31. Financial crises in Spain after Bretton Woods: 1977 and 2008 crises

1977–2020

The Bretton Woods (BW) system, established after the Second World War, was dissolved in 1971. It marked the end of the dollar's convertibility into gold, and from 1973 the major currencies began to float against each other. Floating exchange rates and the elimination of capital controls reinforced international financial flows in a context of abundant liquidity favored by the accumulation of petrodollars due to the rise in oil prices in 1973 and 1979. In addition, many countries underwent a process of financial deregulation. The main result was increased financial instability, with more banking and twin (currency and banking) crises than in the BW period (Bordo et al. 2001). The situation was even worse in Spain.

First, in the post-BW period, crisis frequency[1] was high in Spain by international standards.[2] In this period, Spain suffered five financial crises: 1977, 1982, 1991, 1995, and 2008. However, as the Spanish literature on crises generally holds that the banking problems of the mid-1980s resulted from the 1977 banking crisis, the 1977 and 1982 financial crises will be taken together here. Second, crisis severity has been higher in Spain since 1973 than in previous periods. The two most severe and longest financial crises to occur since 1850 happened in 1977 and 2008.

Finally, in the post-BW era, the Spanish financial crises remained severe by international standards. Laeven and Valencia (2018) provide a database on banking crises for the period 1970–2011, in which they present a median value of the output loss (computed as the cumulative loss in income relative to a pre-crisis trend) for 147 crises of −23 percent. The two abovementioned Spanish financial crises resulted in an output loss above the Laeven and Valencia median values: −25.97 percent in 1977 and −27.33 percent in 2008 (Betrán and Pons 2017). Financial liberalization and external imbalances lie at the root of the higher frequency and severity of the Spanish financial crises in this period. Below, we explain the main sequence of events and drivers of these two most severe crises.

1977 crisis

The 1977 crisis began as an economic and industrial crisis that gave rise to financial turmoil. From the end of the 1950s, Spain opened up timidly to the international markets, although economic growth was mainly based on domestic demand. Spanish exports remained weak, while imports (raw materials and capital goods) increased due to rapid industrialization in the 1960s. The result increased external imbalances, which shot up further with the oil crises of 1973 and 1979 because oil imports represented around two-thirds of total energy consumption. Moreover, unlike in the 1960s, tourism revenues and migrant remittances did not cover trade deficits. These large external imbalances resulted in a currency crisis in which the exchange rate deteriorated between 1974 and 1985 from 58 pesetas/dollar to 160 pesetas/dollar.

Initially, the government tried to smooth the oil crisis's impact on price intervention, but the crisis was deeper than the government had predicted. Consequently, Spain suffered a currency crisis and substantial growth in the public deficit, which led to a fiscal crisis (Betrán and Pons 2017). Inflation and unemployment rates skyrocketed. Inflation peaked at 25 percent in 1977 and 1,200,000 people lost their jobs between 1977 and 1981.

In addition to rising oil prices, the Spanish economy faced other domestic problems. Technical obsolescence, lack of competitiveness, and an overdependence on credit put industrial companies in a precarious situation when the oil crisis broke out, leaving many firms unable to survive. The crisis was transmitted from the industrial to the banking sector through two mechanisms. First, the crisis spread through an increase in failed industrial firms and unpaid clients (with an increase in non-performing loans-to-total loans from 1.1 in 1973 to 3.3 in 1981 and 5.40 in 1984). Second, a stock market crash caused a marked deterioration of the balance sheets of those Spanish banks with large industrial portfolios (Cuervo 1988).

Financial problems exacerbated the economic distortions in the real sector. During the BW years, Spain was quite similar to other countries in terms of its monetary regime, with a fixed exchange rate and capital controls. Following the collapse of BW, Spain switched to a floating exchange rate regime in 1974. Capital controls, however, were in effect until the late 1980s. In this period, the Bank of Spain—which had been entirely subordinated to government interests during the BW era—began to assume a modern central bank's role. After a period of financial repression during the Franco dictatorship, Spain, like other European countries, embarked on a learning process to implement monetary policy that was not without its difficulties. In the Moncloa Pacts, an economic and political agreement was passed in 1977 to stabilize the economy during Spain's transition to democracy.

Monetary policy and the liberalization of financial markets became explicit targets. However, the serious economic difficulties and the state's continuous calls for finance from the Bank of Spain limited the Bank's autonomy to implement monetary policy (Martín-Aceña 2017). In terms of financial regulation and structure, in the 1970s, Spain had a tightly regulated financial system and a concentrated banking sector in which the Big Five banks achieved a dominant position. However, protectionist rules and institutions were incompatible with entry into the European Community, and to pursue that goal, it was necessary to dismantle them progressively. The liberalization process received a major boost starting in 1974. The main changes included implementation of more flexible regulation that allowed greater branch expansion (in 1975 there were 7,218 bank branches and only three years an increase of around 36 percent from 1970 to 1976) and financial assets expansion (the ratio of financial assets to GDP rose from around 1.5 in 1968 to 2.12 in 1977). Some rules that distinguished between banks and savings institutions were eliminated (although some important ones were maintained). The second wave of financial reforms started in 1978 when the authorities approved new banks, and foreign banks were allowed to set up in Spain (although with strong restrictions; for example, they could not open more than three offices). The reform also allowed more flexible interest rates. The process ended in 1987/88 with the deregulation of the different interest rates and commissions and removal of barriers to entry to foreign banks.

