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THE MANAGEMENT OF THE ECONOMIC CRISIS IN SPAIN BY THE PSOE GOVERNMENT:

A DOMESTIC POLITICAL PERSPECTIVE

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Abstract

Accounts of the management of the recent economic crisis in Spain have been dominated by an emphasis on external constraints. However, this approach leaves unanswered important questions about the role of domestic political factors. Using systematic qualitative primary research and employing elite interviewing and process tracing, this dissertation aims to fill this gap for the period of the *Partido Socialista Obrero Español* (PSOE) administration. The question it seeks to answer is: *what role did domestic political factors play in the PSOE government´s management of the crisis in Spain and in its immediate origins?*

The dissertation shows that domestic politics played a crucial role in the management of the crisis, most importantly by determining the shape of the measures undertaken. In its three distinct stages – downplaying/inaction, reaction/stimulus and austerity/reform – the PSOE´s response was certainly constrained by external factors, most notably EMU membership and the actions of sovereign-bond investors, the ECB and Germany. Yet while these external constraints forced the government to act, domestic political factors fundamentally shaped the content of key measures: the fiscal stimulus, the labour, financial and pension reforms, the refusal to accept a bailout or the reform of the Constitution. Seven factors were particularly influential: i) electoral and political cost, ii) party and partisanship, iii) organised interests, iv) domestic institutions, v) ideological preferences, vi) ineffective decision-making, and vii) judgement and personal characteristics of decision-makers.

In conclusion, domestic politics played a more important role in the management of the crisis than is allowed for by dominant approaches focusing on external constraints and weak domestic policy autonomy. The findings provide empirical evidence to support research agendas that identify significant state discretion in the face of international economic integration and an important role for domestic political factors such as institutions, material interests, partisanship and ideology in shaping economic outcomes.

To Sofía and Scott Alexander,

Sapere aude… and be happy

Preface

This dissertation is the result of an intellectual voyage. It commenced with an interest in exploring the role of domestic political factors during the recent economic and sovereign debt crises in Spain in the face of pervasive claims about the powerlessness of domestic politics against the forces unleashed by global and European economic integration. It ended with a realization that, at least in the case of Spain, superficial observations often obscure more complex dynamics and that the role of domestic politics had actually been substantial. Such an intellectual project would not have been possible without the support of many people. Robert Putnam awoke my interest in academic research as a student in his research seminar on social capital while at Harvard, where Roberto Mangabeira Unger first also instilled in me an aspiration for intellectual heterodoxy. Dani Rodrik´s work was the intellectual inspiration for my research topic and he generously supported my PhD application and offered some valuable advice in its early stages. Once at Cambridge, Chris Hill and Pieter van Houten offered pertinent criticism of my initial work. My supervisor, Helen Thompson, steered the dissertation to its completion and often kept me from going down the wrong path; it is to her that I owe my greatest academic debt. I am also grateful to my examiners, Chris Bickerton and Federico Steinberg, for their valuable criticisms. Thanks are also owed to Javier Solana and Ángel Saz for their support and to Ferrán Martínez i Coma for his generous feedback. My research would have been impossible without the contribution of many former colleagues in the Spanish government; among them Andrés Ortega has been a valued friend and mentor. Sebastian Sobecki is probably more to blame than anyone else for my perilous decision to embark on a PhD and has been a constant source of inspiration and a valued friend for many years. Wolfson College provided a privileged setting for my work and for my children to live their early years and I am very grateful to its entire staff. Finally, my greatest debt and appreciation is, as always, to my family, without whose support I would have never persevered: to my parents Wilma and Ángel, who got me on track; to my sisters Sonia and Patricia, who have always been there for me; to my wife Casilda, who joined me in this voyage; and, most especially, to my children, Sofia and Scott Alexander, who kept me going when the going got tough and whose mere existence is my greatest fortune. I dedicate this dissertation to them.

Finally, as required by regulations governing the submission of dissertations at the University of Cambridge, I declare that:

- This dissertation is the result of my own work and includes nothing which is the outcome of work done in collaboration except as declared in the Preface and specified in the text.
- It is not substantially the same as any that I have submitted, or, is being concurrently submitted for a degree or diploma or other qualification at the University of Cambridge or any other University or similar institution except as declared in the Preface and specified in the text. I further state that no substantial part of my dissertation has already been submitted, or, is being concurrently submitted for any such degree, diploma or other qualification at the University of Cambridge or any other University of similar institution except as declared in the Preface and specified in the text.
- It does not exceed the prescribed word limit for the relevant Degree Committee.

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Chapter 1: Introduction

1.1. Introduction

The aim of this dissertation is to enrich our understanding of the factors, in particular the domestic political factors, that shaped the management of the financial, economic, sovereign-debt and euro crises in Spain by the centre-left *Partido Socialista Obrero Español* (PSOE) government, from their immediate origins to the end of the PSOE´s time in office in late 2011. Understanding the management of the Spanish crisis is important. As the second largest economy of the euro periphery, Spain´s economic woes were not only of national relevance but also had a systemic bearing on the rest of the euro zone and beyond. While the economic origins and causes of the crisis have been the subject of an ample body of literature, its management is still an understudied topic. As we shall see, the academic literature on the subject has been mainly descriptive rather than explanatory. Furthermore, it has tended to emphasise external constraints, especially those related to Spain´s membership of the European Monetary Union (EMU). In the words of Armingeon and Baccaro (2012: 162), the crisis in the European periphery, including Spain, shows that 'domestic institutions and politics matter very little for [*sic*] explaining policy responses to the sovereign debt crisis'. Yet, as we shall see, this approach leaves important questions unanswered. Surprisingly, the role of domestic political factors in the government´s management of the crisis and whether they may have had a larger impact than the literature allows has hardly been explored. A thorough and systematic analysis exploring through primary research the management of the crisis, focusing on the role played by domestic political factors, remains, to the best of my knowledge, to be made. The objective of this dissertation, and the contribution to the literature it aims to make, is to conduct such an exercise for the years of the crisis managed by the PSOE government through a reconstruction of its main episodes.

Before proceeding some early clarifications are called for. Firstly, this dissertation covers a period defined by various successive crises: the global financial crisis that began in 2007, the credit crunch in the autumn of 2008, the double-dip recession that followed and the sovereign debt crisis that affected the euro zone, which commenced in earnest in mid-2010 with the eruption of the Greek fiscal crisis and the contagion of fiscal sustainability doubts to other peripheral EMU member states, including Spain, and which led to doubts on the future of the euro itself in the second part of 2011. For practical purposes the dissertation will use the term ‘crisis’, or variants such as ‘crises, ‘economic crisis’, ‘crisis in Spain’ or ‘economic crisis’, to encompass these distinct episodes, unless the discussion pertains specifically to one of them.

Secondly, the period covered by the research requires some justification. Any period chosen to delimit the analysis of the economic crisis could be considered arbitrary. Looking at the data, Spain only came out of recession in the last quarter of 2013. Yet it could be argued that the most intense part of the crisis ended on 26 July 2012 with Mario Draghi´s (2012) ‘whatever it takes’ press conference that led to an easing of the pressures on Spain´s sovereign debt. Alternatively, one could argue that the Spanish crisis receded after the bailout of the Spanish financial system in June 2012. Finally, an argument could also be advanced that the underlying crisis is still ongoing since, even if growth has returned, many of the structural issues that led to the crisis, as well as a mounting debt, still cast a shadow over the country. Limiting the research to the period of the crisis managed by the PSOE government, from mid 2007 to the end of 2011, considering also the immediate origins of the crisis, can be justified on at least two grounds. Firstly, the key policies that defined the management of the crisis were put in place during this early period. The conservative government of the *Partido Popular* (PP), which followed the PSOE government, continued and in many respects intensified these policies, but their nature (the emphasis on austerity, budget deficit reduction and structural reforms, or what at least were presented as such) remained. It was therefore in this first period that the course was set. And secondly, the contrast between external constraints and domestic preferences in the management of the crisis is certainly more apparent during the Socialist administration, for many of these policies were contrary not only to the manifesto which brought the party to office but actually to the policies and ideology that had defined the PSOE for the last three decades since the transition to democracy. Accounts privileging the role of external constraints are heavily reliant on the adoption of austerity measures

(Armingeon and Baccaro, 2012; Hopkins, 2015), which first took place during this period, and therefore to provide evidence to the contrary – to suggest that domestic factors were actually vital in explaining why and how these policies were adopted – would represent the most valuable contribution to this research agenda.

Thirdly, it should be clear that the ultimate interest of the dissertation is the management of the crisis rather than its origins, although to address the former it will be necessary also to consider the crisis´ immediate origins. By ‘management’ of the crisis I mean i) the decisions and actions taken by policy-makers, mainly the central government but also other key institutions such as the central bank and ii) the reasons that explain why and how these decisions were taken.

Finally, the meaning of the terms ‘domestic political factors’ and ‘external constraints’ have to be clarified. The dissertation will regard as ‘domestic politics’ any factor that has its origin in the domestic political realm. This includes political parties, domestic political institutions, organised interests and political economy coordinating mechanisms, electoral and public opinion dynamics, political leaders and their personal characteristics, and the decision-making structures and processes within government. The dissertation will concern itself mainly with the role played by the central government, and not that of regional and local governments, although their actions will be considered when necessary.

‘External constraints’ are understood to be factors originating outside Spain, whether economic, political or institutional. These factors will have conditioned the response in different ways: some will have acted as substantial causes (for example, EMU membership), while others might have been channels or mechanisms through which this external pressure was exercised (for example the sovereign bond spread). Finally, this category will also include different types of agent, most importantly other sovereign states, but also European Union (EU) institutions, mainly the European Central Bank (ECB) and the European Commission; international investors, such as international sovereign bond holders; international financial institutions, especially the International Monetary Fund (IMF); and other international organizations like the Organisation for Economic Cooperation and Development (OECD).

1.2. Literature review

The literature on the management of the Spanish crisis, as opposed to its causes, is not particularly extensive and is often of a descriptive rather than explanatory nature, as the critical analysis that follows will show. That the crisis is a recent phenomenon can in part explain the limited research in the topic. The difficulty in gathering first-hand accounts from key decision-makers, many of whom are still politically active and reluctant to talk on the subject, adds to the difficulty in obtaining a suitable account of the management of the crisis. This dissertation aims partially to fill that gap.

A relatively limited literature has, however, attempted to provide some insight into this question. The following review surveys first the literature that has focused on external constraints as the key explanatory variables in the management of the crisis, and, highlighting their limitations, proceeds to review those sources that have explored the role of domestic factors, first economic and then political. In each case I shall first consider some of the accounts of the origins of the crisis, as approaches to explaining its management are often the projection of different frameworks within which its origin is explained. Yet a thorough analysis of the vast literature on the factors that contributed to these crises, at both international and Spanish levels, falls outside the scope of this dissertation and this review will only cover the literature on the origins of the crisis that directly pertains to its management. Furthermore, this literature review is focused on the empirical literature on the management of the crisis in Spain, or the European southern periphery where it is directly relevant. The theoretical literature on the influence of domestic politics in economic outcomes, in so far as it is pertinent to the dissertation, is discussed in the 'Research Question and Theoretical Framework' section later in the chapter.

1.2.1. External perspectives on the origins and management of the crisis

Analyses of the Spanish crisis have often privileged external constraints as the key explanatory variables for both its origin and management. The following section provides a critical review of such attempts in relation, firstly to the origin of the crisis and secondly to its management.

External perspectives on the origins of the crisis

A number of external factors undoubtedly contributed to causing Spain´s economic woes. The process of economic and financial globalisation, and in particular the role of global macroeconomic imbalances, is a first key factor that fuelled the disequilibria that led to the Spanish economic crisis (Stiglitz, 2010; Wolf, 2010; Eichengreen, 2012). According to this interpretation (Wolf, 2010), economic reforms in emerging economies generated high growth and a glut of savings which, thanks to global free movement of capital and the difficulties of states in regulating these global financial flows (Stiglitz, 2010), found their way to developed markets where they fuelled asset price bubbles. In Europe this was further compounded by a problem of balance of payments between north and south, where the high levels of savings in EMU's core, especially Germany, combined with the ECB´s low interest rates, financed the credit boom, high indebtedness, current account deficits and asset price bubbles in the European periphery, which were at the heart of the Spanish crisis (Eichengreen, 2012). With low returns at home due to low interest rates and intense competition, foreign banks, especially German (Bastasín, 2012: 304), recycled this savings glut into readily accessible funds for investment-hungry Spain. The financing of Spain´s housing and infrastructure bubble, as well as the substantial increase in domestic consumption far and above the country´s saving rate, necessitated the external credit that these external flows provided.

Global financial markets play a key role in this explanation (Johnson and Kwak, 2010; Stiglitz, 2010; Wolf, 2010; Ontiveros 2011; Moghadam, 2014). Firstly, they facilitated the development of the global macroeconomic imbalances described above (Wolf, 2010; Stiglitz, 2010). Secondly, they were undisciplined and ineffective in pricing risk uniformly across the euro area and failing to capture the variance of country risks within it (Moghadam, 2014). And thirdly, they quickly translated the US subprime crisis into a global credit crunch that severely affected a deeply, externally indebted Spain and precipitated the recession (Ontiveros, 2011). This interpretation points to the process of financial deregulation in the US that led to the subprime mortgage crisis and the role played in it by the country´s financial sector (Johnson and Kwak, 2010) as another external indirect cause of the Spanish crisis.

Yet it is Spain´s membership of EMU that is the most common external constraint referred to in the literature to explain the origin of the crisis in Spain. One set of interpretations (Feldstein, 1997, 2012; Thompson, 2007; Issing, 2008; Marzinotto et al., 2010; Pisani-Ferry, 2011, 2012; Eichengreen, 2012; Galí, 2012; James, 2012; Lane, 2012; Dyson, 2013; Fernández-Villaverde et al., 2013; Moghadam, 2014; Sinn, 2014; Baldwin et al., 2015), sometimes commenting on the European periphery as a whole rather than particularly on Spain, but with obvious direct relevance for the Spanish case, has focused on how inherent flaws in EMU´s institutional design and corresponding lack of effective EMU-wide instruments led to the crisis. According to a large body of literature (Feldstein, 1997, 2012; Issing, 2008; Sinn, 2014), these flaws are the unavoidable outcome of the misconceived economic project that the euro represents. The most recurrent argument in this direction has pointed to the economic heterogeneity between peripheral EMU members, including Spain, and core European states (Feldstein, 1997, 2012; Eichengreen, 2012; Sinn, 2014), often in tandem with the theory of optimum currency area which points to different aggregate supply and demand disturbances to regions sharing a common currency as the main challenge to a monetary union (Mundell, 1961). Labour mobility and fiscal institutions to enable transfers to worse-off regions are seen as the key adjustment mechanisms (Kenen, 1969). Yet the fact that both of these were and still are very limited in Europe, the former for cultural and linguistic issues and the latter for political reasons, partially explains the problems that afflicted the economies of the European periphery, including Spain, in the run-up to the crisis. In the absence of equilibrating mechanisms the divergence in productivity rates and thus competitiveness between Spain (and other peripheral EU states) and ‘core EMU’, mainly Germany, was unavoidably to lead to an unsustainable current account deficit in Spain (Marzinotto et al., 2010), as was indeed the case.[1]

A lack of understanding of the deep interconnection that EMU created between banking and sovereign financing was also at the heart of the vulnerability of the euro area (Bastasín, 2012; Lane, 2012). In the view of Lane (2012: 68):

> The origin and propagation of the European sovereign debt crisis can be attributed to the flawed original design of the euro. In particular, there was an incomplete understanding of the fragility of a monetary union under crisis conditions, especially in the absence of banking union and other European-level buffer mechanisms.

The lack of appropriate mechanisms to deal with this interconnection was, however, in the view of Pisani-Ferry (2012: 1), not so much the result of a failed diagnosis but the inevitable outcome of the attempt to combine an 'impossible trinity of strict no-monetary financing, bank-sovereign interdependence and no co-responsibility for public debt'.

The lack of political commitment, rather than the inescapable outcome of economic heterogeneity or a poor understanding of the interconnection of sovereign and baking financing, has also been considered (James, 2012) to be the real source of the design flaws in EMU that affected Spain. While the technical policies that could be implemented through a technocratic ECB did advance (monetary union, introduction of the euro, etc.), those that required political engagement, such as fiscal and banking union, debt mutualisation or a larger EU budget did not, and it is their absence that allowed the disequilibria to develop in peripheral EMU states. Baldwin et al. (2015:14) have argued in the same direction, suggesting that EMU´s design flaws were caused by the fact that there was no 'shared vision on the standards of political and institutional cohesion that would be required to make the project viable'.

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[1] Although for a sceptical view on this, claiming competitiveness losses in the EU Southern periphery have been overstated, see Wyplosz 2011.

EMU´s institutional flaws have also been linked to a prevailing neo-liberal ideology among EU policymakers and especially the German economic elite at the time of their design (McNamara, 1998). This would explain the focus of the Maastricht criteria on nominal convergence, and especially on public debt and inflation targets, and the absence of EMU-wide mechanisms that could have enabled fiscal transfers.

Hall (2014) has however offered an alternative explanation for Germany´s behaviour. Following on his seminal work on varieties of capitalism (VoC) (Hall and Soskice, 2001), he has attempted to explain the origins of the crisis in terms of the diversity in domestic political economy institutions among the euro zone states rather than on the prevailing ideology of its economic elites. According to this view, 'the roots of the crisis are linked to institutional asymmetries between political economies' (Hall, 2014: 1223). In other words the different models of capitalism led inevitably to different economic strategies that in turn led to the current account imbalances that were a key cause of the euro zone crisis. It was Germany´s model of capitalism, which by necessity requires low inflation to remain competitive, that was, according to this interpretation, at the heart of the Maastricht Treaty criteria that allowed these disequilibria to develop without being properly addressed at EU level.

Hopkins (2013, 2015) has also challenged the notion that EMU´s design, and Spain´s inability to adapt to the new context of the monetary union, led to the crisis in Spain. In particular, he has challenged the assumption that the causes of the crisis were characterised by Spain´s refusal to undertake the necessary reforms and has placed the responsibility on Germany´s inability, or unwillingness, to control its financial flows into the periphery in the years prior to the crisis.

Whether the inevitable outcome of an unfeasible project, of a lack of political will, of the influence of neoliberal ideology or of Germany´s political preferences, these institutional limitations are crucial to understanding the difficulties that led to the Spanish crisis. The poor governance and decision-making mechanisms allowed imbalances to develop (Thompson, 2007) and EMU´s institutional flaws impeded the development of EU-wide mechanisms that could have helped redress the imbalances that led to the crisis. A fiscal union and larger EU budget could have helped Spain remedy some of the chronic underdevelopments that are at the heart of the economic problems that led to the crisis, especially poor investment in human capital, research and development and other factors of production (Pisani-Ferry, 2011: 153-159). Similarly, the Maastricht criteria that granted access to EMU and the Stability and Growth Pact that in theory served to monitor member states' economic and financial soundness to remain within it were seriously flawed (Moghadam, 2014), as they focused almost exclusively on fiscal discipline but failed to monitor the private sector imbalances that led to the crisis in Spain, especially current account deficits and private debt.

