Abstract

After a brief review of the literature on the determinants of financial development, the paper compares the Asian and European financial systems in terms of their size and efficiency. It also compares the steps taken in the two regions in the quest for financial development and stability, which in some cases are more similar than in others. While there has been a clear move towards a more balanced financial structure in both regions, financial liberalization, as well as the strengthening of bank regulation and supervision have occurred later in Asia and with a different speed and sequencing. The most striking difference between the two areas is the degree of international - and regional – financial integration, much lower for Asia. Finally, the case of Spain - as a European country with a finance-led convergence process - is analyzed in more detail. Lessons are drawn from the Spanish experience for Asian countries.

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TABLE OF CONTENTS

1. Introduction

2. Financial System Development and its determinants
   • Financial structure: bank versus capital markets financing
   • Financial liberalization
   • Banking crises and the improvement of bank supervision and deposit insurance schemes
   • International (or regional) financial integration

3. The Asian and European financial systems: stylized facts

   3.1. Where do Asia and Europe stand in terms of financial depth and efficiency?
   3.2. Stylized facts of some determinants of financial development
      • Financial structure
      • Financial Liberalization
      • Banking Crises, the improvement in Bank Regulation and Supervision and the DIS
      • International – and regional- financial Integration
      (i) The opening up of the domestic banking system to foreign competition
      (ii) Outward internationalization
      (iii) Regional Integration Efforts in markets and infrastructure

4. The case of Spain

   4.1. The Spanish banking system today compared to the rest of European countries
   4.2. How did it get there?
      • Financial liberalization
      • The banking crisis and the improvement of regulation and supervision
      • The change in the bank structure: Commercial banks versus savings banks
      • The process towards international and regional integration
      • Foreign banks in Spain
      • Outward internationalization: Latin America
      • Regional integration with the rest of the EU

5. Conclusions

GRAPHS

G1 Financial Sector Structure, Europe Union- Asia (% share of GDP)
G2 Financial Liberalization, Banking Crises and Financial Depth in France
G3 Financial Liberalization, Banking Crises and Financial Depth in Thailand
G4 Foreign bank participation in selected European and Asian countries
G5 Consolidated International Bank Claims by selected European countries (as a share of total International bank claims, 2001)
G6 Return on Equity in selected EU countries
G7 Financial Liberalization, the Banking Crisis and Financial Depth in Spain

TABLES

Table1 Deposit insurance schemes
1. Introduction

Recent research has illustrated how financial systems have contributed to economic development, by increasing total factor productivity and ultimately economic growth. Aware of the important role that finance plays for growth, both Asia and Europe have striven to develop their financial systems while trying to maintain financial stability. Some of the steps taken are similar in both regions, including the evolution towards a more balanced financial structure from a bank-based one, financial liberalization, although with a different timing and speed, and the ensuing strengthening of financial supervision following crisis events. Other steps are, however, very different, especially what concerns the degree of international, and especially, regional integration.

Taking as a benchmark a brief review of the experience in both regions, the paper deals with the case of Spain as a country whose process of economic convergence to EU levels has been based, among other factors, on financial development. In fact, the Spanish banking system experienced a deep but lengthy liberalization process, which increased the efficiency of the whole economy. A significant banking crisis occurred a few years after the liberalization process started, although liberalization was not the main reason. Building up from this painful experience, the regulatory framework was improved and solvency monitoring arose as the main driving force for banking supervisors. As a result of this, among other factors such as EU entry and the opening to global competition, the Spanish banking system is now very sound and competitive for European standards, and has managed to expand overseas at large scale, particularly in Latin America. The banking system remains, therefore, one of the main driving forces of convergence.

The paper is divided into four major sections. Section 1 briefly describes the general consensus found in the literature regarding the characteristics of the financial sector which better foster its development and, ultimately, economic growth, as well as the role of financial liberalization, bank supervision and international and regional integration. Section 2 provides some stylized facts comparing financial size and structure, financial liberalization, bank supervision and international and regional integration in Asia and Europe. Section 4 delves into the Spanish positive and negative experiences with financial development. Conclusions are drawn in Section 5.

2. Financial System Development and its determinants

Recent research broadly agrees that financial development contributes to economic growth. The so-called “finance-led” economic literature on growth argues that financial development increases total factor productivity and ultimately economic growth through the functions inherent to the financial system, namely mobilizing savings, allocating capital, monitoring managers and transforming risk.

