bad Computer Models	"Expectations of the performance of complex structured products linked to mortgages were based on only a few decades worth of data. In the case of subprime loans, only a few years of data were available. "[C]omplex systems are not confined to historical experience. Events of any size are possible, and limited only by the scale of the system itself."	
Excessive Leverage	"In the post-2000 period of low interest rates and abundant capital, fixed income yields were low. To compensate, many investors used borrowed funds to boost the return on their capital. Excessive leverage magnified the impact of the housing downturn, and deleveraging caused the interbank credit market to tighten."	.

Causes	Elaboration on the causes	Supplementary Arguments
Tail Risk	"Many investors and risk managers sought to boost their returns by providing insurance or writing options against low-probability financial events. These strategies generate a stream of small gains under normal market conditions, but cause large losses during crises. When market participants know that many such potential losses are distributed throughout the system (but do not know exactly where, or how large), uncertainty and fear are exacerbated when markets come under stress."	
Black Swan Theory	Undoubtedly, this crisis is a result of combination of factors. In particular, someone could say that it is a once-in-a-century event that it is difficult to think of ways and solutions in order for the problems to be solved and not continued.	Of course, the weakness in the interpretation of risk analysis is one of the main reasons of the current turbulent economic situation.
Credit Default Swaps (CDS)	"An interesting paradox arose, however, as credit derivatives instruments, developed initially for risk management, continued to grow and become more sophisticated with the help of financial engineering, the tail began wagging the dog. In becoming a medium for speculative transactions, credit derivatives increased, rather than alleviated, risk."	

Causes	**Elaboration on the causes**
Over-the-Counter Derivatives	Because OTC derivatives (including credit swaps) are largely unregulated, limited and imprudent information about risk exposures is available to regulators and market participants. This helps explain the Bear Stearns and AIG interventions: in addition to substantial losses to counterparties, a dealer default could trigger panic because of uncertainty and insecurity about the extent and consequences of those losses.
No Systemic Risk Regulator	There was not a prudent and responsible regulator to have advisable jurisdiction over all systemically important financial institutions. (The Fed had the role of systemic risk regulator by default, but lacked authority to oversee investment banks, hedge funds, nonbank derivatives dealers, etc.)
Short-term Incentives	"Since traders and managers at many financial institutions receive a large part of their compensation in the form of an annual bonus, they lack incentives to avoid risky strategies liable to fail spectacularly every 5 or 10 years. Consequently, some propose to link pay to a rolling average of firm profits or to put bonuses into escrow for a certain period, or to impose higher capital charges on banks that maintain current annual bonus practices."

PART THREE

THE SPANISH CASE

Towards the European Union and the Single Currency…

(A historical perspective)

The end of World War II created the need for lasting European integration and the avoidance of wars. Thus the majority of the European countries wanted to reconcile with Germany. As a result, the European Community was established. This community was a combination of three separate communities: The European Coal and Steel Community (1951), the European Atomic Energy Community (1957) and the European Economic Community. Spain joined the European Community in 1986. Moreover, in 1992, the Maastricht Treaty was signed, and the community members decided to create the European Union that would lead to the European Monetary Union in which one currency would dominate, the euro.[44]

Undoubtedly, the decision for a single monetary policy created critics and many individuals had made hints for a future financial crisis. Indeed, one of the people who didn't support the euro was Martin Feldstein, who was in favor of a free-trade area but opposed the common currency. He attacked the argument that eliminating currency fluctuations would increase trade among the Eurozone members, putting emphasis on the fact that countries like the United States and Japan have separate currencies and find no barriers to their trading. Moreover, he believed that countries within the Eurozone would lose control and domination over their exchange rates. Another criticism was that countries unable to devalue their currency may have difficulty in becoming competitive in the world market. "Countries often devalue their currency when facing an economic downturn. Devaluation occurs when a country adjusts the value of its currency downward in relation to the currencies of other countries. By doing this, the country's exports will be cheaper and therefore more attractive to other countries. Devaluation also makes importing more expensive, thereby encouraging domestic consumption and production. Countries often use devaluation when there is an economic downturn. Instead of wage cuts, devaluation causes a de facto wage cut because, while workers are making the same amount, their wages buy less. History suggests that workers are much less likely to protest currency devaluation than an actual wage cut. Because of this, currency devaluation is a very valuable monetary tool. By joining the Eurozone, members gave up their ability to individually devalue, which would eventually cause problems.[45]

Finally, there were doubts concerning the independent fiscal policies. In other words, the separate fiscal policies of the countries might be perilous for the Eurozone System; since if a Eurozone member followed irresponsible fiscal policies, it would create inflationary pressures. Consequently, the ECB would raise the interest rates, forcing the other members implementing responsible fiscal policies to bear the higher interest rate costs as well. Finally, to prevent this

[44] Harrington (2011), 1.
[45] Ibid.

problem, the EMU adopted the Stability and Growth Pact ("the Pact") in 1997 in order for fiscal responsibility and discipline to be ensured, after the introduction of the euro.[46]

BRIEF ANALYSIS OF THE SPANISH ECONOMY[47]

"The Spanish economy is facing an unprecedented second recession in under three years and is confronting its most drastic budgetary consolidation of recent times. GDP shrank by five percent between early 2008 and mid-2009, then recovered 1.3 points, to again lose 0.6 percent in the third quarter of 2011 and first quarter of this year. The slump in domestic demand stands out, having declined by almost 13 percent since the start of the recession. In the first quarter of the year 220 thousand jobs were lost, bringing total job losses over the last three years to close to three million people, equivalent to 15 percent of the labour force. The unemployment rate topped 24 percent in the first quarter of the year, an increase of over 16 percentage points compared to the previous minimum in mid-2007, taking it to a level equivalent to its peak in 1994."

"In terms of economic fundamentals, the slowdown in inflation, and in particular, unit labour costs and their differential with the euro area, stand out. The current account deficit and net borrowing have reduced significantly, in parallel with the contraction in domestic demand. Progress has also been seen in the adjustment of the housing market, with new home building coming to a virtual standstill, a marked slowdown in property sales, and a cumulative price drop of almost 25 percent. Households and businesses are now running a net lending position, but the level of debt remains very high and further adjustments are necessary in the laborious process of deleveraging. The correction in the government deficit has proven inadequate, dropping from 11.3 percent of GDP at the start of 2010 to 8.9 percent at the end of last year, against a target of 6 percent for 2011. Gross public debt has doubled over the last four years to exceed 70 percent of GDP, of which just over a third is held by non-residents. The Spanish economy has been profoundly affected by the sovereign debt crisis in the euro area. The strong points which were expected to provide a degree of resilience, such as the solidity of the financial sector, the low level of government debt, and the implementation of a number of structural reforms, have not had the desired effects. Confidence has not returned to the markets, the risk premium has continued to escalate, reaching levels not seen since joining the euro, and the ratings agencies have made further downgrades. The situation reached the point that on 24 June the government formally asked the Eurogroup to open a credit facility to recapitalise troubled financial institutions."

[46] Ibid.
[47] www.aebanca.es (economic and financial report), (2012)

Undoubtedly,the current government is making efforts to succeed a budgetary consolidation, the restructuring of the financial system and structural reforms in order to strengthen the possibility for growth. Nevertheless, their impact in terms of restoring market confidence has been limited. This suggests that investors are questioning the viability and validity of monetary union and the ability of Spain's economy to grow, to meet its budgetary targets, accelerate deleveraging, and restart an expansionary phase that guarantees debt repayments.

"Although the details have yet to be specified, making it impossible to evaluate its true scope, the new approach to economic policy design and priorities agreed at the Summit of Heads of State and Government at the end of June clears away some of the doubts and should have a positive impact on the economy's ability to obtain finance on affordable terms. The European investment programme could be used to complete a number of pending communications projects and open up new avenues of activity. More decisive and giving more cause for optimism are the new modes of financing in the euro area –direct recapitalisation of troubled banks and the European Stability Mechanism's direct participation in the debt market without having preferred creditor status– which should facilitate market access and reduce costs (spreads), which are currently at unsustainable levels. In any event, its use will be conditional upon strict compliance with, and monitoring of, demanding commitments in relation to the budget, the restructuring of the financial system, and structural reforms."

Spain. Macroeconomic forecasts
Percentage change

		Ministry of Finance		EU Commission		OECD		Funcas		IMF	
	2010	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012
Real GDP	-0.1	1.3	2.3	0.8	1.5	0.9	1.6	0.8	1.5	0.8	1.1
Private consumption	1.2	0.9	1.4	0.8	1.1	0.4	1.6	0.6	1.2	0.8	1.4
Govern. consumption	-0.7	-1.3	-0.8	-1.4	-0.3	-1.7	-1.3	-0.9	-0.6	-1.2	-0.8
Gross fixed capital formation	-7.6	-1.3	2.7	-3.4	1.8	-3.4	2.0	-3.5	1.0	-5.1	-0.9
Total domestic demand (1)	-1.2	0.0	1.3	-0.6	1.0	-0.9	1.0	-0.6	0.8	-0.9	0.5
Exports of goods & services	10.3	8.3	7.9	7.0	5.8	9.9	8.7	9.2	6.7	8.7	3.0
Imports of goods & services	5.4	3.0	4.1	1.7	3.8	2.9	6.6	3.6	4.3	2.1	0.8
Net exports (1)	1.0	1.3	1.0	1.4	0.5	1.8	0.6	1.4	0.7	-1.7	0.6
Promemoria											
Private consumption deflator	2.8	2.8	1.9	3.0	1.4	2.9	0.9	3.1	1.7	2.9	1.5
Total employment	-2.4	0.2	1.4	-0.6	0.9	--	--	-0.6	0.6	-0.8	0.1
Unemployment rate	20.1	19.8	18.5	20.6	20.2	20.3	19.3	20.5	20.2	20.7	19.7
Current account balance (2)	-4.5	-3.4	-2.7	-4.1	-4.1	-2.9	-2.3	-3.9	-3.5	-3.8	-3.1
Gen. gov. financial balance (2)	-9.2	-6.0	-4.4	-6.3	-5.3	-6.3	-4.4	-6.4	-5.0	-6.1	-5.2
Gen. gov. gross debt (2)	60.1	67.3	68.5	68.1	71.0	--	--	--	--	-67.4	70.2

(1) Contribution to changes in real GDP. (2) As a percentage of GDP.

Sources: Ministry of Finance (Stability Programme Update 2010-2011, April 2011), European Commission (Economic Forecast, May 2011), OECD (EO/ May 2011), Funcas (July 2011) and IMF / WEO (September 2011).

