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Spain, Ireland and the Euro crisis

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The impact of the GFC in Europe has been, or perhaps remains, arguably more severe than the Great Depression in terms of breadth, depth and persistence. Notwithstanding the capital requirement regime for banks that is governed by the various Basel accords, there is a straightforward policy proposal that addresses the majority of the failings exposed by the GFC.

The global financial crisis (GFC) has been touted as the most destructive economic downturn since the Great Depression.

The spread of superficially common policy failings across many European nations during the GFC leads to the question of whether there is an inherently fatal flaw in the mechanism underpinning the fiscal architecture of the European Union. Consideration of this issue is vitally important to understanding how similar policy errors might be avoided in the future.

The respective experiences of Spain and Ireland provide an intriguing case study in pinpointing the particular structural weaknesses manifested by the GFC. At a superficial level, the path taken by the two countries was similar, in that a housing boom and subsequent bust triggered a domestic recession. However, the underlying strength of each economy, and the role of the financial system during the bust, was crucially different.

Significantly, Spain and Ireland did not indulge in the fiscal excesses that were synonymous with Greece. Accordingly, as the circumstances that gave rise to recessionary conditions in Spain and Ireland were more nuanced, an appraisal of their experiences leads to a far richer appreciation of the underlying faults in the wider European fiscal integration project.

Although the Euro crisis prompted numerous suggested solutions, this paper focuses on a policy proposal by Anat Admati and Martin Hellwig in their 2013 book, The Bankers' New Clothes: What's Wrong with Banking and What to Do about it.

Admati and Hellwig's proposal is remarkably simple: banks should be required to hold significantly more equity. Because equity does not have the strict repayment regime of debt, payments to shareholders can be reduced or suspended without any notion of default. An example is the deferment or reduction of dividend payments. Accordingly, equity has an inherent ability to act as a buffer in absorbing losses.

Notwithstanding the capital requirement regime that is governed by the various Basel accords, Admati and Hellwig argue that a higher equity ratio would be more effective in ensuring better bank performance and correspondingly lower social costs during times of crisis. The claim of Admati and Hellwig is novel in that it argues that a higher minimum equity level produces a social benefit, at no social cost.

The research question posed in this paper consists of two parts.

1. What were the primary domestic factors, within the 'Euro context', which were responsible for the recessions in Spain and Ireland?

2. Compared to the existing regulatory system, does the policy proposal of Admati and Hellwig hold merit for counteracting the specific failings evident in Spain and Ireland?

The study reveals that the primary factor contributing to the recession in Spain was poor underlying economic performance. This, in turn, was largely a function of the country's lack of competitiveness. By comparison, in Ireland, the largest contributor was financial weakness, largely driven by weak regulatory oversight.

The proposals of Admati and Hellwig are broadly validated in the case of both Ireland and Spain. There is a positive correlation between pre-crisis equity and post-crisis performance in both countries, with pre-crisis regulatory capital having no significant influence over post-crisis bank performance. No association is found between equity and loan growth, dismissing the main objection against equity regulation. Given the poor performance of the Irish financial system, there is evidence that a minimum equity standard may be relatively more beneficial than in Spain. This implies that, although equity regulation has broad merit, consideration of individual country factors remains important.

It is acknowledged that many of the respective domestic failings of Spain and Ireland were influenced by the architecture of the Euro mechanism. It follows that regional reforms hold potential value, particularly in avoiding a recurrence of systemic problems. Nevertheless, a pragmatic, unilateral domestic policy approach of the type proposed by Admati and Hellwig has the capacity to address the majority of the failings exposed by the Euro crisis.

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