The debate on the role of financial systems on growth is well-rooted in the history of economic thought. Already Bagehot (1873) and Schumpeter (1911) attributed a key role for economic development to a country’s banking system. The recent interest in the role of the financial system on growth is related to the developments of the new growth theory. While innovation and knowledge creation are the main forces behind capital accumulation and growth in this literature, financial intermediaries also plays a role to the extent that innovation and knowledge are financed with external funds (Greenwood and Jovanovic, 1990; Levine, 1991; King and Levine, 1992; and Chen et al., 1996).
Before analyzing the factors that affect financial development, one should note that financial development may be defined in several ways. In fact, financial systems can develop in terms of size but also in terms of the efficiency in which they intermediate funds. Financial development in terms of size is generally called financial depth. Narrow definitions of financial depth include bank liquid liabilities to GDP (or M2) or bank credit to the private sector to GDP, while wider measures include the domestic capital markets as well as the banking system.

Financial efficiency is hard to measure for the financial system as a whole. The literature has developed measures of efficiency for the different markets that compose the financial system. For the banking sector, the most widely used measure is the net interest margin together with the spread between the lending and the deposit rate. When the net interest margin, or the spread, is narrow, it tends to be associated with greater competition although there may be other reasons, such as low interest rates, particularly in developed countries, and macroeconomic volatility in emerging countries. As regards the capital markets, the most readily available measure of efficiency is turnover, which gives the value of stock transactions relative to the size of the financial market.

Turning to the factors that foster financial development, the literature concentrated first on macroeconomic factors, such as inflation and how wealthy countries are in terms of GDP per capita as well as the saving rate. However, more recently, much importance has been attached to institutional factors, such as the legal and regulatory system, as well as the structure and functioning of the financial system itself. This paper will concentrate in some of the latter factors.

- **Financial structure: bank versus capital markets financing**

  The long-standing debate as to whether bank financing or capital market financing is better for economic growth appears to have reached consensus with recent research. La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997), Levine (1998 and 1999) and Barth, Caprio and Levine (2000) show evidence that the choice between a bank-based and a capital-market based structure is not key for financial development but rather the institutional factors behind the financial structure, and

  Although broad, the latter still misses important sources of financing, such as enterprise financing, external financing (through interbank loans or bonds) and the informal financial sector.

  Boyd, Levine and Smith (2000) find empirical evidence that at low-to-moderate rates of inflation, increases in inflation hamper financial development, in terms of lower volumes of bank lending to the private sector. Khan et al. (2001) basically find the same result with the addition that there is a floor for inflation, below which financial development is hampered as well. More specifically, they find that under certain conditions inflation below 3% and above 6% is detrimental for the main definitions of financial depth (from bank credit to broader ones including stock market capitalization).

  Jaffee and Levonian (2000) find that both GDP per capita and savings are significant to explain financial development.

  Levine, Loayza and Beck (1999) find that countries with legal and regulatory systems that give a high priority to creditors have better functioning financial intermediaries.

  For a broader review of the financial system related factors which foster financial development see García Herrero et al. (2002).
in particular the legal environment, as well as how efficient and safe financial systems are, as shall be touched upon later. All this, however, does not mean that the financial structure is irrelevant. In fact, it appears that most success cases of financial development have a relatively balanced mixture of capital markets and bank financing (Davis, 2001) since bank and capital market financing tend to complement rather than substitute each other.

- **Financial liberalization**
  While the economic literature agrees that financial liberalization strongly contributes to the development of the financial sector in the long run (Shaw, 1973; McKinnon, 1991; and Bailliu, 2000), the evidence is much more mixed for the transition period, especially as regards external financial liberalization and particularly that of the capital account. On the one hand, capital account liberalization offers the opportunity of receiving more funds to develop domestic financial markets, especially when control on foreign ownership of banks is relaxed (IMF, 2000). On the other hand, it carries risks of financial instability if the appropriate institutional framework is not in place when liberalizing (Williamson and Mahar 1998). This risk of financial instability has been the main reason for a good part of the economic literature to advocate gradual – and well-sequenced - liberalization processes with a strengthening of the overall policy environment alongside (Caprio et al 1999). As regards the sequencing, the general view is that macroeconomic stability should take place first, followed by domestic financial liberalization and leave capital account liberalization as the last step (McKinnon, 1991).

- **Banking crises and the improvement of bank supervision and deposit insurance schemes**
  Banking crises are obviously detrimental for financial development in the short run, since all who depend on financial services suffer, but under certain circumstances their impact may be positive in the long run if they are tackled properly. In fact, a crisis might sometimes be the only way for a banking system to be cleaned up properly and for bank credit to resume. One indirect beneficial consequence of banking crises has often been the subsequent improvement in the quality of bank regulation and supervision as a reaction to the crisis. The literature has long argued that high quality regulation and supervision fosters financial development.

