

Spain's Financial Crisis

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Spain experienced a remarkable period of expansion from 1994 until 2007. When the global financial crisis devastated the European economy, Spain was uniquely hit by the crisis, experiencing a severe recession that lasted until 2017. Spain's crisis was the outcome of a confluence of an asset pricing bubble and political and regulatory errors. Though Spain's particular circumstances were unique for a variety of reasons, the country's financial crisis potentially serves as a warning sign to other developed nations whose political, economic, and financial environments bear some similarities to Spain's before the crisis.

The proximal cause of Spain's financial crisis was similar to that of Ireland's and the United States' — the popping of a housing bubble. Spanish housing prices rose by 250% from 2002-2007 (Wagner, 2014). Part of this growth came from the inflow of foreign investment after Spain fully joined the Eurozone in 2002—completing a process that began in 1999. The nation's economy grew rapidly, pushed by the real-estate and construction sectors.

Spain's expansionary period occurred in spite of a decay in national total factor productivity—a measure of the productive capacities of the economy. Garcia-Santana et al (2016) find that this decay wasn't precipitated by a decline in the productive capacities of the Spanish labor force, but rather by a decline in the allocative efficiency of Spanish capital. They suggest that a combination of the credit boom masking the investing efficacy of Spanish firms, an increase in the working-age population ratio, and capital accumulation driven by government subsidies were the factors driving this era of Spanish growth in spite of its productivity declines.

Financing this expansionary period were Spain's financial institutions. Spain's banking system was a significant part of what made it particularly susceptible to the financial crisis. Spain's banks were divided into two categories: the *bancos*, large commercial banks, and *cajas*, or regionalized savings banks. While the *bancos* were governed by national regulations and the Banco de España, the *cajas* were only subject to regional regulation that varied in intensity.

Spain's *cajas* were not only under-regulated relative to Spain's commercial banks, but they were heavily exposed to the overheating Spanish real estate sector. Thus, when the bottom fell out from under Spain's real estate market, many *cajas* were woefully underequipped to deal with the sudden decline in value of their mortgages. Indeed, the Oliver Wyman (2012) post-mortem examination of the Spanish banking system following the crisis revealed a surprising level of decay within the *cajas* network. Many of the policymakers responsible for overseeing the *cajas* were also financially invested in the *cajas*—creating severe conflicts of interest. The financial instability of the *cajas* led to widespread fears of insolvency and default, fueling often futile efforts to save these institutions. Of the 45 *cajas* in Spain prior to the crisis, less than ten remained after defaults, restructuring, mergers and bailouts. In a 2010 effort to preserve these failing regional institutions, seven large *cajas* were merged to form a new entity—Bankia—which immediately became the 3rd largest lender in Spain. Bankia's exposure to the real estate market, botched IPO, and continued reckless lending practices led to insolvency and an eventual bailout that culminated in its nationalization in 2012 (Mallet and Johnson, 2012). Amid the turmoil in Spain's financial markets, only the two smallest *cajas* at the time, Colonya Caixa Pollença and Caixa Ontinyent, survived in their initial form (Pla-Barber et al, 2017).

This financial market turmoil plunged Spain into a credit crunch that coincided with a significant decline in global trade, meaning that Spanish investment and exports declined in tandem. Spain's presence in the Eurozone—once the source of Spain's investment boom—meant that the relative strength of the euro,

even during the financial crisis, did Spain no favors in trying to combat their recession. Spain was unable to devalue their currency to combat the recession. By angling for nearly €100B in bailout funds from the European Central Bank, Spain had to commit to fiscal austerity measures that made expansionary fiscal policy impossible. There would be no easy way out of the crisis for Spain.

The toll that the financial crisis took on Spain was immense. In 2013, unemployment reached 25%, while youth unemployment climbed to more than 50%. GDP contracted by 3.6% in 2009, and then by 2.9% in 2012. As the housing bubble deflated, Spanish housing prices declined by 42% from 2007 to 2015 according to Global Property Guide. Spanish bond yields rose significantly and the increased cost of servicing its debt, combined with a higher national deficit, led to Spain's national debt increasing from 38% of GDP in 2007 to nearly 70% of GDP in 2011 according to Eurostat.

Spain's experience during the global financial crisis highlights the potential downsides of both rapid development and internationalization. Spain's reliance on foreign inflows of currency, coupled with improper regulation of its cajas, led to a disastrous collapse of Spain's economy from which it has taken nearly a decade to recover. The crisis led to a fundamental restructuring of the Spanish financial system, and a persistent, demand-led recession that lasted nearly a decade.

Though Spain's recession officially ended in 2017, Spain is undoubtedly still grappling with the effects of the financial crisis. Spain's unemployment rate sat at 16.1% in 2018, double what it was before 2007. Part of this high unemployment is structural—a combination of stringent labor laws, strong unionization, and a traditionally strong informal economy has kept Spain's official unemployment numbers consistently above that of other developed European countries. But with youth unemployment at 34% as of February, 2018, and national GDP still \$300 billion USD below its peak in 2008 (Eurostat), Spain's economy still likely has a long way to go before it can truly put the global financial crisis in the rearview mirror.

Underpinning these economic conditions is the tumultuous political climate in Spain. Catalonia, the wealthy, autonomous region in the northeast of Spain, has already voted in a referendum to become independent from Spain—a decision that sparked governmental backlash as Spain's central authorities suspended Catalan autonomy and asserted control over the region for nearly seven months.

Examining the experience of Spain during the financial crisis allows us to recognize a couple salient points: firstly, how issues on the financial side of the economy translate to the market for goods and services; and secondly, that though few countries were spared the negative impacts of the global financial crisis, even fewer countries had the exact same experiences and outcomes as one another.

There were many factors that made Spain uniquely susceptible to befalling the exact sort of recession that it did. To recap: Spain's expansionary period upon joining the Eurozone made its real-estate bubble increasingly reliant on foreign investment that could dry up should the investing nations experience an economic shock; Spain's domestic financiers, meanwhile, were uniquely underregulated and heavily invested in this asset bubble; concurrently, Spain's total factor productivity (TFP) declined, likely meaning that should Spain's expansionary period be followed by a recession, the nation's recovery would be difficult and prolonged as the economy's productive capacities had declined. Finally, Spain's presence in the Eurozone meant that it would not have the flexibility to devalue its currency to combat such a recession.

Regional politics, the structure of the nation's financial system, the currency regime, trade policy, and culture all have a role to play in determining how an economy reacts to a financial shock. Spain's financial crisis serves as a case study and a warning—not only to countries with Spain's exact confluence of events, but all developed countries with structural weaknesses in their economy or financial system.

Discussion Questions

1. Pick a country and find out its historical unemployment numbers leading back to 2005. How did its labor laws influence its recovery from the Financial Crisis? Discuss both the impact on the broader economic recovery as well as the impact on the progression of wages in the country.
2. The U.S. Savings and Loan (S&L) Crisis in the 1980's, in some respects, bore many similarities to the collapse of Spain's cajas, in which a coordinated failure of regional financial institutions harmed the nation's financial stability. Following the 2008 financial crisis in the U.S., much of the calls for increased regulation centered on systemically important banks deemed "too big to fail". Discuss the "dangers" posed to financial systems by both localized financial institutions and large, globally important financial institutions.
3. Choose a developed country and describe its financial system. What are its defining or unique characteristics? How do these characteristics make the country more or less susceptible to financial crises?

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