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Banks and the political economy of the sovereign debt crisis in Italy and Spain

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ABSTRACT

This paper sets out to explain why Spain experienced a full-fledged sovereign debt crisis and had to resort to euroarea financial assistance for its banks, whereas Italy did not. It undertakes a structured comparison, dissecting the sovereign debt crisis into a banking crisis and a balance of payments crisis. It argues that the distinctive features of bank business models and of national banking systems in Italy and Spain have considerable analytical leverage in explaining the different scenarios of the crises in each country. This 'bank-based' analysis contributes to the flourishing literature that examines changes in banking with a view to account for the differentiated impact of the global banking crisis first and the sovereign debt crisis in the euroarea later.

KEYWORDS

Italy, Spain, financial crisis, banking crisis, sovereign debt crisis, euroarea crisis, bank business models

BANKS AND THE POLITICAL ECONOMY OF THE SOVEREIGN DEBT CRSIS IN ITALY AND SPAIN

1. Introduction

The sovereign debt crisis that began in the euroarea in 2009 dealt a major blow to the international economy. The periphery of the euroarea was particularly badly hit by this crisis: Greece was the first victim, followed by Ireland, Portugal, Spain, and then Italy. Despite the fact that these countries – often collectively referred to with the unflattering acronym of PIIGS (Portugal, Ireland, Italy, Greece, and Spain) – were hit by the sovereign debt crisis, there are important differences in the causes, dynamics, and outcome of the crises in these countries.

In June 2012, the Spanish government requested euroarea financial assistance for its banks, which the eurogroup approved during its July meeting. They agreed to provide financial assistance from the euroarea member states toward the Spanish government's bank recapitalization fund, and then channel the funds to ailing financial institutions. In December 2012, the Spanish government formally requested the disbursement of about 39.5bn euros of these funds. By contrast, the Italian government has not requested outside financial assistance to date.

This paper sets out to explain why Spain experienced a full-fledged sovereign debt crisis and had to resort to euroarea financial assistance for some of its banks, whereas Italy did not. This is puzzling because at the onset of the global banking crisis in 2007, Spain had a surplus in its budget and its public debt was much lower than in Italy, whose public debt exceeded 100 percent of GDP. Hence, Italy seemed a more likely candidate for a sovereign debt crisis than Spain, which had been on sound fiscal footing (see Table 1). Methodologically, the paper engages in a structured comparison of the sovereign debt crisis scenarios in Italy and Spain dividing the sovereign debt crisis into a banking crisis and balance of payments crisis (Kaminsky and Reinhart 1999).

The paper argues that Spain experienced a severe banking crisis including the bailout of a number of the country's banks that substantially increased the public deficit and debt. By contrast, Italian banks, with one exception, did not experience such significant losses, thus they needed no substantial government recapitalization. At the same time, both countries experienced a balance of payments crisis, which was more intense in Spain because of a higher net foreign debt than in Italy. A large part of Spain's debt was private, generated by banks and fuelled by a property bubble. By contrast, Italy suffered from chronic fiscal imbalances; it had lived with a high level of public debt (mostly held domestically), but posted primary surpluses for decades. However, Italy's low growth rate called into question the sustainability of its level of debt.

While the interest of this article is mainly of an empirical nature, it contributes to the innovative body of scholarly works focused on bank business models and national banking systems (Hardie and Howarth 2013; Hardie et al. 2013) and builds on previous works focused on national financial systems (Allen and Gale 2000; Deeg 1999). It develops a 'bank-based' analysis not only for the banking crisis, but also for the balance of payments crisis, both of which conflated into the sovereign debt crisis in the periphery of the euroarea. Furthermore, it examines two somewhat understudied cases in Southern Europe, teasing out their distinctive features of bank business models and national banking systems that account for the different crisis scenarios in Italy and Spain.

The paper is organised as follows. Section 2 briefly reviews the literature on national financial systems, outlining the main features of the bank business models and banking systems in Italy and Spain. Sections 3 and 4 analyze the anatomy of the banking crisis and the balance of payments crisis to demonstrate the role that banks held in fuelling these crises in Spain, but not Italy. Section 5 concludes the article by summarizing the main findings and discussing their generalisability.

Table 1: Main Economic Indicators: Italy and Spain (2007-2014)

Country	Subject Descriptor	Units	2007	2008	2009	2010	2011	2012*	2013*	2014*
Italy	Gross domestic product, constant prices	%	1.683	-1.156	-5.494	1.723	0.374	-2.369	-1.471	0.516
Italy	Output gap in percent of potential GDP	% of potential GDP	3.076	1.615	-3.692	-1.935	-1.805	-3.396	-4.49	-3.922
Italy	Gross national savings	% of GDP	20.834	18.788	16.866	16.527	16.425	17.092	17.886	18.462
Italy	Inflation, average consumer prices	% change	2.038	3.5	0.764	1.639	2.902	3.304	1.987	1.433
Italy	Unemployment rate	% of total labor force	6.1	6.783	7.808	8.433	8.417	10.633	12.042	12.367
Italy	General government structural balance	% of potential GDP	-3.462	-3.801	-4.074	-3.601	-3.491	-1.292	-0.19	-0.305
Italy	General government net debt	% of GDP	86.892	88.781	97.194	99.18	99.728	103.208	105.751	106.04
Italy	Current account balance	% of GDP	-1.281	-2.85	-1.986	-3.524	-3.069	-0.529	0.316	0.251
Spain	Gross domestic product, constant prices	% change	3.479	0.893	-3.742	-0.322	0.417	-1.419	-1.558	0.738
Spain	Output gap in percent of potential GDP	% of potential GDP	3.768	2.313	-2.763	-3.389	-3.187	-4.5	-5.4	-4.2
Spain	Gross national savings	% of GDP	20.982	19.491	19.181	18.334	17.799	18.564	19.208	19.616
Spain	Inflation, average consumer prices	% change	2.844	4.13	-0.238	2.043	3.052	2.436	1.94	1.504
Spain	Unemployment rate	% of total labor force	8.275	11.3	18	20.075	21.65	25	27	26.5
Spain	General government structural balance	% of potential GDP	-1.114	-5.348	-9.477	-8.043	-7.844	-5.699	-4.539	-5.085
Spain	General government net debt	% of GDP	26.7	30.801	42.491	49.805	57.485	71.931	79.133	84.666
Spain	Current account balance	% of GDP	-9.995	-9.623	-4.822	-4.477	-3.741	-1.072	1.103	2.168