  As regards deposit insurance schemes (DIS), they appear to foster financial development as long as the DIS is explicit and limited (Dale et al. 2000), and the institutional environment, particularly the regulatory system is sound (Cull et al., 2000). However, if implicit or unlimited, the DIS may increase the probability of banking crises (Demirguc-Kunt and Detragiache, 1998)

- **International (and regional) financial integration**
  There is broad consensus in the literature that international (or regional) financial integration fosters financial development, particularly for small countries. We consider three dimensions of it:

  The first one is opening up the domestic banking system to foreign competition by allowing foreign ownership. Several reasons have been given for its positive impact, among which: foreign entry brings fresh capital into the banking system, which can be intermediated and thus increase the size of the domestic financial system (Kroszner 1998). It also limits the volatility of capital movements
and financial markets in general (Kono and Schuknecht, 1999) given that foreign banks start to lend domestically. Finally, management and expertise is imported, which should foster efficiency and competition, improve internal risk management and increase solvency in terms of higher loan-loss provisioning (Claessens et al., 2000 and Crystal et al., 2001).

The second is exporting or importing funds – depending on the financing needs at home. One of the main advantages of opening up to exporting or importing funds is that it allows for a better allocation of capital and reduces the cost of financing for capital importers.

The third aspect is regional integration of markets as well as their infrastructure. Regional market integration generally reduces concerted pricing and collusive agreements by increasing competition in a larger economic area. This is particularly important for the financial development of small countries because of the potential efficiency gains from economies of scale and scope but not only, as the European case shows. Technological development has enormously increased efficiency gains of very large markets, which explains why also relatively large countries can benefit from close regional integration. The same is true for the infrastructure.

3. The Asian and European financial systems: stylized facts

3.1. Where do Asia and Europe stand in terms of financial depth and efficiency?

While European and much more so Asian countries are rather heterogeneous, a brief comparison of the degree of financial development in the two regions will now be conducted. The group of countries selected to calculate the averages for the European and Asian regions are the 15 EU countries, and China, Indonesia, Malaysia, Philippines, South Korea, Thailand, Hong Kong and Singapore for Asia, unless indicated otherwise.

Differences in financial depth, measured broadly by the sum of bank liquid liabilities, stock market capitalization and bond market outstanding, between Asia and Europe have shrunk over time. Financial depth was very low in the 1970s in Asia, below 25% of GDP on average and exclusively concentrated in the banking system. The European financial systems were twice as large, with bank liquid liabilities of 50% of GDP on average. Europe completed its liberalization at the beginning of the 1990s, while Asia liberalized in general some time later. By 1996, one year before the Asian crisis hit, the average size of the financial sectors in Asia had overtaken those in Europe, reaching levels well above 250% of GDP (this average to some extent overestimates the situation in the region, being influenced by the very high ratios of stock market capitalization to GDP of three countries-- Hong Kong, Singapore and Malaysia). The Asian financial crisis brought a

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8 Berger (2000) finds empirical evidence of the large potential for efficiency gains from integration although only a small part of these gains are generally realized. Most of the gains appear to be linked to the benefits of risk diversification.

9 Giovanni and Mayer (1990) show evidence of the high costs of financial market segmentation in Europe and the substantial benefits of regional integration.

10 Note that averages are unweighted as some of them are ratios and, in general, we are trying to show general regional trends and not the weightings of different countries in those regions.
sharp reduction in size across most financial systems in the region, affecting banks but especially the capital markets. However, figures for the year 2000 show that the Asian crisis moderated financial depth, but did not cause a lasting trend reversal.

G1 Financial Sector Structure, EU and Asia (% share of GDP)

Note: Data for bond outstanding in 1980s and for stock market and bond outstanding in 1970s are not available in this Dataset, so the graph may be underestimating financial depth in both decades.

As regards financial efficiency the banking system and the capital markets will be analyzed separately due to the lack of global indicators of efficiency. Regarding bank efficiency, the net interest margin has shown improvements in Europe, from an average of 2% in the period 1992-97 - and even higher level in the 1980s (2.3% on average) it reached 1.5% in 1999 (ECB, 1999). In Asia, the net interest revenue also fell from 2.6% in the period 1992-97 to 2.2% in 1999 (Hawkins and Mihaljek, 2001) but the two measures are not easily comparable. The evolution of the spread between the lending and the deposit interest rates has not been very positive for efficiency in any of the two regions: while it has continued to increase in Asia, it has fallen in Europe but still stands at relatively high levels. As regards the stock market efficiency, measured by its turnover, it fell in Asia as a result of the crisis, but it is still slightly higher than that of Europe.

3.2. Stylized facts of some determinants of financial development

• Financial structure

As shown in the above graphs of financial depth, both Asian and European financial systems have traditionally been predominantly bank-based, and not market-based. Such differentiation began to blur, first with the expansion of domestic bond markets in the second half of the 1980, particularly in Europe and, second, with the stock market boom of the early 1990s. All in all, the structure of the financial system is rather balanced in both regions, as favored in the economic literature. This does not mean, however, that the banking system has lost its prominence. The larger volatility of capital markets, particularly for Asia, and the involvement of the banking system in the capital markets in many European countries with universal banking but also in some Asian ones, retains the crucial role of the banking system in the financial development of both regions.