Finally, EMU is also said to have facilitated the onset of the crisis by delaying structural reforms and leading to deteriorating institutions in Spain. According to Fernández-Villaverde et al. (2013: 151-153), EMU led to this outcome in three ways. Firstly, the credit boom it facilitated eased budget constraints, allowing countries like Spain to borrow their way to growth and delay structural reform. Secondly, the housing bubble it enabled generated a significant increase in fiscal revenue, thus also easing the pressure for reform. And thirdly, euro zone membership and its associated credit boom masked the incompetent actions of political elites in local and regional governments, who fostered real-estate activity for their own benefit, often by corrupt practices, through poorly governed and politicized *cajas*. In their own words:

> Both public and private accountability was diminished during the boom because the consequences of bad decisions are largely imperceptible, at least in the short run, when rising asset prices hide all mistakes (Fernández-Villaverde et al., 2013: 163).

For all the relevance of the factors highlighted above, accounts based purely on external constraints cannot by themselves explain why Spain found itself in such a difficult situation when the crisis struck. Two main objections stand out. Firstly, while globalisation and global macroeconomic imbalances certainly increased Spain´s disequilibria, they do not obviously explain, in so far as these were forces affecting all developed economies, why they led to the particular problems that

Spain encountered. They do not explain, for example, why Spain suffered a housing bubble while other southern European countries like Italy did not. Furthermore, blaming globalisation for the country´s perils often reflects political interest rather than reality. Fernández-Albertos et al. (2013) have conclusively shown that blame for the crisis in Spain was directly correlated to partisanship, with potential voters of the opposition PP most likely to blame the crisis on the government, but PSOE supporters less so in so far as globalisation was often put forward by the government as an explanation of the crisis. There was an obvious incentive, as a strategy to deflect responsibility for the crisis, at least among its own voters, for the government to blame the country´s problems on external factors, such as the pressure of global financial markets, if, as Fernández-Albertos et al. (ibid.: 804) show:

> The incumbent party endorsement of globalisation as a cause of the crisis affects the party's supporters' views of the crisis, (…) and helps exonerate the government and blame other European governments more.

Secondly, the economic heterogeneity within EMU of course in part explains why Spain´s predicament in it was always going to be complicated. But what it cannot explain is why then Spain sought acceptance in the monetary union knowing the perils it could bring about, and why the EU allowed its entry. Furthermore, EMU´s institutional flaws cannot account for the fact that for the first ten years the institutional design did work, as was evidenced by the convergence in sovereign debt spreads between Spain and Germany. This does not mean that institutional design was not a problem, but it obviously cannot explain the early success of the euro project in Spain and the strengthening of Spain´s economic fundamentals. Or, to put it another way, some other factors or triggering mechanisms must have been at play in order for this same institutional design to lead to a deterioration of Spain´s economic fundamentals at a later stage. Finally, and most relevantly for this dissertation, economic heterogeneity and institutional flaws cannot explain why Spanish policy-makers did not act to redress some of the most obvious imbalances, even when they had become obvious, such as the ballooning current account deficit or the housing bubble.

External perspectives on the management of the crisis

Analyses of the management of the Spanish crisis have often found various external constraints to be the key explanatory variables in the government´s response. These accounts have put forward different explanations for the nature and workings of these external constraints, which are often found in the same literature discussed in the previous section, as they are closely intertwined with analyses of the origins of the crisis.

Global financial markets, and in particular international bond investors financing Spanish sovereign debt, played a determinant role in conditioning the government´s response to the crisis (Pisani-Ferry and Posen, 2009; Stiglitz, 2010; Ontiveros, 2011; Armingeon and Baccaro, 2012; De Grauwe and Ji, 2013a, 2013b). According to this perspective, the difficulties in financing the sovereign debt, the risk of a liquidity crisis and the need to regain the favour of bond investors forced the reforms and austerity that characterised the response to the crisis (Ontiveros, 2011; De Grauwe and Ji, 2013a, 2013b). The drastic austerity measures announced in May 2010, which represented a dramatic change of course in the government´s economic and social policy, and which were taken in fear of an unsustainable spike in the cost of Spanish debt due to contagion from the Greek sovereign crisis, are often presented (Armingeon and Baccaro, 2012: 178) as the most dramatic example of the power of the bond markets to condition the Spanish government´s response to the crisis. The sovereign bond spread has acted as the constraining mechanism on policy and international sovereign bond investors have, at each stage of the process, rendered national politics and institutions irrelevant by conditioning and limiting the ability of the Spanish government to act by the threat of forcing Spain into a bailout. In this respect Pisani-Ferry and Posen (2009: 9) have pointed to the end of convergence in risk premiums between EMU members, which had characterised the euro zone since its inception. This literature is of course intimately connected with analyses (Stiglitz, 2010) that have explained the lack of policy autonomy of Spain and other EMU peripheral states during their response to the crisis with reference to their inability to reign over capital in an age of freedom of financial flows.

Yet, as with analysis of the origins of the crisis, EMU membership has been found to be the most important factor conditioning the management of the crisis. A large body of literature (Fernández-Villaverde and Ohanian, 2010; Guerot, 2010; Marzinotto et al., 2010; De Grauwe, 2011; Delpla and Von Weizsäcker, 2011; Pisani-Ferry, 2011, 2012; Sinn 2011; Armigeon and Baccaro, 2012; Feldstein, 2012; Heise, 2012; James, 2012; Lane, 2012; Bastasín, 2012; Dyson, 2013; Krugman, 2013; Baldwin et al., 2015; De Grauwe and Ji, 2015) has focused on the inherent flaws in EMU´s institutional design and lack of effective EMU-wide instruments to explain the management of the crisis. According to this line of analysis there were at least five design flaws in EMU that constrained the Spanish government’s management of the crisis.

The first was the inability of the ECB under its statutes to act as a lender of last resort to EMU states (Marzinotto et al., 2010; De Grauwe, 2011; Pisani-Ferry, 2011, 2012), since Article 123 of the Treaty of Lisbon forbids the ECB the direct purchase of debt instruments from member states. This partially explains why contagion from the Greek crisis led to Spain´s vulnerability to the financial markets (Fernández-Villaverde and Ohanian, 2010). On this interpretation (Bastasín, 2012) the reluctance of the ECB to buy sovereign debt of the most vulnerable states in the early stages of the crisis and its resistance to doing so decisively until August 2011 for those states that were not under an EU bailout program, such as Spain and Italy, seriously affected Spain by dramatically increasing its sovereign bond spread. Bastasín (2012: 269) has provided a detailed account of this aspect of the crisis and has explained how, for example, when in March 2011 the ECB decided to stop buying government bonds of Greece, Portugal and Ireland in order to put pressure on their national governments to adopt more decisive action to deal with the euro crisis, the value of the bonds of those countries that were deemed to have a similar risk profile, such as Spain and Italy, fell. As a result, banks started selling them in fear of a further decline in value, which led to an increase in the Spanish bond spread. In sum, the constraining effect that the dramatic increase in its bond spread represented for Spain was the outcome of her membership of a monetary union without a lender of last resort that could act in defence of any member´s financial needs. Comparing the evolution of sovereign debt-financing dynamics and the bond spreads of Spain and the United Kingdom De Grauwe (2011: 2) has concluded that:

> This difference in the evaluation of the sovereign default risks is related to the fact that Spain belongs to a monetary union, while the UK is not part of a monetary union, and therefore has control over the currency in which it issues its debt.

The absence of common bond instruments such as a Eurobond was a second institutional design flaw in the euro governance structure (Guerot, 2010; Delpla and Von Weizsäcker, 2011) that hampered the Spanish government´s ability to contain the effects of the crisis, as such instruments would have guaranteed to a certain degree the financing of the Spanish debt. Thirdly, and intimately related to the above, was the lack of a true fiscal union or at least a sufficiently large EU budget to enable the necessary fiscal transfers to mitigate the impact of the crisis in the worst affected regions of EMU, including Spain (De Grauwe, 2011; Pisani-Ferry, 2011; Krugman 2013). In the absence of such fiscal support the Spanish Socialist government had no choice but to undertake the austerity policies it did. Fourthly, EMU´s institutional architecture lacked other key mechanisms at both fiscal and banking levels that would have been necessary properly to confront the crisis (Gros and Mayer, 2010; Marzinotto et al., 2010; Molina and Steinberg, 2012). A common banking regulator, if not a banking union, a crisis resolution mechanism for troubled financial institutions and a sovereign rescue fund for states facing financing difficulty were the minimal institutional mechanisms with which EMU should have been equipped (Molina and Steinberg, 2012).

And fifthly, governance and decision-making mechanisms at the heart of EMU were also deemed insufficient (Marzinotto et al., 2010; Heise, 2012; Lace, 2012; Dyson, 2013; Baldwin et al., 2015; De Grauwe and Ji, 2015; El-Erian 2016). Heise (2012: 42) has pointed to EMU´s defective governance, arguing that the poor management of the crisis:

> Is not merely the result of mismanagement by individual governments, but the systematic outcome of an ineffective and even counterproductive European economic governance system.

Dyson (2013) has focused on the absence of crisis prevention mechanisms at EU level and the inability of states to deploy supranational executive decision mechanisms in times of emergency. Baldwin et al. (2015: 14) have argued that the absence of crisis management and shock-absorbing mechanisms led to contagion from the periphery to the core of the euro zone and prolonged the crisis. Marzinotto et al. (2010), Lace (2012) and De Grauwe and Ji (2015) have argued in the same vein, pointing in particular to how the lack of crisis management mechanisms forced the ECB to supplant the role of national governments, given the inability of the latter to act with sufficient speed and determination, an argument also explored more recently by El-Erian (2016).

Beyond these design flaws, membership of the euro zone also denied the Spanish government domestic economic policy instruments with which to deal effectively with a crisis, at least on a temporary basis, and which it had deployed in the past in similar circumstances, most importantly the ability to lower interest rates and to devalue the currency. This forced the government to undertake an internal devaluation, which explains many of the measures taken, especially those related to austerity and structural reforms. Researchers at the Bank of Spain (Ortega and Peñalosa, 2012: 5) have no doubt about the impact of Spain´s euro zone membership in this respect:

> Spanish EMU membership is a crucial aspect for consideration, as it contributes both to explaining the build-up of imbalances in the expansion and to conditioning the nature of the adjustment in the crisis, given that the range of economic policy instruments is significantly narrower in EMU. The macroeconomic and financial imbalances accumulated in the high-growth phase (the real estate boom, excess debt and the loss in competitiveness), which are all closely interlinked, were factors of vulnerability.

The deterioration of Spanish institutions that EMU allowed, as identified by Fernández-Villaverde et al. (2013), was another relevant EMU-related factor. Although their analysis pertains more directly to the origins of the crisis, it also has obvious implications for the way it was managed, as these deficient institutions significantly constrained the ability to manage the crisis more effectively once it arrived. For example, and as we shall see, the political governance of the *cajas* or the significant but opaque influence that Spain´s corporatist economic structure allowed organised interests to exercise over the government were factors that significantly shaped the management of the crisis.

All the above arguments relying on EMU-originated constraints certainly have some unquestionable validity. However, their centrality to explaining the management of the crisis in Spain has been questioned by several authors. An alternative view has been put forward, most notably by Hopkins (2013, 2015) and in more general terms by Hall (2015) and Bastasín (2012), according to which the external constraints that limited the Spanish government's scope for action during the management of the crisis had less to do with EMU´s institutional mechanisms and more to do with the attitudes of Germany and other EU creditor states. According to Hopkins (2013, 2015) the key external constraint on the management of the crisis for the Spanish government was not EMU´s institutional flaws but Germany´s framing of the euro crisis as one originating in the fiscal profligacy, historical institutional weakness and absence of reform in the southern European periphery (Hopkins, 2015: 28). Such a framing allowed Germany and its allies in the European Council, assisted by the EU institutions, to insist on an internal devaluation articulated through austerity measures and structural reforms in EMU´s peripheral economies, including of course Spain, to address these alleged fiscal imbalances (Hopkins, 2015: 21). Two key features of Spain´s response to the crisis are paradigmatic of this process (Hopkins, 2015: 20-21): the pension reform (pairing back on welfare) and the labour reform (reducing dismissal compensation and weakening collective bargaining).

On this interpretation it is Germany and the other EU creditor states that were behind the opposition to the adoption of EMU-wide mechanisms such as debt mutualisation, Eurobonds or direct bank recapitalisation from EU funds, or at least the signalling of the predisposition to adopt them, that would have eased the pressure on the Spanish government and made the crisis more manageable. The German government used the increases in the cost of finance and the threat of a liquidity crisis to force the Spanish government to adopt their preferred policy choices, with the troika and the financial markets as the mechanisms by which to exercise pressure on Spain and impose its priorities (Kirkegaard, 2011). Insisting on this view President[2] José Luis Rodríguez Zapatero (2013) himself has pointed to the unwillingness of Germany to assume its leadership role and adopt a more pro-European stand as the main reason for a relatively contained fiscal crisis in Greece triggering a euro-zone wide crisis.

Furthermore, two features of the management of the crisis at EU level substantiate, in the view of De Grauwe and Ji (2015: 27), claims that the response was framed in such a way as to reflect Germany´s interpretation of the origins of the crisis and proposed solutions. Firstly, it has led to an asymmetric adjustment to the current account imbalances forcing the deficit states into a deflationary austerity without a compensating policy of stimulus in surplus states. And secondly, its focus has been on supply policies and structural reforms. Spain has been on the receiving end of both of these strategies, which, according to the authors, have had at best an insignificant and at worst a negative effect on long-term economic growth.

Various explanations have been put forward of why Germany and its allies in the European Council framed the crisis in such a way (Guerot, 2010; Gros and Alcidi, 2011; Guerot and Leonard, 2011; Hall, 2012, 2014; Hopkins, 2013, 2015; Bastasín, 2012; Molina and Steinberg, 2012; Scicluna, 2014; Newman, 2015). One view (Hopkins, 2013: 17) has emphasised the domestic political advantages to Germany and other northern European member states of placing the responsibility, and therefore need for action, on the southern European periphery, claiming that:

> Blaming the failings of the debtor nations deflects attention away from the reckless and inept management of the North's financial surplus by its financial institutions. A focus on the failings of the financial sector would increase the pressure on northern European creditors to consider debt restructuring (…) and stronger regulation of the European financial system, a thorny political issue that European leaders seem reluctant to address.

[2] In the Spanish constitutional system the head of the executive is formally called 'President of the Government' and not 'Prime Minister'. Furthermore, the term 'Minister' is used to denote the highest-ranking political head of a Ministry or Department, the British equivalent to a Secretary of State.

In other words, placing the burden for the resolution of the crisis on Spain´s need to adopt austerity measures and structural reforms took pressure away from undertaking other measures which would have been politically difficult and costly to the German government, such as EU-wide fiscal transfers, recapitalising its banking sector or liberalising its service sector (Gros and Alcidi, 2011; Newman, 2015). This analysis is intimately connected with accounts that explore how Germany´s domestic politics (Guerot, 2010; Guerot and Leonard, 2011) and judiciary (Scicluna, 2014) conditioned its response. Guerot (2010) and Guerot and Leonard (2011) have analysed the various factors that have led to a loss of enthusiasm for the European project in the country that was once its staunchest supporter. These factors range from a loss of trust in the rigour of institutions such as the ECB and the European Commission to the perceived fiscal profligacy of states in EMU´s periphery. Furthermore, Germany´s Constitutional Court, with its staunch vigilance of any sovereignty-ceding measure (Scicluna, 2014) has also been a constant source of restraint on efforts to address the crisis through EMU-wide instruments or mechanisms.

Molina and Steinberg (2012: 59) have similarly argued that Germany´s ‘authoritarian austerity’ responds to a crisis management model driven by its own interests and based on an incomplete diagnosis of the crisis. Germany´s ability to impose its proposed policy solutions is possible thanks to its ‘power position’ within the EU (Molina and Steinberg, 2012: 62), in an analysis reminiscent of Strange´s (1998) structural power framework. The agreement by the European Council to create a path to constitutionalise austerity in all EMU member states represented the ‘final capture of the European agenda’ (Molina and Steinberg, 2012: 66) by Germany in favour of this interpretation privileging austerity and fiscal discipline.

Bastasín (2012: 269) has focused on the role of the banks in trying to explain Germany´s attitude. In illustration of his case he has provided a detailed account of the way in which the banking and sovereign debt problems were mutually reinforcing, which created a vicious circle in the euro zone. In this regard he has pointed to the key role played by the financial sector as the channel for the debtor/creditor imbalances, arguing that ‘the mechanics for transmitting contagion of the sovereign debt crisis was actually buried within the balance sheets of their banks' (ibid.: 269). According to this interpretation of the crisis the fact that Germany´s banks had a substantial amount of Spanish debt on their books was vital to understanding the pressure exercised by Germany on Spain to adopt austerity measures and even a bailout that would guarantee repayment to its banks (ibid.: 273).

Hall (2014) has offered an alternative explanation of Germany´s behaviour with reference to its domestic political economy institutions. Following on his seminal work on VoC (Hall and Soskice, 2001), he has attempted to explain not only the origins of the crisis, as seen in the previous section, but also the responses to it in terms of the institutional diversity among the euro zone states. According to this view the different models of capitalism and policies of economic governance led inevitably to different approaches to resolving the crisis (Hall, 2014: 1233). Germany´s political and economic clout allowed it to impose the approach that ensued from its particular variety of capitalism. As such, Germany´s particular political economy model conditioned the response to the crisis in three ways. Firstly, Germany, in line with its economic model, responded to the crisis by focusing on supporting its exports. This required containing costs and inflation, which prohibited any substantial expansionary policy that would have increased domestic demand in Germany for other EU states' products and could have helped counter the recession in Spain. Secondly, Germany´s model of capitalism and the pressure of its electorate and of an inflation-conscious economic elite, led to a resistance to adopt measures at EU level that could have allowed a more effective management of the crisis but which would have resulted in a *de facto* fiscal union, such as debt mutualisation, Eurobonds or a common guarantee of bank deposits. As we have seen, the absence of these instruments has been at the heart of Spain´s difficulties in managing the crisis. And thirdly, Germany´s *ordoliberal* approach to market economics and strict fiscal discipline led it to demand from Spain the supply-side reforms and austerity policies that it privileges, and which have come to define Spain´s response to the crisis.

In sum, institutional diversity, in terms of the different VoC, has shaped, from this perspective, not only Germany's internal response to its crisis but also what it demanded of others and in so doing has shaped the way the Spanish government was forced to manage the crisis. In Hall´s own words (2014: 1236):

> In Germany, many analysts and policy-makers have been deeply influenced by the doctrines of a Freiburg school of economics that is focused on monetary stability, sceptical about the value of activist economic management, and inclined towards rule-based approaches to economic policy (…). This perspective is conducive to a diagnosis that locates the causes of the crisis in the failure of governments to abide by the rules of the Stability and Growth Pact and sees the solution as a matter of strengthening such budgetary rules rather than reflating in order to restart growth (…) German experience tends to confirm such views because prescriptions of this sort are well-suited to the management of a coordinated market economy focused on export-led growth, where budgetary restraint underpins wage coordination and many problems are resolved via negotiation among producer groups for which the government simply provides rules or 'framework policies' within which such negotiations can take place.