*Estimates

Source: International Monetary Fund, *World Economic Outlook Database*, April 2013

2. A 'bank-based' analysis of the sovereign debt crisis in the euroarea

National banking systems have seldom been the subject of scholarly works in political economy, with a number of notable exceptions (Allen and Gale 2000; Deeg 1999; Deeg 2005; Deeg 2010). Until recently, the standard work of reference was Zysman's Governments, Markets and Growth: Financial Systems and the Politics of Industrial Change (1983), which distinguished between credit-based and capital market-based financial systems. In bank-based financial systems, banks perform the key function of financial intermediation between household-savers and firms, providing funding to the real economy. In the capital market-based financial systems, markets are the main source of (rather volatile) credit to the real economy. In this typology, both Italy and Spain were classified as bank-based financial systems, as were the main continental countries, such as France and Germany.

In their pioneering work, Hardie and Howarth (2013, see also Hardie et al. 2013) challenge the analytical usefulness of this typology arguing that it fails to detect the significant changes undergone by national financial systems over the last decade and to explain the different impact of the global banking crisis across countries. They develop the concept of 'market-based banking,' noting that banking over the last decade has become mostly market-based, meaning that banks fund themselves in the wholesale market (market-based liabilities) and invest in non-traditional banking activities (market-based assets). Consequently, three main types of national financial systems can be identified: those where non-market based liabilities (i.e., deposits) finance market-based assets; those where market-based liabilities finance non-market based assets (Spain and Italy are included in this category); and those where market-based assets are financed by market-based liabilities. Furthermore, these authors argue that 'the level and form of market-based banking provides a better guide to the impact of the international financial crisis upon different countries than regulatory framework or political economy type' (Hardie and Howarth 2013).

The higher the market-based assets and liabilities, the higher the exposure of national banking systems to the global banking crisis.

In this typology, Italy and Spain are classified next to each other as banking systems that are moderately market-based; Spain has somewhat more market-

based liabilities than Italy, and Italy has somewhat more market-based assets than Spain (Hardie and Howarth 2013). This explanation is problematic because though it fits well with the initial stage of the global banking crisis, when neither Italian banks nor Spanish banks experienced significant losses, the moderate level of market-based banking does not account for the banking crisis in Spain (as opposed to Italy) from 2009 onwards, as discussed in Section 3. Moreover, the typology developed by Hardie and Howarth does not allow for predictions about how the sovereign debt crisis would play out following the global banking crisis because they focused on the latter. To be fair, Hardie and Howarth mention the importance of nationally distinctive features in order to explain crisis outcomes in various countries, especially Italy and Spain, which do not fully fit their model, but they do not systematically investigate this crucial point. The research in this article builds on and further develops the 'bank-based' approach developed by Hardie and Howarth, identifying the distinctive features of bank business models and national banking systems that explain the different sovereign debt crisis scenarios in Italy and Spain.

2.1 Italian and Spanish bank business models and banking systems

In the run up to the global banking crisis, Italian and Spanish banks had a 'traditional' business model, as compared to other European banks. In Italy and Spain, the majority of banks' assets were loans to customers, and a significant part of these assets involved government securities, which at that time were considered among the safest possible asset investments (Pagoulatos and Quaglia 2013; Royo 2013b). There was, however, one main difference between Italy and Spain as far as assets are concerned. Unlike Spanish banks, Italian banks did not fuel a property bubble; namely, they lent to households less frequently than either Spanish or Greek banks. Italian banks predominantly lent to non-financial corporations; the bulk these loans went to services and industry, not construction (see Table 2). A property bubble can also come from residential mortgage lending, but there was no significant rise in consumer lending by banks in the years preceding the crisis in Italy. Lending to non-financial corporations (NFCs) was somewhat higher in Spain, than in Italy and Greece. However, in Spain, the NFC lending included a large proportion of property developers, especially among cajas, as explained below. Moreover, loans made to consumers for the purpose of house purchases were the vast majority of the total loans to consumers (see Table 3).

On the liabilities side, both Italian and Spanish banks had a broad and stable funding base. Funding from retail customers (considered more stable than wholesale funding) constituted a large share of the total liabilities in both countries (Pagoulatos and Quaglia 2013; Royo 2013b). However, banks in both coun-

Table 2: Italian bank loans distribution by customer segment of economic activity

	September 2007	**October 2008**
TOTAL LOANS (million of euros)	**1,453,323**	**1,500,679**
SEGMENT OF ECONOMIC ACTIVITY		
General government	56,985	58,357
Financial companies	161,470	168,448
Non-financial companies	775,447	809,079
of which: Industry	*259,068*	*274,649*
Building	*108,621*	*110,943*
Services	*393,365*	*408,285*
Producer households	88,665	89,645
Consumer households	370,809	375,151
* *of which* mortgages	265,454	261,839

Source: Bank of Italy (2008). *Summary Report of the Statistical Bulletin 2007-2008*, Data on credit, securities business and interest rates, quarter 4, p.3.