Spain: High Priority Recommendations [48]

Recommendations and Authority Responsible for Implementation	¶	Timeframe[1]
Overall Financial Sector Stability		
Finalize the recapitalization of banks based on an in-depth due diligence of the banks' loan portfolios (BdE, MdE).	48	Immediate
Implement time-bound restructuring plans for banks reliant on state support, including measures to strengthen capital buffers, profitability, and governance practices (BdE)	49	Immediate
Design and implement a roadmap to deal with banks' legacy assets (MdE, BdE)	50	Immediate
Establish a reliable and publicly available land and real estate property sale price database, to be maintained by an official agency (MdE, BdE).	64	Near-term
Banking Oversight		
Change the legal regime to clearly prescribe the sole and exclusive roles of the BdE in prudential oversight of financial institutions, avoiding inconsistency in the division of responsibilities (MdE).	62	Near-term
Amend legislation to give BdE operational independence in its supervisory function in line with its independence as a central bank (MdE).	62	Near-term
Amend the current legal framework for banking supervision to provide BdE with effective powers to promulgate prudential rules and sanctioning (MdE, Government).	62	Near-term
Require banks to value their real estate portfolios more frequently, especially during economic downturns, to ensure rapid adjustments to provisions (BdE).	64	Near-term
Insurance Sector Oversight		
Increase resources to strengthen supervisory effectiveness (DGSFP, MdE).	68	Near-term
Improve product disclosure requirements for life insurers (DGSFP).	69	Medium-term
Securities Markets Oversight		
Devote more resources to the supervision of investment services providers (ISPs), in particular for on-site inspections (CNMV).	71	Near to medium-term
Strengthen the independence of the CNMV by removing (i) the role of the MdE in the authorization and sanctioning of ISPs; (ii) MdE representation in the CNMV board; and (iii) the need for pre-approval of the government for increases in human resources (MdE).	72	Medium-term
Use more proactively sanctioning powers in connection with breaches of conduct obligations (CNMV).	71	Near-term
Payments and Securities Systems Oversight		
Improve liquidity risk management of the central counter party (CCP) by regularly conducting stress-tests and providing access to central bank liquidity facilities (CNMV, BdE).	66	Near-term
Put in place coordinated contingency plans to deal with a potential financial failure of a CCP (MdE, CNMV, BdE).	67	Near-term
Crisis Management		
Introduce special tools to resolve banks, such as prompt recapitalizations, purchase and assumption transactions, and bridge banks, as well as related provisions for overriding shareholders' rights and imposing losses on (left-behind) creditors (all agencies).	74	Immediate
Further develop burden sharing mechanisms between the private and the public sector in the restructuring and resolution of banks, by clarifying the financial responsibilities of the FROB and of the FGD, including through a contingency credit line from the State to the FGD (all agencies).	75	Near-term

- "Immediate" is within one year; "near-term" is 1–3 years; "medium-term" is 3–5 years.

[48] IMF Country Report (2012), 1.

- BdE (Banco de España), MdE (Ministerio de Economía y Competitividad), DGSFP (Dirección General de Seguros y Fondos de Pensiones), CNMV (Comisión Nacional del Mercado de Valores), CCP (Central Counter Parties), FROB (Fondo de Reestructuración Ordenada Bancaria), FGD (Fondo de Garantía de Depósitos,FMIs (Financial Market Infrastructures)

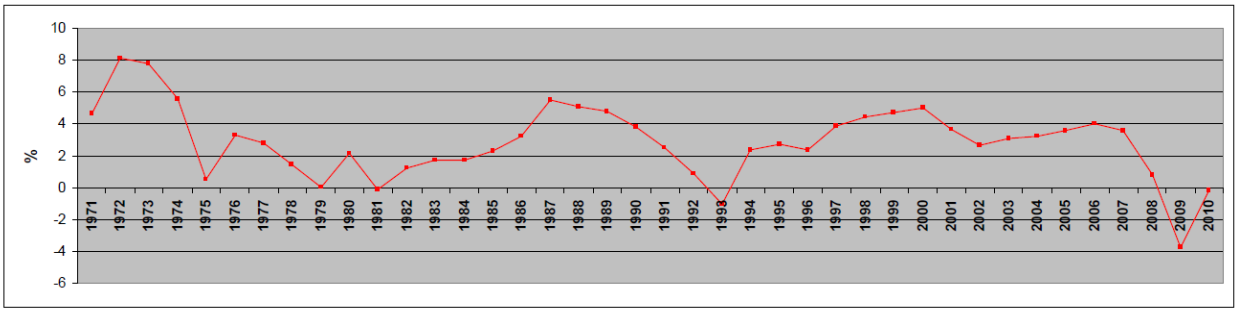
- **The records of the Spanish economy in 2010-2011**[49]

Unemployment:	• More than **4,800,000** individuals were unemployed **in June 2011** (21% of working population) (46% among young workers) • Approximately **1,370,000** families **with all their members unemployed**
Evictions	**300,000 in 2010 (**because of lack of mortgage or rent payment)
Black economy	**17% of GDP** (other estimates present the black economy to the **20-22% of GDP)**
Business profits	➢ The 35 biggest **enterprises of the IBEX** (Stock exchange**) had profits of 49.881 million € in 2010** (Increase of 24.5% over 2009) ➢ **Big banks had profits of 15,300 million €**
Remunerations of High Directors	Those of the IBEX **35 increased 20% on average**

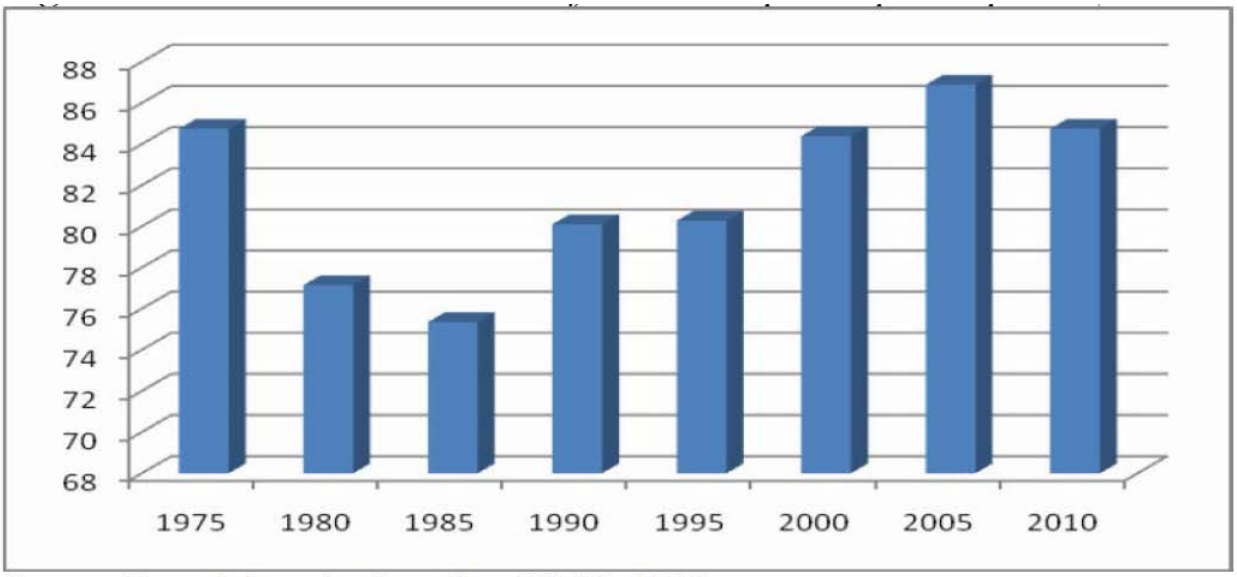
Generally speaking, Spain, historically, does not belong to the category of the rich European Countries. However, its passage (during the sixties) to the developed capitalism as well as its integration to the European Economic Community made this country feel and act as an integral part of the rich part of the world. Indeed, at the beginning of the 21st Century Spain became the fifth industrial power in Europe. As a result, since then, Spanish leaders did not consider themselves part of a poor country but members of an important industrialized country, "*even if in the opinion of European and World leaders has never attained at best more than a*

[49] *Etxezarreta, Navarro,Ribera , Soldevila (2012),1.*

second rank classification." The following figures depict the economic growth and industrial structure of the Country.[50]



Source: Own elaboration based on OECD, 2011



Source: Own elaboration based on OECD, 2011

In a few words, the evolution of the Spanish economy since the sixties is characterized by the following: There is at first industrialization and urbanization. Moreover, internal demand was growing due to industrialization, urbanization and the corresponding increased incomes and the country could export thanks to low wages and a submitted labor force. Later on, during the eighties, Spain became a member of the European Union with a productive model based in low labor costs and low level technology (automobile, food industries) and tried to compete with European industries under the pressure of the Single Act. Increasingly the country became an interesting market for the central countries of the Union.[51]

Unfortunately, this productive model deteriorated due to world and European Competitiveness (East European and Asian countries) and in 1994 unemployment was at 24, 1% of the working population. Of course, there were changes and reductions upon wages increased and especially working insecurity prevailed ,submerged economy, temporality, short term labor contracts that accounted for more than 33% of labor contracts according to Official statistics and

[50] *Etxezarreta, Navarro,Ribera , Soldevila (2012),3.*
[51] Ibid.

to more than 50 % according to other estimates, that decreased Internal demand. However, "the economy recovered a little due to four devaluations between 1992-94, increasing labor precariousness and the beginning of the "building bubble".[52]

"In 2000 unemployment was 20,4% and in 2004 12,2%. But to participate in the Eurozone because of the Treaty of Maastricht another adjustment program was established and, without devaluation, competitiveness (internal and external) became more difficult. Nevertheless the euro permitted to keep a greater external trade deficit. In front of the problems of this model, capitals looked for non-tradable sectors where competition was not relevant (building industry, commercial big areas) or oligopolistic sectors being privatized (energy, communications) or financial speculation. On the side of demand, the willingness to reach the 'European level of consumption' was maintained and even increased through cheap credit, especially to buy apartments and thus the building industry boom was established.[53]

It would be of paramount importance to mention the flourishing period of 2000-2007. In particular, the Spanish economy grew fast. Spain was admired for its turn to liberalization, its new openness to international markets, with new emerging global players such as Telefonica, Ferrovial or Banco Santander. Moreover, unemployment in 2007 was at the lowest since democracy even after absorbing more than 4 million economic immigrants in a decade. The housing market was highly dynamic and prices surged. Finally, we should mention the statement of the president of the government, J.L Rodriguez Zapatero, after advancing Italy in GDP per capita terms in 2007, "in few years' time" he said, "*Spain will overpass France*".[54]

[52] *Etxezarreta, Navarro,Ribera , Soldevila (2012) ,4.*
[53] Ibid.
[54] Ibid.

ECONOMIC INTEGRATION AND THE EUROPEAN PERIPHERY
(Spain in the European Economy and the European Union)

Spain joined the European Union in 1986 (the year of the Single Market). As a result, the fact that Spain was a member of the Single Market, gave security to European investors more interested in buying existing industries than expanding or improving the productive capacity, while many Spanish entrepreneurs took the opportunity to sell their industries. So, the Single Market was the reason why Spain became an attractive market for the products of the central countries of the Union (including technology and technological knowledge). On the other hand, however, an important number of small industries disappeared, the productive power of the country already weakened and a high external deficit was created by the crisis of the seventies. [55]

Later on, during the nineties, the strong desire of the Spanish Government to be among the countries to join first the European Monetary Union alongside the Maastricht Treaty (in 1992) and its conditions, led to a difficult program of adjustment. Thus, when the macroeconomic conditions for taking part in the Eurozone were fulfilled the country became a full member of it. However, the economy did not recover before 1995. Moreover, concerning the sector of production: the car industry and tourism expanded, but competitiveness lagged behind so,the big increase in imports and the slow development of exports led to the corresponding high **deficit in current account**.[56]

ANALYZING THE "DOMESTIC" ASPECTS OF THE SPANISH ECONOMY…..

Summing up, during the 1990s the Spanish economy was heavily dependent on foreign capital that had already started to move out towards Eastern Europe, Asia and North Africa. Moreover, locally owned capital remained uncompetitive internationally. The economy was driven by internal demand, tourism and thanks to the EU Structural and Cohesion Funds, investment in infrastructures was possible beyond the capacity of the Spanish state. However, in the early 2000s this deterioration and stagnation in the Spanish Economy transformed into the "**Spanish Economic Miracle**". In particular, this miracle was characterized by two "phenomena" first of all the **housing bubble** and the **internationalization of a few Spanish-based holdings created from the privatization of state companies and monopolies.**[57]

After the year 2000 and following the world trend, liquidity was abundant and the rates of interest were low. As a result, a combination of factors led to the development of the construction industry. In Spain, that development and expansion of this sector was spectacular. The reasons behind these developments are several. The most important among them were:[58]

- There was a lack of profitability in the manufacturing and service economy.
- There existed already an important building industry. (Is important the fact that for the time being five Spanish enterprises is among the fifty greatest enterprises in the world and most of them date their creation back to the Franco era).