Vermeiren (2013) has also relied on the different models of capitalism to offer an explanation of why Germany acquired so much power in EMU. For Vermeiren the answer can be found (ibid.: 729) in EMU´s impact on the macroeconomic autonomy of its members and in how two key dimensions of its governance regime, namely exchange rate policymaking and the management of balance of payments, greatly benefited CMEs, particularly Germany, to the detriment of mixed market economies (MMEs). In favour of this interpretation Vermeiren points (ibid.: 757) to the role of the ECB and how, through both its monetary policy and its *de facto* control of exchange rate policy, it led to an euro exchange rate regime with an appreciation bias that greatly favoured CMEs, especially Germany. He also claims that the management of the euro zone´s balance of payments has split it between the CMEs as surplus states and MMEs and LMEs as deficit ones, giving the former the ability to deflect the adjustment on to the latter.

Moving away from institutional considerations, geopolitics has been suggested as an alternative factor that can explain Germany´s management of the crisis (Simón and Rogers, 2010; Agnew, 2015). According to this view the euro crisis is at heart the reflection of a geopolitical crisis, a core versus periphery struggle, with Germany projecting its economic model onto the rest of the euro zone and thus conditioning their response. The crisis is thus, in Agnew's (2015: 1-2) view:

> An on-going geopolitical crisis based in the practical conflict between the political demands of a historically German institutionalized conception of political economy (*Ordnungspolitik* or "ordering policies") that has come to dominate euro zone monetary policy, on the one hand, and the fact that the crisis is in its origins a political-economic crisis of the territorial form (the national economy) that the German experience of political economy takes, on the other.

Beyond explanations that have attempted to locate the origin of the external constraints to the management of the Spanish crisis in economic and financial factors, EMU's institutional flaws, debtor/creditor dynamics, Germany´s attitudes or geopolitical considerations, other authors (McNamara, 1998; Bohn and Jong, 2011; Blyth, 2013; Hopkins, 2013, 2015) have pointed to the role of ideology. In particular, and following the work of McNamara (1998), who argued that a neoliberal monetarist consensus had become hegemonic among political leaders and central bank officials in Europe at the time of the signing of the Maastricht Treaty and the creation of EMU and had shaped these, some analyses (Bohn and Jong, 2011; Hopkins, 2013, 2015) have pointed to the influence of this alleged ideological bias on how institutional factors conditioned the management of the crisis. These dominant views emphasised (Hopkins, 2013: 18) financial markets' efficiency, low inflation, fiscal probity and weak regulation and reflected in part the broad *Washington consensus* and in part the preferences of the dominant actors in the European Union and Germany in particular. This ideological straightjacket led to two important constraints on the management of the crisis.

Firstly, it legitimised Germany´s attitudes. As Hopkins (2013: 18) has put it:

> Given these assumptions, the crisis in southern Europe could not possibly be the consequence of financial markets' inherent instability or the dangers of excessive monetary rigidity. Instead, the problems lay in the reckless behaviour of southern European politicians.

The solution to these problems was therefore structural reforms and austerity measures in the European periphery. Blyth (2013: 230) has provided a detailed account, from a constructivist perspective, of how austerity came to be the dominant paradigm in the management of the crisis in the southern periphery, suggesting that the rationale for austerity was both ideological and material. On his analysis ideology was important because the pre-eminence of a neoliberal ideology among the German and EU economic elites that sowed mistrust of the role of government made it possible to characterise what was in origin a banking and private debt crisis as a sovereign debt crisis, the solution to which must therefore be public expenditure cuts (Blyth, 2013: 6). This diagnosis was not only self- interested, as it allowed market participants that were pushing this ideology to walk free of their responsibility, but actually tremendously detrimental as, in Blyth's view, historical evidence shows that austerity is ineffective and leads to lower growth and increased inequality. Some analysts (Lopez and Rodríguez, 2014: 24) have taken an even more ideological view on this same line of thought, arguing that the orthodox structural reforms and public expenditure cuts that were implemented by the PSOE government in Spain after 2010 are clear evidence of the dominance of the 'political oversight of the financial agents' over economic and social policy at a global level.

Secondly, the architecture of the monetary union which resulted from this ideological bias had built within it mechanisms which prevented a more effective resolution of the crisis (Blyth, 2013), such as a central bank that could not act as a lender of last resort or the budget and debt limits enshrined in the Maastricht Treaty. Although by the time of the crisis these limits had been severely compromised, they did serve as a benchmark with which to exert pressure on states such as Spain and prevented a more aggressive expansionary economic policy during the crisis (Hopkins, 2015).

However compelling aspects of the literature reviewed above may be, explanations that rely on the impact of global economic and financial markets, EMU constraints, Germany´s dominant role or the pre-eminence of a neoliberal ideology are insufficient to explain key aspects of the management of the crisis in Spain for at least three main reasons. Firstly, interpretations that suggest that external constraints trumped national politics cannot properly account for the many occasions on which the Socialist government flatly rejected pressures from Germany and its European allies during the management of the crisis. A clear example of this was the ability of the PSOE government to avoid a bailout of Spain at a time in which countries like Greece, Portugal and Ireland had to accept it. As

President Rodríguez Zapatero (2013) himself has acknowledged, it was other factors that explain, at least in part, his refusal to give in to such pressures, such as the domestic political cost or the national prestige at stake and corresponding wish to keep Spain as one of the trusted members of the euro zone, capable of dealing by itself with any difficulty.

The second fundamental limitation of these explanations is that they cannot account for the different way in which the crisis was managed in different states in the southern European periphery. For example, as just explained, unlike other states facing a similar predicament, Spain did not opt for a bailout. This was so even at times when the risk premium on Spanish sovereign debt reached unsustainable levels and Spanish companies, affected by this sovereign risk, found it impossible to access the foreign credit markets, leading to a grave recession which had serious political costs for both parties. Italy, of course, was not subject to a bailout either, but the drastic measures required to avoid the bailout did not lead in Spain to a sudden change in government, as they did in Italy in the autumn of 2011 with the replacement of Berlusconi´s government by Mr Monti´s technocratic administration. Spain´s dramatic decision to amend its Constitution to incorporate a 'golden fiscal rule' that would give assurances of future austerity to Germany and its allies in the European Council is another instance in which Spain´s management of the crisis manifestly differed from that of European colleagues.

Finally, the Spanish case presents a number of Spanish-specific characteristics that would make it inadvisable to attempt to fit it within a supposedly generalisable 'EU-periphery' response framework. Firstly, it was the only large peripheral EMU economy to be governed by a centre-left government during the crisis. Secondly, Spain´s decentralized political structure significantly shapes the politics of the country and makes it a different case from those of other peripheral EMU member states. And thirdly, Spain´s particular history, a dictatorship until as recently as 1977, and where access to the EU was seen as an anchor to democracy and economic prosperity, obviously provides for a distinctive context for analysis of the country´s behaviour towards its euro zone membership. It is illustrative in this respect to note that no anti-euro party has achieved in Spain the level of support obtained in other states facing similar predicaments, like Greece or Italy, or, in a different context, in other peripheral states like the UK. Not even *Podemos*, the populist left-wing party most critical of Spain´s relations with the EU, has ever openly advocated leaving the euro. Some of these factors were of course present in other EU peripheral states, but Spain's is the only case where all of them manifested themselves at the same time.

1.2.2. Domestic perspectives on the origins and management of the crisis

Given the limitations of explanations based on external constraints, it seems necessary to consider analyses that have incorporated domestic factors, whether economic or political, in the analysis of the crisis. The following section conducts such an exercise, considering first the literature that has privileged economic factors and, highlighting its limitations, going on to introduce the literature that, in line with the objectives of this dissertation, has focused on the role of domestic political factors in both the origins of the crisis and its management.

Domestic economic perspectives on the origins and management of the crisis

Most of the literature on the Spanish crisis that has focused on domestic factors has concerned itself with exploring in detail the domestic economic structural flaws that caused the crisis (Alfonso et al., 2005; Estrada, 2009; Suárez, 2010; Carballo-Cruz, 2011; Bentolila et al., 2012a, 2012b; Conde-Ruiz and Ruiz, 2012; Ferreiro and Serrano, 2012; Galí, 2012; Fernández-Villaverde et al., 2013; Solé-Ollé and Valdecans-Marsal, 2013; Jimeno and Santos, 2014; Daly and Zarco, 2015; Ruiz et al., 2015; Otero-Iglesias et al., 2016). Suárez (2010) and Jimeno and Santos (2014) have provided a detailed overview of many of these accumulated imbalances, especially of the housing bubble, high current account deficit, dependence on foreign finance, low productivity and high private indebtedness and how they led to the crisis. Ferreiro and Serrano (2012) have stressed the unsustainable GDP growth composition during the upturn, which relied on indebtedness, external financing, imports and domestic consumption. A score of specialised papers have looked into each of these particular imbalances and structural flaws of the Spanish economy. Bentolila et al. (2012) have drawn attention to the pernicious dual nature of the labour market, which greatly discriminated against those with short-term, insecure, contracts and created perverse incentives for the formation of human capital, factors that are at least partly to blame for the country´s chronically high levels of unemployment. The decrease in competitiveness has been another major issue of attention. Galí (2012), among others, has focused on the increase in labour costs and the drag that it has imposed on Spain´s competitiveness. Estrada (2009) has explored in detail the effect that the combination of low productivity and increasing unit labour costs and corporate margins had on Spanish firms' competitiveness and the corresponding increase in the current account deficit.

The role of particular sectors in generating the crisis, especially housing and banking, has also been the subject of analysis. Daly and Zarco (2015) have analysed in detailed the causes and evolution of the housing bubble. Otero-Iglesias et al. (2016: 11) have provided a detailed examination of the causes of the crisis in the Spanish financial sector, highlighting among them the:

> Deteriorating economic conditions, (…), implosion of the real-estate bubble (…), weaknesses in the regulatory framework (…), bad lending practices (…), the passivity of the Bank of Spain, governance problems in the *cajas* sector (…), vulnerabilities associated with heavy investment in the real estate sector (…), dependency on wholesale markets for funding (…), an element of bad luck from the deterioration of the external environment (…) and euro membership.

They conclude that the Spanish financial crisis confirms the 'long-standing tenant that financial systems collapse when they take on too much risk and when they do not have sufficient capital in reserve' (ibid.: 11). Ruiz et al (2015) have analysed the causes leading to the troubles that affected in particular the *cajas de ahorros* (Spanish saving banks) and Solé-Ollé and Valdecans-Marsal (2013) and Fernández-Villaverde et al. (2013) have looked at the role of institutional factors and regional and local urban laws in fuelling the housing bubble. Carballo-Cruz (2011) has, for example, examined the interplay between these two sectors and how the crisis of the Spanish financial industry, especially its *cajas de ahorros*, as a result of the bad debts generated by the bursting of the housing bubble, has been both cause and consequence of Spain´s economic difficulties, creating a vicious loop with the sovereign debt. This feeds into a large literature on past financial crises. Claessens et al. (2013) for example identify four major causes of past financial crises, which also characterised the Spanish crisis (Bank of Spain, 2011): rapid increases in asset prices, credit booms, a dramatic expansion in marginal loans, and regulation and supervision that failed to keep up with developments.

Other studies have looked at wider issues such as the contribution of a deficient public sector to Spain´s structural economic weakness, analysing issues such as the impact of the low productivity of the public sector on the country´s overall economic performance (Alfonso et al., 2005), the role of regional finances in the country´s public deficit troubles (Conde-Ruiz and Ruiz, 2012) or the flaws of the Spanish tax system, especially how its many loopholes make ineffective efforts to close budget deficits through tax increases (ibid.). More recently, Ferreiro et al. (2014) have highlighted the counterproductive effect that discretionary public spending can have on both the growth cycle and as response to the crisis, when exacerbating macroeconomic and fiscal imbalances.

These economic imbalances are relevant to attempting to explain not only the origins of the crisis, but also its management, as the government´s response was significantly constrained by them (Ortega and Peñalosa, 2012). For example, the budget and current account deficits that these imbalances led to, and the increasing reluctance of international investors to finance them once doubt was cast on their sustainability, forced the government to adopt measures aimed at recovering the credibility of the markets and investors in order to prevent a liquidity crisis in the context of a monetary union where recourse to the ‘printing presses’ of the central bank is not an option.

Yet, although it is undeniable that domestic economic imbalances were a fundamental cause of the crisis and constrained the government’s response to it, they are too limited to explain the prevalence of economic considerations in either the origins or the management of the crisis in Spain. Firstly, many of the economic disequilibria identified had their origin in political and institutional factors, as the next section will show. For example, the vulnerability that the *cajas* represented for the Spanish financial system is clearly linked to their defective governance and the role played in it by political parties (Fernández-Villaverde et al., 2013).

Secondly, while large budget deficits and public debt can lead to economic crises (Reinhart and Rogoff, 2009), this was certainly not explanatory of Spain's case, at least with public finances. In 2007 Spain had one of the lowest public debt-to GDP ratios in the euro zone, at 37 per cent of GDP, significantly lower than that of Germany or France. Furthermore, the correlation between debt and growth is still contentious (Koo, 2008; Krugman, 2012; Herndon, 2013) and many countries have been known to grow and have access to credit while enduring higher levels of public debt (Krugman, 2013). Finally, recent analyses by the IMF (Guajardo et al., 2011; Blanchard and Leigh, 2013) cast doubt on previous assumptions on the positive impact of austerity on economic growth. Yet austerity policies, which by most accounts have had a depressive impact on economic growth, were still implemented in Spain.

Thirdly, De Grauwe and Ji (2013a, 2013b) have persuasively shown how the evolution of sovereign debt spreads in Spain and other southern periphery states was correlated with political decisions at EU level much more than with national macroeconomic fundamentals. In the same vein Klose and Weigert (2013: 1), have, in their analysis of the evolution of sovereign debt spreads during the euro crisis, concluded that 'beside fundamental factors a systemic risk component played a role in determination of sovereign yields'. The drop in the financing costs of Spain and Italy after the intervention by the President of the ECB Mario Draghi points to the fact that economic fundamentals were trumped by other factors, in this case the *quasi-political* intervention by the ECB, when it comes to explaining the evolution of the bond spread.

Fourthly, it is difficult to deny that Spain´s membership of the euro zone constrained the range and nature of instruments at the government´s disposal, pointing to the influence of institutional and political constraints beyond mere economic or market-centred explanation. A significant body of literature has argued in this case, as shown in the previous section.

And fifthly, as already argued, the Spanish response to the crisis displayed important differences from those of other states facing some of the same economic imbalances (a housing bubble and troubled financial sector in Ireland, a large public deficit once the crisis started in Greece), that are difficult to explain without reference to Spain´s institutional and domestic context. These were also described in the previous section and include, for example, the refusal to accept a bailout or the unexpected reform of the Constitution.

Domestic political perspectives on the origins of the crisis

Given the limitations of the existing explanations based on external constraints and domestic economic factors, it is surprising that the role of domestic politics has not been given greater consideration in attempting to explain the origins and especially management of the crisis in Spain. After all, as Pinto (2013: 103) has argued in his analysis of previous economic crises, 'the occurrence, timing and severity of economic crises are directly related to political decisions made along the backdrop of the business cycle'. There is of course an intense debate on the role that the failures of the Spanish political establishment and institutions might have played in causing Spain´s economic woes and on whether it was these political failings that led to the economic crisis or vice versa. A significant body of literature (Molinas, 2012, 2013; De la Dehesa, 2013; Fernández-Villaverde et al. 2013; Royo, 2013, 2015; Garicano, 2013, 2014) has pointed to domestic political and institutional factors as the underlying reason of the economic problems the country developed in the run-up to the crisis, highlighting issues like the high levels of corruption (Royo, 2015) or the weakness of the institutional arrangements that came out of the transition to democracy after the Franco dictatorship, from the legal structure of the *cajas* to the protectionist nature of the labour market (Garicano, 2013, 2014; Molinas, 2013) or the allegedly inefficient and duplicity-prone decentralised administrative structure of the state. For example, Fernández-Villaverde et al. (2013) have explored the role that decentralisation played in the development of the housing bubble. The radical decentralisation process that accompanied the transition to democracy led to urban zoning competencies' being transferred to regional governments that in turn transferred to local authorities that, in association with private developers, were then free to build whole new areas of township. At the same time, two key issues changed in the governance of the *cajas* with the arrival of democracy. First, their control was transferred to the regional governments and, second, they were allowed to expand territorially. This opened the door to easy finance to politically well-connected developers and made possible the construction boom that led to Spain´s housing bubble. In sum, the 'self-reinforcing triangle of regional governments, developers, and (…) *cajas*' (Fernández-Villaverde et al., 2013: 153) added fuel to other factors like the low interest rates brought about by euro zone membership or high immigration to create Spain´s housing bubble.

Royo (2013) has commented in detail on the corruption and supposed incompetence of the Spanish political class in the origin of the crisis, pointing to the inability of President Zapatero to see its depth or even, long after it was obvious, to acknowledge its existence. The Spanish political class is said not only to be incompetent but also to have 'developed its own particular set of interests and instruments to sustain it through a system of rent-seeking based on crony capitalism' (Royo, 2013: 14). The centrality of a dysfunctional political class has also been forcefully argued by Molinas (2012, 2013). In his view the roots of the economic crisis are to be found in the political arrangements that came out of the transition to democracy and in particular in the electoral and party system established by the political elite. The adoption of proportional representation with blocked lists that strengthened the power of the party elite and insulated it from external pressures, together with other institutional developments such as decentralisation, led to a self-serving, corrupt and inefficient political class which was fundamental in allowing a rent-seeking and corporatist economic system to develop. The collusion of political and economic elites led to a process of income and resource extraction (Acemoglu and Robinson, 2012), which blocked much needed structural reform and was responsible for many of the imbalances that led to the crisis, such as the credit boom and housing bubble.

The financial sector is a particularly salient example of these oligopolistic practices, a fact that is at the heart of many of the imbalances that led to the crisis (Pérez, 1997; Royo, 2013; Fishman, 2011, 2012). Writing before the crisis, Perez (1997) argued that the country´s political economy institutional framework sheltered the financial sector from competition after its entry to the EU. The vested interests built into the regulatory and supervisory regime help explain the slow and half-hearted reform of a broken financial system during the crisis. Fishman (2011, 2012) has found in the corrosive role played by the banking sector and its oligopolistic practices a key cause of Spain´s economic problems, including unemployment. From a VoC angle, Royo (2013) has found in the country´s political economy institutions the origins of the financial sector´s historic high regulation and protection from competition.

Yet approaches that place responsibility for the failures that led to the crisis on the failures of the Spanish political and institutional systems have also been forcefully challenged. Sanchez Cuenca (2014) for example has critically analysed this literature and questioned (ibid.: 76-77) why, if domestic flaws were responsible, the economic crisis affected countries with markedly different political and institutional structures from those of Spain, such as Greece, Italy or Ireland. The causes of the crisis are to be found, in his view, not in the Spanish political class, but in external factors and most notably in the role of the global financial markets and the institutional deficiencies of EMU, as described in the previous section.