Table 3: Spanish bank loans distribution by customer segment of economic activity

	September 2007	October 2008
TOTAL LOANS (million of euros)	**1,747,148**	**1,907,070**
SEGMENT OF ECONOMIC ACTIVITY		
General government	41,022	46,401
Other resident sectors	1,706,126	1,860,669
**of which*: Industry	*140,332*	*155,481*
Construction	*150,341*	*156,363*
Services	*594,243*	*667,233*
Households (consumption)	*768,197*	*816,752*
* *of which* mortgages	*577,337*	*617,904*
**Agriculture	*25,085*	*26,593*

Source: Bank of Spain (2008). *Statistical Bulletin 2008 (December)*, Section B: Breakdown of lending and deposits of credit institutions, quarter, pp. 57-61.

tries depended on wholesale inter-bank funding, with some important differences. To begin with, Italian banks primarily lent to each other. Indeed, the average home bias for Italy was the highest among the euroarea's national banking systems (Manna 2011). Furthermore, Italian banks issued several debt securities, selling them to their customers, a funding method that exposed them less to the vagaries in the financial markets. Italian banks had greater access to retail investors for bond issues compared to other European banks (Bank of Italy 2011).

Considering both assets and liabilities simultaneously, a crucial difference between Italian and Spanish banks is that Spanish banks borrowed on the interbank market and channeled this funding to the construction sector through mortgage loans and loans to property developers. Hence, the banking system in Spain intermediated capital inflows,sustaining a massive construction boom (Gros 2012). On the interbank market, Italian banks borrowed to a more limited extent than their Spanish counterparts, and did not use this funding to provide credit to property developers and mortgages. Italian banks did not fuel a credit boom. Contrary to Spain, Italy experienced lower capital inflows, which were not intermediated by banks; most of these capital inflows were purchases of government bonds.

The other important difference is that Spain, unlike Italy had a dual banking system of (private) commercial banks and (public) saving banks, the cajas, which were unlisted in the stock market and accounted for half of the financial sector's assets. Cajas were peculiar credit institutions because they used to dedicate a significant portion of their provisions (usually over 20 percent) to social causes; prior to the crisis, they had strong links with their regional and local governments. In fact, recent studies show that political control of cajas was one main reason for their troubles. Moreover, the cajas were subject to a distinctive regulatory framework, and the Bank of Spain had limited supervisory competences on cajas (Royo 2013c).

In Italy, saving banks were subject to the same regulatory regime as commercial banks in addition to the stringent supervision of the Bank of Italy. Indeed, many casse (formerly, public saving banks) had been merged by commercial banks during the 1990s and 2000s, after the Amato Carli reform. Prior to the 'Amato-Carli' reform (named after two treasury ministers who proposed and enacted it), Italian

savings banks were publicly owned with close ties to local institutions and politicians (Deeg 2012). The 1990 reform introduced the concept of banks as profit making institutions; the reform was instrumental in promoting the privatization, the concentration, and the modernization of the Italian banking system (Ciocca 2005; Panetta 2004). It facilitated the merger of commercial and savings banks, which were not in direct competition (Deeg 2012). This reform also reduced the involvement of politicians and local authorities in bank management (with one main exception, discussed in the following section); hence the politicization of Italian banks was limited compared to Spain.

3. The (late) banking crisis in Spain, but not Italy

Initially, after the US collapse of the the subprime market in late 2007 and the bankruptcy of the US financial firm Lehman Brothers in October 2008, Italian and Spanish banks weathered the banking crisis rather well; they experienced no major losses and required no state recapitalisation. Italian and Spanish banks were relatively sheltered from the most intense forces of global financial contagion in 2008-2009. On the assets side, they had a limited amount of market-based assets; they had not invested in 'fancy' financial products that later proved to be 'toxic' and the majority of banks' assets comprised of customer loans. As for liabilities, Italian and Spanish banks had a broad and stable funding base, mainly from retail customers (see Section 2). Moreover, the Bank of Spain had imposed a regulatory framework requiring higher provisioning thereby providing cushions to Spanish banks to initially absorb losses caused by the outset of the global financial crisis (Royo 2013a).

In late 2009, major financial problems began for many of the Spanish savings banks (cajas). Unlike Italian banks that mainly lent to non-financial corporations, especially small and medium enterprises, Spanish banks, especially the cajas, lent to property developers as well as providing consumers credit for mortgages (see Section 2). This turbo-charged lending, funded by the interbank-market on the liability side of the Spanish banks' balance sheets, is crucial to understand the banking crisis in Spain. During the boom years, cajas successfully captured market shares from banks, investing heavily in real estate, lending both to consumers and developers. Both big Spanish banks and cajas took on significant levels of interbank liabilities. However, the cajas in particular expanded geographically and strengthened their national presence, as illustrated most visibly by a rapid growth in the number of employees and branches.

When the economic recession reached the country following the global banking crisis, they were exposed to the collapse of the construction sector and the payment difficulties of mortgage holders. Cajas, highly dependent on international wholesale financing because of their business model, were forced to ask the government and the European Central Bank (ECB) for liquidity when wholesale markets froze. However, Spain was unique in that the largest banks did not face significant problems. While cajas struggled under the weight of bad mortgages and loans to construction companies, the exposure of 'Big Three's' large banks (BBVA, Santander, and La Caixa) to toxic assets associated with the Spanish real estate sector was a relatively small setback. BBVA and Santander diversified internationally, gaining access to funding that allowed for liquidation of toxic property assets at a lower price compared to that of their rivals and with limited damage to their earnings. Hence, for the largest Spanish banks, geographical diversification helped counterbalance their domestic losses.

Since the inception of the crisis, Spain adopted five financial reforms in three years and implemented three rounds of bank mergers, the number of cajas dropped from 45 to 9. The Spanish government repeatedly increased capital provisions; those banks unable to meet the new standards could borrow additional money in state-backed convertible bonds carrying a ten percent interest rate. Furthermore, banks could transfer their riskiest assets to state-guaranteed asset management companies to help hurry the sale of real estate assets the bank held. Each bank was forced to create a bad bank into which it put physical property assets at devalued prices, in preparation for potential sales to outside investors (Royo 2013c).