[55] *Etxezarreta, Navarro,Ribera , Soldevila (2012) ,7.*
[56] Ibid.
[57] *Etxezarreta, Navarro,Ribera , Soldevila (2012) ,7.*
[58] *Etxezarreta, Navarro,Ribera , Soldevila (2012) ,12-13.*

- During the second part of the nineties important deregulation measures and an essential and efficient legislation for building and urbanization took place. (Indeed, land use was liberalized, and a new category of land was created: "**suelo urbanizable**" which means developable land. In other words, potential land for construction).

- There was a prevalent situation of imprudent and cheap credit both the world over and also in Spain. In other words credit with good terms both for the real estate industry and the families, since they received cheap mortgages

- The conception that cheap credit and new developments meant a longing for better homes of the Spanish population that invested their new incomes mainly to the provision of better housing.

A confirmation to the previous points is the fact that even a fair number of European visitors decided to buy an apartment or a house in Spain, especially in the sunny areas of the East and the South, were many English and German pensioners found a good climate and cheap cost of living in relation with their pensions. Also, in the last period of the boom immigrants who had a job, mainly in the building industry, started to buy apartments. Moreover, many enterprises expanded their previous trade or started building apartments which were sold very easily with the help of 'favorable' terms of credits to buying them as well as fiscal benefits for buying them. The prices of apartments started rising very rapidly and strongly but credits were awarded for longer periods – mortgages changed from 12-15 years to 30-40 years - and the rate of interest was low, therefore many working people could afford a new house. In addition, is important the fact that the idea that the value of houses could only go up was well established and important and attractive offers of credit by the banks and the Saving banks led people to engage themselves in apartments and in mortgages of thirty and forty years. As a result, people kept buying thinking that they could always sell the house if they changed their mind or found themselves in difficulties. Building followed a remarkable rhythm and Foreign investment in real estate increased sensibly up to 7,000 million euro. Building and selling house became" **the big business**" of the country accounting for 15.7% of Gross Value added and 23.4% of employment. This led to a period of prosperity, there was an increase in employment and wages in the construction sector were not bad in comparison with other sectors. Consequently, Spain was able to accept a great number of immigrants that were absorbed directly in the building industry.[59]

We should mention that there was a boom in an international level. In other words, the boom sector in the building industry coincided with a good conjecture in the rich world too. There was a flourishing "activity" in the car exports and the building and real estate industry. Moreover, tourism was the only sector presenting some problems because its old buildings and structures which led to decreasing competitiveness in front of new countries. But from 2003 to 2007 Spain experienced a period of high prosperity. By 2004, **1.8 million new jobs** had been created, unemployment had fallen to a record low of **8.1 percent** of the active workforce, and 60 percent of all new jobs in Europe were created in Spain[60].Finally, it is noteworthy that, when most

[59] *Etxezarreta, Navarro,Ribera , Soldevila (2012) , 13.*
[60] (Royo), 2009.

governments in the EU were struggling to keep their fiscal deficits in check, Spain enjoyed three years of **consecutive surplus between 2005 and 2007.**[61]

Unfortunately, that "fairy tale" of the Spanish Economy went bad, since on the one hand financial institutions demanded credits abroad in order to increase their lending to the domestic building industry and on the other hand there was an increasing trade deficit which increased the external debt of Spanish economy. So, all the prosperity came abruptly to an end." At the end of 2006 the big building industries were already giving signs that the building boom could not continue given the extremely high price of houses. But in the second semester of 2007 with the financial crisis of the United States and the freezing of credit the world over the whole house of cards came down. The real economy was operating fictitiously for many years –real wages were not increasing and productive activity was concentrating in very few sectors- and demand was being financed and sustained with credit; when it froze not only house buying and building stopped but overall consumption came down rapidly. And the many and serious weaknesses of the Spanish development model of the 21st century came fully into the open".[62]

Another 'domestic' aspect of the economic development of Spanish economy is the existence of few powerful firms in strategic sectors, popularly called the "**national champions**". The capitalist development of Spain has also meant that a few big Spanish holdings have been developed, some of them previously public industries that were privatized during the 90s. Indeed, the concentration of capital after the privatization of public companies gives them an oligopolistic – if not monopolistic in some cases – position in the domestic market. This situation allowed them to have a solid base for succeeding as national champions and internationalize their activities. In neoliberal discourses and strategies in Spain, they have played a fundamental ideological role in selling internally the Spanish Miracle. Yet, at present a few firms and banks are significant in the global economy: Repsol (petroleum), Sacyr (building), Aguas de Barcelona (itself owned by Suez-EDF, but highly active in Latin America), Telefónica, Banco Santander & Banco Bilbao Vizcaya Argentaria (BBVA) and some others such as Ferrovial (civil engineering, utilities), Abertis (utilities) Zara and Mango (fashion).[63]

It is noteworthy the fact that these enterprises at the beginning developed in Latin America but later on until today they have expanded to the whole world; "*And most of the times, their expansion came heavily leveraged. Obviously that implies that substantial investments have gone to foreign lands increasing the external deficit at least in the short run"*.[64]Finally, it is a fact that the country depends on foreign technology and knowledge. Even the prosperous sectors were of medium level of technology, like the building sector and car industry.[65]

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[61] *Etxezarreta, Navarro,Ribera , Soldevila (2012) , 14.*
[62] Ibid.
[63] Ibid.
[64] Economist, (2007).
[65] *Etxezarreta, Navarro,Ribera , Soldevila (2012) , 14.*

Some technologically advanced industries in Spain. The country has a significant industry in **hemoderivatives** (Grifols, third in the world), **telecommunications** (Telefonica, first in Europe and third in the world), trimensional radars, fly simulators, control of air traffic, telecommunications satellites (Indra and GMV) satellite communications and aeronautics (Hispasat). Spain counts with the greatest firm in the world in **transport infrastructure** (Ferrovial-Cintra) and among the 10 greatest, five are Spanish, REPSOL is leader in energy, and in **renovable energies** three Spanish firms are important (Gamesa, Abengoa, Iberdrola). Even in machine-tools it is important with Germany as its more important client.[66]

THE FIRST IMPACTS OF THE CRISIS ON THE SPANISH ECONOMY

At the beginning of the American crisis Spain seemed to react in an optimistic and positive way. In particular Spanish banks were not influenced by the the American mortgage problems, on the contrary Spain had tighter regulations and reserves than the Western banks due to a banking crisis that suffered in the eighties. Nevertheless, in March 2008, Spain started to face the crisis. In particular, the government (and the main economic agents) understood the problem for the Spanish economy as a temporary external shock. In addition, there were no domestic fundamentals, not even the hypertrophied real estate sector or the low productivity of the local economy. For two years, 2008-2009, the Socialist Spanish we could admit that it tried to confront the whole situation with incoherent and inefficient measures. These measures supported mainly the industrial capital; in addition initiatives for the increase of unemployment were weak. Particularly**, unemployment** was already **above 19% of the working population in 2009**. Furthermore, temporary jobs increased (**more than 94% of new contracts were temporary**).[67]

During the period 2008-2010 Spain faced an increasing **deficit and debt** and had an intense need for **foreign credit.**[68]

[66] El País, Negocios, (2011).
[67] *Etxezarreta, Navarro,Ribera , Soldevila (2012) , 16.*
[68] *Etxezarreta, Navarro,Ribera , Soldevila (2012) , 17.*

Public deficit (as % GDP), some European countries, 1998-2010

	EU(27)	Euro area	Germany	Greece	**Spain**	France	Italy	Finland	Sweden
1998	-1,9	-2,3	-2,2	:	**-3,2**	-2,6	-2,8	1,5	0,7
1999	-1	-1,4	-1,5	:	**-1,4**	-1,8	-1,7	1,6	0,9
2000	0,6	0	1,3	-3,7	**-1**	-1,5	-0,8	6,8	3,6
2001	-1,4	-1,9	-2,8	-4,5	**-0,6**	-1,5	-3,1	5	1,5
2002	-2,5	-2,6	-3,7	-4,8	**-0,5**	-3,1	-2,9	4	-1,3
2003	-3,1	-3,1	-4	-5,6	**-0,2**	-4,1	-3,5	2,4	-1
2004	-2,9	-2,9	-3,8	-7,5	**-0,3**	-3,6	-3,5	2,3	0,6
2005	-2,5	-2,5	-3,3	-5,2	**1**	-2,9	-4,3	2,7	2,2
2006	-1,5	-1,4	-1,6	-5,7	**2**	-2,3	-3,4	4	2,3
2007	-0,9	-0,7	0,3	-6,4	**1,9**	-2,7	-1,5	5,2	3,6
2008	-2,4	-2	0,1	-9,8	**-4,2**	-3,3	-2,7	4,2	2,2
2009	-6,8	-6,3	-3	-15,4	**-11,1**	-7,5	-5,4	-2,6	-0,7
2010	-6,4	-6	-3,3	-10,5	**-9,2**	-7	-4,6	-2,5	0

Source: Eurostat (2011)

Public debt (as % GDP), some European countries, 1998-2010

	EU (27)	Euro area	Germany	Greece	**Spain**	France	Italy	Finland
1998	:	72.9	60.3		**64.1**	59,4	114.9	48.4
1999	65.7	71.7	60.9	94,0	**62.3**	58,9	113.7	45.7
2000	61.9	69.2	59.7	103,4	**59.3**	57,3	109.2	43.8
2001	61	68.2	58.8	103,7	**55.5**	56,9	108.8	42.5
2002	60.4	68	60.4	101,7	**52.5**	58,8	105.7	41.5
2003	61.8	69.1	63.9	97,4	**48.7**	62,9	104.4	44.5
2004	62.2	69.5	65.8	98,6	**46.2**	64,9	103.9	44.4
2005	62.8	70.1	68	100,0	**43,0**	66,4	105.9	41.7
2006	61.5	68.5	67.6	106,1	**39.6**	63,7	106.6	39.7
2007	59	66.3	64.9	105,4	**36.1**	63,9	103.6	35.2
2008	62.3	70	66.3	110,7	**39.8**	67,7	106.3	34.1
2009	74.4	79.4	73.5	127,1	**53.3**	78,3	116.1	43.8
2010	80	85.3	83.2	142,8	**60.1**	81,7	119	48.4

Source: Eurostat (2011)

At this point it would be substantial to clarify that debt can be categorized. In particular, the Spanish **public debt** is low in comparison with other countries but **private debt** is high and especially **external private debt.** [69]

[69] *Etxezarreta, Navarro,Ribera , Soldevila (2012) , 18.*

Spanish Debt 2009-2010 (Millions of euros)

	Total		Foreign debt		
	Millions €	% GDP	Millions €	% GDP	% foreign debt
Public debt					
Spanish total public debt	*706,425*	*66.48*	*351,966*	*33.12*	*20.19*
Central goverment	539,597	50.78	*n.a.*	*n.a.*	*n.a.*
Regions	114,279	10.75	*n.a.*	*n.a.*	*n.a.*
Municipalities	35,380	3.33	*n.a.*	*n.a.*	*n.a.*
Social Security	17,169	1.62	*n.a.*	*n.a.*	*n.a.*
Private debt					
Residential sector	*2,378,656*	*223.85*	*1,391,581*	*130,96*	*79,81*
Non financial societies	1,476,546	138.96	*n.a.*	*n.a.*	*n.a.*
Households	902,110	84.90	*n.a.*	*n.a.*	*n.a.*
Financial entities	*1,127,688*	*106.13*	*n.a.*	*n.a.*	*n.a.*
Total debt	**4,212,769**	**396**	**1,743,547**	**164**	**100**

