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Angela Garcia Calvo

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Author: Angela Garcia Calvo

Correspondence:

Collegio Carlo Alberto, Via Real Collegio 30, Moncalieri (Torino). Italy.
E-mail: angela.garciacalvo@carloalberto.org

The role of banking institutions in enabling bank competitive transformation: the Spanish case

Abstract

This paper explores national banking institutions and their contribution to the competitive transformation of big commercial banks in the context of late industrializing, transitional, and peripheral economies. The paper uses a comparative historical analysis to establish that strategic coordination is a structural feature of the banking sector but may be articulated differently across nations depending on the underlying balance of power between states, banks and industry, the preferences of these actors, and their capabilities and resources. The paper then uses evidence from Spain since its democratization in the late 1970s to map the structure of state-bank interactions and to assess its contribution to the competitive transformation of big Spanish banks. The paper argues that in Spain, state-bank coordination was defined by peer-coordination, a non-hierarchical system of negotiated interactions and mutual exchanges of benefits between small groups of decision-makers at the government, the central bank, and big banks. Under PC, large banks contributed to the fulfilment of public policy objectives to develop the central bank's capacity to conduct monetary policy, strengthen supervision of the banking system and modernise the financial sector. In exchange, big banks benefited from a favourable regulatory environment that enabled them to undertake the deep restructuration necessary to consolidate their market leadership, redress operational problems, and reach the efficiency frontier of their industry.

Key words: Models of capitalism, banking, state-bank relation, banking restructuration.

1. Introduction

Institutionalist scholars[1] consider the structure of financial markets, especially the role of banks in sheltering (or not) firms from the rigors of short-term market pressures, to be a distinctive feature of different models of capitalism. Few contributions, however, have studied the interactions between national institutions and large commercial banks or their contribution to the competitive transformation of banks, despite considerable changes in competitive banking dynamics and institutional frameworks since the 1980s. Moreover, existing studies have been written from the viewpoint of the most advanced industrialized economies, which tend to have very well-developed institutional structures.[2] Consequently, these analyses do not normally focus on the negotiation processes between state actors and big banks that lead to the development and consolidation of institutional structures. Neither do they address institutional change in banking in the context of regime transitions. This situation has negative consequences for the study of capitalism in general and for understanding the structure of capitalism in late industrializing, transitional, and middle-income countries in particular. The focus on already well-developed institutional infrastructures limits our understanding of institutional change, resulting in relatively static perspectives of capitalist models. In addition, a perspective based on leading economies has little direct applicability to emerging countries that aim to reach the next rung in the global division of labor.

This paper addresses these gaps by studying the process through which the Spanish institutional structure changed since the early 1980s, by establishing the characteristics of the Spanish framework and by appraising its role in enabling the competitive transformation of big Spanish commercial banks. The Spanish case combines several critical features. The transformation of Spain's relatively small and inefficient "big banks" into two of Europe's largest and most efficient commercial banks is one of the few instances in which banks from a non-leading economy have reached —and at times redefined— the efficiency frontier of the banking sector. Various contextual factors in the Spanish case offer insights that can resonate with other transitional and middle-income countries. These include Spain's late industrialization, its transition into an open economy and a fully-fledged democracy in the 1980s and 1990s, and the country's position in the European periphery. Finally, Spain falls into the category of mixed-market economies, or hybrid institutional ecosystems. These cases are not sufficiently understood by the "varieties of capitalism" (VoC) literature, although they are expected to underperform

1 Zysman (1983); Deeg (1999); Whitley (1999); Hall and Soskice (2001); Amable (2003); Herrigel (2010).

2 Zysman (1983); Erturk and Solari (2007); Hardie and Maxfield (2010); Hardie and Howardth (2013).

relative to liberal and coordinated market economies.[3] By taking up the study of a hybrid case, this paper aims to make a contribution to the understanding of mixed systems.

The paper takes a historical perspective that relies on a combination of macro- and microeconomic analysis. The research design relies on the triangulation of data collected from different sources, with interviews playing a secondary role to publicly available data. The paper develops a comparative analysis of bank performance using specialized databases (ECB, OECD), annual bank reports, and additional information from other specialized sources, including the IMF, the World Bank, the BIS, and selected national central banks. The analysis of Spain's banking institutions is based on information from parliamentary session transcripts, published laws, published interviews with key stakeholders, and semi-structured interviews with sixteen civil servants, public employees, and bank experts. Interviews are used to complement, contrast, and interpret the data obtained through other sources, to help fill out data gaps, and to form a clearer idea of industry-level developments and the shape of the productive system. Whenever possible, the paper makes references to written, published documents rather than interview responses.

The paper first establishes that non-market or strategic coordination between big banks and the state is a structural feature of the banking sector. But the paper also shows that state-bank coordination can take on different forms depending on the underlying balance of power between states, banks, and productive industry; the preferences of these actors; and their capabilities and resources. The analysis of these features in Spain reveals that productive industry took a secondary position relative to banking, and the relationship between big banks and the state occupied the center-stage. The banks and the state had distinct but compatible objectives which they were unable to achieve autonomously. The combination of compatible goals and limited capacity to fulfil them favored the development of a peer-coordination (PC) structure. PC was a non-hierarchical system of negotiated interactions and mutual exchanges of benefits between small groups of decision-makers at the government, the central bank, and big banks that helped the state and big banks further their respective goals. The paper argues that PC enabled the competitive transformation of big Spanish banks and the modernization of Spain's financial system. In addition, the paper contends that despite PC's benefits for big banks, the system did not amount to state capture. The government's long-term commitment to national economic development and the consistency between such commitment and policy formulation and implementation indicates that PC also helped advance public goals. Furthermore, the presence of a competent body of specialized civil servants with strong analysis and leadership capacities served to preserve the state's autonomy. Moreover, the state capture hypothesis is inconsistent with the degree of competitive

3 Hall and Gingerich (2009).

transformation, innovation and competitiveness demonstrated by big Spanish banks.

The rest of the paper is divided into five parts. Section two establishes the role of state-bank coordination in banking and showcases different forms of articulating the relationship through comparative, historical examples. Section three shows changes in the characteristics and performance of the Spanish banking sector through quantitative and qualitative cross-country comparisons. Section four outlines standard explanations for the competitive transformation of big Spanish banks and discusses their limitations. Section five explains in detail the process through which PC developed and consolidated in Spain, and PC's contribution to the transformation of big Spanish banks. Section six concludes.

2. The institutional structure of commercial banking

Problems of asymmetric information make the banking sector prone to disequilibria. If left unchecked, these problems can quickly escalate and turn into systemic financial crises that may provoke deep, protracted economic recessions. A public system of bank supervision is a crucial guarantee of the stability and efficiency of a credit system. Consequently, coordination between credit institutions—especially big banks—and states is a structural feature of the banking sector. Moreover, commercial banks provide essential services for any form of economic activity, a role that has historically prompted states to influence credit allocation, especially in bank-based systems.

Postwar European financial systems were characterized by institutional diversity that stemmed from variation in the distribution of power among states, banks, and downstream industry; the preferences of these actors; and their respective capabilities and resources. Institutional diversity translated into structural differences in national banking sectors. France represented the paradigm of a state-influenced developmental system. Bank credit in France was an instrument for the implementation of broader industrial policies designed by a large bureaucratic apparatus, and credit controls were based on formal legislative procedures that served to orient credit toward preferred firms.[4] Loans from the Big 3[5] nationalized lending banks were the main sources of credit. These banks could hardly operate against the desires of the state and had relatively few incentives to forge strategic relationships with their corporate clients.