• Financial Liberalization

Both Asia and Europe have pursued financial liberalization as a means to enhance competition and efficiency in their financial systems, and broaden the provision of financial services. Liberalization processes in the two regions hold similarities but also crucial differences which play a role in explaining the present shape of financial systems, as well as the incidence of crises. The main differences refer to the starting point and length of the liberalization processes. While in Europe financial liberalization started in the mid 1970s, it did not gather speed until the mid 1980s.

Shirai (2001) emphasizes the role played by the banking sector in the development of corporate bond markets in several Asian countries.
In Asia liberalization processes start later and suffered from more reversals and—as a consequence—it took longer to complete them.

A few conclusions can be drawn from the graphs in this section showing bank liquid liabilities and credit to the private sector, both as a percentage of GDP, for a selected group of Asian and European countries, together with three measures of the degree of financial liberalization over time, one for the domestic financial sector, another for the capital account, and the last for the stock market. These measures have been borrowed from Kamisky and Schmuckler (2001), who construct indexes from 3 to 1, from less financial liberalization to more. The degree of domestic banking liberalization is measured primarily by the free setting of deposit interest rates. The degree of capital account liberalization is measured by four variables: the possibility of offshore borrowing by domestic financial institutions, that of offshore borrowing by non-financial corporations, the absence of multiple exchange rate markets and that of controls on capital outflows. Finally, the degree of liberalization of stock markets is measured by the possibility of acquisition of shares by foreigners and the capacity of repatriation of capital, interest and dividends.

The first conclusion is that Asian financial systems were much smaller than the European ones when financial liberalization started. In Asia, bank liquid liabilities were typically about 30% of GDP, and sometimes as low as 10-20% of GDP. Second, taken France as an example, graph 2 shows that financial liberalization started earlier in the selected countries in Europe than in Asia, in all its fronts (domestic, capital account or stock market). Domestic financial liberalization was accomplished relatively swiftly and without reversals in a number of countries (France, UK and Germany) but took longer in others such as Spain or Italy. Capital account liberalization, in turn, typically lagged domestic financial sector liberalization. In Asia, in contrast, the extent of financial liberalization in different countries has been much more mixed. While most countries started to liberalize their domestic financial sectors towards the mid 1980s, in several cases it remained limited in scope for many years. The duration of financial liberalization processes in Asia was thus typically longer than in Europe. As for the sequencing of reforms, it appears that many countries in Asia also started to liberalize their domestic financial systems before the capital account.

G2 Financial Liberalization, Banking Crises and Financial Depth in France


G3 Financial Liberalization, Banking Crises and Financial Depth in Thailand


12 We have selected Germany, France, Italy and the UK among European countries for this exercise, and will add Spain in the next section.
Evidence seems generally supportive of the fact that liberalization tended to increase the share of credit as a percentage of GDP in the European economies even faster than bank liquid liabilities, which allowed for a better intermediation of funds (see graphs 2 and 3 above). In Asia, a similar process appears to have taken place.

**Banking Crises, the improvement in Bank Regulation and Supervision and the DIS**

As the previous graphs already showed (vertical line in black), many countries experienced banking crises in the aftermath of financial liberalization. Most countries in Asia – and to a lesser extent in Europe - experienced at least one banking crisis, and in many cases a systemic one. The causes of these crises were of very different nature, but there was at least one common development: an accelerated growth of credit to the private sector following, in many instances, financial liberalization. From the experience with crises, it has resulted a tightening of financial regulation and supervision, particularly in Asia but also in some European countries as will be shown for the case of Spain later. Another feature that distinguishes financial regulations in Europe and Asia is the existence of DIS.

![Table 1, Deposits insurance schemes.](image)

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13 In the Europe, 11 out of 15 countries had at least one banking crisis in the period under consideration. 4 of those banking crisis were considered as systemic. In Asia, in contrast, all 8 countries in our study had banking crisis and 4 of them were considered systemic.
Today, all European countries hold a limited-coverage and explicit DIS as shown in Table 1. About half of them are fully funded by the private sector, and the rest are funded jointly by the private and public sectors. By contrast, only two out of seven countries in Asia (South Korea and the Philippines) had an explicit and limited-coverage DIS in place before the Asian crises. When the crisis hit, many countries, which did not have a DIS (Indonesia, Thailand and Malaysia, as well as Korea which did have a limited one), moved to extend blanket guarantees on deposits to prevent deposit runs.

- **International – and regional- financial Integration**
  We shall now compare the three main dimensions of financial integration reviewed in the previous section.