Source: Own elaboration with data from Banco de España and other sources

- *"It becomes clear that the Spanish public debt is not that high, and stands well below most Eurozone countries. If Spain had only to care for its public debt it does not seem the problem will achieve such dimensions as it is estimated that even now, with all the increases in the 'country risk premium' that the evaluations of the rating agencies are inducing, the cost of interests on the debt is not more than 2.2% of GDP well below other previous periods".*[70]

THE SPANISH CRISIS AND THE EUROPEAN UNION

It is an undeniable fact that the economic survival of Spain is essential for two reasons. Firstly, because it is a role model for the weaker countries, such as Portugal, Italy, Ireland, Greece. "Secondly, Spain is representative of a larger entity—the Eurozone. Spain is a founding member and is often associated with the more powerful France and Germany. If Spain is unable to pay back its sovereign bonds, analysts and investors fear the entire Eurozone will be in jeopardy. Because many Eurozone countries have struggling economies, they are importing much less. This is taking a toll on the larger, export-driven economies like Germany. If countries like Spain continue to struggle, the countries with stronger economies may face problems as

[70] Ibid.

well. For example, if Germany's economy deteriorates, the interest rates on its own sovereign bonds may increase, making it more difficult for Germany to pay back its sovereign debt. This could trigger financial instability in the country."[71]

Concluding, we should mention that the drastic "involvement" of the European Union in the Spanish Crisis took place only after the second meeting of the G-20 where the Union presented its first rescue program and **60,000 million euro came from Union funds, while the other 170,000 million euro were the sum of national programs.** Since 2010 the European Union seems to struggle to take measures in order to maintain the euro and ensure the survival of the Community[72]

THE EFFECTS OF THE CRISIS

Undoubtedly, **the Spanish population** was strongly affected by the crisis. In particular, the problem of unemployment, the degradation of wages and the uncertainty and insecurity for those who are working, are the main concerns in the Spanish society. Indeed, unemployment is higher than ever: **5 million workers, 21% of the working population**,(in some regions above 30%). Moreover, **unemployment of the youth is above 42%** and many of them think of migration. Temporary work becomes the norm; wages of the 'privileged' that have a job lag behind, and also more and more people is evicted and remain in debt for the future. On the other hand, the Spanish economy is characterized by **black economy.** Particularly, Spain is estimated to have **5 million people unemployed**, **1,3 million families with all of its member unemployed** and there are numerous unemployed without subsidy as well as **four million people** are estimated to **work in the submerged economy under precarious conditions of wages and stability.** As a result, many unemployed people turn to black economy in order to survive despite the fact that in the Pact for the Euro is required from the countries to eliminate the black economy.[73]

Under these circumstances there is **also lack of growth and deterioration of the demand.** Since the government is decreasing its current and investment expenditure there is no demand for the productive activity and growth scarcely resumes. In other words, **external demand increased 2,6% but domestic demand fell down 1,9%**. Moreover, Spain is getting more and more in a situation of "**low activity disequilibrium"** that makes extremely difficult a real improvement of the situation for the population, even for industry and services (tourism suffers a lot from temporality and low expenditure tourists), for employment and the social rights. Moreover, **nominal growth of recorded wages has been of 0.5% in 2010 (inflation rate about 3%).** Finally, it becomes clear that, in a society in which lack of growth, heavy unemployment and a very weak productive structure prevail, it is also impossible to think of paying the debt.[74]

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[71] Harrington (2011), 7.
[72] *Etxezarreta, Navarro,Ribera , Soldevila (2012), 21 .*
[73] *Etxezarreta, Navarro,Ribera , Soldevila (2012), 24.*
[74] *Etxezarreta, Navarro,Ribera , Soldevila (2012), 26.*

THE SPANISH BANKING SECTOR IN TURMOIL

Spanish regional savings and loan banks, called **cajas,** account for half of Spain's banking system and there are around **24,000 branches** of cajas throughout Spain. Moreover, is of paramount importance the fact that Cajas are controlled by regional politicians rather than shareholders. The majority of cajas' clients are families, small and medium-sized business, and non-governmental organizations such as health care facilities, environmental groups, and cultural groups. Before the crisis, cajas often loaned to those that the larger banks turned away because they were considered inappropriate clients and irresponsible for paying their loans back. «Unlike the rest of the banking system, cajas were relatively unregulated, and they were not required to disclose certain information such as collateral on loans, repayment history, and loan-to-value ratios. As a result, this nondisclosure prevented the Spanish government from understanding cajas' financial situations before and during the crisis. Finally, the government was also unaware of the depth of cajas' investment in the real estate market.[75]

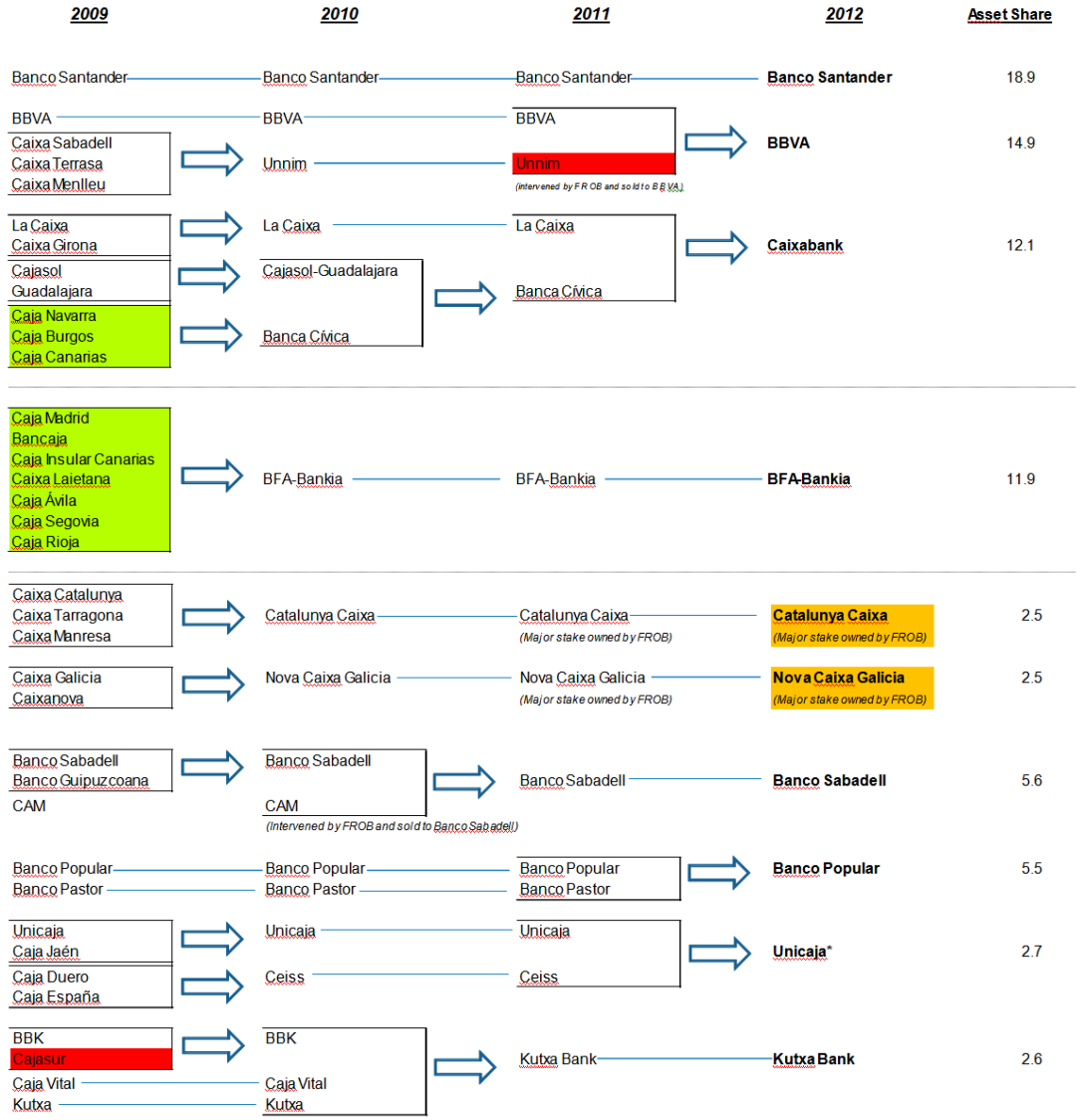
It is noteworthy that Spain's two largest banks, Santander and BBVA (Banco Bilbao Vizcaya Argentaria), in 2007 did not follow the lending procedure as strongly as in the past, but at the same time the cajas continued to lend heavily into the cooling housing market. **By 2009, cajas owned 56 percent of the country's mortgages, and loan payments** from property developers accounted for one-fifth of the cajas' assets. Because the cajas were not required to disclose much of their investment information to the government, their continued lending to the real estate market was uncontrollable. However, when the housing market crashed in 2009 debtors fell into bankruptcy and bad loans dramatically increased, the cajas were paralyzed by a lack of income from these delinquent loans and the high costs attributable to this bloated caja system. "*The Bank of Spain estimated the amount of potential troubled loan exposure in the Spanish banking system (any problematic loans that may face default) in the real estate market was around €180.8 billion in mid-2010. According to some analysts,* ***Spanish banks were only capable of handling losses of only a third of that amount,*** *and the cajas could handle much less."* [76]

As a result, the Spanish Banking crisis was a reality,**by 2009, the construction industry owed billions of euros to the Spanish banking system.** Many construction companies had already gone bankrupt. The regular, listed banks had delinquent loans including construction loans of approximately 3.2 percent of their portfolios, while troubled loans at cajas reached 4.4 percent**. In March 2009, the Spanish government announced its first bailout of a caja.** Thus the Spanish Financial Sector was under pressure. «After the bailout, investor confidence in Spanish banks plummeted, causing bank shares to plunge. Banks needed more cash to pay the depositors who lined up to extract their deposits, creating a "run on the banks." **During the first four months of 2010, depositors withdrew €21.6 billon**". So, all this situation made the Spanish government to implement various bank bailouts. Nevertheless, on the one hand these bailouts were a «salvation» for the Spanish banks, in order not to go bankrupt, but on the other

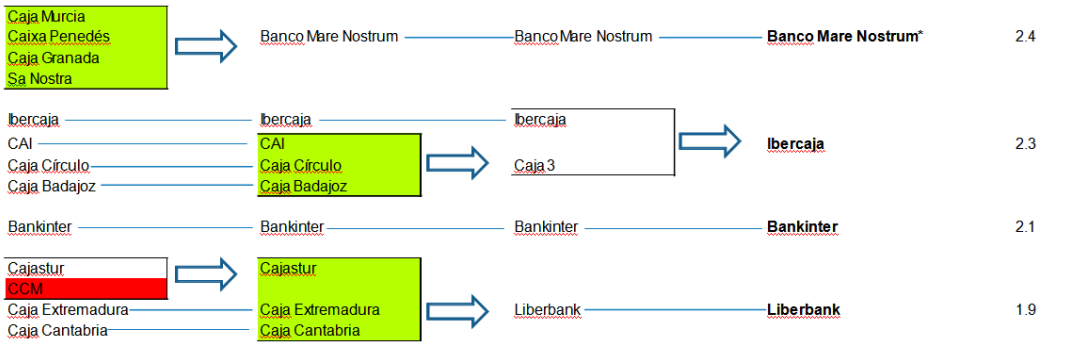
[75] Harrington (2011), 4.
[76] *Etxezarreta, Navarro,Ribera , Soldevila (2012), 32.*

hand the trust of the investors in the Spanish banking system and Spanish economy, in general was diminished dramatically.[77]

Regardless the financial occasions in Spain, it is an undeniable fact that an essential restructuring of the banks is under way.[78]



[77] Harrington (2011), 5.
[78] IMF Country Report (2012), 2.