The German banking sector shared France's developmental and bank-based nature, but the state maintained a more distant oversight through a system of public banks whose mandate was to promote development. Banks, not the state, were responsible for decisions about credit allocation, which was based

4 Zysman (1983).

5 Banque Nationale de Paris, Crédit Lyonnais, and Société Générale.

on market criteria. These two features, a development mandate and responsibility for credit allocation, encouraged big German banks to acquire in-depth knowledge about their debtors, typically industrial firms. German banks were also allowed to invest in productive firms and to represent shareholders who deposited their shares with the banks. These legal prerogatives further reinforced the banks' interests in corporate decision making and enabled them to exercise it through board memberships.[6]

By contrast, the UK financial system relied on highly developed capital markets and was strongly oriented toward protecting the sterling as an international reserve currency rather than toward industrial development. Consequently, British clearing (commercial) banks were not the primary source of credit for large corporations, although their role in corporate credit and trade was still important in the postwar period and has strengthened since the 1960s.[7] British bank loans, unlike German loans, tended to be short-term and were guaranteed through assets rather than operations. Consequently, clearing banks did not need to acquire (and did not normally develop) an in-depth knowledge of their debtors.[8] Although the state in the United Kingdom did not own participations in clearing banks or strongly influenced credit allocation, the Bank of England held close non-statutory relationships with the Big 4.[9]

Rapid worldwide economic growth in the 1960s generated liquidity and fostered demand for new types of financial products and operations, particularly from large international corporations. Credit institutions catered to these needs with innovative products like the Euromarkets, which they could issue at low cost thanks to information and telecommunications innovations. By the 1970s, the economic crises laid bare the limitations of industrial policies and led to state retrenchment in productive activities and the credit allocation systems that supported them. Changes in the interests and preferences of crucial economic actors generated pressure for institutional change. By the 1970s, the additional risks that derived from financial innovation caused financial crises in different countries, triggering effective change.

Throughout the 1970s and 1980s, countries tended to formalize and overhaul the supervisory roles of central banks and to progressively eliminate capital controls. These changes were followed by others aimed at increasing competition, privatizing credit institutions, consolidating, and deepening

6 Huffner (2004).

7 Miles (2009); Davies and Richardson (2010).

8 Zysman (1983).

9 Barclays, Lloyds, Midlands, and Royal Bank of Scotland.

wholesale markets. By the early 1990s, these trends transformed what used to be national systems into a multilayered system with international and national features. Cross-national coordination and supervision was structured around the 1988 Basel Capital Accord, followed by the Basel II revision of 2001–2006. Within Europe, the first and second Banking Directives and the adoption of the euro in 1999 laid the groundwork for the EU's Single Market.

Despite these changes, even in Europe's highly integrated context, national commercial banking structures and the interactions between banks and downstream industry did not converge toward a single model. As of 2014, key aspects such as bank supervision, and therefore the solvency and risk management of the system, remain the responsibility of national central banks.[10] Furthermore, despite common industry trends that have modified business models, such as market-based financing, securitization, and the increase of fee-based activities, the underlying balance of forces among states, banks, and industry has not changed uniformly across countries. As of 2014, there is no uniform European competitive environment either, which explains why local banks still handle the overwhelming majority of retail banking operations in each Western European market and why banking sector consolidations have taken place primarily within rather than across markets.[11] Consequently, to understand the strategies and trajectories of big commercial banks, it is crucial to examine the various contributing factors, in particular the balance of forces among national economic agents; the mechanisms through which they articulate their relationships; and the preferences that derive from these systems.

The VoC and the financial literatures are of limited assistance in mapping these features. The VoC literature[12] describes the structure of financial systems as a defining component of specific forms of capitalism, but authors have neither looked at the banking sector as an industry, nor evaluated the impact business dynamics on institutional structures. As a result, this literature under-theorizes the institutional conditions that may help big commercial banks develop advantages. In addition, VoC's characterization of financial systems as either credit or capital-market based obscures two crucial factors: (a) that bank credit is an important source of capital in both types of financial systems,[13] and (b) that commercial banking features a high degree of strategic coordination, even in liberal market economies such as the United Kingdom.

10 This paradigm may change after the introduction of the Single Supervisory Mechanism in the EU. But even after the mechanism comes into force in November 2014, it is still unclear whether it will achieve convergence in commercial banking, and, if so, how long the process will take.

11 Vander Venet (2003) in Herrmann and Lipsey (2003); Cabral et al (2002).

12 Zysman (1983); Deeg (1999); Whitley (1999); Hall and Soskice (2001); Amable (2003).

On the other hand, the financial literature offers valuable descriptive information about national institutional systems, but it is less interested in analyzing the manner in which the balance of forces among economic actors shapes those systems and their transformations, influencing banks strategies.[14] Recent contributions at the crossroads of international political economy, VoC, and economic geography[15] chart changes in business models over the past three decades, focusing in particular on the late 1990s. However, these studies concentrate on establishing a connection between increasing levels of securitization, lending patterns, and the 2007 financial crisis. In addition, Spain rarely features in these analyses. Where it does,[16] contributions focus on explaining the connection between the corporate governance structure of savings banks (*cajas de ahorros*), the availability of cheap credit in the post-euro era, and the unsustainable business practices that led to their crisis. The big, publicly listed commercial banks that this paper is concerned with are not part of these analyses.

I argue that in the Spanish case, state-bank coordination was based on direct relationships between the state (the government and the central bank) and the so-called Big 7, which were Spain's big commercial banks. Downstream industry, with the exception of a few selected corporations,[17] occupied a distant secondary position, and social intermediaries played a supportive role in implementation. The basis of state-bank coordination was a system of interdependencies that stemmed from: (a) the existence of a pact subscribed to by all of Spain's economic actors that provided focus and direction to economic reforms, (b) the development and implementation of public policies consistent with that commitment, and (c) the presence of compatible state and bank objectives that neither actor could achieve without collaboration from the other.[18] Certain factors prevented the Big 7 from capturing the state, including (a) the government's commitment to economic development, (b) the consistency of that commitment with policy formulation and implementation,

13 Kosmidou et al. (2006); Hardie and Maxfield (2010); Davies and Richardson (2010).

14 IMF (2004); Pérez, Saurina, and Salas (2005); Huffner (2010); Bank of England (2013).

15 Erturk and Solari (2007); Hardie and Maxfield (2010); Hardie and Howardth (2013).

16 Garicano and Cuñat (2009); Royo (2013).

17 As has been documented by S. Pérez (1997), Pons (1999, 2002), and Guillén and Tschoegl (2007), Spanish big banks did not have a strong commitment to industry, with the exception of a few large firms in service sectors (primarily telecommunications and energy), with which they had long historical relationships.

and (c) the existence of a cohesive group of skilled economic civil servants selected on merit. In addition, the presence of well-established banks with autonomous strategic and financial resources, alongside the existence of a group of forward-looking professional bankers prevented bank capture by the state. The result was a non-hierarchical system based on negotiated exchanges that helped overcome the weaknesses of both the state and the big banks, furthering their respective interests.

The Spanish tradition of separating elite groups in the public and private spheres as well as the strategic and financial independence of big Spanish banks distinguished PC from France's institutional structure. In France, cohesive elites straddled government and industry, facilitating the synchronization between the interests of the state, big banks, and industrial corporations. In Spain, the coordination of interests between the Big 7 and the state could not be assumed. In addition, big Spanish banks were never participated by the state, which made them more autonomous than their French counterparts. The private character of big Spanish banks, their for-profit orientation, and the lack of long-term links between banks and downstream industry distinguished PC from Germany's institutional structure. In Germany, persistent and long-term relationships between banks and industry (both corporations and SMEs) continue to be an enabling force for industry and a source of advantage for banks in the form of a barrier against foreign competition.

Despite changing circumstances, such as the inauguration of the Single Market, the international expansion of big Spanish banks, and the succession of governments dominated by different political parties, PC has continued to operate because the features that led to its development—the presence of interdependencies between the state and big banks and the inability of either actor to accomplish their goals without the other—have not disappeared over time.

3. Overview of Spanish commercial banking

This section is divided into two parts. The first provides a comparative snapshot of Spanish banking in 1985 and 2009. The second provides a more detailed account of the trajectory of big Spanish banks.

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18 These weaknesses were partly a legacy of Francoism. Franco employed the divide-and-conquer strategy and exercised it by purposefully issuing arbitrary favors or imposing constraints, thereby weakening any potentially influential group in the country, which spurred confrontation between various groups or their individuals (Preston 1986, 1995; Carr 1979). After Franco's demise, established and emerging elites needed to coalesce to further their respective interests in a new context.