  (**iv**) *The opening up of the domestic banking system to foreign competition*

Foreign bank participation in Asia and Europe stand at relatively low levels, when compared with other regions of the world such as Latin America, and even more so Eastern Europe\(^\text{14}\). While they average over 20% of total bank assets in Asia as shown in graph 4, they stay at roughly 10% in

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\(^{14}\) Shares of foreign banks stand well over 50% of total bank assets in these regions.
Europe with the clear exceptions of the UK, Ireland or specially Luxemburg where foreign banks hold more than half of total assets.\(^{15}\)

**G4: Foreign bank participation in selected European and Asian countries**

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<td>Note:</td>
<td>Hong Kong and Singapore in Asia and Luxemburg, UK and Ireland in Europe.</td>
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Although the two areas hold relatively low shares of foreign-owned banks in their banking systems, the underlying reasons are different. Asia still maintains restrictions to foreign ownership, with the exception of Hong Kong and Singapore as off-shore financial centers, while European countries have practically fully liberalized foreign entry\(^{16}\). This has been particularly warranted in the run-up to a Single Market in Europe, in order to profit from economies of scale and scope.

\(^{(v)}\) *Outward internationalization*

Another important angle of the international integration of a banking system is the amount of assets it holds abroad. In this regard, BIS consolidated banking statistics provide a good indication of the degree of outward internationalization of financial systems of the 23 reporting countries based on information on total foreign claims by country and by world region, both in local and foreign currency. Disaggregated data for European countries is available but not still for Asia. Therefore, using BIS figures we can learn about the degree of internationalization of most European countries, but not of Asia as of yet.\(^{17}\)

Graph 5 shows the increasing participation of European banks in foreign banking systems, which may be partially explained by diversification efforts in the run-up to monetary union, and by excess liquidity or capacity of European banks because of increasing market saturation and low returns in the area\(^ {18}\).

**G5: Consolidated International Bank Claims by selected European countries**

| Source: | ECB 1999 |

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\(^{15}\) In the two regions, special cases have been excluded from the average, namely Hong Kong and Singapore in Asia and Luxemburg, UK and Ireland in Europe.

\(^{16}\) The First Banking Directive, and especially the Second Banking Directive have introduced provisions for mutual recognition, home country supervision and the elimination of capital requirement for branches within other EU countries. In addition, by granting a single passport the Second European Directive provides a large incentive for harmonization. Finally, European countries have decided unilaterally to lift restrictions on branching of all or some institutions.

\(^{17}\) Total foreign claims include cross-border claims plus local claims of reporting banks’ foreign affiliates in foreign and local currency, but are not collected on a net basis and only show the asset side of the consolidated balance sheet.

\(^{18}\) See ECB 1999.
As a result, European banks appear to have acquired a leading role as international lenders, their foreign claims amounting to 53% of all international bank lending. However, it is remarkable that total foreign claims of European banks to Asia show just a meager 4% of total international lending. Low levels of integration in Asia are also evident when we look at the degree of outward internationalization of Japanese banks. While Japanese banks are relatively active international lenders at the aggregate level (10% of total international claims), their exposure to Asia amounts to just 1% of total international consolidated claims, a level close to that of the US or Germany but lower than for example that of the UK.

iii) Regional Integration Efforts in markets and infrastructure

This is obviously the area in which the differences between Asia and Europe are most striking. Europe has moved forward in terms of financial market integration since the introduction of the Single Market, and particularly since the creation of EMU. Today, there is a single monetary policy and money markets have become fully integrated. Government debt markets have become more harmonized with the consequent reduction of spreads among different euro area countries.

4. The case of Spain

4.1. The Spanish banking system today compared to the rest of European countries

EU accession in 1986 marked a crucial turning point for Spain, both in terms of economic growth and of financial sector development. Since 1986, Spain real GDP per capita in PPP terms has increased by over 10 percentage points relative to the European average in less than 15 years. Financial depth as measured by the ratio of credit to the private sector to GDP has soared from 55% to over 90% in 2001, something that clearly indicates a key contribution of the financial sector to Spain’s catching-up with the rest of the EU.

Banks in Spain rank well in terms of profitability relative to European standards. In the last few years, operating income as a percentage of total assets, although declining, has been clearly above the average of the Euro Area, and even European Union countries. Bank efficiency, measured by operating costs to operating income, is about average. And the return on equity (ROE) and the return on assets (ROA) of Spanish banks have consistently remained well above the euro area average during the last years of available data (graphs 6). Spanish banks also do well in terms of solvency. Capital adequacy ratios are about the EU average. This is even more so if one considers that the Spanish regulator, namely Banco de España, requires tighter capital standards than in most other European countries.\(^\text{19}\) If measured by Basel standards, the capital ratio of Spanish banks would appear, on average, a 20% higher than with the national standards.