Total 14 large and medium-sized banks	***88.0***
Small private banks	*3.1*
All other non-foreign banks not included above	*5.1*
Cooperative sector	*3.7*
Total banking sector, excluding foreign bank branches	**100.0**

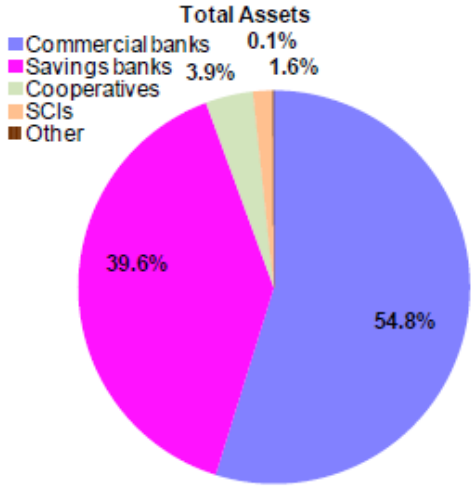
Sources: Data from the authorities; El Pais; and IMF staff estimates.

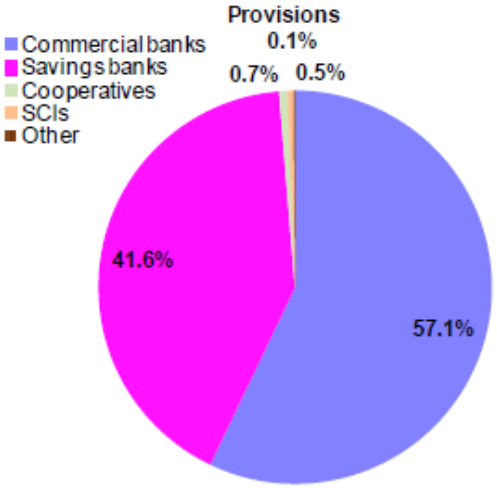
THE SITUATION IN THE SPANISH BANKING SECTOR IN 2012

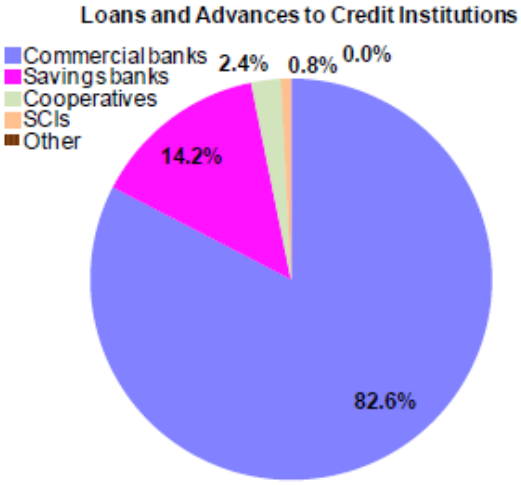
According to the Report of the International Monetary Fund of 2012, in the Spanish Society Banks dominate the Spanish financial system and an integral part of its economy. The **total assets of the Spanish banks** (excluding foreign branches) **amount to about 320 percent of GDP** taking into account international activities of the banks, with the largest five banks accounting for more than 70 percent of total assets. What is more as the following figure proves the **loans** which have to do with **the private sector** in Spain account for **166 percent of GDP** .[79]

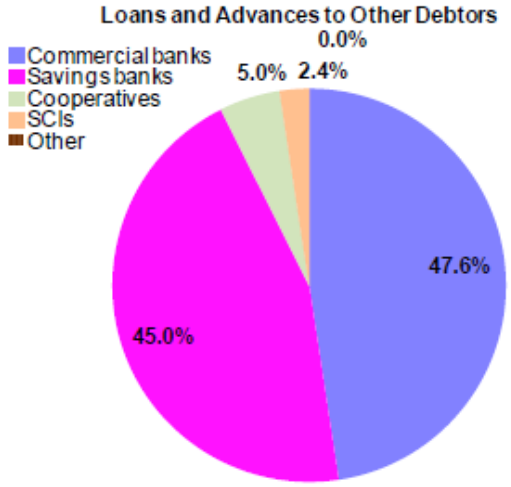
[79] IMF Country Report (2012), 11.

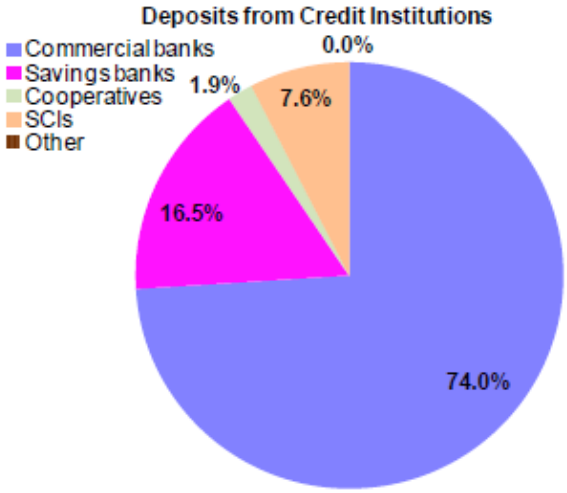
Spain: Market Shares of Credit Institutions as of End-2010

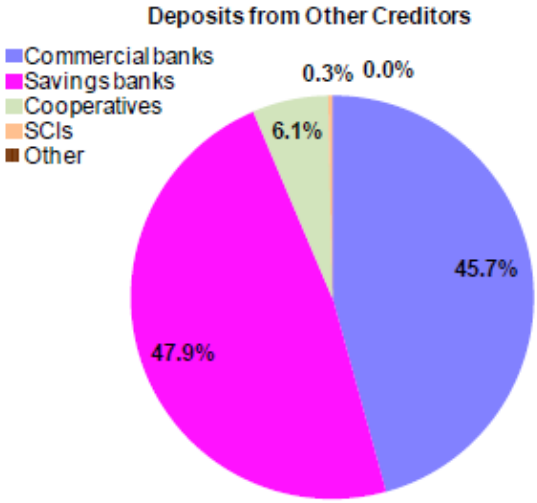




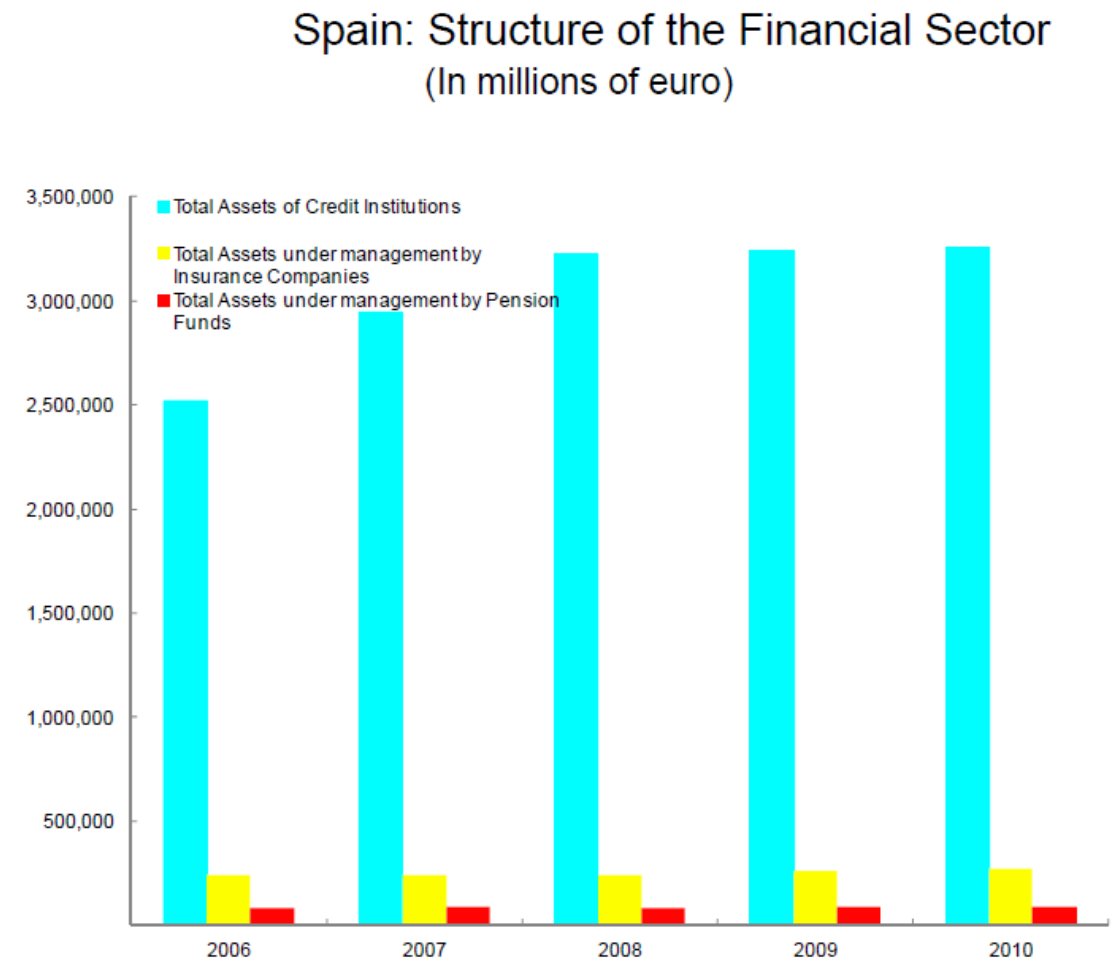








"In contrast, the growth of nonbank financial entities has not kept pace with the domestic banking industry and with EU peers, and this segment represents a relatively small share of the financial sector."[80]



Sources: BdE; and ECB.