3.1 Comparative overview

This subsection offers a comparative overview of Spanish commercial banks through two snapshots at key points in time: 1985, which is the year before Spain joined the EU, and 2009, which is the latest data available.[19] Bank performance is assessed through cross-country comparisons of operational efficiency, operational profitability, and capitalization, measured through three ratios: operating expenses to income, net income to total assets, and Tier 1+2 capital over assets. Data come from the OECD banking income statement and balance sheet statistics.

In addition, this section relies on qualitative output and on a brief evaluation of a sample of banks to take into account the impact of national factors such as national regulation, input costs, different business models, degree and quality of risk management, and the level and structure of competition in bank performance. The qualitative analysis relies primarily on annual banks reports and on the ECB banking statistics.

In 1985, the Big 7 dominated the financial landscape. Spain's wholesale markets were "narrow, lacked fluidity, had a strong speculative component, and were very illiquid"[20] until their reform in 1988. Until 1989, savings banks —commercial banks' natural competitors—were subject to strict constraints that prevented them from expanding beyond their province of origin and from offering credit to businesses. The expansion of foreign credit institutions was also heavily restricted until 1993, and foreign competition was therefore negligible. In such a context, big Spanish banks provided the majority of credit to industry, normally on a short-term basis (up to ninety days),[21] except in the case of a few public-private monopolies operating in sectors such as petrol, tobacco, and telecommunications. Spanish banks were highly profitable, but not necessarily efficient as is indicated by their high ratios of operating expenses over assets and operating expenses over income (Table 1).

Big Spanish banks had less cross-national experience than their European counterparts and were considerably smaller. These features are attributable to the smaller size of the country's economy and to the legacy of Francoism.[22] In 1985, Spain's volume of domestic credit operations was approximately one-fifth the equivalent measure in Germany and one-third of that in Italy, in line with the relative size of the Spanish economy, which was 25 percent of

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19 The OECD Banking Statistics database has been discontinued.

20 Pellicer (1992).

21 Pons (2002).

22 Francisco Franco ruled Spain through a dictatorial regime between the end of the civil war in 1939 and his death in 1975.

Germany's and 40 percent of Italy's at the time.[23] Despite Spain's lower volume of credit operations, the country had seven big banks, compared to only four in Germany and the United Kingdom, and three in France and Italy. Consequently, the Big 7 were small by international comparison. The largest, Banco Central, ranked 100th in the world and was about one-fourth the size of Deutsche Bank.[24] The lack of concentration in the Spanish banking sector can be traced back to Franco's strategy of ruling the country by dividing any potential opposition and his concern that any single big bank may become too large to be controlled.[25] These calculations led the dictator to veto an attempted merger of the two largest banks in 1965, after which there were no further consolidation attempts among the Big 7 until 1987.

Finally, data on foreign direct investment positions shows that Spanish banks not only had managed to avert the foreign threat at home, but they had established a significant position abroad despite their lack of previous international experience

23 World Bank Statistics.

24 Guillén and Tschoelg (2008).

25 Carr and Fusi (1979); Lannon and Preston (1990).

Table 1 Bank ratios in 1985.

e/Assets
erest income/
expenses/ Net
expenses/Asse
Tier 2 Capita
er 1,000 inha
per branch

Banking statistics

Table 2 Bank ratios 2009.

	Spain	Switzerland	US	Sweden	Germany	Italy	Netherlands	France
Net income/Assets	0.023	0.021	0.051	0.020	0.017	0.022	0.016	0.015
Net non interest income/Total income	0.308	0.638	0.402	0.477	0.204	0.363	0.307	0.580
Operating expenses/ Net income	0.372	0.774	0.589	0.574	0.756	0.632	0.691	0.624
Operating expenses as % of assets	0.009	0.016	0.030	0.011	0.013	0.014	0.011	0.009
Tier 1 and Tier 2 Capital as % of assets	0.086	0.064	0.112	0.082	na	0.065	0.055	na
Institutions	153	207	6905	59	1774	768	93	325
Branches per 1,000 inhabitants	0.323	0.213	0.268	0.205	0.455	0.564	0.190	0.609
Employees per branch	7.4	53.8	23.2	22.0	17.0	9.7	35.1	11.1
Inwards FDI positions (Millions USD)	27,812	319,729	254,411	256,694	53,654	91,957	91,870	111,109
Outwards FDI position (Million USD)	157,633	344,217	733,245	420,433	194,384	312,116	175,864	237,307

Source: OECD Banking statistics, Factbook statistics (population) and International Direct Investment Statistics (FDI positions). Own elaboration

FDI positions exclude insurance and pension funding activities.

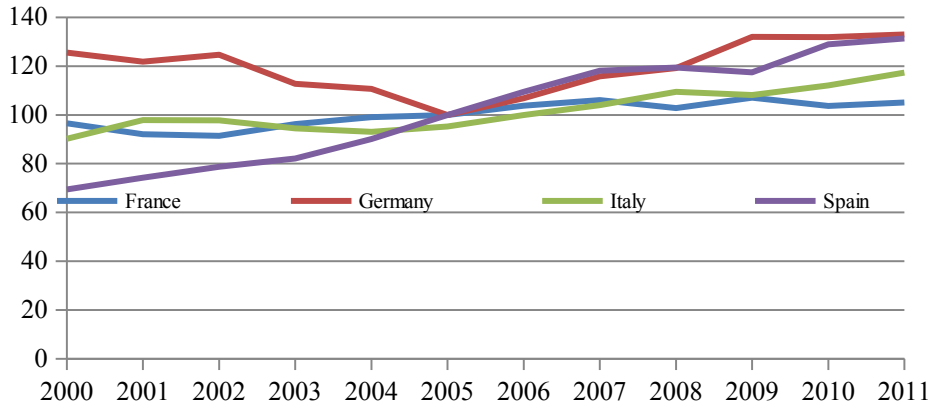
Table 3 Market performance ratios for selected global banks in 2009.

	Cost/efficiency (%)*
UBS	103
Credit Suisse	73
BNP Paribas	58.1
Deutsche Bank	72
HSBC	52

Source: Annual bank reports (2009). Own elaboration

*The cost-efficiency ratio is defined as total operating expenses divided by net operating income before loan impairment charges and other credit-risk provisions.

Table 4 Annual person-based productivity, financial, and insurance activities.



Source: European Commission and European Central Bank calculations based on Eurostat data. Own elaboration.

3.2 The trajectory of big Spanish banks

The position of the Big 7 (Santander, Hispano Americano, Central, Banesto, Bilbao, Vizcaya, and Popular) strengthened during Francoism. The Banking law of 1946 gave big banks control of the market by prohibiting the foundation of new entities and heavily constraining competition with savings banks. Big banks also provided the largest share of capital for Spain's industrialization in the 1960s and 1970, multiplying their profit by six along

the way.[26] Furthermore, bankers gained political influence by lending their expertise to the government.

The industrial and banking crises of the late 1970s and early 1980s affected the Big 7 —especially those banks that had large industrial portfolios— and marked the beginning of the end of a profitable era characterized by restricted competition and cartelistic practices. By 1989, the context had radically changed into one dominated by competition based on new savings products and defensive mergers to prevent unwanted acquisitions in the run-up to the European cross-border liberalization in 1993.[27]

After a first round of mergers between 1988 and 1994, there was little room for big banks to grow rapidly through domestic acquisition. Therefore, in the big banks set their sights abroad, primarily on Latin America. Spain's plans to adopt the euro in 1999 opened new opportunities for expansion back in Spain, and big banks switched their attention back to the home market, spurring a new round of mergers between 1999 and 2002.

In the 2000s, BBVA and Santander, the two banks resulting from the consolidation of six of the Big 7, continued their expansion, this time mainly in Europe and North America. Santander's largest operations in these regions were the acquisition of the UK's Abbey in 2004 and the acquisition of the US' Sovereign in 2008. BBVA also established a base in the United States. Through the financial crisis that started in 2007, BBVA and Santander continued to expand in emerging markets such as Poland, Ireland, China, and Turkey.