The high level of capital held by banks is one of the main factors behind the soundness of the Spanish banking system but not the only one. Banco de España has also introduced a new, so-

\(^{19}\) The difference is not in the denominator of the ratio (i.e., the weighting of different assets) but the definition of capital. Tier 1 definition is almost the same. However, Spanish regulators do not allow counting general provisions and undisclosed reserves as Tier 2. The Basel Accord considers undisclosed reserves (up to 45% of total) as Tier 2.
called “statistical”, provision to be added to the existing specific and general provisions. The statistical provision aims at covering expected losses dynamically from the moment a loan is made. This should, first, reduce the procyclical nature of other provisions and, second, result into profit and loss accounts that better reflect correlations between income and expenses through the life of a loan\textsuperscript{20}. The statistical provision should, thus, allow banks to react to an economic slowdown from a better position.

G6 Return on Equity in selected EU countries

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Data for 1998 & \\
\hline
Source: ECB 2000a & \\
\hline
\end{tabular}

4.2. How did it get there?

Several crucial issues have occurred in the Spanish banking system since the 1960s, which explain the current situation, as described above. First, financial liberalization, after a decade of financial repression. Second, the banking crisis, which was more related to bank mismanagement than financial liberalization although the latter certainly did not help. And, finally, the rapid international – and regional- integration process, with the participation in, and acquisition of, banks abroad, particularly in Latin America, and the always closer integration within the European banking system.

\begin{itemize}
  \item Financial liberalization
  
  The Spanish banking system was tightly regulated until the end of the 1960s. All interest rates both in the asset and the liability side of the banks’ balance sheets were set administratively. There was directed credit at below market rates to sectors such as agriculture, shipbuilding and housing. The number of branches that a bank could open was also regulated by a system of quotas distributed among incumbent banks. Foreign banks were not allowed to operate in Spain\textsuperscript{21}. All in all, a significant amount of decisions, as well as business orientation, were kept away from Spanish banks’ managers, and remained the competence of regulators. This, among other factors, resulted in an oligopolistic structure with large economic rents for incumbent banks but with a large welfare cost for investors and depositors\textsuperscript{22}.

G7: Financial Liberalization, the Banking Crisis and Financial Depth in Spain

\begin{tabular}{|c|c|}
\hline
Source: Banco de España; Kaminski and Schmuckler (2001) & \\
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\textsuperscript{20} A detailed rational for the statistical provision, the way it works and the objectives it covers can be found in Fernandez de Lis et al (2001).

\textsuperscript{21} Except for four banks which were already operating in the country before the forties. In any case, the market share of those four banks was almost negligible.

\textsuperscript{22} In particular, compulsory investment coefficients had a negative impact on equilibrium quantities in the loan market, decreasing the funds available for those economic sectors more dynamic and profitable, not included as beneficiaries of cheapest sources of funds.
Policy makers realized that liberalizing the financial system was needed in order to enhance competition and efficiency. The financial liberalization process started formally in 1969, although it only gathered speed in the early 1970s, and ended towards the end of the 1980s - beginning of the 1990s. Financial liberalization was by no means a linear process in Spain but rather lengthy and with reversals, but at the end Spanish banks were allowed to freely determine interest rates on their assets and liabilities. Captive investments disappeared (except for a small reserve requirement), geographical restrictions to branch opening were lifted first for commercial banks and eventually also for the savings banks, and foreign banks were licensed to operate in Spain.

The liberalization of the banking system was meant to increase competition. However, as increased competition eroded economic rents\(^23\), it also enhanced the bank incentives to adopt riskier policies. A lower franchise value, stemming from bank deregulation and increased competition, provided fewer incentives for banks to reinforce their solvency through capital. The likelihood of a banking crisis to occur was, therefore, high, especially if one considers the particularly delicate political and economic situation that Spain was undergoing.

- **The banking crisis and the improvement of regulation and supervision**

From 1978 to 1983, Spain suffered a large banking crisis, with the closure, merge or acquisition of 52 banks out of 116 existing at the start of the crisis, which amounted to a total of 25% of total commercial banks´ assets. The crisis started with small local banks, but later reached some important banking conglomerates. The causes of the crisis were a deep economic crisis and a too weak regulatory framework\(^24\) in the process of financial liberalization, but primarily mismanagement, related party, and single borrower lending. In fact, as in many other cases, the banking crisis could not withstand the poor economic conditions prevailing after a period of strong economic growth. Many of the bankrupt banks had been newly licensed during the 1960s. New bankers focused mainly on industrial banking (long term financing of non-financial firms) with important loans to the more risky real estate sector which first experienced a boom during the sixties as the country started to industrialize and later, between 1974 and 1980, benefited from the sharp decline of the stock exchange, acting as some kind of safe haven. More importantly, banks lent many of the funds to the same group’s non-financial firms. Lending to related parties and single borrowers inside those groups was as high as 50% in some bankrupt conglomerates\(^25\). In order to cope with liquidity problems, some banks started to pay higher interest rates, breaching the regulatory ceilings or entered into a branch-opening process in order to attract funds.