It seems that a drastic and significant **restructuring of the savings bank sector occurs**. The reforms to the savings banks legal framework together with financial support from the state-owned vehicle, the FROB (Fondo de Reestructuración Ordenada Bancaria), were instrumental in restructuring and consolidation of the banking sector.[81]

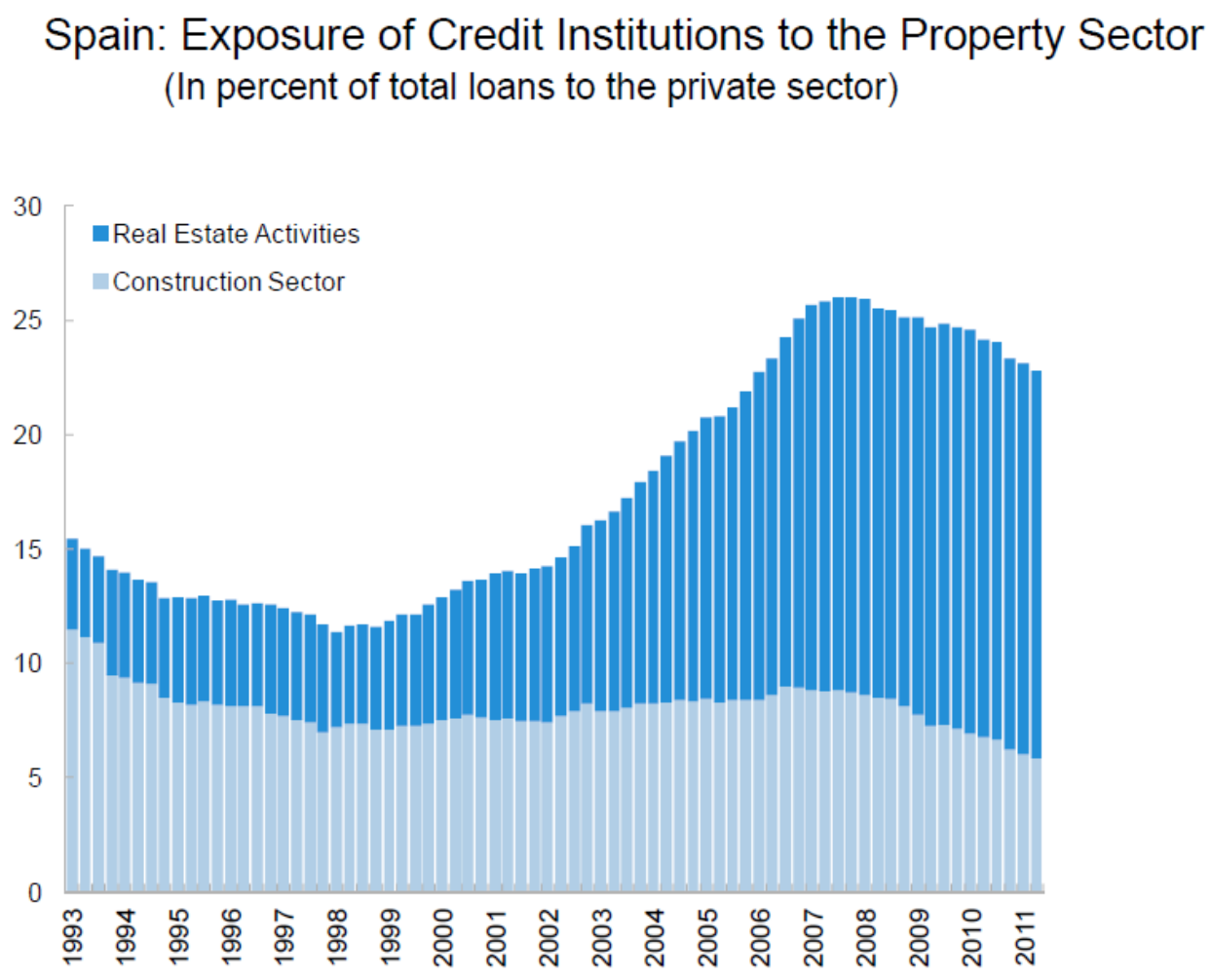
[80] Ibid.
[81] Ibid.

Program	Operations	Amount (In billions of euro)	Actual Use as of End-March 2012	Notes
Deposit Insurance	In October 2008, the deposit insurance limit was increased to EUR100,000	N/A	0.0	
Guarantee	In October 2008 a program was settled under which a maximum of EUR100 billion in 2008 and another maximum of EUR100 billion in 2009 could be granted. Under this program, the government granted EUR89.8 billion of guarantees to bank senior bond issues in December 2008. In September 2009, the government granted an additional amount of EUR56.9 billion to guarantee bank senior bond issues. The right to issue bonds with a State guarantee under these programs expired in December 2011.	187.9	96.9	1/
	In January 2012 a new program, authorising the granting of state guarantees to bank senior bond issues for up to EUR100 billion was put in place. Under this program, EUR4.2 billion of guarantees have been granted up to February 2012.			
Other liquidity support measures	In October 2008, the government established the Fondo para la Adquisición de Activos Financieros (FAAF) with an endowment of up to EUR50 billion to buy high quality asset-backed securities issued by banks and other financial institutions. All the operations carried out by the FAAF have reached their maturity; as a result, the outstanding amount is zero.	50.0	19.3	
Capital support	In June 2009, the government created the FROB. Initial capital was EUR9 billion, which was increased to EUR15 billion under RDL 02/2012. FROB can raise funds by issuing State guaranteed debt for an amount of up to EUR45 billion, which can be increased to EUR90 billion. 2/	99.0	13.8	3/
	Deposit Guarantee Fund intervention in Caja Castilla-la Mancha.		4.2	4/
	Deposit Guarantee Fund support for Banco Caja Mediterraneo		5.2	5/
	Deposit Guarantee Fund support for Unnim		1.0	6/
Total		336.9	140.4	
In percent of GDP		*31.4*	*13.1*	

Source: MdE.

We should refer to the fact that number of **institutions** has been **reduced** from 45 to 11, through interventions mergers or takeovers. Moreover, despite significant consolidation and loss recognition**, banks' access to wholesale funding markets remains limited. Banks are exposed to further losses** on their loan portfolios, notably to the real estate and construction sectors, due to the weak macroeconomic environment.[82]

[82] IMF Country Report (2012), 8.



"The deterioration in markets' perception of sovereign and bank risk has further increased pressure on the Spanish banks, most of which rely on wholesale markets to fund important parts of their portfolios. **The authorities are, rightly, focusing on strengthening the banking sector**. There is an appropriate sense of urgency from the authorities, as well as the awareness of the need for a carefully designed strategy given the potential implications for public debt dynamics. Indeed, "*unless the non-viable banks are resolved**, the sound banks will continue to be penalized by tighter regulations and expensive funding, with the risk of delaying renewed growth in credit in the country, and ultimately economic recovery".***[83]

Last but not least, market encourages the bank recapitalization. According to its estimates the potential **capitalization needs for the banking system range from € 60−90 billion.** In general, the causes of the estimated capital shortfalls are:[84]

- losses associated with real estate exposures, incorporating RDL (Royal Decree Law)02/2012 and RDL 18/2012

[83] IMF Country Report (2012), 11.
[84] IMF Country Report (2012), 37.

- The deterioration in the mortgage and SMEs (Small and Medium-sized Enterprises) loan portfolios, showing the worsening economic environment
- The inability of many banks to organically generate pre-provision income sufficient to cover expected losses (net of outstanding specific and general provisions), typically over a two-year period.

Spain: Selected Financial Soundness Indicators for the Banking Sector

(In percent unless indicated otherwise)

	2005	2006	2007	2008	2009	2010	2011
Solvency							
Regulatory capital to risk-weighted assets 1/	12.0	11.9	11.4	11.3	12.2	11.9	12.4
Tier 1 capital to risk-weighted assets 1/	8.1	7.5	7.9	8.2	9.4	9.7	10.6
Capital to total assets	6.0	6.0	6.3	5.5	6.1	5.8	5.9
Returns on average assets	0.9	1.0	1.1	0.7	0.5	0.5	0.2
Profitability							
Returns on average equity	16.6	19.5	19.5	12.0	8.8	7.2	2.8
Interest margin to gross income	55.7	53.3	54.8	62.8	65.6	64.2	65.2
Operating expenses to gross income	52.1	47.0	44.4	45.7	42.7	46.7	49.8
Asset quality							
Non performing loans (billions of euro)	9.6	10.9	16.3	63.1	93.3	107.2	135.8
Non-performing to total loans	0.8	0.7	0.9	3.4	5.1	5.8	7.6
Provisions to non-performing loans	255.5	272.2	214.6	70.8	58.6	66.9	58.3
Exposure to construction sector (billions of euro) 2/	262.8	378.4	457.0	469.9	453.4	430.3	396.8
of which: Non-performing	0.5	0.3	0.6	5.7	9.6	13.5	20.1
Households - House purchase (billions of euro)	417.0	523.6	595.9	626.6	624.8	632.4	626.6
of which: Non-performing	0.4	0.4	0.7	2.4	2.9	2.4	2.8
Households - Other spending (billions of euro)	181.6	213.4	221.2	226.3	220.9	226.4	212.2
of which: Non-performing	1.6	1.7	2.3	4.8	6.1	5.4	5.4
Liquidity							
Use of ECB refinancing (billions of euro) 4/	30.3	21.2	52.3	92.8	81.4	69.7	132.8 in
percent of total ECB refin. operations	7.7	4.9	11.6	11.6	12.1	10.8	-- in
percent of total assets of Spanish MFI	1.4	0.8	1.7	2.7	2.4	2.0	10.8
Loan-to-deposit ratio 5/	161.0	165.0	168.2	158.0	151.5	149.2	150.0
Market indicators (end-period) Stock market (percent changes)							
IBEX 35	18.2	31.8	7.3	-39.4	29.8	-17.4	-13.4
Santander	22.1	26.8	4.6	-51.0	73.0	-30.5	-26.3
BBVA	15.6	21.0	-8.1	-48.3	49.4	-38.2	-12.1
Popular	6.2	33.3	-14.8	-48.0	-13.9	-24.1	-9.1
CDS (spread in basis points) 6/							
Spain	3.1	2.7	12.7	90.8	103.8	284.3	466.3
Santander	9.3	8.7	45.4	103.5	81.7	252.8	393.1
BBVA	9.1	8.8	40.8	98.3	83.8	267.9	407.1

Sources: BdE; ECB; WEO; Bloomberg; and IMF staff estimates. Data are on a consolidated basis for all resident credit institutions in Spain, including foreign ones.

PART FOUR

AFTER THE FINANCIAL CRISES…..WHAT?

Beyond a shadow of a doubt the financial crisis of the United States is characterized by all the indicators which denote the difficulty of the economic situation, such as asset price inflation, rising leverage, large sustained current account deficits and a difficult procedure of economic growth. Nevertheless, there are various principles which are related to the aftermath of the U.S Financial Crisis and the systemic crises, in general.[85]

- The collapse of the asset market is profound and has a long duration. In addition, reductions in real housing prices average 35 percent and their duration is more than six years, whereas equity price collapses average 56 percent over a downturn of about three and a half years.