By 2011, both big Spanish banks turned to the home market to make extraordinary provisions in response to Spain's real estate and sovereign debt crises. By early 2013, the presidents of the two banks expected to play major roles in a new round of consolidation that would increase their market shares in Spain,[28] and by mid-2013 both banks announced higher profits relative to 2012.

4. Standard explanations for the transformation of big Spanish banks

The two major existing explanations for the transformation of the Big 7 identify firms as the main drivers of upgrading. Scholars follow two different lines of inquiry within a firm-driven approach. The first aims to explain the international expansion of the Big 7 by looking at the detailed trajectories of individual firms. The second explores the performance of the Big 7 in the context of their relationship with the state by analyzing historical patterns of institutional change and studying the role of banks in shaping that process.

26 Pérez (1997); Torrero (2001).

27 Second Banking Directive 89/646/EEC.

28 El País (2013).

This section states the two approaches succinctly, including a variant of the second line of inquiry, and explains their limitations.

4.1 Standard explanations

4.1.1 Creative destruction and competitive advantages

Most scholars examining the trajectory of the Big 7 focus on explaining their internationalization process.[29] Of these authors, Guillén[30] makes the most systematic analysis. He attributes the internationalization of big Spanish banks to a combination of leadership skills, business know-how, process and product innovation, and experience with mergers and acquisitions. The state does not play a major role in this analysis except to facilitate the transition toward a market environment.

According to Guillén and Tschoelg,[31] Santander's President, Emilio Botín, embodies the innovative, discreet, diplomatic, and decisive leadership style of a generation of progressive bankers who took over the sector in the second half of the 1980s. Botín did not feel bound by the cartelistic practices of the Big 7, and his idea to launch innovative and competitively remunerated products ignited a deposit war that unraveled the banking cartel in 1989. As of 2014, Botín's public interventions have been scarce, and he has never declared his allegiance to any single political party. Instead, he has built relationships with the two major right and left wing political parties. For example, he was on excellent terms with former socialist premier Zapatero, but as of 2014 several members of Santander's executive board have ties to the conservative People's Party (PP).[32] Finally, Santander's acquisitions of Banesto in 1994 and Abbey in 2004 —on which he reportedly had the final say— incarnated the hands-on, top-down decision-making style that enabled the Big 7 to make swift decisions and take advantage of unique investment opportunities for expansion.

According to the creative destruction argument, big Spanish banks honed their competitive skills and gained experience with mergers and acquisitions during the liberalization process that started in the 1980s. Big Spanish banks were forced to compete with savings banks, whose market share increased at the

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29 Avedaño and Moreno (2004); Banco de España/Gonzalo Gil (2005); Guillén (2005); Parada, Alemany, and Planellas (2007); Martín Aceña (2007); Rodríguez Inziarte (2008); Guillén and Tschoelg (2008); Guillén and García-Canals (2010); Casilda Béjar (2011).

30 Guillén (2005).

31 Guillén and Tschoelg (2008).

32 Santander (2010); Financial Times (2013).

expense of banks.[33] In addition, the Big 7 acquired experience in mergers through the acquisition of medium and small entities following the banking crisis of the 1970s to 1980s. Big Spanish banks further consolidated their experience in mergers thanks to a first wave of consolidations among the Big 7 in the late 1980s and early 1990s. When banking liberalization took place across Latin America in the 1990s, this knowledge enabled big Spanish banks to take advantage of investment opportunities in the region, and later in Europe and North America. Finally, according to the creative destruction argument, an important part of the success of big Spanish banks resided in their specialization in retail banking, an area where they faced less competition from well-established global banks, which tended to concentrate on corporate or private banking.

4.1.2 State capture and state-bank cooperation

A second set of scholars explains the trajectory of the Big 7 through a historical perspective that looks at the politics of financial regulation, the role of the banks in influencing institutional change, and the consequences of such changes for the banks. In contrast to the creative destruction argument, the political-historical line of inquiry highlights the state's active role in supporting the banks and, therefore, in enabling their transformation. However, a comparison between the two main authors that explore this line of thought shows that the relationship between the state and the Big 7 can be subject to different interpretations. One interpretation contends that the state acted as an instrument of the Big 7's interests. The second interpretation argues that although the state actively supported the interests of the Big 7, it did so in exchange for collaboration from the banks to achieve public policy objectives. Both interpretations are based primarily on analyses of the Francoist period.

Specifically, S. Pérez[34] connects the growth of the Big 7 during Francoism with Spain's late industrialization and a waning state. Within that context, she argues that the Big 7 came to play two crucial roles: they were the main providers of capital during the 1960s and 1970s industrialization, and they became a hinge in the configuration of conflict among state elites. These two roles were the basis of a system in which big Spanish banks captured the policy-making process, consolidated their positions, and multiplied their profits.

S. Pérez sees evidence of the long-term persistence of state capture in the way Spain addressed its public deficit in the 1980s, solved the 1977–1985 banking crisis, and liberalized the financial sector. She points out that in the 1980s, the Big 7 opposed the creation of a market for short-term public debt to help

33 Cals (2001); CECA (2011).

34 S.Pérez (1997).

finance the public deficit because it would have meant that the state competed directly with big banks in attracting private savings, which were the banks' main source of capital. In response to the Big 7's concerns, the state did not immediately create a short-term public debt market but instead forced banks to purchase public debt by introducing a compulsory investment ratio. S. Pérez argues that this measure benefited the Big 7 because unlike a short-term debt market, it relied on the big banks as necessary intermediaries of the system. In addition, the compulsory investment ratio was a high-paying instrument that enabled big Spanish banks to maintain their profit margins in a context where declining demand for credit and excess liquidity made profits uncertain. S. Pérez finds additional support for the capture argument in the government's 1983 takeover of a large industrial conglomerate —Rumasa— along with the privatization process of its group of banks. Rumasa's banks accounted for 4 percent of Spain's deposits, which means they were large enough to threaten the position of the Big 7. Therefore, their expropriation and later re-privatization process eliminated the cartel's largest rival. Finally, she points out that although Spain took legislative measures to set the banking sector on the path toward eventual liberalization in the late 1970s, it did not simultaneously take active measures to challenge the Big 7's control of the financial system, such as enabling foreign banks to operate freely in Spain or consolidating the domestic stock markets.

Pons[35] acknowledges the importance of ties between the Big 7 and the state as well as the role of regulation in articulating those interactions during Francoism. However, she refutes the state capture interpretation by arguing that the Big 7 were not the sole beneficiaries of the system and that the interests of the state and the bankers were not necessarily aligned. She instead sees the Francoist environment as one in which agents with different interests played each other out to further their respective goals. Pons contends that the Francoist governments of the 1960s and 1970s wanted to accelerate industrialization and to reward valuable social and economic elites. She also argues that they used the Big 7 to achieve these objectives and to obtain cheap public financing. In exchange, the Francoist governments offered big Spanish banks some advantages to secure their collaboration. Although the Big 7 did not hesitate to benefit from these measures, Pons argues that the interests of banks were not necessarily aligned with those of Francoism. She points out that several bankers were liberals, such as Villalonga, who was the president of Central (the largest of the Big 7), and Lladó, who was associated with Urquijo (Spain's largest industrial bank). She also contends that several government measures did not benefit the Big 7, including mandatory investment coefficients that tied up to half of the bank's resources to low profitability investments, restrictions to the distributions of dividends, limits to branch expansion, and the government's right to veto mergers between banks. Nonetheless, Pons argues that the Big 7 viewed collaboration with the

35 Pons (1999, 2002).

Francoist dictatorship as a lesser evil and that they were conscious of the benefits of maintaining good relationships with decision-makers in a regime that operated by fiat.