\(^{23}\) Not all the deregulation measures had the same impact on economic rents. The most important measures were those related to interest rate liberalization, in particular, those of non-remunerated deposit accounts (i.e. current and savings accounts), as well as the lifting of restrictions on branches (for both commercial and savings banks). A thorough study of the impact of the Spanish banking sector liberalization on economic rents and risk incentives is in Salas and Saurina (2002).

\(^{24}\) A summary of the causes of the Spanish banking crisis as well as the regulatory responses can be found in Juan (1993).

\(^{25}\) Sheng (1996) argues that none of the banks created during the financial liberalization of the 1970s survived as independent institutions, and 90% of the banks involved in the banking crises were created between 1973 and 1978.
A few supervisory flaws made it very difficult to stop the banking crisis. First of all, banking regulations did not allow supervisors to intervene banks before bankruptcy. Moreover, there was a huge shortage of on-site supervisors, and the existing ones were more focused on assessing compliance with bank regulations than on monitoring the solvency of banks. Banco de España began to tighten supervision and information disclosure in the late 1970’s, but bank regulations remained to some extent outdated until the first half of the 1980’s.

The cost for the taxpayers of the banking crisis bail-out was sizeable –about 5% of GDP - but still much smaller than many other banking crises. When the crisis started, no deposit insurance scheme (DIS) was in place. As the magnitude of the crisis was reckoned, a limited DIS jointly funded by the commercial and savings banks and by Banco de España was implemented immediately. The institution created to manage the DIS funds also received emergency restructuring powers over insolvent banks. With these powers, it could take control of a bank, write-off losses, recapitalize banks, restructure and finally sell them to the private sector. From that painful experience, regulators and supervisors become aware of the importance of tight solvency regulation and supervision, and spent the following years introducing them. The cornerstone of the new approach—other than stringent solvency regulation—was a frequent on-site inspection where assets classification and proper provisioning were carefully reviewed. Banks were required to comply with stricter capital requirements. In addition, credit-risk concentration limits were applied relative to capital requirements (as it turned to be one of the main leading causes of the former banking crisis), tighter entry requirements for new banks were also introduced, together with early intervention and stronger sanctions for rule breakers. Finally, professional as well as honorability requirements to become a banker were established, and regulators were provided with the ability to intervene banks when in doubt of their solvency and liquidity.

- The process towards international and regional integration

- Foreign banks in Spain

Foreign banks were not allowed to operate in Spain until 1978, when banking franchises started to be offered but still under important restrictions. Among the most relevant, foreign banks could open only a limited number of branches nationwide, they were not allowed to buy stakes in non-financial Spanish firms and they could only fund 40% of their investments in the Spanish market while the rest had to come from abroad.

The main policy objective for maintaining these restrictions at that time was to open the Spanish banking system to foreign competition without causing large disruptions in the domestic market. Foreign banks were believed to bolster innovation and competition as well as efficiency but there was the perception that domestic banks might note be able to withstand the competition. It is interesting to note that one of the easiest ways for foreign banks to enter the Spanish retail market was to buy restructured banks from the DIS. In this way, the DIS managed to dispose of several of the banks it had intervened over during the banking crisis.

26 More stringent than the Basel capital ratio since general provisions and unrealized gains are not counted as own funds.
In general, foreign banks never reached a major share in the Spanish banking system. From 8% of total assets in 1985 they reached 11.7% in 1997 and gradually decreased to the current 10% of total assets. For many of the foreign banks, learning about local credit policy and adequate risk management for the country's financial habits took time, and the amount of non-performing loans strained profit and losses accounts more than expected.

The response of Spanish banks to the threat of foreign competitors entering the market helps explain the difficulties that foreign banks faced to increase market share significantly. Confronted directly with foreign competition, Spanish banks improved processes, rationalized their networks and operational procedures, updated their IT systems and became more competitive in their pricing policies. High branch density also contributed, at least in part, to the high customer loyalty which characterizes the Spanish banking system.

- **Outward internationalization: Latin America**

One of the distinguishing features of the Spanish banking system in the last few years has been its rapid outward internationalization process mostly concentrated in Latin America. Today, slightly less than one fourth of the assets of the Spanish banking system are abroad, half of which in Latin America. The other half concentrates in developed countries, mainly western Europe, which is an important sign of regional integration, as will be tackled later. The exposure of Spanish banks to Asia, East Europe, Africa and Middle East is very low.

Although some Spanish banks already had a presence in Latin America, it is not until 1996 when their participation increases significantly, as a result of purchases of local banks, in many cases through privatization processes. The largest move forward in this strategy occurred in 2000, when the Spanish banks increased significantly their market shares in the largest economies of the region: Mexico and Brazil, which meant a qualitative and quantitative jump in terms of their predominant role in the Latin American banking system. Today, Mexico is the country in the region where Spanish banks concentrate the largest share of their investment, followed at a long distance by Brazil, Chile and Argentina (less that 15%)²⁷.