Domestic political perspectives on the management of the crisis

Yet, beyond these accounts of the role of political factors in the origins of the crisis, the literature devoted to exploring the role of domestic politics in the management of the crisis itself is relatively limited and, as we shall now see, is often intertwined with attempts to explain its origins. A first approach has relied on the VoC literature in trying to explain Spain´s response (as opposed to Germany´s, which was covered in the previous section). Hall (2014: 143) has, for reasons already explained, claimed that ‘each nation´s initial response to the crisis was conditioned by its institutional architecture’. Thus the initial response in mixed market economies such as Spain was to rely on stimulus to promote internal demand, which explains the initial substantial fiscal stimulus adopted in Spain, before pressure from the EU and Germany to adopt austerity measures became salient.

In two of the most comprehensive studies of the Spanish economic crisis from a political perspective, Royo (2013, 2015) has also applied the VoC framework to advance two alternative explanations of the role of domestic institutions in shaping the response to the crisis. In his most recent work (Royo, 2015) he finds in Spain´s domestic institutions, and in particular their progressive deterioration, the key both to the origins and response to the crisis. On this interpretation institutional degeneration in the years prior to the crisis created a pervasive lack of accountability which:

> Led to a Spanish version of crony capitalism characterized by the misgovernment of the public, an outdated and inadequate policy-making process; an inefficient state and an often corrupt and inefficient political class. (ibid.: 2)

These institutional deficiencies were, in Royo´s view, also present in the management of the crisis, at least in its early stages (Royo, 2015: 19). It is notable that while, as previously reviewed, Fernández-Villaverde et al. (2013) have found in EMU a causal explanation of this institutional deterioration, Royo uses the same evidence to draw an altogether different conclusion, namely that the deterioration of Spain´s institutions had an endogenous origin and that EMU, far from having led to institutional convergence among its members, has actually been witness to a divergence (Royo, 2013: 19).

In an earlier analysis, Royo (2013: 106-224) has suggested a complementary explanation of the management of the crisis, rooted also in a VoC approach to the crisis, based on what he terms 'policy continuities' and 'the endemic inability of the Spanish political system to generate alternative responses to address economic challenges' (ibid: 224). According to this view, in many sectors of the economy, the different governments since the transition to democracy, either from the PSOE or the conservative PP, have adopted similar policies, regardless of the paucity of their effectiveness. He explains this policy continuity in the management of the present crisis with reference to Spain´s political economy institutional arrangements, and especially to the informal coordination mechanisms that granted significant influence in economic policymaking to existing social agents. Unlike in other more formally coordinated market economies, such as those of Germany or the Scandinavian states (Hall and Soskice, 2001), Spain´s social and economic agents do not represent large segments of workers and citizens, especially those who were worst affected by the crisis, which allowed for vested interests to dominate the bargaining process, creating significant barriers to change. The management of the crisis with respect to the financial sector is, in Royo´s (2013: 177) view, particularly illustrative in confirming the relevance of a VoC approach to understanding the crisis. His analysis assigns an important role to financial institutions in explaining attempts to reform the financial system during the first phase of the crisis, stressing the agency of domestic actors, in this case the banks, in shaping national financial system change. Furthermore, Royo´s analysis also purports to show that the management of the global financial crisis in Spain promoted rather than undermined coordination among domestic economic actors. Far from converging towards deregulation as a result of the pressures of globalisation, the crisis led to extensive regulatory intervention that served to reinforce the preexisting model of coordination, at least in financial markets, with Royo (2013: 35) concluding that ‘analysis of the Spanish experience during the crisis confirms the thesis that coordination is a political process’.

Fishman (2012) has pointed in a similar direction of flawed policy continuity inertia, citing the evolution of the labour market and insistence of successive governments on adopting policies that focused on increasing the flexibility and liberalisation of the labour market even in the face of their failure to reduce unemployment (ibid.: 70). This ‘recurrent use of an unsuccessful strategy is an anomaly of policy making’ (ibid.: 69) in Spain which explains the failure to address not only chronic unemployment but also other of Spain´s structural economic problems, such as low productivity and particularly pronounced boom and bust cycles.

Fishman (2012: 70-71) goes on to criticise accounts of the origins and response to the crisis based on a supposed lack of market freedom, claiming that:

> An adequate answer to that question requires us to look beyond the variables emphasized by the narrow version of economic analysis that assumes that market freedoms and incentives can resolve all problems.

He suggests exploring the impact of policies, legal structures and network structures. Allowing for the role of these domestic and institutional factors helps explain, for example, the role of Spain´s finance sector, and its oligopolistic nature, in many of the country´s economic management, not least:

> Endemically poor labour market performance through the mediating mechanism of restricted lending to small and medium enterprises (SMEs), thus undercutting the ability of such firms to increase employment or invest in innovation. (ibid.: 71)

Key to understanding both the origins and management of the crisis is, therefore, according to Fishman (2012: 74), recognition that despite evidence of poor performance and intense social pressure against further labour market liberalisation, the political system has tended to *screen out* the voices of socially disadvantaged sectors to a greater extent than otherwise comparable polities such as Portugal. In Fishman´s (ibid.: 74) view, Spain’s resilient neo-liberal economic policy paradigm is emblematic of broader features of the country’s post-Franco political system and can be explained to a significant extent by the hegemony of a technocratic elite nurtured in the Bank of Spain and which has supplied most of Spain´s top economic policy-makers since the transition to democracy. This has led, Fishman argues, to an anomaly in Spain with respect to other states: there has hardly been any competition on economic policy ideas between the two largest parties for the last 30 years. Rather, it has been driven by a ‘neoliberal consensus’ implemented even by the Socialists. This ‘policy consensus’ is fundamental, Fishman argues, to explaining the orthodox response to the crisis by the Socialist government, much more than putative external pressures by markets or the EU institutions and partners.

Beyond these political-economy institutional analyses, other authors have explored the management of the crisis in terms of electoral politics and parliamentary alliances (Dellepiane and Hardiman, 2013; Field, 2013; Calvo, 2014). Dellepiane and Hardiman (2013: 220) have argued, in their comparative study of the crisis in Spain and Ireland that, although both countries faced external pressures that caused policy changes:

> There are marked differences in the way these decisions were arrived at, which can only be understood in the context of the partisan dynamics of party competition and the underlying political cleavages in the two societies. Partisan differentiation of policy preferences was more deeply rooted in Spain than in Ireland, which meant that the breach in the preferred government policy stance in May 2010 was particularly damaging for the incumbent PSOE.

The role of parliamentary dynamics in exercising pressure on the government during its management of the crisis is confirmed by data on the questions faced by the PSOE government in Parliament during this period. Analysis of these by Borghetto (2014: 1) shows that the economy completely dominated the political agenda:

> As never before in Spanish democratic history, the legislative agenda contracted and the economy dwarfed all other issues (…). This results mainly from the opposition parties' strategy of directing attention to economic failings so as to attack the government and gain an electoral advantage.

Focusing also on the role of parliamentary dynamics, Field (2013) finds that there was a marked change in the alliance strategy of the Socialist government from one of *asymmetric geometry* siding with different parties in order to pass each item of legislation during the first, less politically difficult, phase of the management of the crisis, to a more encompassing agreement that allowed the government to pass the difficult economic measures during the second stage from May 2010, when tough decisions became unavoidable. According to this account (ibid.: 76) 'while the strategy change can be explained by the economic crisis, the choice of allies has much to do with territorial politics and the largely orthodox policy response'. What is interesting in this analysis is that it shows that a minority position was no obstacle to the government's adopting the policies it considered necessary, since it could use concessions, sometimes in the realm of regional politics, to gain its allies' support.

Complementing this perspective, Calvo (2014) has usefully looked at how the decentralisation of the Spanish state and Spanish politics played an important role in the crisis. She argues that the parliamentary power of regional parties made management of the crisis more complex, as many of the policy instruments were not in the hands of the central government, which made them subject to regional political dynamics. However, she shares Field´s view (Field, 2013) that it also allowed President Zapatero to put reforms through Parliament without a parliamentary majority, by being able to rely on the support of regional parties in return for concessions on regional policy.

Other political accounts have centred on personality or ‘leadership’ traits in explaining President Zapatero´s response to the crisis. For example, Olmeda and Colino (2014) have argued that it was his inability to recognise an important change in his leadership context (namely the advent of the crisis) that explains his poor management. They claim that:

> Due to this lack of vision he could not make sense of the looming crisis, complicating his communicative performance because he was not able to make meaning [of the crisis] to explain his policy change and unpopular reforms. As a result there was an acute loss of political capital and credibility. (ibid.: 16)

Which, one could add, also prevented him from managing the crisis more effectively.

The ineffective decision-making process that characterised various episodes of the management of the crisis has been the subject of study by other authors. For example, in their analysis of the crisis in the financial sector, Otero-Iglesias et al. (2016: 11) highlight the role played by ‘misdiagnoses by the political authorities in its early and medium stages (…) and the slowness in reacting throughout the process, (…)’. In similar vein Bosco (2013) has looked at Zapatero´s government response from a management perspective, emphasising its management failures and claiming (ibid.: 28) that ‘the government´s attitude towards the crisis – first denied, then played down, and finally suffered – was a big blow to the President´s credibility’. As we have seen before, references to alleged incompetence and erroneous diagnosis of the government are common in other analyses of the management of the crisis (Royo, 2013; Molinas, 2013).

Finally, it is clear that the social cost of the crisis, in particular the dramatic rise in unemployment and the social discontent it brought about, also conditioned the government´s response. Polavieja (2013) and Álvarez-Díaz et al. (2015) have provided evidence of the causal relationship between the increase in unemployment and the deterioration of the political situation in Spain. It is significant that, according to the latter, there is a lag of about one year between a negative shift in unemployment figures and its negative effect on the public´s opinion of the political situation (Álvarez-Díaz et al., 2015: 57), which helps explain why domestic political pressure might have been a factor in the shift to reform by mid-2009, just over a year after the unemployment figures started to increase dramatically in mid 2008 (by the end of 2008, the number of unemployed had increased by over 600,000 in a single year (*Instituto Nacional de Estadística* (INE), 2008)).

Valuable as all the above contributions are, they only offer partial explanation of how domestic political factors may have shaped the management of the crisis in Spain. Arguments relying on ‘policy inertia’ caused by the political economy of Spain´s institutional arrangements fail to take into consideration the role of agency and in particular the diagnostic errors that were so critical in the management of the crisis. Parliamentary dynamics and the strategy of ‘variable geometry’, siding with different parties to pass different items of legislation, can of course be helpful in understanding how the Socialist government was able to pass measures that were opposed not only by a majority of the Spanish electorate, but also by a majority of the parliamentary parties. But they are of limited value in helping us understand why the government adopted the measures it pursued, often contrary to its own electoral manifesto. Similarly, regional dynamics were of course vital in the parliamentary game, as the Socialist government was very often able to pass legislation by counting on the support of regional parties in return for concessions on regional issues. Yet, again, while this asymmetrical parliamentary game explains how the government was able to pass its unpopular policies, it is does not explain why it decided to adopt such measures. Explanations relying on electoral dynamics also pose some questions. They certainly explain some aspects of the crisis, like for example the decision to reform the Constitution rather than adopt the more electorally damaging second labour market reform that his EU partners were demanding from President Zapatero, but they cannot explain the immensely unpopular measures that the Socialist government took from May 2010 onwards. Finally, management and leadership ‘styles’ or lack of ability are unlikely to be the major factor in explaining how the crisis was managed. Diagnostic errors were widespread among Spain´s political elite and figures with markedly different backgrounds and management profiles, from the Minister of Economy and Finance to the Governor of the Bank of Spain, partook in them, as they did in the failure to undertake the necessary measures to deal more effectively with the crisis.

1.2.3. Summary: the limitations of the existing literature

This literature review reveals that existing explanations cannot fully account, each for different reasons, for a number of relevant aspects of the immediate origins and management of the crisis by the PSOE government. The prevailing narrative has privileged the role of external constraints and suggested that, as a result, domestic politics were rendered of little effect. Illustrative of this approach is Armingeon and Baccaro´s (2012: 162) assertion, in a recent volume analysing the response of European peripheral states to the crisis (Bermeo and Pontusson, 2012), that ‘domestic institutions and politics matter very little for [*sic*] explaining responses to the sovereign debt crisis, and that external constraints are much more important’. Similarly, Hopkins, one of the few authors that, as we have seen, has closely studied the Spanish crisis from an comparative perspective, has asserted that:

> Although there has been a mix of centre-left and centre-right political forces in power across Southern Europe in the period since the crisis began, the overriding imperative of deficit reduction through fiscal tightening, and the absence of available monetary levers at the national level, have meant that policy has been little affected by the electoral process. (Hopkins, 2015: 19).

As we have seen, this reliance on external constraints to explain the management of the crisis is shared by many other well-informed academics when analysing the response to the crisis in Spain and the European periphery (Marzinotto et al., 2010; De Grauwe, 2011; Ontiveros, 2011; Pisani-Ferry, 2011, 2012; Bastasín, 2012; Armingeon and Baccaro, 2012; Molina and Steinberg, 2012; De Grauwe and Ji, 2013a, 2013b, 2015; Hall, 2013, 2014; Fernández-Villaverde et al., 2013; Hopkins, 2013, 2015; Sanchez-Cuenca, 2014; Torreblanca, 2014). These claims have been given further apparent support by journalistic accounts (De Barrón 2014a, 2014b) which have reported in detail the external pressures to which the Spanish government was subject, not least to accept a bailout, from directly concerned parties like the heads of state of other EMU members or the head of the ECB.

Yet explanations privileging external constraints, while undoubtedly relevant in many respects, have also been shown to have serious limitations. Firstly, global macroeconomic imbalances and global financial markets certainly enabled the development of the credit boom and asset price bubbles, but explanations predicated upon them ignore the constraints that other political and institutional factors such as EMU membership played. Investors and the bond spread certainly exerted pressure on the government and constrained its response, but the evolution of this spread was more closely correlated with the sequence of the euro crisis and actions by the ECB than to Spain´s macroeconomic fundamentals (De Grauwe, 2011; De Grauwe and Ji, 2013a, 2013b).

The second set of external constraints identified by the literature, namely institutional flaws in EMU, were again undoubtedly a significant factor shaping both the origins and management of the crisis, not least the absence of a lender of last resort, a more integrated approach to banking regulation and the rescue of troubled institutions, or the lack of appropriate sovereign crisis resolution mechanisms. The role of Germany in imposing a particular narrative of the crisis and a corresponding set of measures based on austerity and structural reform, was a third major external constraint identified, whether path-dependant, given its set of political economy institutions and economic system, or driven by an interest in framing the crisis in a way that was politically advantageous. Finally, the ideological bias of policy-makers in Germany and the European institutions have also been referred to as an external factor constraining the Spanish government´s response to the crisis. Yet explanations of the origins and, especially, management of the crisis predicated on the influence of global markets, EMU´s design flaws, Germany´s pressure or external ideological constraints, fail to account for the particularities that defined both the origins and management of the crisis in Spain and the occasions on which the government did not respond to pressures from EU sources or Germany. A number of instances, which will be explored in detail throughout the dissertation, offer substantial evidence of this.

Firstly, these external constraints cannot account for why, despite ample external pressure from the European Commission or the ECB, Spanish President Zapatero refused to acknowledge the gravity of the crisis for many months. It is also surprising that during these first few months the Ministry of Economy and Finance insisted on portraying the crisis as a temporary recession triggered by the real-estate crash despite the fact that many economic analysts, and even the electoral manifesto of the Socialist Party, had warned of the serious structural flaws of the Spanish growth model and its vulnerability to a credit crunch because of its high, externally financed, current account deficit.

Secondly, accounts privileging external considerations fail satisfactorily to explain why the government failed to accompany the fiscal stimulus measures in the early stages of the crisis with a credible plan to return to financial sustainability. This is especially noticeable as at the time there was ample foreign pressure to do so and economic rationale also pointed in such direction.

Thirdly, it is also difficult to explain from an external constraints perspective why the problems of the financial sector were so underestimated. External factors cannot properly account for why the Bank of Spain failed to warn the government of the weak state of many of the *cajas* and for why the government did not take more forceful action and mishandled the financial reform when the state of Spain´s financial sector was a constant source of concern for the EU and its EMU partners from late 2009 onwards.

Fourthly, external constraints cannot explain why an effective strategy did not materialize to implement reforms that were economically necessary, had been identified in the PSOE manifesto and for which there was strong external pressure. For example, external constraints can hardly account for the way in which the government managed the reform of the labour market. Despite strong international pressure and an economic rationale (at least in the view of the domestic business sector) for the reform, the Zapatero government refused to act promptly on this matter and when the reform was finally adopted in May 2010 it was much less far-reaching than the business community demanded, even though responding to its demands would probably have given his government significant credibility not only domestically but also with international institutions, markets and investors.

Fifthly, as already mentioned, it remains to be properly explained why the government did not yield to the pressures of its European partners in accepting a bailout, which was asked of the Spanish government on three occasions (Rodríguez Zapatero, 2013). It was not as certain as it might look now *a posteriori* that the government would never consider asking for a bailout, even at times when the risk premium on Spanish sovereign debt reached unsustainable levels and Spanish companies, affected by this 'sovereign' risk, found it impossible to access the foreign credit markets. Just as significant is the fact that the government never contemplated an exit from the euro that would have allowed the country to gain competitiveness via a devaluation of the exchange rate rather than painful internal devaluation, which led to massive public disapproval and certain electoral defeat.

Finally, it is also difficult to understand from a point of view privileging external constraints the decision of the Spanish government to respond to the requests by the ECB for substantial measures in return for the purchasing of Spanish sovereign bonds, not by acting on the labour market, as requested by the ECB, but by reforming the Constitution. As we shall see, neither the ECB nor Germany and its allies in the European Council ever explicitly requested such a reform.

If accounts privileging external constraints have been shown to be insufficient, so have analyses focusing on domestic economic factors. While economic disequilibria had certainly led Spain to a very vulnerable position by 2007, a number of issues are difficult to reconcile with a response driven by domestic economic rationale: why was the government so slow to acknowledge and react to the crisis? Why once the gravity of the crisis had become apparent did it not act more forcefully to address problems that obviously and urgently required solution, from the labour market to the financial sector? Why did it not accompany the fiscal stimulus with a mid-term rebalancing plan that would have offered sovereign debt markets certain guarantees of fiscal prudence? Why did crucial elements of the response, from rejection of a bailout to reform of the Constitution, prevail, when not immediately explainable from a domestic economic perspective? And why were some of these responses so different to those from other countries facing similar economic predicaments?

Notwithstanding the partial explanatory power of external constraints and domestic economic issues, the literature review has shown how domestic political factors can prove vital in understanding both the immediate origins and management of the Spanish crisis. However, as the review has also shown, this approach has been the subject of limited attention, offering valuable but partial explanations of the management of the crisis and its origins. What is lacking is empirical evidence that can strengthen and enrich these claims, helping build an account that ties together these and other domestic political considerations and provides a more nuanced, holistic and systematic account of the role played by domestic political factors in the management of the crisis that does not invalidate, but complements existing explanations. This is the objective of this dissertation and of the research question that guides it.

1.3. Research question and theoretical framework

1.3.1. Research question

This dissertation privileges a domestic political perspective in the analysis of the management of the crisis in Spain. It aims to make a contribution to the literature in two ways. Firstly, there is to my knowledge no comprehensive account of the management of the crisis based on primary research exploring the role played by domestic political factors in the decisions of Spanish policy-makers during the crisis and its immediate origins, and certainly not one based on first-hand knowledge provided by the decision-makers themselves. Secondly, it conducts this analysis in a time-specific context through a chronological reconstruction of events and decision-making in the key episodes of the crisis as it unfolded before the eyes of the PSOE government.