- *"In the aftermath of banking crises there are changes and declines in the sector of output and employment. In particular," the unemployment rate rises an average of 7 percentage points during the down phase of the cycle, which lasts on average more than four years. Output falls (from peak to trough) more than 9 percent on average, although the duration of the downturn, averaging roughly two years is considerably shorter than that of unemployment."*[86]

- *"The value of government debt seems to become "huge". "The main cause of debt explosions is not the widely cited costs of bailing out and recapitalizing the banking system. Admittedly, bailout costs are difficult to measure and the divergence among estimates from competing studies is considerable. But even upper-bound estimates pale next to actual measured increases in public debt. In fact, the biggest driver of debt increases is the inevitable collapse in tax revenues that governments suffer in the wake of deep and prolonged output contractions. Many countries also suffer from a spike in the interest burden on debt, for interest rates soar, and in a few cases (most notably that of Japan in the 1990s), countercyclical fiscal policy efforts contribute to the debt build up. (calibrating differences in countercyclical fiscal policy across countries can be difficult because some countries such as the Nordic countries, have powerful built-in fiscal stabilizers through high marginal tax rates and generous unemployment benefits, whereas other countries, such as the United States and Japan, have automatic stabilizers that are far weaker)."*

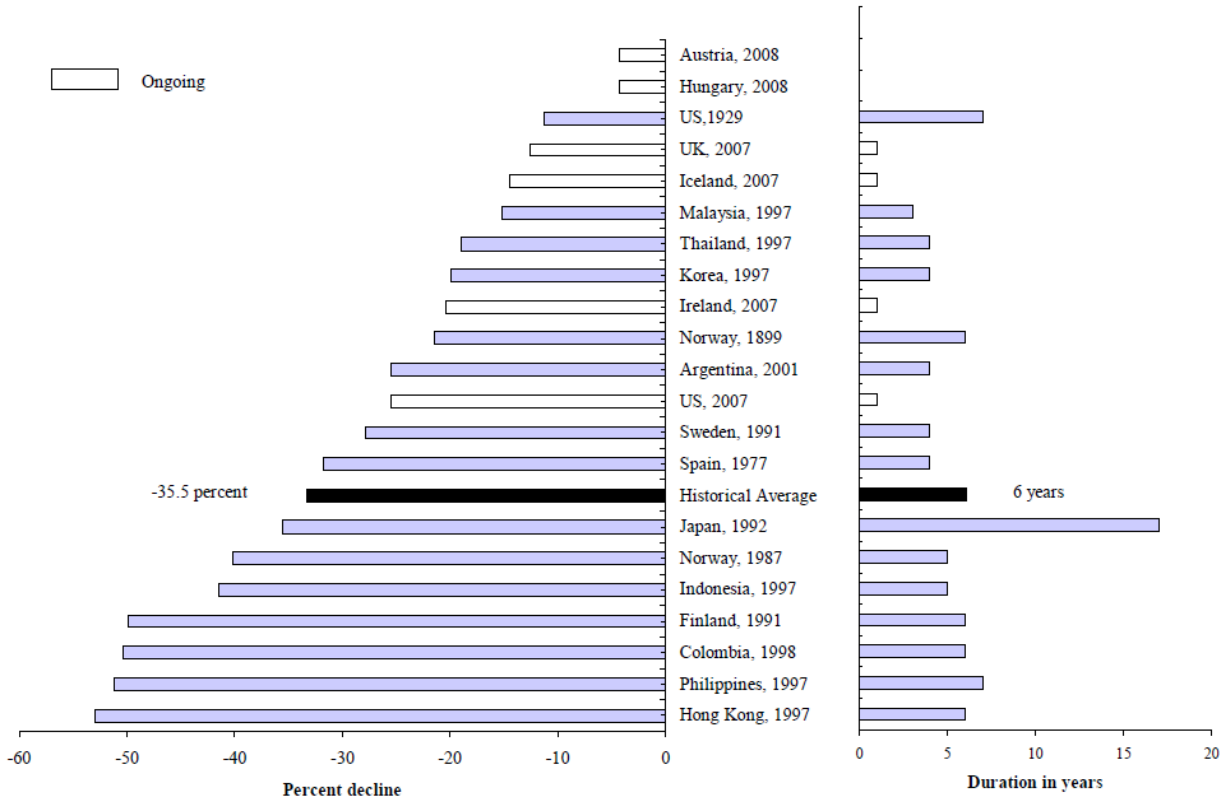
[85] Reinhart, Rogoff (2009), 224.
[86] Ibid.

THE SITUATION AFTER CRISIS: A COMPARATIVE PERSPECTIVE

The following figure shows the deteriorating phase in housing price cycle during the banking crises, putting emphasis on the U.S case and a number of other countries – "victims" of the banking crises, such as : Austria, Hungary, Iceland, Ireland, Spain, and the United Kingdom. It becomes clear that the most profound declines characterized Finland, the Philippines, Colombia and Hong Kong. Their crashes were 50 to 60 percent, measured from peak to trough. Moreover, is really remarkable the fact that the housing price decline experienced by the United States during the current episode (almost 28 percent according to the Case–Shiller index) is already more than that registered in the U.S. during the Great Depression. Notably, the duration of housing price declines is on average six years, with exemption the case of Japan which experienced seventeen consecutive years of price declines).[87]

Past and Ongoing Real House Price Cycles and Banking Crises:

Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)



88

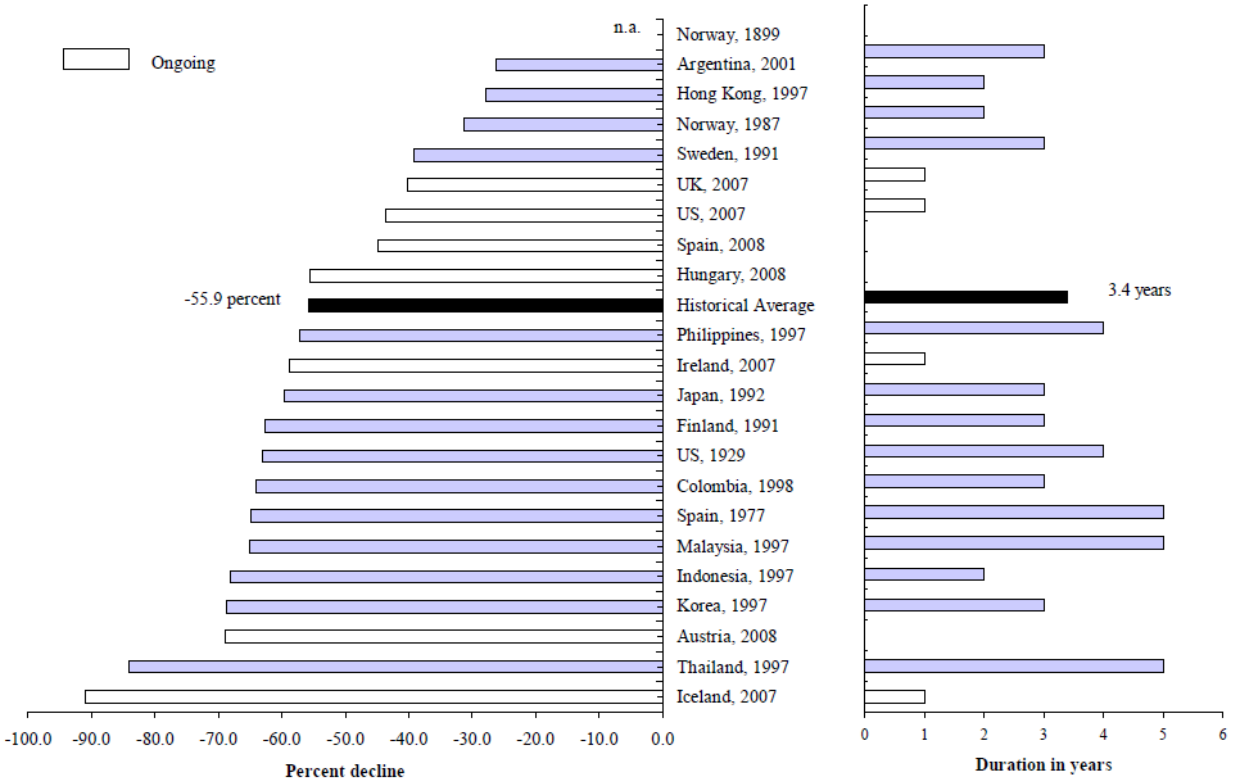
[87] Reinhart, Rogoff (2009), 226.
[88] Reinhart, Rogoff (2009), 227.

- Ongoing crises are in dark shading, past crises are in light shading. The cumulative decline in real housing prices from peak to trough averages 35.5 percent

"According to the next figure it becomes obvious that the equity price declines that accompany banking crises are" far steeper than are housing price declines, if somewhat shorter lived[89]*"*. The shorter duration of the downturn when compared with real estate prices is consistent with the observation that equity prices are far less inertial. The average historical decline in equity prices is 55.9 percent, with the downturn phase of the cycle lasting 3.4 years. Notably, during the current cycle, Iceland and Austria have already experienced peak-to-trough equity price declines which are longer than the average of the historical comparison group.[90]

Past and Ongoing Real Equity Price Cycles and Banking Crises:

Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)

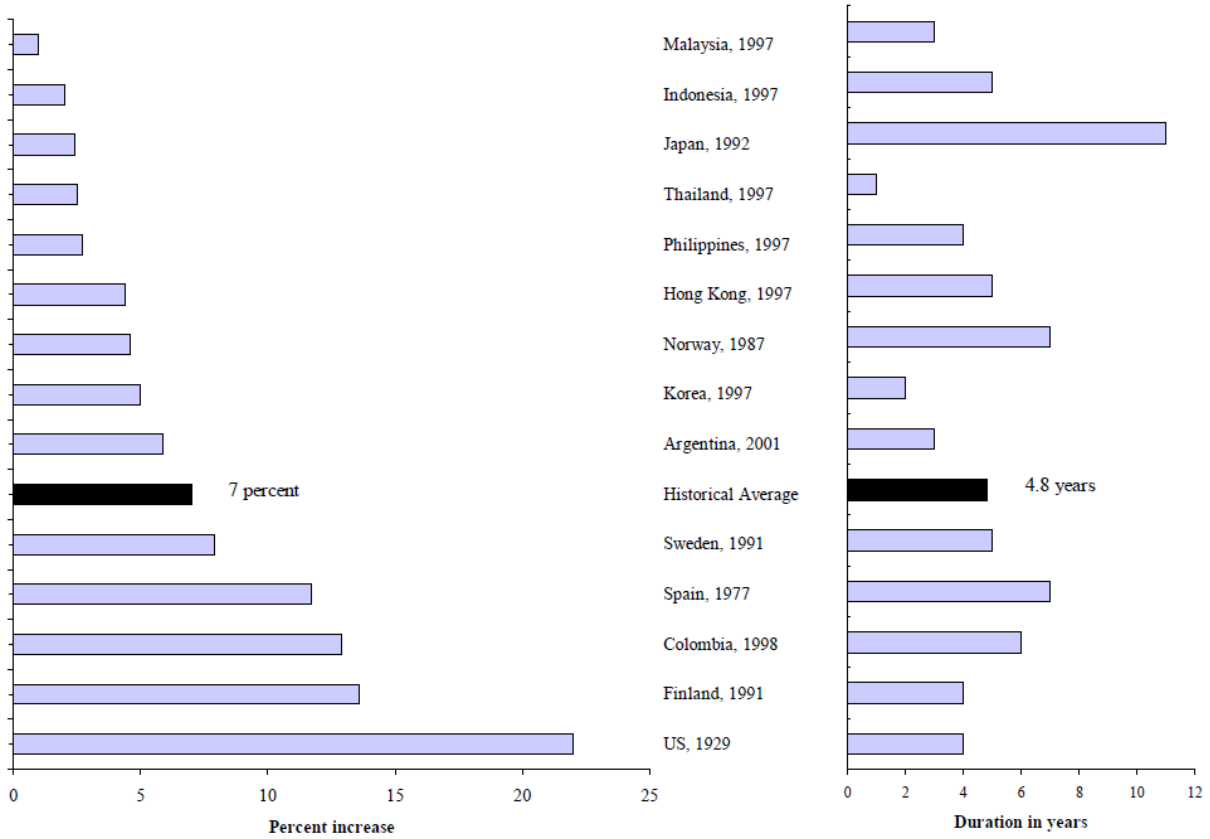


In the figure further down increases in unemployment are stressed, of course under the spectrum of a historical analysis and comparison. It becomes obvious that: " *On average, unemployment rises for almost five years, with an increase in the unemployment rate of about 7 percentage points. While none of the Post-war episodes rivals the rise in unemployment of over*

[89] Reinhart, Rogoff (2009), 226.
[90] Ibid.