All these changes increased banking competition (Caminal et al. 1993) but also financial instability. As banks were not used to operating in a competitive environment, in this new context, their main reaction was to expand their geographical and business areas, leading to an increase in operational costs. The problem was that liberalization was not accompanied by appropriate prudential regulation and supervision (Poveda 2012), and banking and credit growth was coupled with bank mismanagement, leading to a large number of risky, speculative, and even illegal banking practices (Cuervo 1988). When the 1977 banking crisis occurred, monetary authorities were forced to introduce the necessary mechanism to tackle banking problems and increase supervision (Cuevas and Pons 2020).

The main impact of the 1977 crisis was on the banking sector (Table 31.1). In total, 63 banks out of 110, representing 20 percent of banking system deposits, experienced solvency problems, and this crisis was categorized as one of the so-called recent "Big Five Crises" by Reinhart and Rogoff (2008). Although the crisis started in smaller, younger banks (90 percent of the banks that were involved in the crisis had been founded between 1973 and 1978), in 1982/1983, it eventually affected Rumasa, a large industrial holding company with 20 banks, as well as Banco Urquijo, an industrial bank that was among the eight biggest banks in Spain (Cuervo 1988). The final result was a banking restructuring that led to an increase in concentration (because the larger banks purchased those banks in difficulties) and strengthened the regulatory framework. The cost of the crisis for the period 1977–1985, measured as the contributions of the public and private sector in order to deal with the banking crisis, was estimated by Cuervo (1988) at 6 percent of GDP (Table 31.1); that is, not far off the median of 6.8 that Laeven and Valencia (2018) calculated for their sample of crises from 1970–2011. Despite the serious macroeconomic consequences of the 1977 crisis, currency manipulation (with devaluations in 1976, 1977, and 1982) allowed Spain to mitigate to some extent the negative effects of the crisis.

2008 crisis

The 2008 crisis occurred after a period of rapid growth (mainly driven by the construction sector) accompanied by a decline in competitiveness that began in the mid-1990s (Escrivá and Correa 2010). This economic growth was sustained by foreign private debt and large current account deficits (Betrán and Pons 2017, 2019). External imbalances were the result of (a) a continuous decline in competitiveness that produced trade deficits, (b) an expansion in internal demand, especially in the real estate sector, and (c) the entry of foreign capital after joining the euro in a period of capitalist globalization and low interest rates that accentuated the growth in credit and the debt of households and non-financial corporations (which rose from 94 percent to 191 percent of GDP in the period 2000–2007 (Bank of Spain 2017)). Entry into the European Economic and Monetary Union was good for the growth of the Spanish economy since it helped attract investment capital at lower interest rates; however, it also meant the loss of certain policy instruments, particularly the monetary and exchange rate policies.

Financial liberalization was also behind the 2008 crisis. From the last decade of the twentieth century until 2007, there was a new wave of deregulation to encourage competition by allowing banks and savings banks to carry out the same operations. Moreover, re-regulation was aimed at adapting the financial sector to conform to the EU. As in the 1970s and 1980s, the main result was strong competition fueled by technological change, globalization, and EU integration. This strong competition produced a fall in banking interest margins that from 1997 to 2006 decreased by 41 percent (in contrast to a decrease of only 24 percent in the Eurozone). Increased competition prompted the restructuring of the banking sector through bank mergers.[3] Moreover, banks reduced their branch network and the larger banks had an international expansion, mainly in Latin America (Berges, Ontiveros, and Valero 2012). Saving banks, however, had limitations to internationally expand[4] and in this competitive market, they adopted an aggressive geographic expansion process. Moreover, in a context of low interest rates and increasing housing prices,[5] saving banks supplied credit demand, especially in the building sector (mortgages and loans to real estate) and real estate risk in their portfolios went from 32.7 percent in 1997 to 62 percent in 2007 (Jimeno and Santos 2014). Illegal banking practices and imprudent management were also common in savings banks.[6] Although saving banks supervision was in the hands of regional governments, a conflict of interest became apparent because regional governments also controlled these financial institutions.

The international context (the bursting of the US housing bubble in 2007) was crucial in bursting the Spanish bubble and the associated banking problems. The Spanish economy was very dependent on external financing and in the years preceding the crisis Spain was the recipient of large capital flows. When the international crisis erupted, it triggered a reversal in international capital inflows and restricted Spanish banks and the government's access to international markets (Jimeno and Santos 2014).