In order to do so the research question that the dissertation will aim to answer is: *what role did domestic political factors play in the PSOE government´s management of the crisis in Spain and in its immediate origins?* It is important to note that, in thus framing the research question, there is no assumption that external factors did not play a role. On the contrary, global financial markets, Spain´s membership of EMU or Germany´s attitudes played an important role in the origins and management of the crisis. These and other international political and economic factors interacted to create a complex political dynamic. Yet, as Gourevitch (1978: 911) argued in his seminal study of the relationship between international and domestic politics ('the second image reversed'), 'however compelling external pressures may be, they are unlikely to be fully determining'. The PSOE government was forced to balance forceful external political constraints with domestic political realities; an international political context defined by the battle for survival of an increasingly threatened EMU with a challenging domestic political scene in which interests, ideology, party politics and electoral dynamics were always present. While the external constraints were important, the claim of this dissertation, substantiated by the analysis conducted in the literature review, is that it is essential also to look at domestic political factors and recognise that these may not have been given sufficient consideration in some of the predominant accounts of the management of the Spanish crisis. That *politics matter* in the management of the economy is, of course, quite uncontroversial. Yet, as we shall see, the purpose of the dissertation is not only to attest to the relevance of domestic politics in the management of the crisis, but also to explore why and how they influenced it.

These political factors can enrich our understanding of the management of the crisis in Spain in at least in three ways. Firstly, they can provide explanatory variables for developments which otherwise are difficult to explain. Secondly, they can provide an alternative explanation of decisions that, while conditioned by external factors, may actually be more fully explained by incorporating domestic political factors. And thirdly, while external constraints might have forced the government to act in a certain way, the specific measures with which the government attempted to reduce those pressures, were, as we shall see, often determined by domestic political factors.

1.3.2. Theoretical framework

In theoretical terms, this dissertation locates itself within the debate on the impact of economic globalisation on states' capacity to act, privileging a domestic perspective in determining what states can do under conditions of international economic integration. It aims to provide primary research to substantiate this claim to the relevance of domestic political factors in the particular context of the Spanish crisis. The debate on the impact of globalisation on states' economic discretion is an intense one (Hay, 2008). A well-established academic literature (Strange, 1988, 1996; Ohmae, 1990; Rodrik, 1997, 2012; Ruggie, 1998; Held et al., 1999; Stiglitz, 2010; Gamble, 2014) has argued and chronicled how the process of economic integration that is said to characterise the global economy has led to a weakening of the state's power and autonomy. According to one line of thought, originally and most forcefully argued by Strange (1988, 1996), power over others is exercised through a number of structural forces, such as security, credit, knowledge and production that have for the last decades spilled over the territorial boundaries of states. In an analysis particularly premonitory of the euro area sovereign crisis, Strange (1996: 192) argued that:

> The management of foreign debt (…) is a good example of the structural power of powerful states exercised indirectly through the bureaucracies of international organizations.

The impact of financial globalisation is also said from this perspective to have been critical in diminishing the autonomy of the state (Stiglitz, 2010). Having lost the ability to control capital flows and thus tax capital, states have been forced to compete for investment by adopting low taxation and investment-friendly policies, which usually entail increased labour market flexibility and overall deregulation, regardless of domestic political needs or ideological preferences.

A second perspective (Held et al., 1999) has highlighted the transnational nature of many of today´s economic and global dynamics and advocated the need for a new regime of global governance that would supersede the limitations of nation states to deal with them. In this context, liberal internationalists (Ruggie, 1998) have long argued that a set of international regimes has been supplanting the state as the key locus of political action.

Finally, a third mainstream line of argument, often critical of the impact of globalisation and its ‘neoliberal’ underpinnings, has focused on the challenges that globalisation presents to democracy (Rodrik, 1997, 2012; Gamble, 2014). The high level of economic interdependence which characterises the modern economy has led to a need for political governance functions above the state level, which require either global governance or government, as described above, or hegemonic leadership (Kindleberger, 1973). In neither case is there a necessary connection with democracy, leading to what has been termed the ‘democratic deficit’ (Gamble, 2014: 117) or the *trilemma* of *hyperglobalisation*, which Rodrik (1997, 2012) has theorised as the impossible attempt to accommodate at the same time deep economic integration, democracy and national sovereignty. The alleged undermining of the state´s capacity to act democratically caused by globalisation is further intensified by a neoliberal ideology that privileges open markets and nudges states towards investment-friendly policies (Gamble, 2014). It is not so much that due to globalisation national governments do not have a choice. They do have formal discretion, but often the alternatives are unpalatable (ibid.: 117) or ‘national governments impose these constraints on themselves as the price for remaining in the larger entity’ (ibid.: 116). This leads to a constant tension between democracy and supranational governance, which has been particularly noticeable in the EU during the crisis.

However compelling these claims may be, the alleged loss of autonomy and capacity to act of states may not be as conclusive as suggested. Firstly, questions can be asked as to whether we really live in such an economically integrated world and concerning the theoretical and empirical veracity of the mechanisms through which it is said to limit the ability of states to act (Feldstein and Horioka, 1980; Dunning, 1988; Zevin, 1992; Frankel, 1997; Rodrik, 1997, 2012; Cooke and Noble, 1998; Hirst and Thompson, 1999; Traxler and Woitech, 2000; Hay, 2008; Bekaert and Wang, 2009). Claims of an unprecedented level of economic globalisation are predicated on assumptions that are questionable both theoretically and empirically. At a theoretical level, and as Hay (2008: 320) has argued, the most important of these, the alleged high mobility of capital, is based on dubious assumptions: that capital has perfect information and will go where it can secure the highest return, that it has perfect mobility, that the cost of exit is zero, that it will secure the greatest return where there are more flexible labour markets and lower taxation, and that the welfare state has no positive externalities. The challenges to the idea that we live in such an economically integrated world are also empirical. International trade is less as a percentage of global GDP than it has been in previous ages (Hirst and Thompson, 1999) and is concentrated within regions and within Europe, North America and Asia Pacific, with geography still being the single highest correlated factor (Frankel, 1997). The true extent of the globalisation of capital is also questionable. Were global capital flows to be truly integrated they would be expected to lead to a convergence in asset prices. Yet, as Bekaert and Wang (2009: 37-38) have concluded in their extensive review of several measures of convergence of bond and equity returns, as well as of interest rates, 'it is somewhat challenging to document strong effects of globalisation on the convergence of asset prices', something which, in their view:

> Confirms the findings of early studies of the dynamics of market integration (…) which argue that integration is a non-smooth process that may actually reverse and is only weakly linked to *de jure* openness. (ibid.)

Furthermore, if global capital flows were truly integrated, there should be a low correlation between domestic savings and investment, as foreign direct investment (FDI) would be readily available from external sources. Yet this was not the case in the early stages of globalisation (Feldstein and Horioka, 1980), and, while the so-called 'Feldstein-Horioka puzzle' has been called into question in recent times, the challenges to it are not conclusive (Hay, 2008: 339-340).

Even if economic globalisation were a reality, whether this process has been accompanied by a weakening of the state is an altogether different question. There is first the issue of whether in fact the state has less of a presence today than it used to. Theoretical implications from the *hyperglobalizaton* thesis would tend to imply it must. If there were perfect mobility of capital, then there should be a constant pressure on states to lower corporate tax rates that would result in lower tax receipts and thus lower public expenditure (unless governments borrow, an assumption not warranted by the relatively moderate levels of public debt as a percentage of GDP, in historical terms, that most developed economies presented until the crisis). Similarly, it would generate a race to the bottom in issues such as labour and environmental regulation to reduce costs to investment. Yet the empirical evidence does not warrant this conclusion. Contrary to what the *hyperglobalisation* thesis may suggest, there is no inverse correlation between openness and *stateness* (Hay, 2008: 333); in fact there is a continued positive correlation between public expenditure and economic openness (Rodrik, 1997). Similarly there is no inverse correlation between FDI and levels of corporate taxation, labour market regulation or generosity of welfare benefits protection (Dunning, 1988; Cooke and Noble, 1998; Traxler and Woitech, 2000).

Finally, to the claim that the origins of the crisis of the nation state reside, not in economic globalisation per se, but in the increasingly global nature of the problems faced and the inability of the state to deal with them (Held et al., 1999), the obvious response is that such a claim tells us nothing about the state´s ability to deal with the kind of problems it has traditionally had to deal with. While dealing with transnational issues may in fact pose a challenge, this challenge says more about the difficulties that a system of sovereign states has in dealing with transnational problems than it does about the ability of the state to manage the problems it has traditionally had to deal with (Hay, 2008: 325). An altogether different issue is the use of globalisation by national policymakers as a convenient scapegoat for unpopular policies that have nothing to do with it (Fernández-Albertos et al., 2013). As Hay (2008: 315) has suggested:

> There is a certain danger that, in accepting over-hastily an influential conception of the inevitable demise of the nation state´s capacity an autonomy, we provide a convenient alibi for politicians keen to justify otherwise social and economic reforms by appeal to the harsh reality of a global age.

Beyond these theoretical and empirical arguments, other observations from the recent crisis also question whether globalisation has rendered the state powerless. Firstly, the crisis undermined the validity of the efficient market hypothesis and corresponding claims that markets could be relied upon to self-regulate; the need for regulation, which often must still emanate from national parliaments, has become unquestionable. Furthermore, responses to the crisis, whether through fiscal stimulus or bank bailouts, were predominantly national, even within the EU. Secondly, as seen in the literature review and predicted in the VoC literature, the response to the crisis was defined in part by the type of capitalism predominant in a country, whether in Germany or Spain, going to show that there are differences marked by the state and domestic political institutions. Or, to invert the argument, if the state were irrelevant, we would have seen a convergence in responses, which was certainly not the case, at least in the initial stages: the shape of the fiscal stimulus took a very different form in Spain from that in Germany, for example.

There are therefore substantive reasons to argue that globalisation and economic integration has not fundamentally annulled the economic discretion of the state. Yet what this general argument highlighting state autonomy does not explain is the way in which domestic political factors shape economic policy and outcomes. The interaction of politics and markets at state level is, however, a subject for which there is ample theoretical guidance emanating from the field of political economy and, in particular, comparative political economy. The most relevant contemporary point of departure for any analysis of the political dimension of the domestic management of economic crises is probably Karl Polanyi´s (1944) *The Great Transformation*. In his genealogy of the rise of the modern market from the 18th century to the convulsions of the 1930s, including of course the Great

Depression, Polanyi emphasises the cultural and political underpinnings of markets, and shows how these are embedded in a particular institutional and political context, and can neither be understood nor operate sustainably without them. In recent times various research agendas have explored how domestic political factors shape economic outcomes, and it is to them that we must turn our attention to establish a theoretical framework within which to set the dissertation. These contemporary approaches to the study of comparative political economy can be usefully structured around the privileging of the explanatory power of three sets of factors: institutions, interests (material and political) and ideas. Taking into account these factors, and following discussions in Hall (1997) Blyth (2009) and Bermeo and Pontusson (2012), I identify four main comparative political economy research agendas: institutional, interest-based, partisanship-based and ideational.

Institutional political economy

A first approach relies on the role of institutions to explain economic outcomes, both in normal times and during crises (Deyo, 1987; Haggard, 1990; Wade, 1990; Hall and Soskice, 2001; Greif, 2006; Iversen, 2007; Royo, 2008; Chung and Thewissen, 2011; Acemoglu and Robinson, 2012; Hooren et al., 2014). Probably the most important research agenda in this field is that of VoC (Hall and Soskice, 2001; Iversen and Soskice, 2006; Iversen, 2007), which has been discussed in the literature review from a more empirical standpoint with respect to how it helps explain Germany´s and Spain´s response to the crisis. At a theoretical level, this approach argues that variations in economic policy can be traced to institutional differences between nations and it identifies the level of coordination between business firms and the state that emanates from these institutional arrangements as the key differentiation factor between models of capitalism (Hall and Soskice, 2001). These can be classified into coordinated market economies (generally speaking continental European countries) and liberal market economies (exemplified by the US and the UK). This original model was expanded with the category of mixed market economies for those countries that do not naturally fit in either of the two main categories; Mediterranean economies such as Spain are deemed to be of this category. According to this literature (Royo, 2008), Spain is characterised by strong coordination in financial markets but not in labour relations.

A VoC approach enriches political economy analyses in a number of ways (Hall, 1997: 182): it helps move beyond the tendency of economics to treat all developed economies as institutionally identical; it puts firms at the centre of the analysis and highlights how institutions interact to create distinct outcomes; and, in so far as it is based on the assumptions of rational agents responding to incentives in a game theoretical framework, it offers an approach to political economy that can be conversant with contemporary economic science. The VoC framework can also help explain governments´ responses to crisis as domestic political economy institutions are seen as playing a key role in shaping the demand for policy choices (Iversen and Soskice, 2006; Iversen, 2007). In fact, Iversen´s analysis suggests that we can plausibly predict the way a crisis will be managed in a given country given its model of capitalism. According to this approach 'exogenous shocks are expected to lead to different government responses depending on existing institutional frameworks' (Iversen, 2007: 278). These claims have been corroborated by further literature. Chung and Thewissen (2011: 357) have argued that 'existing institutional settings shape the expectations and behaviour of citizens, politicians, and pressure groups', and that the institutional differences that the VoC literature identifies 'act as powerful inducements to replicate existing institutions'. Hooren et al. (2014) have further argued that governments stick to crisis routines anchored in existing institutions, primarily because people opt for rigidity and well-known 'old habits' during times of uncertainty.

Beyond VoC, Greif (2006), in his game-theoretical analysis of the different evolution of medieval Christian and Muslim traders, identifies cultural beliefs rather than interests as the key factor that determines the formation and evolution of institutions. The latter are not just the politically and interest-determined rules by which economic transactions are governed in a society; they are the combination of cultural beliefs as conveyed by formal and informal rules. Different institutions arise among nations because of the different cultures, norms and organised groups with differing degrees of power that prevail in each country.

Finally, a more historical approach has also tried to understand the difference that institutions have made in economic development. Focusing on East Asia, Deyo (1987) and Haggard (1990) have focused on the role of the state in industrial development, while Wade (1990) has placed emphasis on the successful experience of some East Asian states in *governing* the market. More recently, Acemoglu and Robinson (2012) have also defended the centrality of institutions in explaining why some nations fail and others succeed, suggesting that the difference is to be found in whether a state is characterised by the centrality of extractive institutions, where a corporatist elite exploits a nation´s resources to its benefit, or by inclusive institutions, where a more ample representation of the population acts as a barrier to such exploitation.

Interest-based political economy

The material interests of different producer-group coalitions can have a substantial influence on economic policy (Gourevitch, 1986; Rogowski, 1989; Alesina and Drazen, 1991; Frieden, 1991; Hiscox, 2002; Mares, 2003; Iversen, 2005). According to certain interpretations, of which Peter Gourevitch´s *Politics in Hard Times* (1986) is the modern foundational source, coalitional dynamics trump ideology, institutions and international factors in explaining policy choices during crises. Although policy responses adopted during crisis are putatively aimed at addressing the economic and social impact, what they really reflect is the efforts of these different organised interests to shape political and economic environments to their benefit. The content of those responses is therefore a function of the expected distributional consequences and the ability of affected organised interests to mobilise politically to shape them. Whatever the external constraints, there is always an element of choice in the government´s response and therefore domestic politics, and the fight to define the response by the various organised interests, always plays a role. Crises are thus critical moments when a new political-economy equilibrium for the country is set:

> History has its points of critical choice, moments of flux when several things might happen but only one actually does. For years afterward, the winning alternative will pre-empt other possibilities, and things will seem more closed. Economic crises create one such set of points of choice. (Gourevitch, 1986: 9–10)

These interests-based coalitions may not be sector-specific. Shifts in the terms of trade of a nation can shift the interests of larger groups across sectors (workers, capital owners, etc.) and lead to a new class or factor-based coalitions (Rogowski, 1989) or across specific sectors according to their competitiveness (Frieden, 1991). Whether these coalitions are narrowly defined by sector or take a broader foundation may in fact be related to the degree of inter-industry factor mobility (Hiscox, 2002), with less advanced economies, where skills transfer is more feasible, more likely to engender class-based coalitions. In fact, an alternative approach to understanding coalition forming has focused on the role of skills. One interpretation suggests that the shared interest of workers and employers in skill acquisition could lead to coalitions among them forming across sectors (Mares, 2003), which could lead to different welfare and employment protection schemes across nations, depending on the distribution of skills in a given economy. An alternative skill-based explanation (Iversen, 2005) places the explanatory power on whether an economy relies on general or more specific skills, with the latter more conducive to creating welfare systems that can protect workers in the riskier situation of acquiring specific skills.

Finally, other strands of work (Alesina and Drazen, 1991) have focused on the study of the mechanisms by which organised interests shape policy decisions with substantial distributional implications. According to this interpretation this process is defined (ibid.: 1170) by a ‘war of attrition’ where each socio-economic group finds it rational to ‘wait each other out’ in trying to shift the burden of stabilization, which only occurs when ‘one group concedes and is forced to bear a disproportionate share of the burden of fiscal adjustment’.

An interest-based approach may prove particularly fruitful in understanding the management of the Spanish crisis. The political economy arrangements that developed out of the transition to democracy were characterised by a deep enmeshing of the public and the private, thus allowing many channels for the interests of the different stakeholders, whether unions, business organizations or representatives of individuals sectors or firms, to influence government policy. Regulated or formerly regulated industries constitute the bulk of the Spanish economy and thus the relationship between many firms and the regulators and the government is deep. Furthermore, the corporatist nature of the Spanish economy that resulted from such political-economy arrangements led to different interest coalitions. Some were across different business sectors, such as those that developed as a result of the housing boom between financial firms, especially the *cajas*, and construction firms. But other coalitions brought together actors from trade unions and business organisations, both of which had an interest in maintaining the system of collective bargaining that gave them both ample social power and economic means.

Partisanship-based political economy

The interests that shape economic policy may be material but also political. Accordingly, partisanship can be a conditioning factor in economic policy-making (Nordhaus, 1975; Hibbs, 1977; Alt, 1985; Weir and Skocpol, 1985; Alesina, 1989; Scharpf, 1987; Boix, 1996, 1998; Garret, 1998; Iversen and Soskice, 2006; Broz, 2013; Galasso, 2014). According to this line of thought it is the interest of political leaders and parties in re-election that helps explain economic policy decisions. This partisanship approach serves as a bridge between interest-based approaches, where some authors have actually located them (Hall, 1997), and ideology-based explanations, which are of course closely related to partisanship.