20 percentage points experienced by the United States during the Great Depression, the employment consequences of financial crises are nevertheless strikingly large in many cases". Furthermore, the figure leads us to the conclusion that during banking crises the emerging markets such as in the Asian case are in a better position (in terms of unemployment) than the advanced economies.[91]

Past Unemployment Cycles and Banking Crises: Trough-to-peak
Percent Increase in the Unemployment Rate (left panel) and Years Duration of Downturn (right panel)



[92]

The next depiction shows the cycles in real per capita GDP during banking crises. Moreover a remarkable average magnitude of the decline, at 9.3 percent is shown. It becomes clear that the advanced economies are in a better position than the emerging market ones. In particular, it happens because the declines in real GDP are smaller for advanced economies than for emerging market economies. "Moreover, compared to unemployment, the cycle from peak to trough in GDP is much shorter, only two years. Presumably, this is partly because potential GDP growth is positive, and only absolute changes in income are measured and not gaps relative to potential output'. However, the conclusion is that the recessions because of the financial crises tend to be longer compared to normal and usual recessions that typically last less than a year. Practically, long recessions characterize countries that need reorganization; for example Britain

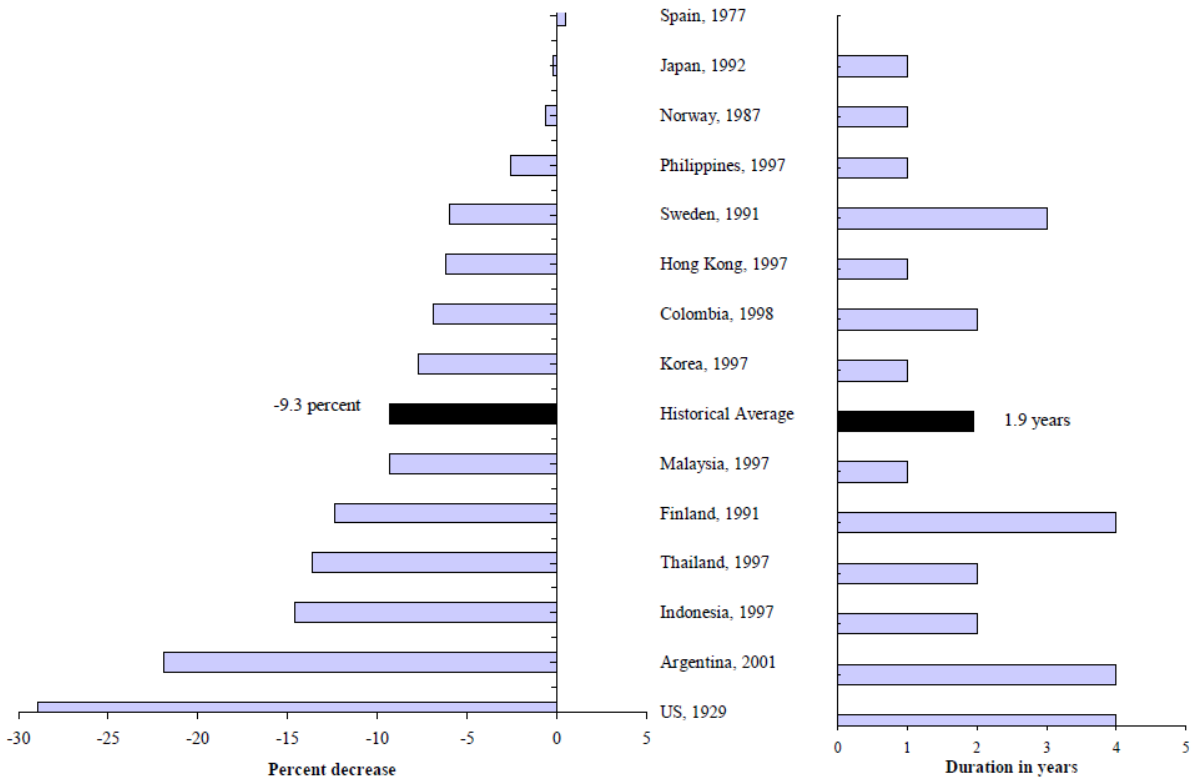
[91] Reinhart, Rogoff (2009), 228.

[92] Sources: Organisation for economic Co-operation and Development; International Monetary Fund (various years), International Financial Statistics; Carter et al. (2006); various country sources; Rogoff's and Reinhart's calculations.

in the 1970s (prior to Thatcher), Switzerland in the 1990s, and Japan post-1992 (the latter not only due to its financial collapse, but also due to the need to reorient the economy in light of China's rise). [93]

Past Real Per Capita GDP Cycles and Banking Crises: Peak-to-trough

Percent Decline in Real GDP (left panel) and Years Duration of Downturn (right panel)



94

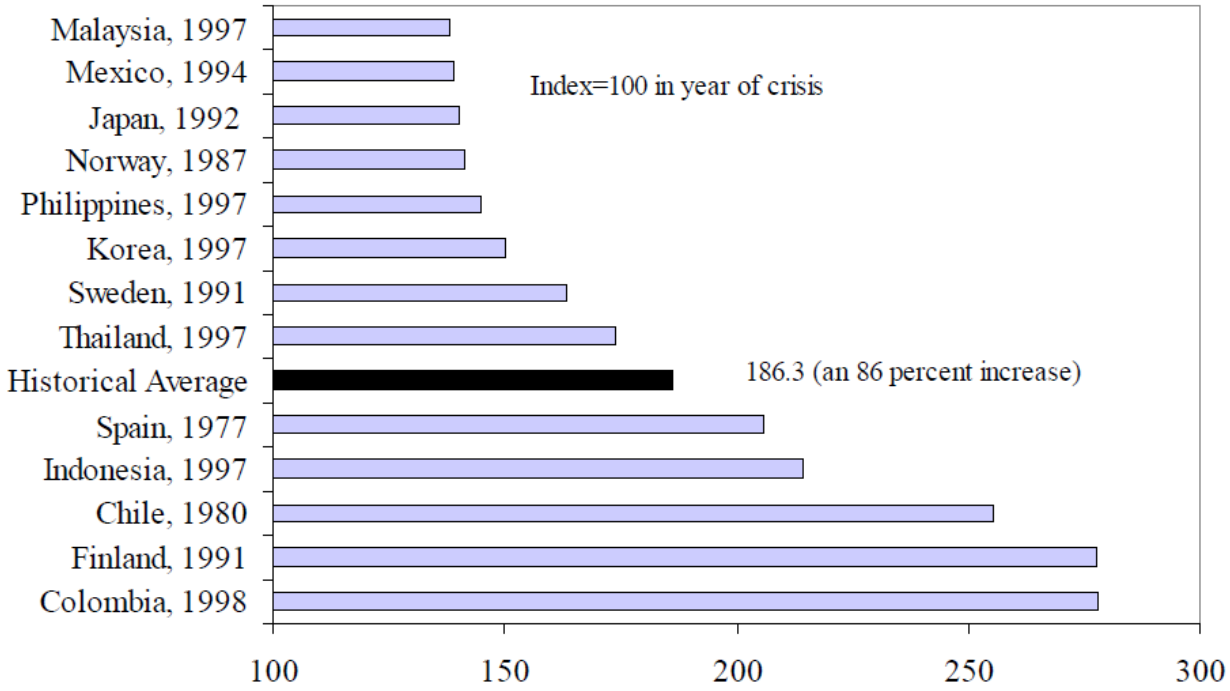
The last figure in the "after the crisis" analysis shows the rise in real government debt, in the three years following a banking crisis. The deterioration in government finances is striking, with an average debt rise of over 86 percent." According to Reinhart and Rogoff (2008b), who came into the conclusion, after a research on historical data on domestic debt, that in the aftermath of banking crises this same buildup in government debt is a basic characteristic, for over a century. *"On the other hand, there is a percentage increase in debt, rather than debt-to-GDP, because sometimes steep output drops would complicate interpretation of debt–GDP ratios"*. Reinhart and Rogoff (2008b) claimed that, *"the characteristic huge buildups in government debt are driven mainly by sharp falloffs in tax revenue and, in many cases, big surges in government spending to fight the recession. The much ballyhooed bank bailout costs are, in several cases, only a relatively minor contributor to post–financial crisis debt burdens."*[95]

[93] Reinhart, Rogoff (2009), 229.

[94] Total Economy Database (TED), Carter et al. (2006), Rogoff's and Reinhart's calculations.

[95] Reinhart, Rogoff (2009), 230.

Cumulative increase in real public debt in the three years following the banking crisis



[96]

[96] Reinhart, Rogoff (2009), 232.

THE AFTERMATH OF THE FINANCIAL CRISES IN A FEW WORDS (CONCLUDING)

Undoubtedly, the "victims" of a financial crisis seem to be **the asset prices**, **the employment** and **the output**. Particularly, the increased unemployment and the housing price declines last on average two years. Furthermore, at the end of each financial crisis, there are massive increases in government debt. Consequently, it would be wise to highlight the "lessons learned from the historical incidents of the financial crises and to make some comparisons. So, we realize that the authorities today follow a more flexible monetary policy thanks to a less rigid global exchange rate regime. Furthermore, some central banks have already shown passion and aggressiveness to take incentives that was notably absent in the 1930s, or in the Japanese experience. Of course, it does not make us smarter or superiors to our predecessors and in my opinion it does not "allow" us to ignore the historical data or underestimate them; on the contrary if we study them we will be able to comprehend the present financial crisis and make provisions about its future.[97]

CONCLUSION

Concluding, beyond a shadow of a doubt, the global nature of the crisis will make it far more difficult for many countries to "run off"it through higher exports, or to smooth the consumption effects through foreign borrowing. In such circumstances, the recent lull in sovereign defaults is likely to come to an end. As Reinhart and Rogoff (2008b) highlight, defaults in emerging market economies tend to rise sharply when many countries are simultaneously experiencing domestic banking crises.[98]

Most analysts and international organisations project a further decline in real GDP, both in the present and coming financial years, with a further deterioration in the labour market, and a failure to meet the strict budgetary targets. Given this scenario, from the internal viewpoint, there is no alternative but to complete the restructuring of the financial system, and in a way that abides by principles of maximum transparency, design a credible strategy of medium-term budgetary consolidation, and, above all, deepen the structural reforms which intend to improve and boost Spanish businesses' competitiveness and the economy's potential growth through a more intensive and efficient use of the factors of production. From the European viewpoint, concerted action to overcome the obstacles to the proper functioning of monetary union, in a way

[97] Reinhart, Rogoff (2009), 238-239, 277.
[98] Reinhart, Rogoff (2008 b),339-344.

that avoids placing a further burden on its growth capacity, would be substantial benefits for all Member States and the European Union as a whole.[99]

Concluding, **as far as I am concerned**, the global current crisis, which started from the U.S subprime crisis, was a result of the ***This – Time – Is - Different Syndrome.*** In other words, the previous years of the financial boom prevailed the idea that financial crises do not happen to our countries and that our life will never be affected by them. Moreover, we tended to underestimate the previous generations because they experienced financial crises and economic difficulties and thus we denied learning from their mistakes. Furthermore, we rejected the fact that the economic science and accomplished economists always stressed the norm of the economic cycles: " *years of great prosperity are followed by economic decline"*. So, we come into the conclusion that **this time was not different**; the world experiences a remarkable financial crisis that has made people unable to ensure their survival. Moreover, unemployment, inflation, lack of growth and uncertainty characterize individuals' lives. As we mentioned one of the European countries which experiences economic and financial crisis is Spain, whose "failure" in the banking sector threatens other European countries and especially Italy. However, labels and descriptions that underestimate and humiliate the status of the country are not advisable in such a difficult economic period. As a result, Spain does not deserve the "adjective" "**perdus" (perdidos) (losers),** that the French newspaper "Liberation" attributed to it. Last but not least, except for the technocratic and economic measures taken for the "salvation" of the countries, solidarity would be equally essential.

[99] Reinhart, Rogoff (2008).

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