In May 2012, the Spanish government was forced to nationalize Bankia, the country's largest real estate lender that was created by the merge of several ailing cajas. The Bank of Spain oversaw the largest bank nationalization in the country's history. The failure

of Bankia validated concerns regarding insufficient regulatory oversight, as well as the perception that Spanish banks and the Bank of Spain had downplayed the risk posed by real estate loans. In this regard, the supervisory failure of the Bank of Spain had much to do with the political control of cajas. Indeed, the deeper the political connection of the managers to these entities, the more likely it was that the Bank of Spain would look the other way; and conversely, the more politicized the cajas, the deeper their financial problems were during the crisis (Garicano 2012).

In August 2012, a new financial reform was approved in response to the EU financial rescue package. As a result, the Spanish government created a 'bad bank' that could absorb the toxic assets from the real estate sector, and had the authority to buy and sell a variety of assets, as well as issue bonds. The 2012 reform reinforced the Bank of Spain's role in the creation of the 'bad bank.' It also established a new process to restructure and liquidate financial institutions, giving a central procedural role to the Fund for Orderly Bank Restructuring and the Bank of Spain. Finally, the reform reduced the role of the regional governments in the restructuring and liquidation of cajas as well as saving cooperatives. The five financial reforms implemented in less than three years were largely perceived as 'too little and too late,' and failed to sway investors' confidence in the Spanish financial sector. Both the Socialist and Conservative governments were reluctant to admit the depth of the liquidity and solvency problems of many institutions, particularly the cajas, where politics played a role throughout the crisis.

Italian banks did not provide substantial funding to the construction sector; instead, they mainly lent to small and medium enterprises. The number of banks lending to consumers was moderate, especially loans made to consumers for the purpose of house purchases (see Section 2). Consequently, Italy did not suffer a property boom and bust. When the global banking crisis broke, Italian banks mainly restricted credit to the real economy, which deepened the economic recession but did not cause major losses for banks on the assets side. On the liabilities side, at the height of the crisis, banks cut their lending to those abroad far more than their lending to those domestically based. So the fact that Italian banks lent to each other meant that inter-bank borrowing was more stable than in those systems where inter-bank funding was largely from abroad (Manna 2011).

The only Italian bank that experienced serious losses as a consequnence of the global financial crisis was the Monte dei Paschi di Siena (MPS), the world's oldest bank. The origin of the MPS's financial problems was its (overpriced) acquisition of Banca Antonveneta for 9bn euros in late 2007. Santander, which sold Antonveneta to the MPS, had valued Antonveneta, minus a subsidiary that it kept, at 5.6bn euros. This acquisition gave the MPS the largest corporate loan book relative to its size in Italy and substantially weakened its capital base at a time when the financial crisis was gaining momentum. After the acquisition, the MPS had to rebuild capital. In March 2009, MPS took 1.9bn euros in state capital injections in the form of 'Tremonti Bonds' (named after the Treasury minister who promoted them). Afterward, the MPS did several (non-public) derivatives deals with Deutsche Bank and Nomura in order to keep huge losses off its balance sheet (Financial Times, 14 February 2013).

Once these deals (or rather the losses they were covering up) became public and as a consequence of moral suasion from the Bank of Italy, the top management of the MPS was replaced in April 2012 and was subsequently subjected to judicial investigations. The new management of the MPS immediately made public the huge losses suffered by the bank, making clear that they needed state financial assistance. The second bailout worth 3.9bn euros (the so-called Monti bonds, named after the prime minister who proposed them) was decided in January 2013 (Financial Times, 28 January 2013). It was subjected to scrutiny by the ECB, particularly the Directorate General on Competition Policy of the European Commission. Indeed, the European Commission, as part of its state aid policy, was very active in monitoring public financial support offered to banks across the EU during the crisis.

The MPS's downfall discredited the bank's former management and exposed the close ties between politicians and the bank. The management of the MPS was appointed by the bank's largest shareholder, the MPS Foundation, which controlled more than fifty percent of the bank's share. The Foundation, com-

posed mainly of local politicians, used its profits to finance a variety of non-bank related local activities, such as hospitals, museums, low-cost housing, the local soccer team, and even the Palio. However, unlike the Spanish cajas, political interference in bank management tended to be the exception to the norm in Italy, after the so-called 'Amato-Carli' reform of the 1990s, which opened the door to the privatisation and modernisation of the Italian banking system. Nowadays, foundations hold more than twenty percent shares only in two (large) Italian banks: Monte dei Paschi and Banca Intesa (De Bonis et al. 2011).

Despite the MPS debacle, banking supervision in Italy was assessed as systematic and diligent during the crisis and in the years preceding it (IMF 2008). The Bank of Italy, like the Bank of Spain, discouraged lenders from adopting risky 'off balance sheet' accounting methods, as well as from acquiring billions of euros of repackaged US subprime mortgages and other toxic assets. Moreover, the Bank of Spain and Bank of Italy forced all banks to focus on conservative risk management and quality of capital, limiting their leverage and debt equity ratio (Barth, Caprio, and Levine 2006). Clearly, this was not sufficient in the case of Spanish cajas, which, as explained above, were partly outside the Bank of Spain's supervisory framework.