4.2 Limitations of standard explanations

Neither of the two approaches outlined above provides a satisfactory explanation of the competitive transformation of big Spanish banks. The creative destruction explanation fails to acknowledge the role of the Spanish institutional environment in enabling banks to unleash and exploit their capabilities, including the leadership potential of talented bankers such as Botín. In this regard, the creative destruction argument documents the banks' trajectory, but it does not fully explain what enabled them to accomplish it.

The political-historical explanations show that the relationship between the state and big banks was crucial because it shaped the terms of competition for the sector. However, the dialogue between S. Pérez and Pons underscores the difficulties of characterizing the state-bank relationship. Pons's interpretation highlights the need to examine the alignment of interests of the two actors and to explore the presence of exchanges in the relationship before confirming the state capture hypothesis.

Furthermore, some of S. Pérez's evidence admits interpretation. For instance, in a context in which public debt had been traditionally financed through expansions in the monetary base and banks had been able to monetize their debt, J. Pérez[36] contends that it was necessary to create market infrastructures, change habits, and develop sustainable policies before creating markets, such as the short-term public debt market that S. Pérez mentions. Rumasa's expropriation remains highly contentious to this day. In 1983, Ruíz-Mateos —the entrepreneur behind the Rumasa holding—was already considered the epitome of the nonprofessional bankers who had entered the banking business in the previous two decades to provide liquidity for the operations of fictitious or unsustainable businesses.[37] As of 2014, Ruíz-Mateos has been tried and convicted of several counts of fraud. In this light, one can interpret Rumasa's expropriation three months after the Partido Socialista Obrero Español (PSOE) —Spain's Socialist party—won the elections as a sign of the new administration's stance against speculation. Furthermore, although some of Rumasa's banks ended up in the hands of the Big 7, thereby expanding their business, the only profitable bank in the holding was acquired by a consortium led by the Arab Banking Corporation (70 percent) and the state-owned Banco Exterior de España (25 percent).[38]

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36 J. Pérez (2012).

37 El País (1983).

38 Goodhart (1995).

Finally, S. Pérez's and Pons's interpretations of state-bank relationships concentrate on the Francoist period and its immediate aftermath, leaving out most of the post-liberalization era that this paper explores. Consequently, they fail to analyze the period during which the Big 7 transformed their structures and reached the efficiency frontier.

5. State-bank coordination in Spain

This section characterizes state-bank coordination in Spain through empirical evidence. The first subsection traces the origins of the model to Spain's political transition. The second subsection outlines its consolidation during the run-up to the Single Market. The third subsection explains PC's resilience after the inauguration of the euro and the international expansion of big Spanish banks.

5.1 Early stages during the Transition (1977–1985)

The proximate roots of PC can be traced back to the Spanish political and economic transitions, and to the country's integration into the global economy. By 1977, Spain faced a severe multifaceted crisis with deeply intertwined political and economic factors. Transforming Spain's economic model was considered necessary to address the acute social tensions that threatened the democratization process.[39]

Spanish economic agents reached a consensus regarding the main lines of reform necessary to transform Spain into a democracy and a modern, open economy. In 1977, representatives from all political parties with parliamentary representation, the Prime Minister, and some members of government privately debated the objectives, instruments, and specific measures necessary to turn around the Spanish economy. They also discussed the legal reforms necessary to recognize and protect basic civil liberties. The two agreements that resulted from these negotiations—one for economic reforms and another one for civil liberties—were collectively called the Moncloa Pacts. The pacts were voted on in Parliament, approved by the representatives of the two main unions, and endorsed by the employers' association. Fuentes Quintana, the vice-president for economic affairs, even explained the main lines of the economic pact to a general audience in a public broadcast.[40]

The economic pact asked specifically for the central bank to conduct an active monetary policy, the development set of measures aimed at increasing the reaction capacity of the economy to exogenous shocks, and the progressive liberalization of the financial system.[41] The development and implementation

39 Moncloa Pacts (1977).

40 The sixteen-minute broadcast remains today a rare example of government straightforwardness and a case of using mass media for political purposes.

41 Moncloa Pacts (1977); Fuentes Quintana (1985).

of these ideas was understood to be a long-term process of deep change that could not be achieved solely through government fiat.[42]

The Moncloa Pacts provided focus and direction to the program of economic reforms that followed. Initial reforms aimed to reinforce the powers of the Banco de España (BdE)—the Spanish central bank—to conduct monetary policy, to develop effective bank supervision mechanisms, and to set the basis for liberalization. Because of the macroeconomic nature of these measures, the initiative and the strategy for these reforms departed from the BdE. However, the government and the BdE lacked sufficient powers and instruments to independently achieve these transformations and needed cooperation from the Big 7.

A central bank can exercise monetary policy through two alternative mechanisms: variation in interest rates or control of the monetary base growth. The first mechanism requires the existence of an active interbank lending market. The second requires synchronization with the banking system, especially big banks, because banks expand the monetary base through their ordinary credit operations. In the late 1970s, Spain had a rudimentary interbank lending market that was insufficient to enable the BdE to exercise monetary policy.[43] Realizing the need for long-term collaboration with the Big 7, Fuentes Quintana pressed for the creation of a representative industry body with which the state could negotiate. The result was the creation of the Asociación Española de Banca (AEB)—the Spanish banking association—in 1977. Fuentes Quintana favored and obtained the appointment of a sympathetic industry representative at the AEB, Rafael Termes, a self-defined liberal and the person who would become Quintana's interlocutor.[44]

To fulfil the government's reform objectives, the Big 7 needed to agree to a more powerful BdE and to the principle of economic liberalization. The BdE could only become more powerful at the expense of the Big 7. But liberalization was likely to drive interest rates down, reduce banks' margins, and threaten their control of the market. Consequently, the Big 7 were expected to oppose the BdE's reforms. However, by the late 1970s, a minority of progressive bankers like Termes supported a degree of change. Specifically, Termes supported the elimination of mandatory investment coefficients and increases in the interest rates at which preferential sectors could borrow. These instruments tied up bank resources to unprofitable investments and, therefore, harmed banks' earnings. Some bankers also saw advantages in a rigorous supervisory system exercised by the BdE to keep in check dubious banking practices and help prevent crises that may disrupt business and stain banks'

42 Fuentes Quintana (1985).

43 S.Pérez (1997); J. Pérez (2012).

44 Fuentes Quintana (1985); Termes (1991).

reputations. Nonetheless, the Big 7 opposed market competition with foreign and domestic rivals, which would have had a direct impact on their bottom lines.

Ultimately, the initial reform package for the banking sector did not fully achieve the government's aims, especially in terms of market liberalization, and this reflects the concerns of the Big 7. But initial reforms were consistent with the overall guidelines contained in the Moncloa Pacts and strengthened the powers of the BdE to exercise monetary policy and supervise the banking sector.

Royal Decree 1,839/1977 established the progressive reduction of mandatory coefficients from approximately 40 percent to 21 percent and brought interest rates for preferential industries close to market rates. Royal Decree 1,388/1978 authorized the installation of foreign banks in Spain but imposed heavy constraints on their operations. Royal Decree 1,839/1977 eliminated restrictions that barred savings banks from offering commercial discounts (an instrument used to provide corporate credit), enabling them to offer the same range of products as banks. This decree, however, maintained geographical restrictions for the expansion of savings banks, thereby limiting their ability to compete directly with the Big 7. These restrictions to competition were long lasting. Foreign banks did not operate in equivalent conditions to Spanish banks until 1993, and savings banks were not allowed to freely expand their geographical footprint until 1989. The terms of these reforms were also indicative of the weakness of industry relative to that of the banks. By constraining competition, Spanish banks continued to charge double-digit interest rates in the midst of an acute economic crisis that choked even profitable firms. For example, in 1980 the president of the AEB admitted to charging 20 percent interest rates.[45]

These banking reforms were quickly followed by a set of measures that strengthened the powers of the BdE and showcased the mutual exchange nature that defines PC. Some of these measures reinforced the independence of the BdE relative to the Big 7. Law 30/1980, for example, dismissed professional bankers from decision-making roles at the BdE and substituted them with public employees. Law 30/1980 established a system of incompatibilities between public and private employment in the banking sector. Other measures aimed to strengthen the power of the BdE to conduct monetary policy by building the infrastructures and institutions necessary to develop a well-developed interbank lending market. For example, in 1976, the BdE introduced a telephony-based interbank exchange system, the first step toward creating an operational, real-time payment system. This mechanism was also a valuable source of information about the operations of the Big 7 and the level of risks the banks were assuming, which enabled the BdE to

45 Torrero (1981).

monitor potential disequilibria.[46] In addition, the BdE introduced a rigorous supervisory mechanism for big Spanish banks based on the principle of establishing "a close relationship to the firms through trust and knowledge exchange between supervisor and supervisee."[47] Specifically, big banks became subject to constant supervision through a team of inspectors that worked full-time at the supervised banks. In 2008, one third of the BdE's inspectors were dedicated to this task. Micro-prudential supervision mechanisms based on similar principles have been adopted by other European countries in the aftermath of the 2007 financial crisis, but prior to 2010 they were considered too intrusive by most OECD countries. The BdE also acquired indirect powers over the decision-making structures of big Spanish banks through its ability to veto candidates to board-level positions.