The reasons behind the expansion in Latin America are manifold. First of all, Latin American countries offer growth opportunities because the level of banking products and services to GDP is relatively low. At the same time, Spanish banks moved into Latin America hand in hand with their main local corporate customers, who have also expanded in this region through foreign direct investment. Larger margins and potential efficiency gains from the introduction of a new technology and well-designed financial services which had been very successful in Spain, were important reasons for the Spanish banks to expand in Latin America. This is particularly the case if one considers the strong competition among Spanish banks at home and the fact that margins had

²⁷ The relatively low weight of Argentinean assets over total Latin American Assets explain why the impact of the crisis in this country has not brought about a sharp decline in market capitalization of Spanish banks. There is no significant contagion of the Argentinean problems to other Latin American countries, both in terms of sovereign spreads and banking difficulties.
been declining since the beginning of the 1990s. Risk diversification has been another reason to expand abroad, with the aim to profit from different cycles in other countries. Last, but not least, the fact that many Latin American countries share a common language and similar idiosyncrasy helps considerably take control of a bank purchased in the region. Middle management can be sent to the acquired bank, and business policy and practices can be easily transferred.

• Regional integration with the rest of the EU

Since Spain joined the European Union in 1986, the country has taken all the necessary steps to become as integrated as possible with the rest of the European financial system. The strategy chosen by Spanish commercial – but also saving banks - in this regard has been closing alliances with major European banks, through cross-share holdings, mainly French, Italian, German, Portuguese and British.

5. Conclusions and possible lessons from the Spanish experience for Asian countries

A brief comparison of the Asian and European financial systems indicates that a few of the steps taken in the two regions in the quest for financial development and stability are very similar in timing and nature. This is particularly the case for the move towards a more balanced financial structure, which basically started in the early 1990s in both regions. Other steps are similar in nature but not in timing, such as financial liberalization, clearly longer-lasting and with more reversals in Asia, and the strengthening of the regulatory and supervisory framework that Asian countries generally undertook only, after their 1998 banking crises. The most striking difference between the two areas is the degree of international - and regional – financial integration, generally much lower for Asia.

In the case of foreign ownership, while the share is low in both regions, the reasons are different: in Asia regulatory restrictions basically explain the trend while strong competition is the main reason in Europe.

From a more detailed analysis of the case of Spain, a few useful insights can be drawn for economies in the quest for financial development and stability, such as several of the Asian countries. Financial liberalization in Spain started later than in other European countries and took longer to complete partially because of an adverse macroeconomic environment, but also because of an outdated regulatory framework and the incidence of an important banking crisis. In spite of the crisis, Spanish banks learnt how to adjust to the new environment of increased competition both internally and from abroad, which later allowed them to follow a strategy of outward internationalization, as a consequence of improved efficiency.

Financial liberalization also increased, together with other factors, financial depth, and the availability of credit in Spain, and favored a better-balanced financial system structure (with a
larger presence of capital markets). Finally, it also translated into shrinking intermediation margins, with a clear beneficial effect on the economy as a whole.

The Spanish experience also highlights the importance of sequencing financial sector reforms when the regulatory environment is weak. Although the banking crisis was not so much related to financial liberalization and much more to bank mismanagement, it is clear that moral hazard could increase in a more liberalized system. In this regard, the Spanish crisis draws some key similarities to the Asian one: a liberal bank licensing policy, risky lending to the real estate sector and connected and single party lending in the context of a weak regulatory framework. Although it is almost impossible to curtail moral hazard incentives of fraudulent managers, the Spanish experience shows that the impact on solvency and the cost for the tax payer can be minimized through stricter solvency regulation and supervision. It is also important to highlight that the crisis had a catalytic role for the improvement of bank regulation and supervision, as has later happened in many Asian countries. Important bank regulations such as the establishment of a well-designed deposit insurance scheme, or a stronger focus on solvency of bank supervisors may be considered direct consequences of the crisis.

One possible implication from the Spanish experience for Asia is on the sequencing of financial sector liberalization, and on the key pre-requisites. In this regard, although at times financial literature has advocated for fast-track liberalization processes, aware of their catalytic role in promoting broader economic reforms, it appears that the risk of financial instability in today’s world of large and potentially volatile capital flows would support a more gradual and well-sequenced financial liberalization. At any rate, irrespective of the sequencing of reforms, the overriding conclusion of the analysis is that strengthened regulation and supervision are key prerequisites to successful liberalizations.

From a sound and competitive situation achieved through better regulation but also better management in view of the fierce competition, also from abroad, Spain embarked in an outward internationalization process, reaching a predominant role in Latin American financial systems. In addition, Spain has made efforts –particularly through cross-share holdings- to integrate further in the European banking system.

Challenges remain for the future, among them, contributing to the creation of a more integrated and more efficient single market for banking services in Europe. However, with the benefit of hindsight, the Spanish experience appears today as a success story in the quest for financial development and stability.