4. External and internal imbalances in Spain and Italy

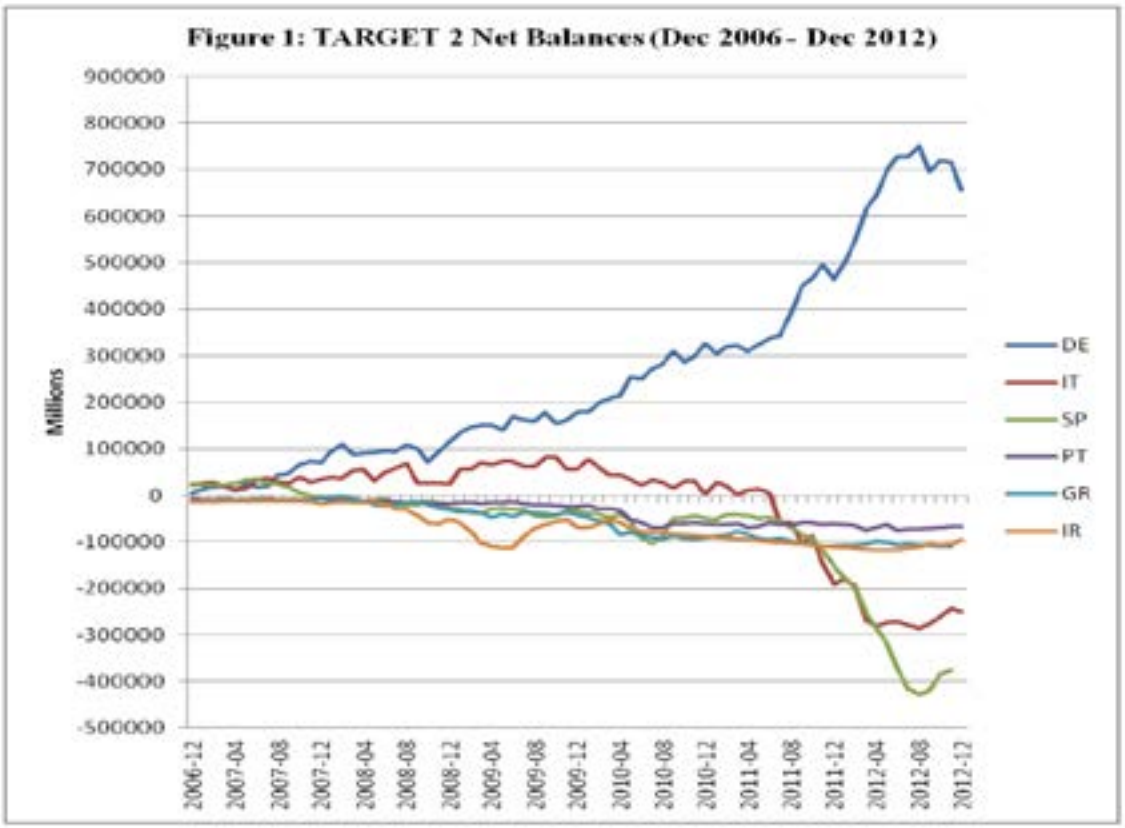
In the euroarea, economic imbalances built up over the decade prior to the crisis as massive capital flows moved from core euroarea countries, first and foremost Germany, to Southern euroarea countries. The capital-exporting countries invested their surplus savings abroad, and a large share of these cross border flows was intermediated through the global banking system, especially in capital-importing countries (Bank of International Settlements 2010). Similarly, in capital-exporting euroarea countries, most of the excess savings was intermediated by the banking system and other highly regulated intermediaries (e.g., insurance companies, pension funds, etc.) (Bank of International Settlements 2010). These intermediaries had a strong bias toward investing in the euroarea, hence capital outflows were mainly directed towards the periphery of the euroarea. However, the inflow of foreign capital served for different goals. In Spain (like in Ireland), banks borrowed on the wholesale market and channeled this funding into the construction sector domestically (Gros 2012). Contrary to Spain, Italy experienced lower capital inflows and did not experience a pronounced credit boom: most of the capital inflows in Italy were not intermediated by banks, but were purchases of government bonds.

Both Italy and Spain suffered from internal and external imbalances. As Bini Smaghi put it (2008), 'external imbalances are the reflection of internal imbalances.' The expansion of domestic demand, financed by capital inflows, contributed to making Southern euroarea countries uncompetitive. Their loss of competitiveness was thus a symptom, rather than a primary cause for the imbalances (Gros 2012). All periphery countries hit by the sovereign debt crisis had a persistent current account deficit over the last decade, coupled by significant private capital inflows from 2002 to 2009. Yet, in comparison to other countries, in particular to Spain who held the largest current account deficit in the euroarea, Italy had a much smaller current account deficit.

In both countries, current account imbalances were mainly funded through portfolio debt securities and bank loans (Merler and Pisani-Ferry 2012). As Merler and Pisani-Ferry (2012) note, 'such a financing structure, biased towards banks' intermediation, ren

dered the deficit countries very exposed to the unwinding of capital inflows.' Indeed, at the inception of the banking crisis, private cross-border flows reverted suddenly and a massive withdrawal of foreign private resources took place in the Southern euroarea countries. These capital outflows were reflected by Eurosystem central banks' position in the TARGET 2 (the Eurosystem's interbank payments system). Until 2007, TARGET 2 positions were close to balanced. When the global financial crisis began in 2007, and even more so when the sovereign debt crisis broke out in 2010, imbalances emerged within TARGET 2, whereby Germany was the largest creditor and Greece, Spain, Ireland, and Portugal were net creditors (see Figure 1). Italy became a major net debtor in TARGET 2 in late 2011, as explained below.

As for internal imbalances, despite the tendency to lump Spain, Italy, Greece, Portugal, and Ireland (PI-



Source: Authors' own compilation on the basis of monthly data from national central banks' datasets. Some data for Ireland are missing.

IGS) together and view the crisis as caused by fiscally irresponsible governments, it is important to emphasize that Spain's public finances were robust prior to the European sovereign debt crisis. Indeed,public debt was only 36.3 percent of GDP, and the country had budget surpluses from 2003 through 2007. In Spain, public deficits and debt soared as a consequence of the crisis; in response, the government implemented an 8 bn euro public-works stimulus. These expenses, combined with fall in revenue and the need to recapitalize a large number of Spanish banks (see previous section), regional deficits blew an enormous hole in the public accounts (see Table 1).

When the crisis hit, regions in Spain were shut out of credit markets, crippled by mountains of debt accumulated during boom years, struggling to cut their budget deficits. Many of these regions asked the national government for emergency financing, tapping into the 18bn euro fund established by the central

government to help regional governments meet their debt repayment obligations. The regional governments combined debts of 140bn euros, of which 35bn euros matured in 2012. Hence, Spain's regional state structure (with exceptions of Basque Country and Navarra) had limited fiscal power, effectively worsening the state of public finance.