A second episode of this period, the resolution of the 1977–1985 banking crisis, offers additional testimony to the cooperative and mutually beneficial nature of PC and showcases the competence and leadership capacity of the economists at the BdE. By 1977, Spain faced a significant banking crisis. Between 1977 and 1985, fifty-one banks out of the existing one hundred and ten banks, which accounted for 20 percent of the country's deposits, were rescued. Addressing the crisis required a strategy to rescue ailing banks and turn them around. In line with the Moncloa Pact's commitment to move toward a market-based system, the BdE's strategy to address the banking crisis was based on private-sector turnarounds rather than the long-term nationalization of ailing banks. Specifically, the BdE created the Deposit Guarantee Fund,[48] which was funded through contributions from the banks. The fund bought the majority of an ailing bank's stock at a symbolic price, restructured it with talent from other banks, and then sold it off via public auction.[49]

The successful implementation of the BdE's turnaround strategy was, therefore, based on obtaining the banks' financial resources for the initial rescue operation and on using their expertise and capabilities to turn around failed banks. In exchange for their cooperation, the Big 7 and some growing contenders, like Banco Sabadell, were able to expand their presence by purchasing intervened banks, usually at symbolic prices. Despite these benefits, turnaround operations could involve substantial costs, and the Big 7 did not always have the option to decline the job. This was the case of Banco Urquijo's turnaround by Hispano Americano. Urquijo was Spain's largest

46 J. Pérez (2012).

47 Bank of Spain (2009).

48 Royal Decree 3,048/1977; Royal Decree 54/1978; Royal Decree-Law 4/1980.

49 Dziobek and Pazarbasioglu (1998); Martín Aceña (2005).

industrial bank, and due to historical ties between Urquijo and Hispano Americano,[50] the BdE attributed the responsibility of absorbing Urquijo's losses to the latter. Hispano Americano was already struggling itself and had difficulty accomplishing the massive restructuration of Urquijo. Following the absorption of Urquijo in 1984, Hispano Americano posted negative annual results and was subsequently forced by the BdE to cancel its annual issue of dividends. This was the first occasion one of the Big 7 had ever done so, and the measure sent a powerful signal regarding the depth of Hispano Americano's financial problems. By 1991, Hispano Americano had ceased to be an independent bank.

As befits a negotiated arrangement based on interdependencies, the Big 7 were not the only beneficiaries of the BdE's strategy. The swift and efficient management of the banking crisis by the BdE, and its contrast with the government's weak approach to industrial restructuration during the late 1970s, revealed the technical strengths of central bankers, particularly those of a cohesive network of young economists formed at the BdE's research department. This group had been recruited primarily from the faculty of economics at Madrid's Complutense University and nurtured by Luís Angel Rojo, a respected academic at Complutense and the director of the BdE's research department between 1971 and 1988.[51] These economists constituted Spain's emerging intellectual economic elite, and they supported market-oriented reforms and a central bank fully equipped to control the system's liquidity. Furthermore, the rigorous orthodoxy of this group of economists and the strong professional credentials of each individual contrasted markedly with the generalized corruption, inefficiency, and nepotism that had characterized the civil service during the Francoist era.

These young economists' actions during the management of the banking crisis generated a broader set of benefits for them and ultimately helped strengthen PC. The PSOE victory in the 1982 general election empowered the BdE's emerging elite to turn their ideas into policy; the PSOE's young and charismatic leader, Felipe González, recruited talent from the BdE to fill top policy-making positions. The first Minister of Economics and Industry, Miguel Boyer, and his successor between 1985 and 1993, Carlos Solchaga, were both BdE-trained economists. After a ministerial reorganization in 1986, many of those in second-tier positions also had similar backgrounds or at least

50 Through a pact signed in 1944 (Pacto de las Jarillas), Hispano and Urquijo became two separate entities that concentrated on retail and industrial investment activities, respectively. However, both banks concentrated on retail activities and Urquijo on industrial investments, while continuing to collaborate closely.

51 Malo de Molina (2012).

compatible opinions.[52] Under this new economic leadership, the relationship between the BdE and the government became fluid. The relationship between the BdE and the Big 7 strengthened, developing a stronger policy-making dimension and remaining locked within a tight group of individuals comprising professional bankers, central bank-trained individuals, and a small group of academics and state economists who also came to occupy positions of responsibility. These groups constituted the core of Spanish economic policy making.

Despite their intellectual leadership, the consolidation of the rising BdE elite and the implementation of the economic orthodoxy measures they defended were not undisputed and would not have taken place without implicit support from big Spanish banks. Within government, opposition was led by vice-prime minister Alfonso Guerra, who criticized premier González's choices and advocated a traditional approach to tackle the economic crisis based on public deficits and strong support for industrial employment. France's experience weakened his arguments,[53] and ultimately Guerra left government amid a fraud scandal involving his brother. The PSOE's union, Unión General de Trabajadores (UGT), also criticized the party's shift away from traditional pro-worker policies. The UGT leader, Nicolás Redondo, went as far as breaking party discipline[54] to vote against the annual budget in 1987 before renouncing his parliamentary seat as a protest against the government's industrial restructuration process. In 1998, Redondo also organized a general strike in conjunction with the other national union, Comisiones Obreras (CC.OO). The strike forced the government to soften some of its restructuration measures but did not stop them.[55] Ultimately, the defeat of the opposition and their arguments showcased the secondary role that industry and their representatives played throughout this period relative to the more assertive roles of the state and the big banks.

5.2 PC consolidation in preparation for the Single Market (1986–1993)

The features that enabled the development of PC in the previous decade persisted after Spain joined the EU in 1986. These features included the state's commitment to Spain's modernization and development, the compatibility between the goals of the state and those of big banks, and the need for these actors to cooperate to achieve their respective aims. These three factors

52 El País (1986).

53 Rand Smith (1998).

54 In Spain, party representatives support party leadership. Breaking discipline may involve administrative sanctions (fines) and political sanctions (expulsion from the party).

55 Rand Smith (1998).

explain why, despite changes in the external context, PC consolidated during this period, underpinning the competitive transformation of the Big 7.

By the mid-1980s, the BdE had achieved much progress in strengthening its powers to conduct monetary policy and to develop effective supervision mechanisms to ensure the stability of the financial system. As Spain joined the EU in 1986 and prepared for the inauguration of the Single Market, priorities shifted toward achieving the remaining goals outlined in the Moncloa Pacts: liberalize and modernize the banking sector.

Whereas the policy goals of the previous decade had a strong macroeconomic character, the modernization and competitive transformation of the banking sector were microeconomic challenges. Because the Big 7 were fully private firms, the initiative and strategies necessary to achieve these goals rested on the shoulders of the banks. The state could support and help shape the process, but it could not carry it out.