Alternative interpretations have been put forward in the ample literature that has examined the role of partisanship in shaping economic policy. Nordhaus' (1975) pioneering work on political business cycles, that is, on how political factors determine macroeconomic cycles, attributed decisions on economic policy to pre-electoral considerations. Hibbs (1977) suggested that partisan policymakers (on the left or the right) had different macroeconomic goals along the inflation/full employment axis and that it was these differences that explained variance in economic policy-making. Boix (1996: 347) has also argued persuasively that partisanship determines policy responses, identifying party preferences, as well as the ideas and institutions within which they operate, as the defining variables by which partisanship shapes policy outcomes. Accordingly, social democratic parties would in principle look to increase public spending in order to expand social policies to redress inequality, which would imply higher taxes. By contrast conservative parties would take measures to encourage the workings of the free market, such as a reduction of public spending and taxes. Iversen and Soskice (2006) have shown how electoral systems, a dimension somewhere between institutional and partisanship-based approaches, are crucial in determining the composition of governing coalitions, which in turn explain variance in redistribution. Centre-left governments are more common in proportional representation systems, which redistribute more than majoritarian systems, where centre-right governments dominate.

Other authors have supported the view that partisanship shapes economic policy but with certain qualifications. Alt (1985) has allowed for the importance of partisanship but conditioned by the international economic context, while both Weir and Skocpol (1985) and Scharpf (1987) have framed the margin of action of partisanship in the changing institutional circumstances within which they operate. Alesina (1989) has argued that the impact of partisanship is to be found in the approach to the unemployment / inflation trade-off, claiming that, when elected, social democratic parties tend to focus first on fighting the former, conservatives on the latter. Garret (1998) has focused his work on the intermediating role played by trade unions. Most recently, Galasso (2014), in his analysis of the relationship between political partisanship and structural reforms in the labour, product and financial markets of OECD countries, has concluded that partisanship does indeed matter for structural reform, with right-wing governments more in favour of it. However, he also observes that crises modify partisan behaviour: conservative governments refrain from privatisation and stricter financial regulation, while left-wing parties are more open to privatisation. This willingness to go against their traditional policy positions suggests that ‘during a crisis, these parties may learn the true cost of these non-competitive regulations, and can credibly convey it to their electorate’ (Galasso, 2014: 145). Furthermore, Broz (2013: 75), in his analysis of partisanship in financial cycles, has shown how the partisan character of government is both cause and consequence of financial crises, claiming that there is a ‘partisan-policy financial cycle’ in which right-wing governments preside over financial booms funding credit expansion and asset price appreciation with large current-account deficits.

This literature may be helpful analysing the Spanish crisis in a number of ways. Approaches that highlight how the election cycle influences economic policy may well be particularly suited to explaining why the Spanish government downplayed the effect of the crisis in the run-up to the 2008 general election. Explanations that rely on partisanship factors to explain economic policies aligned with specific centre-left policy preferences, such as high public spending or low unemployment, even at the risk of inflation or the generation of a housing bubble, may also prove to be a useful prism through which to understand the actions of the PSOE government. Finally, approaches that predict more openness by centre-left governments to liberal policies and reform in times of crisis may of course be relevant in explaining the apparent contradiction between the PSOE´s traditional support for high levels of public spending and the austerity drive it put in place from May 2010.

Ideational political economy

Ideas, culture and ideology can also influence economic policy (Katzenstein, 1985; Hall, 1989; Fligstein, 1990; Sikking, 1991; Sabel, 1995; McNamara, 1998; Berman, 2006; Jabko, 2006; MacKenzie, 2006; Blyth, 2009, 2013). An early application of such an approach was the suggestion that ideology explained why smaller, and in principle more vulnerable European economies, came out better from the 1970s crisis with reference to how they shared an ideology of social partnership that made it easier to make the necessary adjustments (Katzenstein, 1985). More recent approaches that privilege the role of ideas claim they can do so in at least two ways (Blyth, 2009: 210).

Firstly, ideas are said to be of substantive instrumental influence in shaping economic policy in so far as agents use ideas and ideological constructs to realise their interests. On this interpretation, epistemic communities play a vital role in defining economic policy and the dominant ideas within a given professional group are essential to explaining the choice of policies (Hall, 1989; Fligstein, 1990; Sikkink, 1991). In the context of European integration such approaches have been used to suggest, for example, an alleged neoliberal bias in the original construction of EMU, which would have been the result of the predominance of neoliberal ideas among economists and policy-makers responsible for its design (McNamara, 1998). Blyth (2013) has also adopted an interest-based ideational argument to explain the framing of the crisis as one caused by sovereign debt and thus the privileging of austerity as a remedy despite ample evidence of its counterproductive impact.

Some interpretations have taken this ideational approach further and suggested that, once deployed, ideas can actually take the interests at the service of which they were initially deployed in different directions. Berman (2006) and Blyth (2009) have reasoned in such a manner in their attempt to explain the different political and institutional outcomes that resulted out of the Great Depression. More relevant to this dissertation, Jabko (2006) has deployed such a line of argument to account for the EU´s institutional design, focusing on the role of the European Commission, a weak actor which, nevertheless, as transmitter of a set of ideas privileging market liberalism, was able to create a momentum for an integrationist outcome which superseded the interests of the actors on behalf of whom it has originally set out to work.

A second set of ideational approaches goes beyond an instrumental understanding of the role of ideas and suggests that these can be the main forces behind economic policies and not just mediating factors for pre-existent material interests of actors or the path dependency created by institutions. On this interpretation, ideas not only describe the context within which firms and states operate but in fact help create the kind of assumptions that they predicate. The work of MacKenzie (2006) on the financial sector is an example of such an approach, suggesting that development of a financial idea such as the Black-

Scholes valuation model and its deployment by market agents to an increasing number of asset classes ended up altering pricing patterns in such a way that made reality fit the stylized model. Going further down this line of argument, other authors (Johnson, 1994; Ziegler, 1997; Sabel, 1995) have argued that ideas and culture should be considered the primary cause of economic outcomes since they underlie the systems upon which all individual and social action takes place, including economic ones.

An ideational approach may be of value in helping understand certain episodes of the management of the Spanish crisis. A number of issues are difficult to explain without reference to the centre-left ideological preferences held by President Zapatero and some of his key ministers: the resistance to liberalisation in the labour market despite ample pressure from domestic and external sources to allow it; the reluctance to institute structural reforms in areas requiring an increase in competition, which can be traced back to the PSOE´s and in particular President Zapatero´s belief in the role of an active state in the management of the economy and in the public/private social dialogue that had characterised the PSOE´s approach to industrial relations; or the eagerness to adopt a large fiscal stimulus, even at the risk of running a significant deficit. An ideational approach may also be useful in explaining aspects of the crisis beyond the attitudes of the Socialist government. For example, ideational approaches that privilege the explanatory power of the role played by epistemic communities in advancing particular ideas may be suited to explaining the role of the Bank of Spain, the staff of which has traditionally held quasi-hegemonic power in the development of economic ideas in the nation. Finally, an ideational approach may of course be particularly relevant in explaining the framing of the euro crisis as one of excessive public spending in the European periphery and privileging the idea of austerity as the preferred policy path for these states, including Spain.

In sum, the discipline of comparative political economy offers a rich set of domestic political factors that may help to guide an understanding of Spanish economic policy-making in the management of the crisis. An institutional approach may help explain the role of key institutions such as those of political economy that govern areas like industrial relations and corporate governance, as well as others such as Parliament and the electoral system or the Bank of Spain. Yet such an approach may not be able to capture the interests of key actors, whether material or political, an aspect for which interest-based and partisanship-based approaches may prove more fruitful. In turn these interests are shaped by ideological preferences held by policy-makers as well as by other stakeholders such as trade unions or the business elite, and ideational approaches may be useful to filling this gap. This set of variables and the differences between them will be used to frame the dissertation´s empirical analysis and its findings will allow us to consider in the Conclusion whether the Spanish case supports the predictive assumptions of these different research agendas.

1.4. Methodology and chapter structure

This dissertation employs a qualitative research approach, relying on both primary and secondary sources. The primary research techniques used are those of process tracing and elite interviewing. Among the various research techniques at the disposal of qualitative researchers (King et al., 1994; Brady and Collier, 2010) these two are deemed the most appropriate for this research project. Process tracing is especially useful for qualitative research projects in the social sciences where the goal is to obtain information about well-defined and specific events and processes (George and Bennett, 2005), as is the case with this dissertation. Elite interviews are often the most suitable method for policy process tracing research, as they offer researchers a rich vehicle for obtaining unique data from ideally placed interviewees with which to investigate the complexities of policy and politics (Dexter, 1970). They also offer a chance to obtain information on the policy decision-making process and rationale which can be critical to explaining political economy developments and which would otherwise be difficult to get. As Beamer (2002: 87) explains when referring to elite interviewees:

> These individuals may have special insight into the causal process of politics and interviewing them permits in-depth exploration of specific policies and political issues.

This objective also guides the sampling process, since the choice of interviewees should have as its goal obtaining information from the subjects best positioned to analyse the phenomenon at hand. Such an approach to sampling and investigation is consciously not probabilistic in nature, but rather aims to identify the best-placed individuals to help make causal observations that can explain the phenomenon studied. As Tansey (2007: 765) has put it:

> The most appropriate sampling procedures are thus those that identify the key political actors, those who have had the most involvement with the processes of interest. The aim is not to draw a representative sample of a larger population of political actors that can be used as the basis to make generalizations about the full population, but to draw a sample that includes the most important political players who have participated in the political events being studied.

The choice of interviewees for this dissertation was guided by such an approach. The dissertation is based on extensive in-depth interviews with twenty-four senior government officials and policy makers at the highest level of government. These officials were selected because they were the key protagonists in the management of the crisis or were in a privileged position from which to observe it. With the exception of the President, who was not available for interview, the most senior policymakers in all the key departments involved in the management of the crisis have all been interviewed. These include the ministers of all the ministries closely involved in the management of the crisis, many of the secretaries of state in those ministries and senior officials in other relevant institutions, such as the President´s Office, the President´s Economic Office and the Bank of Spain. Because of the seniority of these officials, the fact some of them are still active in politics, and the sensitivity of the issues discussed, it was agreed their responses would be reported anonymously.

A number of methods exist to ensure the reliability of the data obtained in this type of interviews (Beamer, 2002: 939). Firstly, newspaper articles, legislative records and other similar sources can be useful to ensuring that the interviewees' answers are factually accurate. Secondly, responses to similar questions can be compared to detect inconsistencies. Similarly, if various interviewees provide similar answers to a question it can be seen as a probable indication of the respondents' accuracy.

The dissertation will follow these methods. In general, an evidence-based empirical claim will be made if at least two separate sources that are deemed trust worthy on the issue have corroborated it. Besides the interviews with senior government officials, the dissertation relies on other materials such as legislative records from the Spanish Parliament and EU institutions, newspaper articles, speeches and press conferences from Spanish and European officials, as well as data sets and reports from the Spanish Ministry of Economy Finance, the Bank of Spain, the Spanish National Statistics Institute (*Instituto Nacional de Estadística* [INE]) or the National Sociological Research Centre (*Centro de Investigaciones Sociológicas* [CIS]), as well as from international organisations, such as the IMF, the OECD or the Statistical Office of the European Union (Eurostat).

The project´s research design, following the definition of the research question and the consideration of the broad theoretical debate within which the dissertation places itself, consisted of the following steps. Firstly, it was necessary to define the key episodes along which the account of the crisis and its origins could be structured. Secondly, a set of issues and questions were determined to help understand how these various episodes were managed. Thirdly, extensive interviews were conducted orally, using unstructured interview guides that covered all of the main topics but offered the flexibility to gather the most valuable information from each senior official. Fourthly, the information was classified chronologically along the key episodes previously identified. Fifthly, the answers were assessed for possible contradictions and to ensure their veracity as far as possible, employing the methods described above. Sixthly, the findings were analysed. And seventhly, an account of the management of the crisis and its immediate origins was elaborated and conclusions gathered with relation to the research question. The final output of the dissertation is an analytical account that reconstructs the key episodes that defined the management of the crisis and its immediate origins and illuminates the factors that shaped it, helping understand what was going on in the *black box* of the government´s response to the crisis.

In order to conduct this exercise, the dissertation is structured in six chapters. Following the present Introduction, Chapters 2, 3, 4 and 5 conform the empirical core of the dissertation, offering a chronologically organised account of the management of the crisis and its immediate origins informed by the outcome of the interviews. Chapter 2 analyses the actions of the government in the period immediately prior to the crisis and examines the reasons for its apparent inaction when faced with mounting economic imbalances. Chapter 3 provides an informed explanation of the decisions taken by policy-makers from the onset of the financial and economic crises in 2007 until May 2010, a period characterized first by the downplaying of the crisis and then by a reaction based on fiscal stimuli and some early structural reforms, but always preserving social policies. Chapter 4 analyses the management of the crisis from May 2010, when the spread of concerns about Greece ignited the euro crisis and forced the Spanish government to adopt a U-turn and start implementing unpopular austerity policies and more substantial structural reforms. Finally, Chapter 5 covers the management of the crisis during the second phase of the euro crisis up to the end of the Socialist government´s time in office in December 2011. The concluding chapter summarises the empirical findings and draws the relevant conclusions, developing a domestic political perspective of the management of the crisis in Spain that identifies the key factors and mechanisms at play. It concludes by considering the relevance of these findings for the research agendas identified in this Introduction and suggests how they can help advance future research on the subject and on related theoretical and empirical agendas.

Chapter 2. Inaction

(*March 2004 to August 2007)*

2.1. Introduction

This chapter analyses the role of domestic political factors in the management of Spain´s main economic imbalances prior to the crisis. While the main objective of the dissertation is to study domestic politics during the crisis rather than its origins, it is useful, for at least two reasons, to explore the years up to the crisis. Firstly, many of the factors that shaped the management of the crisis were already present in, indeed emanated from, these early stages. And secondly, it provides early illustrations of economic policies and decisions that were shaped by domestic political factors. In so doing the chapter serves as a transition between analysis of the origins of the crisis and that of its management.

Two caveats are, however, necessary. Firstly, this chapter will concentrate on the study of domestic factors and will only consider the role played by external constraints in so far as what has already been explored in the previous chapter. The external context in the years before the crisis was relatively benign: there was little direct pressure from external agents, either investors or other governments, on the Spanish government to act in a given way.

Secondly, this chapter will not attempt a detailed study of all the complexities of the relationship between economic and political factors during these years, as the main focus of the dissertation is the management of the crisis and not the years prior to it. Nor will it aim to explore in detail whether Spain´s putative political deficiencies, with all their institutional complexities, caused the economic crisis or vice-versa. It will limit itself to the analysis of the specific issue of the role played by the Spanish Socialist Workers' Party´s (*Partido Socialista Obrero Español* [PSOE]) government in the management of the economy during these years. In particular, it will explore why some key economic imbalances were managed as they were, and whether domestic political factors played a significant role.

2.2. Management of the economic imbalances

The management of four issues in particular merits analysis, since they were significant economic problems that had been clearly identified but where action was not taken, and which help throw some light on the PSOE government´s approach to economic management. These four issues were the housing bubble, the credit boom and associated current account deficit and high levels of private debt, the dysfunctional labour market and the absence of reforms to change Spain´s growth model from one based on low productivity and competitiveness towards high productivity tasks and sectors. The problems afflicting the financial sector, one of defining factors of the Spanish crisis, are not discussed in this section, as they were, for the most part, not particularly salient prior to 2007, but developed during the crisis. They are therefore discussed in the next two chapters.

2.2.1. Credit boom, current account deficit and high private debt

The most noticeable imbalance that Spain displayed in the run-up to the crisis was probably its massive current account deficit, which reached almost 11 per cent of GDP in 2007 (Statistical Office of the European Union (Eurostat), 2014). This deficit was at least in part the direct consequence of the monetary shock entailed by Spain´s accession to the euro. International financial markets reacted to the European Monetary Union (EMU) by reducing the perceived risk of all member states, including the euro zone periphery, which brought about a substantial reduction in interest rates in Spain among other members (Pisani-Ferry and Posen, 2009: 9). As described in the literature review, some interpretations (Hopkins, 2013, 2015; Bastasín, 2012) have placed responsibility for the massive capital inflows that Spain experienced not on EMU´s institutional flaws but on the inability (or unwillingness) of Germany and other northern European states more responsibly to control their capital outflows and the lending of their banks. In any case, the large capital inflows set the stage for the remarkable increase in the country´s current account deficit and private debt, most of it externally financed.

By 2007 household debt had reached 86 per cent of GDP and total private debt (household, corporate and financial) 378 per cent of GDP (Haver Analytics, 2013).

Restricting the flow of credit within a monetary union is not easy. Spain was caught in what Shoenmaker (2011) has called 'the financial *trilemma*': it is impossible to achieve financial stability, integration and national financial policies all at the same time. Yet, as officials in the Ministry of Economy and Finance have acknowledged,[3] more could have been done, or at least attempted, to stem the growth of credit. Even if the Bank of Spain could not set interest rates, signals could have been sent to economic agents showing more forcefully the government´s concerns at excessive credit lending and its willingness to take measures to deal with the housing bubble. Measures such as the scrapping of tax credits for mortgage repayments, raising taxes to stem consumption or tightening financial regulation to nudge banks toward restricting credit, were all within the government´s reach.

Given that the signs of a credit bubble were increasingly apparent and the economic consequences this could bring about were well known from experience, it is pertinent to ask why the government did not act. As a senior figure in the Ministry of Economy and Finance acknowledged:[4] 'we all knew that this massive expansion had to come to an end at some point and the failure to act was clearly reflective of a lack of political will'. From the interviews conducted a number of factors seem to stand out when trying to explain why.

The first was the failure of Spanish policymakers to understand the implications of EMU. This is of course an issue that was not peculiar to Spain, yet in so far as it points to the technical ability or lack thereof of Spain´s decision-makers and their advisers, it can certainly be considered a key domestic political determinant. There was among economic policy-makers in Spain, as acknowledged by a senior member of the President´s economic team:[5]

[3] Research interviews.
[4] Research interview.
[5] Research interview.

> A lack of understanding of how debt and current account deficits would affect a member of the euro zone; some economists argued that, being part of EMU, current account deficits no longer mattered.

The failure to appreciate the implications of EMU, which was in the words of this official 'a once-in-a-lifetime monetary shock', was behind both increased private indebtedness and the current account deficit. On the latter, often an early indicator of a crisis, policy-makers clearly relaxed their concern once Spain entered EMU.[6] A high-ranking official of the Ministry of Economy and Finance witnessed the prevalence of such sanguine attitudes among government officials:[7]

> In so far as they represented a lack of financing, current account deficits could not lead to a sudden stop, given our membership of EMU. In the same way that no one really knows what is the current account deficit between California and Florida, many thought that things in EMU would work the same way.

Yet the crisis showed that that was obviously not the case. This relaxed attitude extended to the high level of private debt. While the increase in the indebtedness of individuals and corporations was impossible to miss, Spanish policy-makers were hoping,[8] according to a senior official at the Ministry of Economy and Finance, that this process was a natural consequence of EMU membership (Pisani-Ferry, 2011; Eichengreen, 2012) that markets would tolerate. As a result of being in a framework where the economies were more stable, so the thinking went, there were fewer macroeconomic risks. Interest rates were lower and it was therefore possible to borrow more. It is symptomatic of how pervasive this attitude was within the government that even Pedro Solbes, the Vice-President and Minister of Economy and Finance and former European Commission Vice-President, did not foresee the implications of EMU. In his memoirs (Solbes, 2013: 348) Mr Solbes accepts that at first he was not overly concerned by the first episodes of the subprime crisis in the US in the summer of 2007. Mr Solbes was, however, not alone in this attitude. A senior economic advisor to President Zapatero recalled:[9]

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6 Research interview.
7 Research interview.
8 Research interview.
9 Research interview.