Moreover, the key problem for Spain (unlike Italy) was not so much public sector debt in as much as private-sector debt, driven by record-low interest rates after the country joined the EMU in 1999, fuelled by reckless bank investments and loans (see Table 4). These, in turn, were funded by capital inflows that

turbo charged a property bubble that Italy did not experience. Land prices increased 500 percent in Spain between 1997 and 2007. At the end of 2010, the International Monetary Fund reported Spain as having the largest real estate bubble in the developed world.

Table 4. Indebtedness and Leverage in Selected Advanced Economies
(Percent of WEO projections for 2012)

	Euroarea	Italy	Spain
General Government Debt			
Gross	90	123	79
Net	70	102	67
Primary balance	-0.5	3	-3.6
Household Debt			
Gross	70	51	89
Net	-123	-171	-72
Nonfinancial Corporate Debt			
Gross	138	112	196
Debt divided by equity (percent)	106	139	149
Financial Institution			
Gross debt	142	97	109
Leverage of domestic banks	23	19	20
Bank claims on public sector	n.a.	32	26
External Liabilities			
Gross	191	142	221
Net	14	23	93
Government debt held abroad	25	49	28

Source: IMF Global Financial Stability Assessment 2012

And yet again, banks were at the heart of this development. In Spain, the decision by cajas to channel funding disproportionally to the construction sector (both to construction companies and real estate developers), but especially private mortgages, was critical to fuel the bubble in that sector (Serra Ramoneda 2011). There was reticence to lend to small and medium enterprises (SMEs) outside of construction and real estate sectors. Indeed, restrictive lending to SMEs was a reason for poor labor market performance because it undercut these firms' efforts to create jobs and innovate (Fishman 2012 293–299).

The relatively high customer funding gap meant that market-based liabilities 'turbocharged' traditional lending (see Section 2). Spain had high levels of securitized lending (banks transforming mortgages into asset-based securities (ABSs)) that contributed to the property market bubble. Indeed, between 2000 and the summer of 2007, both the securitisation market and the covered bond market significantly expanded in Spain. These securities were issued for funding purposes. Between 2000 and 2007, the net flow of loans was persistently above the flow of deposits, and Spanish financial institutions relied on bond markets to fund this gap. Financial institutions relied not only on the securitisation market, but also on other fixed-income markets for the same purpose, notably including the covered bond market.

In terms of outstanding amounts, by June 2007, Spain was ranked second (after the United Kingdom) in Europe in the securitization market and third (after Germany and Denmark) in the covered bond market. Hence, banks' intermediation played a key role in attracting capital inflows and channeling them in the construction sector, rendering the Spanish economy vulnerable were there ever to be sudden withdrawal of these funds (Merler and Pisani-Ferry 2012). One consequence of the global financial crisis has been the evaporation of market liquidity; its impact was particularly severe for ABSs because market liquidity is an important characteristic of those assets (Blanco 2011, 17-19). On the liabilities side, funding for Spanish banks was complicated by difficulties in accessing international wholesale markets because securitization markets (and others, such as the inter-

bank or senior debt markets) were still not completely open to small and medium-sized institutions.

The crisis burst the real estate bubble in Spain, thus further complicating the banks' funding problems, and increasing the proportion of non-performing loans. By the end of 2011, land prices, adjusted for inflation, had fallen about 30 percent from the 2007 peak, and home prices were off by about 22 percent. House prices fell by 11.2 percent in 2011 alone, while in Madrid, prices went down by 29.5 percent. Expectations, however, are still that the original house price increases may be reversed, so prices would have to fall 40 percent from that level (Financial Times, 11 April 2011). The implosion of the real estate market exposed the vulnerability of the banking sector to that market, which constituted 60 percent of the banking loans (i.e., loans to families, enterprises in the real estate sector, or direct real estate assets), as explained in the previous section.

Unlike in Italy, the main fiscal problem in Spain was not the total amount of its public debt, but rather its total net foreign debt. Indeed, the debt ratio that really matters in determining a country's solvency is not so much the ratio of net public debt to GDP, but total public and private external debt (see Table 4). In the case of Spain it reached 170 percent of GDP at the end of 2012. In Italy it reached 'only' 124 percent (Munchau 2013). Furthermore, most of Spain's external debt positions originated from banks (as opposed to the government or NFC). About half of it was short term, and half long term; foreign direct investment was limited; and finally, the monetary authorities – central banks – increased their already high net debt positions during the crisis (see Figure 1). As a consequence, the country's problems intensified when foreign investors became reluctant to refinance debt, as reflected by increasing yields in 2011 and 2012. The high degree of Spain's external indebtedness was partly the consequence of record current account deficits and capital inflows that Spain experienced during the first decade of EMU membership.

Italy managed a public debt over 100 percent of GDP throughout the last three decades, but the level of private debt was rather low. On the negative side, the Italian government failed to take advantage of low interest rates following the entry of the country into the EMU – a move that would have substantially reduced the outstanding public debt (Bini Smaghi 2013). On the positive side, Italy ran a primary surplus from 1992 on, with the exception of a primary deficit in 2009 and 2010, mainly due to a falling growth rate (see Table 1). The main problem in the Italian case was not so much the high level of public debt, especially when accounting for the relatively low level of private debt (see Table 4) and that public debt was mostly held domestically. It was the low growth rate that raised serious issue regarding public debt sustainability (Jones 2012). Italy has been suffering from low economic growth for more than a decade; it experienced 0.54 percent annual average real GDP growth between 2000 and 2010, compared to 1.37 percent for the euroarea, whereas economic performance in Spain was significantly better (thanks largely to the real state bubble) in the decade prior to the bubble.