Not all big Spanish banks were conscious of the need—or willing—to transform their structures and strategies to become competitive in preparation for the Single Market. This was the case of the three largest banks among the Big 7 (Banesto, Central, and Hispano Americano), which were still run by the same bankers who headed them through the Francoist period. These traditional bankers were challenged by an emerging generation of progressive bankers who presided over the rest of the Big 7. The main leaders of the progressive bankers' group were Emilio Botín (Santander), Pedro Toledo (Vizcaya), and José Angel Sánchez Asiaín (Bilbao), who shared a common educational background at the University of Deusto.[56] The progressive Deusto bankers understood that the Single Market represented a unique business opportunity, but they were conscious of the necessity to transform their banks' structures and their business strategies to take advantage of the opportunity and to avoid losing control of their entities at the hands of potential European rivals. The progressive bankers' perspective was anchored in an analysis of business threats and opportunities, but their view was compatible with the BdE's goal to modernize the Spanish banking sector and prevent attacks from foreign speculators that may destabilize the financial system.

The Big 7 faced three main competitive challenges relative to their more sophisticated European rivals: (a) they were significantly smaller, (b) they tended to have higher fixed costs, and (c) and as late as 2000 (Table 4), they were significantly less productive than their counterparts in Germany, France, and Italy. These weaknesses made the Big 7 likely targets of hostile acquisitions and speculative attacks. Size was a particularly important concern

56 The fourth bank, Popular, and its president, Rafael Termes, adopted a much lower profile regarding these transformations, although they did not oppose them, and Termes continued to be the state's interlocutor at the AEB until 1990.

for the banks headed by the progressive bankers because these banks were better run than the rest of the Big 7 but smaller in size, two features that combined made them attractive targets for foreign acquisition. The fastest path to grow was through mergers and acquisitions, but the banks faced several obstacles. First, if the sector was liberalized immediately, banks risked being acquired by foreign investors before having the chance to adjust and grow organically. This type of uncertainty intensified the risks and decreased the benefits of carrying out mergers. Second, mergers and subsequent changes to the banks' boards of directors required approval by the BdE. Third, mergers needed to be followed by structural reforms, which involved reductions in labor that contravened the legal terms of pre-existing, lifelong contracts and were expected to be financially expensive.

The way the state and the progressive banks addressed these challenges reflects the pattern of exchanges characteristic of PC. The BdE actively supported the goals of the progressive bankers and through them jump-started the modernization of the banking sector, while protecting the industry from unwanted speculative investments. The BdE defended a strategy of mergers between a progressive bank and a traditional bank, and it assumed that the progressive bank would lead the merged entity. The progressive banks supported the consolidation approach, but they opted to merge among themselves, showcasing the diversity of opinions between private and public sector bankers. The first merger in 1987 consisted of an alliance between two progressive banks, Bilbao and Vizcaya, to form BBV. The two largest traditional banks, Central and Hispano Americano, merged in 1991 to form BCH. This was a defensive move that aimed to prevent the progressive banks from launching a potential hostile takeover against any of them.

The BdE and the government facilitated the mergers through several measures. The combination of the fear of foreign acquisition of the big banks and the state's own concern for financial instability led the state to take a protective stance toward the banking sector. To this end, the state exercised tight control over foreign investment in the sector. Law 26/1988 mandated that anyone taking control of 5 percent of the social capital of a bank needed to inform the BdE, and participations over 15 percent required a specific authorization. This protection was necessarily temporary because Spain was scheduled to join the Single Market in 1993, but it enabled the Big 7 to undertake mergers and restructuration with minimal interference from foreign competitors. The government's defensive approach also aimed to prevent speculative investments that could cause instability in the financial sector. This was, for instance, the purpose of Minister Solchaga's request that the Kuwait Investment Office withdraw its stake in Banco Central in 1987.[57] Spain's position with regards to its banks contrasts markedly with the country's liberal approach to foreign investment (FDI) in most other sectors, and it illustrates

57 Congress 9 February 1993.

the preferential treatment awarded to banks relative to other industries, especially manufacturing sectors. In 1986, Spain introduced legislation that enabled foreign investors to invest in most sectors under the same conditions as resident Spaniards.[58] By 1992, Spain's share of world FDI represented about 5 to 6 percent, a much higher share than Spain's 1 percent share of global GDP.

The government also facilitated the modernization and competitive transformation of the banks by helping negotiate and fund their internal re-structuration. Employment at Spanish commercial banks decreased continuously between 1980 and 2004, losing a total of 70,000 jobs. Between 1995 and 2000 alone, Spanish commercial banks downsized by 27,000 employees, while France decreased by 8,000 and Germany and the United Kingdom increased employment by 5,000 and 14,000, respectively.[59] Downsizing operations were usually negotiated with the government, and unions played an important implementation role. Most layoffs took the form of voluntary pre-retirement agreements generously funded by the state, which contributed approximately half of the ensuing pensions.

The protective stance of the state, and the restructuration measures outlined above substantially lowered the risks and the costs of transforming the banking sector, and the progressive bankers embraced the opportunity. In 1989, Santander, followed later by BBV, launched innovative savings products that unchained a deposit war, which signaled the breakup between progressive and traditional bankers. As mentioned above, the sector also underwent a massive internal restructuration that lowered fixed costs. In addition, following a first round of mergers among Spanish banks, progressive banks engaged in an expansion spree in Latin America. Along with being a defensive strategy against hostile acquisitions, internationalization boosted profitability by increasing the banks' volume of operations and by allowing banks to benefit from Latin America's larger interest spreads. Moreover, the diversification of operational risk inherent to internationalization protected banks against future economic downturns in Spain, making them more solid and competitive.

The pattern of collaboration between the BdE and the progressive bankers to achieve compatible goals showcases the interdependencies and mutual-collaboration pattern characteristic of PC. In addition, the following factors distinguish PC from state capture: (a) the consistency between the guidelines for economic reform contained in the Moncloa Pacts and the policy choices of the BdE, (b) the leadership position of the BdE in facilitating the modernization process, and (c) the diversity of opinions between progressive bankers and traditional bankers and between traditional bankers and the state. The innovative and proactive attitude of the progressive bankers also contrasts

58 Royal Decree-Law 1,265/1986.

59 OECD Banking Statistics.

significantly with theoretical expectations of low innovation, lack of initiative, and shallow structural transformation usually associated with the state capture hypothesis.[60]

The course of action followed by the BdE was not the only option available. The state could have supported a strategy based on long-lasting relationships between banks and industry along the lines of the German system, but this would have compromised the BdE's objectives. The progressive banks, especially Santander, had relatively small industrial investments and were unwilling to play a role in industrial decisions that were outside their field of expertise. By contrast, the three biggest conservative banks had large but often incoherent industrial investments.[61] Consequently, a German-like strategy would have involved supporting the position of the traditional bankers, who opposed strategic reforms, possibly delaying the modernization of the banking sector. Additionally, part of the institutional core of the German banking system is the presence of a set of public banks that do not operate solely on the basis of profitability criteria.[62] Such an approach would have gone against the historical for-profit orientation of big Spanish banks, and it would have compromised the BdE's goal of increasing competition through liberalization.

60 Hellman and Kaufmann (2000); Hellman et al. (2000).

61 S. Pérez (1997); Rivases (1989); Guillén and Tschoegl (2008).

62 Huffner (2004).

In Spain, 1986–1993 was also characterized by the development of more permanent institutional foundations to support the dialogue and interpersonal negotiations that characterize PC. Luís Angel Rojo, the father of the BdE elite, was instrumental in the creation of two bodies: Fundación de Estudios de Economía Aplicada (FEDEA)—Foundation for Applied Economy Studies—and Centro de Estudios Monetarios y Financieros (CEMFI)—Center for Monetary and Financial Studies. FEDEA was created in 1985 and produces applied economic research. Financed by the BdE, along with the big banks and a few other large Spanish corporations, FEDEA's strength lay in its ability to engage and bring together senior Spanish economists affiliated with top universities around the world. CEMFI is a private postgraduate education foundation founded by the BdE in 1987 "in response to the perceived need of highly qualified specialists in economics both at the BdE and elsewhere in the Spanish economy."[63] CEMFI is, therefore, a direct source of talent for the BdE; it produces international-quality research and carries out projects funded by the ministry of economics.