> What we thought was that, in a financial system structured around the euro as a single currency, where capital is free to move and where there are excess savings, we would not experience a shortage of financing. We were relatively relaxed about our high current account deficit; we did not give it too much importance (…). The second question was: will we have access to credit? And we thought, well if there is an excess of savings in the euro zone and we have freedom of movement of capital, we should be able to. No one at that time thought there would be a renationalization of credit as we would start to see in 2008.

These difficulties in assessing the potential implications of the credit bubble were behind a second political factor that seems to have acted as an obstacle to action: the disagreement and division within the cabinet between those who thought action was justified in order to avoid a hard landing, and those who thought such a hard landing was unlikely and was therefore not worth the political cost the measures would entail. Unsurprisingly, each party placed emphasis differently. Senior officials at the Ministry of Economy and Finance[10] claim to have warned the President about the danger signals piling up and to have advised him to take precautionary measures. However, other ministers and senior political advisors to the President claim Mr Solbes and the Ministry´s team ignored the dangers of the credit boom and failed to take action. In any case it seems beyond doubt that the President was himself optimistic and little worried about a hard landing, a view confirmed by two of his closest advisors.[11]

The attitude of the President towards the credit boom was also conditioned by electoral worries, as many of the measures required to reduce the credit flow would have been unpopular. One of the most effective, constantly pointed to by economists and international financial institutions, was the scrapping of the tax deduction for first-residence mortgage repayments. Yet such a measure was hugely unpopular with voters. PSOE party officials and the more political of cabinet ministers feared the negative reaction of public opinion and advised the President against it.[12]

[10] Research interviews.
[11] Research interviews.
[12] Research interviews.

The party was not the only organised interest to lobby against more determined action to stop the flow of easy credit. The financial sector was of course very active in this respect as well. The housing bubble and the consumption credit boom were significant sources of profit for the sector through the financing of construction companies, mortgages and consumer loans (Fernández-Villaverde et al., 2010; Carballo-Cruz, 2011). Furthermore, banks in Spain were already being subjected to counter-cyclical provisions, unique in the EU, so they were resistant to further measures that would affect their competitiveness. Executives in the financial sector knew that such a level of credit expansion was unsustainable but were of course keen to reap the profits for as long as possible. As explained in Chapter 1, the *cajas* were particularly vulnerable given their exposure to the housing sector. They discretely lobbied the government, and directly the President, advising against taking any serious measures, raising the risk of financial stability. Various members of government[13] pointed to one person in particular as particularly influential in this respect: Mr Botin, the head of Banco de Santander, who had direct access to the President.

The key to the effectiveness of such pressure was, various government sources recalled,[14] the banks' constant claim to have reached a point of no return and that trying to burst the credit bubble would be too destabilising. One of the ministers in Zapatero´s government put it in graphic terms when he asserted:[15] 'The banks have you in their claws, so to speak, and that certainly greatly conditioned our response'. This is why pressure came much more from the banks than from construction companies, he added: 'construction companies could be allowed to fail, but the biggest risk was the collapse of part of the financial establishment'.

Anecdotal evidence of this climate of *looking the other way* came, for example, when, as early as 2003, an article (Ayuso et al., 2003: 65) in the *Boletín Económico del Banco de España,* the Bank of Spain´s prestigious economics bulletin, warned that property prices could be overvalued by between 10 and 25 per cent. The article was criticised by the Minister for the Economy in the *Partido*

[13] Research interviews.
[14] Research interviews.
[15] Research interview.

Popular (PP) conservative government, Rodrigo Rato, accusing the authors of exaggeration (De Barrón, 2011). Behind this criticism was, according to a senior Socialist figure,[16] the pressure of the financial sector. To talk of a bubble at the time was, he says, 'taboo'.

Another area where more forceful government intervention would have been possible to deal with excessive credit was in improving the highly-politicised corporate governance of the *cajas de ahorros* (Royo, 2013; Fernández-Villaverde et al., 2013; Santos, 2014), the regional saving banks behind a lot of the excessive and bad-quality credit to housing and construction. But politics again proved an impossible hurdle, as all political parties were represented on the *caja*s' boards and benefited from them, not least in ensuring that credit was available for popular projects that would grant political dividends, as a senior member of the PSOE government familiar with the workings of the *cajas* admitted.[17]

The pressure on the *cajas* to provide credit came not only from politicians but also from unexpected quarters. An interviewee recalled[18] hearing executives from these institutions say, at the height of the bubble, that the Bank of Spain was encouraging them to provide more mortgages and loans to developers, as it was important for them to grow into bigger entities and the only way of extending their balance sheet was through lending to the property sector. Although it is true that the small size of many of these *cajas* and the fragmented nature of the sector was a constant worry to Spanish banking regulators, it is difficult to see that such a call to enlarge their balance sheets would have been allowed without political acquiescence at the highest level of the Bank of Spain, something that one of the highest ranking officials at the Ministry of Economy and Finance admitted.[19]

In this and other respects, not least its failure to be more forceful in its regulatory and supervisory capacity, the role played by the Bank of Spain has been widely criticised, with one well-placed member of the President´s Office harbouring no

16 Research interview.
17 Research interview.
18 Research interview.
19 Research interview.

doubts that 'the Bank of Spain fed the property bubble'.[20] The ideological collusion of the Bank of Spain with the more orthodox elements of Spain´s economic and financial world has also been analysed in the previous chapter from a more academic angle (Fishman, 2012) and has been the subject of various journalistic investigations.[21] Although it is clear with hindsight that a credit bubble did take shape under the surveillance of the Bank of Spain, and that its regulatory and supervisory capacities would have allowed the Bank to act more decisively to try to stop it, it is of course also true that monetary policy was no longer the responsibility of the Bank. Furthermore, the Bank was not alone in its complacency. Defending the actions of the Bank during this period, one of its most senior officials[22] pointed to a May 2006 International Monetary Fund (IMF) report on the Spanish financial system (IMF, 2006) which argued that the Spanish financial system was well positioned to absorb any potential credit shock.

In sum, it seems clear that it was not only the low interest rates or freedom of movement of capital associated with EMU that led to the credit boom in Spain. Domestic political factors contributed significantly to it too. A poor understanding of the workings of EMU, divisions within the cabinet as to the likelihood of a hard landing and the need for precautionary measures, an unwillingness to face up to the pressure of the financial sector to stem the flow of credit, the politically-driven supervisory failures at the Bank of Spain or the politicised governance of the *cajas de ahorros*, were all factors that were crucial in allowing the credit boom and current account deficit to develop.

2.2.2. The housing bubble

The worst effect of this massive credit expansion was the housing bubble that Spain experienced in the years before the crisis. According to data from the Bank of Spain (*Banco de España,* 2010), house prices grew at an annual rate of 13.7 per cent between 2000 and 2003 and of over 8 per cent between 2004 and 2008,

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[20] Research interview
[21] See for example De Barrón, 2011.
[22] Research interview.

when investment in the housing sector grew over 7 per cent annually. 75 per cent of all funds obtained by the financial sector were channelled to the construction sector, and 52 per cent of all banking assets were in the property sector. Mortgage lending reached growth rates of 30 per cent and an average of 20 per cent between 2000 and 2007. The contribution of the construction sector to Gross Value Added (GVA) in 2007 amounted to 12.3 per cent of GDP.

The causes of the housing bubble were briefly discussed in the previous chapter (Carballo-Cruz, 2011; Fernández-Villaverde et al., 2013; Solé-Ollé and Viladecans-Marsal, 2013) and cannot here be covered in detail. Suffice it to say that it was fed not only by cheap credit but also by the poor design of urban zoning laws, the decentralisation process (Daly and Zarco, 2015; Fernández-Villaverde et al., 2013), the role of the *cajas* (Ruiz et al., 2015) and counterproductive tax incentives. In any case, the possible overheating of the housing sector was already a matter of concern by the time the PSOE reached government in 2004. In fact, the need to tackle a possible housing bubble was included in the PSOE´s economic manifesto for the 2004 general election (PSOE, 2004). This concern continued during the first Socialist term, yet, as a senior official in the President´s Economic Office acknowledged,[23] it was systematically ignored, an omission symptomatic of the lack of willingness to undertake the necessary reforms. In fact, within months of arriving in office, the government's discourse had changed, according to a senior official in the President´s Economic Office,[24] from one of 'puncturing the bubble' to one of 'riding the bubble to change the economic model' and using the revenues the bubble generated to invest in research and development and other measures to shift the economy to higher valued-added sectors. The public warnings of senior officials, including the then Deputy Minister for Economy and Finance and later Governor of the Bank of Spain, Miguel Ángel Fernández Ordóñez,[25] were systematically ignored.

The question is then why a problem that experts both at home and abroad had had clearly identified (IMF, 2006) was not addressed. The potential electoral cost

[23] Research interview.
[24] Research interview.
[25] Research interviews.

of the unpopular measures required to puncture the bubble was a principal reason for the change in discourse and policy. Representatives of both the Ministry of Economy and Finance and the President´s Economic Office have acknowledged[26] that the scrapping of the tax deduction for primary residence mortgages, one of the most important measures that would have been required to address the housing bubble, was not implemented mainly because of the electoral cost it would have entailed. This potential electoral cost of acting to dampen the growth in the housing market was made worse by the fact that the construction bubble benefited, at least in the short term, a large segment of society. It did so in two ways. Firstly, through an increase in the stock of wealth, since Spain has a high house ownership ratio and thus the increase in value of housing assets benefitted a significant proportion of the population, either directly through the sale of property or at least through the 'wealth effect' of increased valuations. And, secondly, it boosted employment. According to figures provided by Valeriano Gómez, Minister of Labour in the last two years of the Socialist government,[27] employment in the construction sector went from 800,000 in 1984 to 2.7 million in 2010, when, according to analysis conducted by his department, the 'natural' level of employment in the sector should have been no more than 900,000. In 2005 Spain added, in just one year, 900,000 new employees, most of them in the construction sector.

Another reason for the resistance to pricking the housing bubble was that the tax revenue created by the bubble was paying for the social policies the Socialists had pledged in their manifesto and securing a high level of support among the electorate. The increase in property construction and transactions generated significant tax revenue both at local level through property taxes and at national level through corporate tax on the profits of developers and construction firms and income tax on their hundreds of thousands of new employees (Fernández-Villaverde and Rubio- Ramirez, 2009). As a high-ranking official in the Ministry of

[26] Research interviews.
[27] Research interview.

Economy and Finance acknowledged:[28] 'in the short term the housing bubble was very good for the public coffers'.

These positives side effects of the bubble led to an undue optimism and lack of caution among policy-makers that characterised the management of the economy in these pre-crisis years. This optimism was well on display when, as employment figures started to turn sour in the third quarter of 2007, members of the government would question the official figures claiming that the National Statistics Institute (*Instituto Nacional de Estadística* [INE]) was not properly capturing all existing employment.[29] It was this optimism that also partially explains why the government did not to pursue a more counter-cyclical policy during the first term to try to reduce the housing bubble and instead adopted pro-cyclical measures such as the reduction in tax rates or, as a government minister self-critically acknowledges, the lowering of national insurance contributions. In his own words:[30]

> Economic policy-makers may sound prudent in their public statements, but are quite happy to see the public coffers fill up when employment and tax intakes are at record high.

Even the Ministry of Economy and Finance and the Bank of Spain, traditionally seen as the guarantors of financial stability and therefore inclined to greater prudence, shared this optimism, which was fuelled in part by absence at the time of any significant external pressure to act. Maybe because of the high economic growth rates, and beyond recommendations for some limited policy changes like that discussed above regarding the residential mortgage tax deduction, the housing bubble was not an issue to which, at that stage, international financial institutions attached great importance, claimed a senior member of the President´s Economic Office:[31]

> I don´t recall their ever raising any excessive concern about the bubble, probably because they thought the regulation of the Bank of Spain would

[28] Research interviews.
[29] Research interview.
[30] Research interview.
[31] Research interview.

> eventually take care of it. Neither the international financial institutions, nor the regulators, nor the political establishment were conscious of the problems that the internal disequilibria could cause for Spain. It is true that international organisations were warning of the problems, but the problem was knowing when and how and with what probability these disequilibria would lead to disruptions in the macro financial stability.

This attitude was supported by the Bank of Spain´s own analysis. The Bank´s January 2004 Economic Bulletin (*Boletín Económico)* ruled out the existence of a housing bubble and talked positively of the increase in the valuation of housing assets, as a factor contributing to the 'overall healthy state' of household finances (*Banco de España*, 2004: 13). Furthermore, according to Miguel Sebastian, one of the President´s closest economic advisors, the Bank´s top brass denied the existence of a housing bubble in a private conversation with Zapatero in 2004 while the PSOE was still in opposition (Sebastian, 2015).

Key in explaining the government´s behaviour was also the opposition of different political actors to dealing with the excesses of the construction bubble. One such source of pressure could be found in the regional governments, which had little interest in reducing the investments in infrastructure and construction that were generating so many local jobs, as confirmed by senior PSOE regional leaders.[32] The pressure of regional and local governments was especially strong from those controlled by the Socialists, given the important role that the PSOE structure has traditionally given to its regional leaders, according to an official at the President´s Economic Office who witnessed these pressures first-hand.[33] Together the party and the *cajas de ahorros* served as the main mechanism of transmission for this pressure (Santos, 2014; Fernández-Villaverde et al., 2013), given the highly politicised nature of their boards.

Pressure on government officials was coming not only from the party or regional governments, but also from organised industry interests, most notably the banking sector. According to even one of the government´s most liberal ministers,[34] banks were constantly warning government officials, in public and in private, that a

[32] Research interviews.
[33] Research interview.
[34] Research interview.

reduction in the price of property assets would gravely harm their balance sheets, which would cause them to close the flow of credit and lead to a recession.

The fear of possible financial instability was compounded by the uncertainty about other disruptive effects that measures to prick the bubble could have. The impact of a sudden burst of the bubble on economic growth, employment and fiscal revenue was unknown but likely to be more than politicians without an urgent need to undertake them were willing to risk. As an official in the Bank of Spain and former senior member of the President´s Economic office acknowledged:[35] ‘it is always more difficult to undertake serious reforms when times are good and it is difficult to predict the impact they will have’.

In conclusion, domestic political factors seem to have played a crucial role in the management of the housing bubble before the crisis. The electoral cost of the unpopular measures that would have been required, the influence of the PSOE, especially its regional leaders, the lobbying efforts of the financial sector and the unwillingness to compromise the tax revenue it generated to pay for social services, were all factors that weighed heavily on the government and go a long way in explaining why no more forceful action was taken to dampen the overheated housing sector. As a leading figure of the PSOE´s economic team during this first term said when referring to the relevance of these political factors in not dealing more forcefully with the bubble:[36] ‘Once in government you see all of the benefits and are painfully aware of the costs. And, if no one is pressuring to act on it, why pay the price?’

2.2.3. A dysfunctional labour market

A third issue which merits attention is the labour market. Even before the advent of the crisis Spain had for decades suffered chronic unemployment problems. That in 2008, after twelve years of continuous growth, unemployment was, and

[35] Research interview.
[36] Research interview.

had never been below, 8 per cent is clearly symptomatic of a serious problem in Spain´s job market. While Spain´s economy, geared to low-productivity sectors and incapable of generating resilient employment in high-value added sectors, was certainly a key factor explaining the country´s dismal employment record, Spain´s labour laws and institutions were also deeply dysfunctional and conducive to chronically high unemployment. The collective bargaining system added to the labour market´s inefficiencies, as it was conducted at provincial/sectorial level, which was not efficient in capturing either micro or macroeconomic change, as well as feeding inflation, another of Spain´s chronic problems (Bentolila et al., 2012a, 2012b; Jaumotte and Morsy, 2012).

For these reasons reform of the labour market had been on the agenda of all governments since the transition to democracy and the goal of most of these policies was to increase flexibility. One of the most relevant changes was the promotion of temporary contracts (not part-time but full-time short-term contracts), which accounted for 33 per cent of all contracts between 1998 and 2007 in Spain, compared with just 15 per cent in the euro area (Organisation for Economic Cooperation and Development (OECD), 2010a). As argued by Bentolila et al. (2012), creating a two-tier labour market was a politically viable way of introducing flexibility when resistance of unions was strong, a strategy followed by both conservative and progressive governments. This however created a dual labour market-place with a corrosive insider/outsider dynamic, where young new entrants to the job market were mainly employed through temporary contracts with very low levels of job security while older employees were protected by the high security provided by their indefinite contracts negotiated under the umbrella of collective bargaining.

Despite the high flexibility expected from these policies, the reality is that the Spanish labour market performed very poorly both before and during the crisis. Bentolila et al. (2012) argue that although temporary contracts promote job creation during expansionary economic periods, they also increase job destruction during downward economic cycles. They concluded that a directly relevant part of the poor performance of the Spanish labour market can be explained by the generalised use of this kind of contract and in particular by the lax regulation on their use and the large gap in firing costs between permanent and temporary workers (Betolila et al., 2012: 184). According to other analysts (Fishman, 2012; Dubin, 2012) this corrosive duality of the labour market is the result of the continuous push for liberalisation and flexibility that, despite its poor record, has characterised all attempts at labour market reform in the last three decades. According to this interpretation these reforms were driven as much by an economic rationale as by an ideological conservative bias.[37]

In any case, failure to undertake a comprehensive reform of labour legislation was one of the main criticisms levelled at the government by most economists and it had, well before the crisis, become a sign to international investors of a lack of resolve to fix the country´s economic problems (Schmieding, 2008). There was therefore clear economic reason as well as pressure from international economic institutions and investors to act in this direction, and yet it did not happen. There are a number of reasons for this.

Firstly, there was a clear political commitment by the President and his Minister of Labour and close ally, Jesús Caldera, to protect workers´ rights against the liberalising labour reform demanded by the business community and international institutions, which advocated increasing flexibility and limiting labour rights. This commitment was grounded on three political factors: electoral considerations, ideological preferences and the strong ties of the PSOE and many members of the government, including the President himself, with the trade unions. These factors will be explored in more detail when the labour reform of 2010 is analysed in the next chapter but, in so far as they were already at play at this early stage, it is necessary at least to introduce them at this point.

As explained above, Spanish labour legislation is characterised by high levels of protection for permanent contracts (Bentolila et al., 2012). Any attempt to reduce this protection, by lowering dismissal compensation or making it easier to dismiss employees, has traditionally been extremely toxic politically, leading in the past to

[37] Dubin (2012) has discussed in detail how reforms of the welfare state and especially the labour market were driven by 'neoliberal' principles and policies.

various general strikes. It is therefore not surprising that the Socialist government did not entertain such a reform at a time when Spain had reached its lowest level of unemployment in recent history and there seemed to be little urgent need for it.

Reluctance to increase the flexibility of the labour market by lowering workers' rights was not only a political calculation for President Zapatero and Minister Caldera and his team at the Ministry of Labour, but also an ideological commitment. In interviews for this project, a senior official at the Ministry of Labour[38] acknowledged that President Zapatero and Minister Caldera were both clear that, under their watch, worker´s rights were not going to be diminished: 'it was a principle'. Of course, this ideological stand was backed by an analysis of the origins of Spain´s labour ills, that, contrary to what the business community and international investors argued, claimed that the problem of the labour market had less to do with dysfunctional norms than with a business culture that refused to behave in a responsible manner and abused the legislative framework resulting in an epidemic of temporary work that undermined productivity.