Unlike Spain, Italy had limited external indebtedness (see Table 4) and did not experience high level of capital inflows. This was the consequence of the relatively small current account deficits that Italy saw during the first decade of EMU membership and the high savings rate in the country (see Table 1). Unlike Spain, Italy had the second-largest manufacturing and industrial base in Europe, after Germany, and is one of the biggest export-oriented economies in the euroarea. 'Made in Italy' is still a valuable brand around the world. Furthermore, Italian banks, unlike those in Spain, did not channel capital inflows into a property bubble. Most Italian bank lending was to manufacturing and service sectors (see Section 2 and Table 2). Like Spanish banks, Italian banks borrowed in international markets through securitization, but Italian securitization assets comprised half of that in Spain, as measured as a percentage of GDP. Moreover, fewer than half of Italian securitization was residential mortgages (Hardie and Howarth 2013), which were badly hit by the implosion of the property bubble.

Yet, the global financial crisis eventually precipitated a balance of payment crisis in Italy in January 2011 caused by a massive sell-off of Italian sovereign debt and Italian bank stocks. In addition, there was evidence of a drain on bank deposits as well (Jones 2012). Italy, akin to Spain, experienced significant

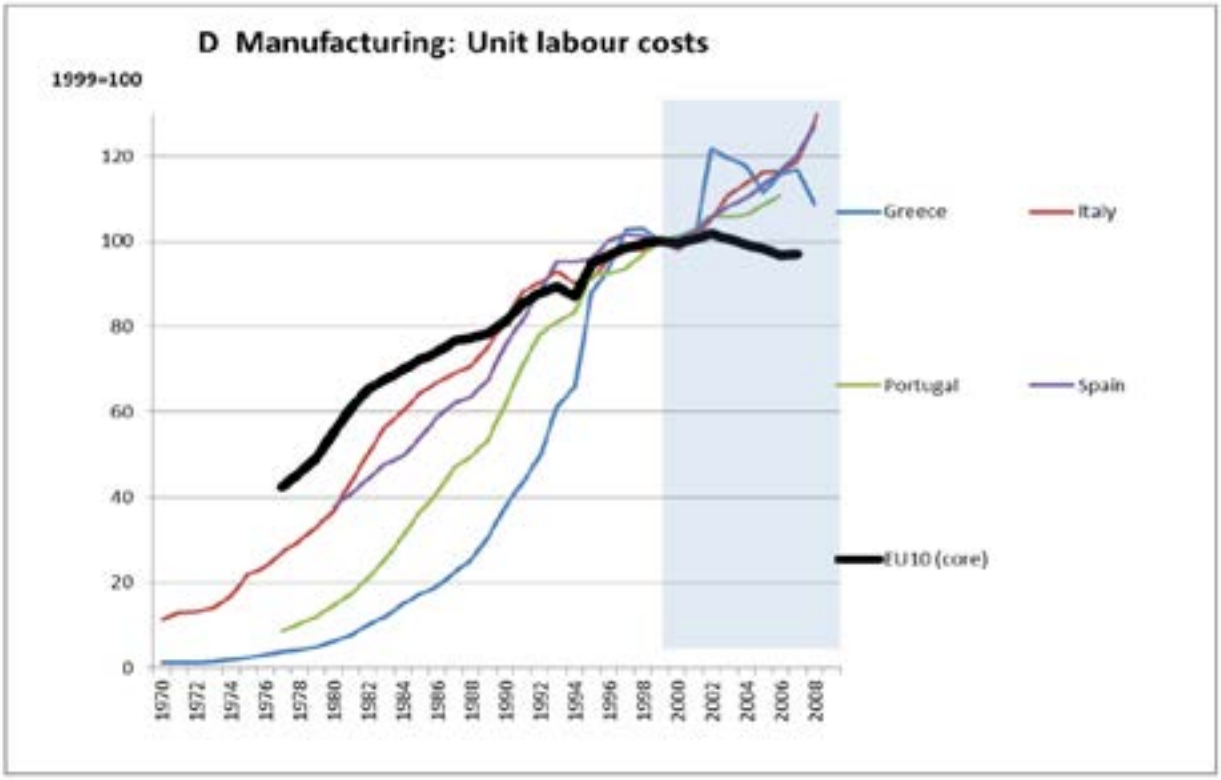
capital outflows during summer 2011. The liquidation of Italian public debt held by foreign investors caused capital outflows. Italian bonds were sold in large quantities because they were no longer considered risk free assets. In the TARGET 2 system, the Bank of Italy, previously a creditor, became a net debtor after late 2007 (see Figure 1).

The ECB responded to these market developments and to the increasing spread on Italian and Spanish government bonds by establishing the Long-Term Refinancing Operation (LTRO) in December 2011. The ECB issued loans at a one percent interest rate for a three-year period to European banks, requiring government bonds, mortgage securities, and other commercial papers in bank portfolio as collateral. Concurrently, the ECB changed its collateral rules, accepting lower quality collateral in return for loans. Under this program, the ECB loaned 489bn euros to 523 banks, mainly in Greece, Ireland, Italy, and Spain. Indeed, Italian and Spanish banks took nearly sixty percent of all new ECB loans, with Spain's overstretched banks taking marginally more than Italy's. Banks used these funds to buy government bonds, effectively easing the debt crisis. In February 2012, following the second Greek bailout, the ECB held another three-year auction of 529bn euros to 800 European banks. Although the ECB program did not specifically target Italy or Spain, these countries benefited from a temporary reduction in borrowing costs.

The ECB lent to euroarea banks, which in turn lent to euroarea governments using the purchased government debt as collateral for even more ECB loans. Euroarea market instability and unsustainable borrowing costs for countries such as Spain and Italy led to the ECB's decision, announced on 6 September 2012, to purchase euroarea countries' short-term bonds in secondary markets, as part of the new program dubbed Outright Monetary Transactions (OMT). However, they required beneficiary governments to apply for euroarea rescue funds in compliance with OMT conditions in exchange for support. To date, neither Italy nor Spain have applied for it.