5.3 Impact of the euro and the internationalization of big Spanish banks

The relational nature of PC, or the coordination dynamics already set in motion in the previous decades, did not change significantly after the PP came to office in 1996, which attests to the institutionalization of PC. Many of the individuals who had held high responsibilities in the previous PSOE administrations played key roles in designing and implementing some of the most crucial economic policies of the period. For instance, Luís Angel Rojo, who had become governor of the BdE in 1992, remained in his post until 2000 and was responsible for designing the monetary policy that enabled Spain to join the euro, premier Aznar's pet aspiration.

The government's drive to qualify Spain for the euro prompted a new wave of mergers that finalized the modernization and transformation process of big Spanish banks and consolidated the progressive bankers' leadership. The acquisition of BCH by Santander in 1999 represents the final instalment of the war among conservative and progressive bankers. Despite a so-called "merger of equals," the bitter squabbles between BCH and Santander executives over strategic direction epitomize the acrimony between conservative and progressive bankers. Internal struggles came to an end when top BCH executives José Amusátegui and Angel Corcóstegui, the last representatives of Spain's traditional banking philosophy, renounced their executive positions in 2001 and 2002.[64]

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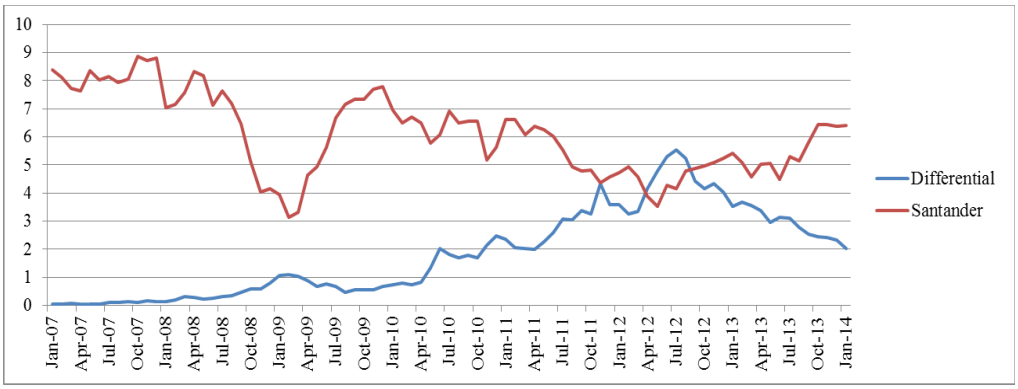
63 CEMFI, accessed 21 August 2014, http://www.cemfi.es/about/index.asp.

64 El País (2001); ABC (2002).

The PP governments did not hesitate to use the tools at their disposal to eliminate those they disagreed with, a behavior that underscores the non-market character of PC, the persistence of divergent opinions among the government and banking elites, and the independence of state criteria. In 2000, Emilio Ybarra, the president of BBVA, was forced to renounce his post among a scandal related to offshore secret accounts. The issues in question preceded Ybarra's presidency, and it is generally accepted that the case surfaced at the initiative of premier Aznar and of those close to him as a response to intense criticism of Aznar on a TV channel controlled by the Ybarra family.

PC is based on the equilibrium between the resources and capabilities of the state and banks, and on the presence of interdependencies between these two actors. Consequently, factors that affect the respective capabilities of the state or banks can potentially unravel PC. One such factor is the internationalization of big Spanish banks. According to Culpepper and Reinke,[65] internationalization diversifies risks and reduces a banks' dependence on operations in any single country, strengthening the position of the bank in negotiation with government. Although this could compromise the future of PC, recent evidence shows that the performance of big Spanish banks in major markets outside Spain still remains sensitive to changes in Spain's macroeconomic conditions. This is possibly due to the fact that Spanish financial institutions are large holders of Spanish public debt (37 percent of outstanding debt as of 2012[66]). A comparison between Santander's quotations in the London Stock Exchange FTSE index and the evolution of the price differential between the Spanish ten-year bond and the German ten-year bond up to January 2014 illustrates this point by showing a strong correlation between investors' perception of Santander and the evolution of the Spanish sovereign debt crisis.

Table 5 Santander's FTSE monthly stock performance and Spain's bond differential in 2007–2014.



65 Unpublished.

66 BDE (2013).

Source: Yahoo Finance for FTSE quotations and ECB for bond differentials

6. Conclusions

This paper has explored national banking institutions and their contribution to the competitive transformation of big commercial banks in the context of late industrializing, transitional, and peripheral economies using the Spanish case. The paper has established that strategic or non-market coordination is a defining feature of commercial banking, thus questioning the conventional dichotomy between liberal and coordinated market economies regarding commercial banking. An international comparison also showed that non-market coordination can take on different forms depending on the relative power of the state, big banks and productive industry, the preferences of these actors, and their capabilities and resources.

The paper has shown that the development of Spain's institutional framework was rooted in the following factors: (a) the political consensus that defined the country's transition to a democracy in the late 1970s, (b) a developmental state whose commitment to Spain's modernization could only be fulfilled with cooperation from industry, (c) the presence of a new generation of bankers whose goals were consistent with the state's objectives and could not be achieved by the bankers alone, and (d) a context in which the interests of productive industry were secondary to those of the banking sector.

These factors favored the development of a non-hierarchical system of interactions among high-level decision-makers in government, the central bank and big Spanish banks. PC enabled the state to modernize and increase the resilience of the Spanish financial sector. In addition, PC empowered a group of progressive bankers, enabling them to undertake the complex and costly transformations necessary to reach the efficiency frontier of the sector. Despite the power of big banks, PC did not drift towards state capture, thanks to the government's sustained commitment to economic development, the consistency between this commitment and policy formulation and implementation, and the presence of a highly skilled body of specialized civil servants. The innovative and transformative capacity demonstrated by big Spanish banks is also at odds with the state capture hypothesis.

PC has persisted despite the banking sector's evolution towards greater supra-national coordination and the internationalization of big Spanish banks. This is because to date these developments have not significantly affected the relative equilibrium of power between the state and big Spanish banks. State-bank coordination continues to be a structural feature of commercial banking and the main guarantee of stability in national financial systems. In addition, the performance of big Spanish banks continues to be sensitive to the evolution of the Spanish economy. Nonetheless, future changes that alter these features could transform or unravel PC.

Insights from the Spanish case, in particular the connection between the economic transformations and democratization, the development of a broad-based consensus in the early stages of the transition, and the empowerment of a new economic elite, highlight the importance of examining transitional contexts to understand the development and consolidation of banking institutions. Evidence from Spain also suggests that barriers against state capture and the presence of progressive industry leaders play an important role in determining whether institutional development supports the competitive transformation of big banks, or simply entrenches the position of already influential banks. Nonetheless, further comparative research, preferably in the context of late industrializing, transitional economies is still necessary to generalize these insights for a broader context.

Appendix 1, Interviews

1. Alejandra Bernad - Regulatory Division, Bank of Spain
2. Ramon Casilda Béjar - Instructor, Spanish School of Diplomacy
3. Alfonso Caro (AEB) - Spanish Banking Association
4. Luís Gutierrez de Rozas - Research Department, Bank of Spain
5. Mauro Guillén - Professor Wharton School of Business
6. Alejandra Kindelán - Head of Research and Public Policy at Banco Santander
7. Manuel Marín González - Former MP
8. Soledad Nuñez - Director of the Treasury
9. Aldo Olcese Santonja - Royal Academy of Economics and Finance
10. Iliana Olivié - Associate Professor Complutense University, Researcher Real Instituto Elcano
11. Sofía Pérez - Associate Professor, Boston University
12. Santiago Pernías (AEB) - Spanish Banking Association
13. María Angeles Pons - University of Valencia
14. Karina Robinson - Principal, Robinson Hambro Ltd
15. Vicente Salas-Fumás - Professor University of Zaragoza, former Board Member Bank of Spain
16. Francisco Uría - Partner, KPMG, Financial Sector Specialist

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