The 2008 crisis was a banking crisis that mainly afflicted the savings banks (Table 31.1), although other banks were also exposed to toxic real estate assets (defaults on mortgages and loans to property developers) and most of them kept repossessed properties, which were overvalued, on their balance sheet. The crisis led to the disappearance of the savings banks (there were 45 savings banks in 2007 and only two in 2010) and the restructuring of the Spanish financial system as savings banks were merged with or acquired by other entities and transformed into new commercial banks. The crisis affected around 35 percent of total financial assets and around 50 percent of total loans and deposits (Martín-Aceña, Martínez-Ruiz, and Pons 2013).

The burst of the housing bubble and the problems with savings banks (due to their involvement in the construction sector) produced a credit crunch (Table 31.1). This reduced investment and had a strong impact on job destruction. Worsening economic conditions (particularly the large rise in unemployment rates, which peaked in 2012 at 25.8 percent) had a direct impact on public finances (sparking a sovereign debt crisis) as a consequence of the drop in public revenues and the increase in expenses linked to unemployment insurance programs and the adoption of some measures aimed at counteracting the contraction of private demand (Conde-Ruiz and Martínez-Ruiz 2020). As

Table 31.1 *Impact of the 1977 and 2008 crises*

	1977	2008
Type of financial intermediaries affected by the crisis	Small and medium-sized banks	Savings banks
Number of financial intermediaries affected	63 banks	14 savings banks received financial aid and 4 were merged
Non-performing loans	The highest rate in 1984 (5.4%)	The highest rate in 2012 (10.43%)
Credit crunch: change in the credit-to-GDP ratio from the crisis year to the year with the lowest ratio (%)	−11.91 %	−16.05%
Output loss (%)	−25.97	−27.33
Cost of the crisis as % of GDP	1977–1981 (6%)	2008–2013 (5–9%)

Source: Betrán and Pons (2017).

a result, Spain passed from a fiscal surplus of 2 percent of GDP in 2007 to a deficit of 4.4 percent in 2008. There are no accurate estimates of the total cost of the crisis intervention, but the most optimistic estimates suggest that from 2008 to 2014, it was around 5 percent of GDP, not far off the estimates for the 1977 crisis; other estimates put it at around 9–10 percent of GDP (clearly above the 1977 crisis) (Betrán and Pons 2017). In this crisis, Spain's membership in the Eurozone prevented it from using the monetary instruments needed to tackle the crisis. In particular, in 2008 Spain had lost the exchange rate policy as a consequence of being in the euro zone and could not devalue the currency. Instead, it turned to an "internal devaluation" (austerity measures and wage adjustment) to increase competitiveness and correct its external position and public sector problems. By contrast, being in the euro area averted a "real" currency crisis.

To sum up, the 1977 and 2008 crises were multiple crises (banking, currency, stock market, and debt crises). They happened in a period of floating exchange rate regimes, with capital controls in 1977 (which disappeared in 1982) and without capital controls in 2008. In 1977 and 2008, Spain had large external imbalances (related to trade deficits and foreign capital inflows) following a period of economic growth that fed the growth in loans, especially after joining the EU. In both crises, there was an international shock (the 1973 and 1979 oil crises, the 2007 US subprime mortgage crisis, and the 2010 euro crisis) that precipitated the crisis and facilitated a sudden stop after a period of capital bonanzas. Financial liberalization without an efficient supervisory system and globalization were also factors in both crises, facilitating banking expansion and credit growth (more notably in the 2008 crisis). In both cases, the Bank of Spain acted relatively rapidly after the crisis to introduce new institutions and a wide array of instruments. However, the resolution to each crisis differed and was conditioned by the different monetary policy regimes: whereas the peseta's depreciation was used as a key shock absorber in 1977, it was no longer possible in 2008.

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Notes

1. Frequency is measured as the number of years with a crisis as a percentage of the total number of years.
2. For the period 1973–1997, Bordo et al. (2001) calculated a frequency of 12.2 percent for a sample of 56 countries. In Spain, the frequency for the period 1973–2000 rises to 14.8 percent.
3. During the 1980s and 1990s, there was a process of banking concentration. For example, as a result of different mergers, BBVA was created in 1991 and Banco Santander Central Hispano (BSCH) in 1999.
4. Savings banks did not have adequate mechanisms to increase their own resources and consequently were not large enough to operate internationally.
5. The strong demand for housing was stimulated by low interest rates, economic expansion, the financial sector competition, the influx of immigrants, and housing purchases by non-residents (Carballo-Cruz 2011).
6. Savings banks have a long history as non-profit entities. However, as a consequence of deregulation, mainly the 1985 Reform, regional and local governments started to exercise considerable control over the way they were run, and local politicians used savings banks to pursue their local objectives, sometimes with ruinous consequences (Santos 2014).

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