Both Spain and Italy suffered from a loss of competitiveness since joining EMU. Between the introduction of the euro in 2008, unit labor costs in the

Figure 2



Source: OECD

manufacturing sector – the strongest indicator of the economic competitiveness – continued increasing more rapidly in both Italy and Spain than the EU10 average (see Figure 2). During that period, the countries' productivity marginally increased. According to the World Economic Forum's annual 2012 competitiveness ranking, 'one of the shared features of the current situation in all these [Southern European] economies is their persistent lack of competitiveness…. Over all, low levels of productivity and competitiveness do not warrant the salaries that workers in Southern Europe enjoy and have led to unsustainable imbalances, follow by high and rising unemployment.'

5. Conclusions

This paper asked why Spain experienced a full-fledged sovereign debt crisis resorting to euroarea financial assistance for its banks, whereas Italy did not. The answer is that Spain had both a banking crisis and a balance of payment crisis, whereas Italy only experienced a balance of payments crisis. Banks in Spain played a key role in the build-up of the banking and balance of payments crises, Italian banks did not do so. Banks in Spain (to be precise, the cajas) turbocharged a property bubble, funded through short-term capital inflows, which resulted in high net foreign debt. The implosion of this property bubble coupled with dependence on wholesale market liabilities in addition to the depth of the economic crisis, meant trouble for the Spanish cajas, triggering a traditional banking crisis. The cajas, unlike Italian banks and Spanish large commercial banks, suffered heavy losses and 'banked on the state' for financial support (paraphrasing Haldane and Alessandri 2009). A balance of payment crisis followed, due to sudden and significant capital outflows. The Spanish government did not have sufficient funds to recapitalize its ailing banks resorting instead to euroarea funds. Indeed, Reinhart and Rogoff (2009) show how historically, most sovereign debt crises started off as banking crises.

By contrast, Italian banks did not fuel a property bubble and were not burdened by unsustainable levels of mortgage debt, therefore avoiding significant losses during the global financial crisis. Unlike in Spain, Italian banks were not instrumental in fostering significant pre-crisis capital inflows; hence, Italian net foreign debt remained limited, and the country had a lower gross external debt position than Spain (124 percent of GDP versus 170 percent in Spain). Italy, however, experienced significant capital outflows in summer 2011, when foreign investors sold large quantities of Italian public bonds, requiring ECB interventions. The problem for Italy was the vicious circle of an economic recession, lack of credit, and a public sector with very limited resources to stimulate the economy (OECD 2010). The high level of debt that minimally increased during the crisis coupled with the low level of growth raised concern of the debt sustainability.

As for the 'so what' question, developing further the bank-based literature pioneered by Hardie and Howarth (2013), this research identifies two distinctive features of bank business models and national banking systems that account for the different sovereign debt crisis scenarios in Italy and Spain. These findings can be extended to other countries, especially those at the periphery of Europe.

With reference to bank business models, the crucial difference was that Spanish banks borrowed (mostly short-term) funding on the wholesale market and channeled them into the construction sector, fuelling a property bubble (like in Ireland) and fostering massive capital inflows. Italian banks (like Greek banks) borrowed less on the wholesale market and did not lend substantially to the construction sector. Capital inflows in Italy and Greece were mainly purchases of government bonds with the difference that in Greece a higher percentage of government debt was held by non-residents. Spain and Ireland experienced a property bubble, which was followed by major losses for banks when the bubble imploded. Italy and Greece did not have a property boom and bust. They experienced a traditional fiscal crisis and balance of payments crisis, following the sell-off of government debt by non-residents.

The second important feature concerns the duality of national banking system, as was the case in Spain, but not in Italy. It explains why some parts of the banking sector were heavily politicized in Spain and

were able to escape to some extent the normal regulatory framework and the supervision of the Bank of Spain. Other countries at the periphery of Europe did not have a dual banking system like Spain. However, Germany and Austria had a three-pillar banking system that somewhat resembled the Spanish one. And indeed, public banks in Germany (especially the Landesbanken) experienced serious losses during the global financial crisis (Hardie and Howarth 2009), and required financial assistance from the government. The German government, unlike the Spanish one, was in a position to do so. Italian banks, which were subject to the stringent supervision of the Bank of Italy, were marginally hit by the global banking crisis and required minimal financial support from the state.

Whereas the role of banks in the play out of the banking crisis is not much of a novelty, more insightful is their role in the build up of the macroeconomic imbalances that led to the balance of payments crisis. This paper focuses on banks in Spain and Italy. However a similar analysis could be extended not only to banks in other debtor countries, such as Ireland and Portugal, but also to banks in creditor countries that were indeed heavily exposed in Southern Europe when the sovereign debt crisis broke out. Capital inflows from banks in creditor countries fuelled macroeconomic imbalances in debtor countries. When these banks suddenly pulled out some of their investment, they worsened the crisis in the periphery. This analysis suggests that the causes of the crisis were complex, and that banks within (and outside) debtor countries played a major role in it.

ENDNOTES

1. However, Italy, like Spain, benefited substantially from the European Central Bank's purchase of government bonds in the secondary markets attempting to reduce borrowing costs. For an overview of governments' reactions to the crisis in several countries, see Bermeo and Pontusson (2012).

2. Cuñat and Garicano (2009) have shown that cajas with politically connected chief executives with no previous banking experience and no graduate education did substantially worse in the run up to the crisis (i.e., the executives granted more real estate developer loans, up to half of the entire loan book, in some instances) and during the crisis with higher non-performing loans.

3. Spanish banks increased their ECB borrowings by more than six times between June 2011 and October 2013. In March 2012, they borrowed a record 316bn euros from the ECB, 28 percent of the euroarea total, the highest level in absolute terms among euro area banking systems (Royo 2013b).

4. This deal was subsequently investigated by Italian magistrates, following accusations of corruption and fraud.

5. The Palio is the historical bareback horse race in the town square.

6. Merler and Pisani-Ferry (2012) estimated that the accumulated net position of the Northern euroarea central banks reached 800bn euros in December 2011, matched by the southern euroarea central banks' equally negative position.

7. Reported by the BBC www.bbc.co.uk/news/business-18058270 on 4 May 2012.

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