In defence of this view one may note that public expenditure in unemployment subsidies barely fell despite the dramatic decrease in unemployment during the high-growth period, a fact that senior officials at the Ministry of Labour ascribed to the 'spurious use of labour protection mechanisms'[39] and abuse of the legislation by employers. As an example he cited the fact that up to 500,000 workers were, each week, 'dismissed on a Friday and rehired on a Monday'[40] in order to keep them under temporary contracts and benefit from public incentives. The 750,000 illegally working immigrants the Ministry´s 'immigration amnesty' disclosed also evidenced, according to this view, employers' lack of respect for labour legislation. This is the reason why the Socialist labour reform of 2006, which Mr Caldera sponsored, centred not on changing the labour legislation to deal with issues identified by the business community (rigidity, excessive dismissal costs and burdensome collective bargaining) but on trying to foster stable employment by trying to reduce the abuse of temporary employment mechanisms. That this

[38] Research interview.
[39] Research interview.
[40] Research interview.

interpretation of the ills of the labour market was not just an ideological stance taken personally by Mr Caldera but that it pervaded the Ministry of Labour, which was the department tasked with its reform, is given further support by his views' being shared by Valeriano Gómez, Caldera´s deputy and himself Minister of Labour from 2010 to 2011.[41] It is therefore clear that there was a nucleus of high government officials in ideological opposition to further liberalisation of the labour market who were close to the President and influential in blocking further reform. That successive labour ministers ascribed the labour market ills, not to regulation, but to a corrosive business culture is not only quite remarkable but also a clear example of the significant impact of ideological and personal political views in the government´s approach to reforming the labour market in the years leading up to the crisis.

Needless to say, this view was well aligned with that of the trade unions. The extent and nature of their influence on government policy and, in particular, their ascendancy over President Zapatero, has long been a matter of dispute and will be considered more closely in the next chapter. Suffice it at this stage to say that a minister of labour in Zapatero´s government acknowledged[42] that the trade unions 'did have a lot of influence' in the government, but he saw this as a positive factor since, he claimed, trade unions had been a responsible partner in the past, helping achieve wage moderation when needed, a view that has been defended also by more impartial observers (Hopkins, 2015). According to various officials close to him,[43] President Zapatero agreed with the perspective the unions and Mr Caldera took of the ills of the labour market and that reform should be orientated not to increase flexibility but to close loopholes and discourage employers' abuse. And he did so, according to these accounts,[44] out of both 'ideological conviction and willingness to find consensus with the unions'. It was, one of these officials said,[45] a clear party line: 'no one in the PSOE would have conceived of undertaking a labour reform without working with the unions'.

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[41] Research interview.
[42] Research interview.
[43] Research interview.
[44] Research interview.
[45] Research interview.

This *a priori* political alliance with the trade unions had a rather less positive side in that it undermined the government´s negotiating power when it came to negotiation with trade unions and business representatives on the 2006 labour reform. As a senior official at the Ministry of Economy and Finance in charge of negotiating parts of this labour reform with the trade unions lamented:[46]

> From the moment the President publicly announced that he would not sign any reform that was not acceptable to the trade unions he quashed any negotiating power the Ministry of Economy could have.

In sum, it is clear that the trade unions exercised significant influence on the government´s economic policy in the years before the crisis. In the words of this same government official,[47] 'nothing that was against the interest of the trade unions could be done', perhaps an exaggerated claim but, no doubt, one that expressed a justified concern.

The way that communications and decision-making on this issue were organised also seems to have played a key role in blocking any serious reform. Business representatives and trade unions would hold discussions under the guidance of the Secretary of State of Labour, Valeriano Gómez, who would then communicate with the Minister, Mr Caldera, whom in turn would inform the President. Mr Gómez was close to the trade unions. In fact, he was a member of the General Union of Workers (*Unión General de Trabajadores* (UGT)), the country´s second largest union and with traditionally strong links to the PSOE, which is likely to have given him a pro-union bias in the negotiations. The process was therefore one in which negotiation was controlled by the Ministry of Labour and where the Minister of Economy and Finance, Pedro Solbes, was left, with the acquiescence of the President, in a weakened position, as senior officials within his ministry have acknowledged.[48] This sidestepping of Mr Solbes was further facilitated by the President´s Economic Office, which, under the leadership of Miguel Sebastián, the

[46] Research interview.
[47] Research interview.
[48] Research interview.

President´s closest economic advisor and a personal friend, had become a channel through which economic affairs often reached the President directly.

An episode in the early days of Zapatero´s government illustrates this dynamic. At the first cabinet meeting after election to office the Socialist government adopted a significant increase in the minimum wage. Mr Solbes has described in his memoirs (Solbes, 2013: 271) how he felt uncomfortable with this decision. Yet, what is less known, but was confirmed by two ministers interviewed for this project who were present in the cabinet meeting, is that there was actually a heated debate on the subject, and the President sided clearly with Mr Caldera in defence of a substantial rise. Such a public rebuttal of Mr Solbes in front of other cabinet colleagues can only be interpreted as a deliberate action by the President to undermine Mr Solbes' authority in the labour market reform.

In sum, it is clear that, whether from their influence or simply because of a shared ideological view of the relationship between business and workers, increasing labour market flexibility against the will of the trade unions was not a priority of the Socialist government in the years leading up to the crisis. There was a clear political logic that underpinned the government´s refusal to undertake a radical labour reform, caused by a combination of electoral motives, closeness to the trade unions and ideological preferences.

2.2.4. Change of growth model

The PSOE´s 2004 electoral manifesto (PSOE, 2004) had clearly identified Spain´s excesses during the growth period as well as the need for Spain to adopt a growth model based on higher productivity and competitiveness. Spain had suffered a sustained loss of competitiveness during these years (Galí, 2012), caused by poor productivity, whose growth between 1996 and 2008 was a mere 0.6 per cent compared with an EU average of 2.3 per cent (Statistical Office of the European Union, 2014), higher growth in unit labour costs (Spain´s costs growing by 6.7 per cent between 1996 and 2008, compared with an EU average of just 3.3 per cent (ibid.)) and high corporate profit margins (*Banco Bilbao Vizcaya Argentaria*

[BBVA], 2010). By 2007 there was clear evidence that Spain´s growth model, based on easy credit, a construction boom and concentrated on low productivity tasks and sectors, was becoming exhausted. The reforms needed to redress these imbalances were also well known. In the words of one of the closest advisors to President Zapatero, who played a leading role in the Socialist´s economic manifesto:[49] 'we were perfectly aware of these disequilibria and we knew what we had to do'. The question must then be why they were not addressed.

The single most important factor was that many of these reforms were unpopular and the long period of growth removed any need for the first Zapatero government to act, as it had for the conservative government before it. There was little incentive to pay an electoral price for taking unpopular measures, such as the elimination of the mortgage tax deduction discussed earlier, when there was no imminent pressure to do so. As a high-ranking official who occupied senior posts at both the President´s Economic Office and the Ministry of Economy and Finance put it:[50] 'it is very difficult to adopt difficult reforms when there is no immediate reward and a high political cost'. The reluctance to assume the political cost of such unpopular measures was compounded by the fact that the 2004 Socialist electoral victory came as a surprise to many in the party, who did not expect to have to pay the political price of implementing these unpopular reforms. One of the leading figures in the PSOE´s economic team while in opposition put it bluntly:[51]

> We did not expect to win the 2004 election, so that allowed us to identify all the imbalances the economy was suffering from and incorporate in our manifestos the painful solutions; but we never expected to have to implement them.

Another indication that political resistance was a crucial determinant of the government´s passive attitude towards its own reform agenda is the fact that other policies and reforms that had been included in the Socialist manifesto and which

[49] Research interview.
[50] Research interview.
[51] Research interview.

did not entail a political cost were indeed pursued. Efforts to improve Spain´s dismal research and development and innovation record are a clear example. From 2004 to 2008 public investment in research and development grew from less than three billion euros to 7.6 billion euros (PSOE, 2008). But as a Director General in charge of innovation at the President´s Economic Office readily admitted:[52]

> The reason why there were indeed advances in increasing the budget for research and development and innovation is because there was the money to do so and it did not incur any political cost.

A second factor that accounts for the little progress with these structural reforms was the influence and *capture* (Hopkins, 2015; Molinas, 2013; Ortega, 2014) of the policy decision-making process by the sectors that would have been affected. The construction sector is a clear example. A senior member of the President´s cabinet described the process in the following manner:[53]

> My thesis is that when we first joined the EU we asked for structural funds and we made good use of them because there was a lot of civil infrastructure we needed to build and we did. But then the funds kept coming and we put ourselves in the hands of the construction companies who have an interest in the continued provision of these funds and we ended up confusing means with ends; it was no longer about building needed infrastructure, which was a means for a more productive economy, but about feeding the construction companies as an end in itself. And why is this system perpetuated? Because construction is not only positive in terms of employment creating but also in terms of tax revenues, a lot of it going to regional governments and from there to financing political parties.

Construction companies captured the decision-making process through insistence on the need not only to keep building housing and civil infrastructure but also in more novel sectors. The renewable energy sector, for example, became a new activity thorough which construction firms secured vast sums from the state and, in turn, financed political parties illegally (Hernández and Romero, 2013). This was made easier by Spain's decentralized political and administrative system (Fernández-Villaverde et al., 2013). Most illegal financing episodes have taken place at regional and local level, where the strict controls that were established for

[52] Research interview.
[53] Research interviews.

the central government after the wave of corruption scandals in the early nineties are not in place.

The high degree of economic management that decentralisation bestowed upon regional governments was also key in feeding the excessive investment in infrastructure as opposed to research and development or other more productive sectors. One of the leading officials in the government´s drive to foster research and development during the first Socialist term recalled[54] that regional government officials would always demand more investment in physical infrastructure and be sceptical of and reluctant to have research and development investment instead:

> They would always ask: "how many immediate jobs will this generate, how much income for my budget?" When we answered that the short-term returns were less but that that when the proposed research and development projects grew they would provide stable and high quality jobs and income, they were often sceptical and uninterested.

This attitude was deeply entrenched, even after the crisis hit. A minister with an economic portfolio during Zapatero´s second term recalled[55] that the President kept telling him how, in his visits to the regions, regional party bosses never asked for investment in research and development and innovation and were only interested in getting investment related to physical infrastructure, especially the high speed train.

Domestic political factors such as the decentralised nature of the Spanish political system and the collusion of construction firms and government, especially at local and regional level, seem, in sum, to be have been at the heart of this excessive investment in infrastructure. The steady flow of EU structural and cohesion funds of course also played a role. Yet this explanation has its limitations, as the EU funds represented at most a net annual financing surplus of no more than 1.2 or 1.3 per cent of Spain´s GDP and yet at the height of the bubble construction represented 16 per cent of GDP.[56]

[54] Research interview.
[55] Research interview.
[56] Research interview.

The personal characteristics and judgement of the decision-makers, not least the two most important figures at this time, President Zapatero and Vice-President and Minister of Economy and Finance Pedro Solbes, are one final factor that seems to have played an important role in the failure to address Spain´s economic shortcomings and change the growth model in the years preceding the crisis. In the case of the latter, despite his deft managing of the country´s finances (in 2007 he achieved a budget surplus of two per cent of GDP and brought the public debt to a historically low of 37 per cent), his conservative approach is deemed by many to have stood in the way of the bold reforms Spain needed. A senior Spanish political figure who has occupied important positions in both the Spanish government and EU institutions was in no doubt that this helps explain the actions of Vice-President Solbes.[57] According to his analysis, with which other former government officials agreed,[58] Solbes had always been one for whom the priorities were budgetary and fiscal policy; a stronger economic policy hat, which is what enacting the much-needed structural reforms would have required, was not something he was characterized by. This approach was already evident during Solbes´ tenure in the European Commission. When Mr Solbes abandoned his post as European Commissioner to join the Spanish government, the DG for Economic and Financial Affairs, which had been under Solbes' supervision was, according sources in the Commission,[59] chiefly concerned with budget oversight and had time and resources for little else. This attitude continued during his tenure in the Spanish government, according to this same source:[60]

> In the years up to the crisis I would sometimes meet Spanish officials, including Solbes, and show them with concern our analysis pointing to the divergence in Spanish unit labour costs, loss of competitiveness, higher structural inflation, and other disequilibria. I would explain that, in the absence of a much tighter fiscal policy to achieve a higher primary surplus, and given that the ECB´s monetary policy was fuelling Spain's housing bubble, it was essential to undertake structural reforms to change the growth pattern. But this would fall on deaf ears. The only thing they cared about was balancing the books, not serious reform. And this certainly influenced the government´s reaction, as Solbes was at the time the

57 Research interview.
58 Research interviews.
59 Research interview.
60 Research interview.

> economic strongman in the government, and he imposed his insistence on budgetary issues, fiscal discipline and achieving a budget surplus.

President Zapatero´s personality has also been blamed for the failure to adopt more audacious reform during the first term. His perennial optimism, which would be derided during the worse moments of the crisis, was already at this early stage blamed for a failure to acknowledge the depth of the crisis. Others who have worked closely with him for years[61] have criticised his short-termism, his tendency to choose politically divisive issues that would allow him to keep the opposition in check rather than focus on necessary economic reforms, or a lack of economic knowledge and acumen that prevented him from understanding the gravity of the problems Spain faced. In reference to one of the most controversial comments made by the President in the first term, claiming that low taxation was a left-wing objective, one of Spain´s leading economic commentators, close to the PSOE, and an insider in economic policy circles for over twenty years, said:[62]

> Why does he say such an odd thing as 'lowering taxes is progressive'? I think because first he is imbued with the *Washington Consensus* thinking as a result of certain insecurity when it comes to the understanding of economic affairs and second because he wants to project an image of modernity and even audacity. But he does it in a manner that is completely counter-productive for what was needed at the time was to raise taxes to cool off the economy. I think there is also a bit of narcissism of looking at the mirror and wanting to be provocative and admired. This is also valued in politics and he knows it.

In a context in which prices, interest rates and inflation were all distorted and not useful as danger signals, and in which there was no immediate need to act, leadership in taking the decisive step to reform would have been essential. And in this case, in the words of a senior Spanish socialist:[63] 'the character of the leaders was not there'.

[61] Research interview.
[62] Research interview.
[63] Research interview.

2.3. Conclusion

It is clear that an attitude of certain complacency had come to dominate the management of the economy under the Zapatero administration in the period leading up to the crisis and prevented action to deal with the economy´s worsening imbalances. This attitude was to a significant extent driven by domestic political factors and it would come to shape the management of the crisis itself when, in 2007, the global financial crisis started to take shape. These domestic political factors affected the management of the various imbalances in different ways.

The electoral cost of unpopular measures was critical in the government´s decision not to pursue reforms identified in its electoral manifesto to deal with the housing bubble, most notably the scrapping of the tax deduction for first-residence mortgages. It was also behind the unwillingness to take measures to try to stem the credit flow and consumption, such as stricter bank regulation or increased taxes on loans and consumption, that could have helped ameliorate the credit boom and associated current account deficit.

Party politics was also critical. The influence of the regional PSOE leaders was key in allowing the construction bubble, as construction became an increasingly important source of funding for local governments, developing a perverse incentive to keep feeding the bubble. Similarly, the benefit that regional party representatives derived from their presence on the *cajas de ahorros'* boards was a key factor in preventing reform of the politicised governance of these institutions, which fuelled the ineffective lending behind the construction and housing bubbles. Finally, there was an unwillingness to compromise the tax revenues generated by these bubbles and which paid for the social services upon which the government´s popularity rested to a significant degree. All of these factors weighed heavily on the government and go a long way in explaining why no more forceful action was taken to dampen the overheated construction and housing sectors.

The highly decentralised nature of the Spanish public administration was also an important factor. The high levels of autonomy and resources that decentralisation bestowed upon regional governments were key in feeding the excessive investment in infrastructure that characterized this period, as it generated local jobs and tax revenues. Decentralization was also a factor that fuelled the highly political nature of the governance of the *cajas*.

Ideological opposition to further liberalisation of the labour market that dominated Socialist thinking was a significant obstacle to necessary labour reform. There was a clear political commitment by the President and his Minister of Labour and close ally, Jesus Caldera, to protect workers´ rights against the liberalising labour reform demanded by the business community and international institutions, which advocated increasing flexibility and decreasing labour rights. This commitment was grounded on strong ideological preferences among senior government members, not least the President himself.

Differing views as to the likelihood of a hard landing prevented more forceful action that could have helped stem the credit boom and associated housing bubble, a sign that divisions within the cabinet also played a critical role. The divisions between officials in the Ministry of Labour, closer to the position of the trade unions, and in the Ministry of the Economy and the President´s Economic Office also prevented more forceful action to reform the labour market.

The financial sector successfully lobbied the government and the Bank of Spain against more stringent regulation that could have slowed the pace of the credit boom that fuelled the housing and construction bubble, offering a clear example of how the pressure of organised interests was also critical. Trade unions were also influential in preventing more forceful labour reform. Whether by virtue of their influence or simply because of a shared ideological view on the relationship between business and workers, increasing labour market flexibility against the will of the trade unions was not a priority of the Socialist government in the years up to the crisis. The influence and capture of the policy decision-making process by the sectors that would have been affected by structural reform also explains why the much needed change in growth model did not take place during the high growth years when it would have been more economically feasible.

Finally, the personal characteristics of the leaders were also behind the failure to address Spain´s economic shortcomings in the years prior to the crisis. Pedro Solbes´ conservative approach stood in the way of the bold reforms that Spain needed and the attitude of the President, always optimistic, consensus-driven and temperamentally uncomfortable with fighting the trade unions that had helped him to power, also precluded more determined action.

Chapter 3. From downplay to reaction

(Mid 2007 to May 2010)

3.1. Introduction

It was in this attitude of complacency and politically driven resistance to adopting difficult measures that Spanish decision-makers confronted the early stages of the crisis in the summer of 2007. During the following months, even when some warning signs such as the unemployment figures started to signal a deteriorating domestic situation, the government showed a reluctance to acknowledge the impending crisis. Events would, however, eventually force it to react, even if only gradually.

This first stage of the management of the crisis had various distinct phases. The first, once the first signals of distress had come from the US in the summer of 2007, was to deny that there was a crisis at all and to argue that the difficulties were confined to the US, would not affect Spain and that, at most, there would be a temporary but moderate growth glitch. The second stage started in September 2008, with the advent of the post-Lehman Brothers global financial crisis and acceptance that the crisis had hit Spain, but blaming international factors for Spain´s woes, rather than anything to do with Spain´s own economic disequilibria and insisting that the downturn would be short and moderate. This response took the form, as in most others developed economies, of actions to prop up the financial sector and a substantial fiscal stimulus. Finally, from mid 2009 came the third stage, with the realisation that the crisis was deeper than had been expected, that Spain had its own problems and remedial action was necessary, leading to some early reforms.

The following sections present an analytical chronicle of this evolution of the management of this crisis. The narrative uses as its anchor points key policy decisions, considering the role played by domestic political factors, but also exploring alternative possible explanations based on external constraints.

3.2. Downplay (*mid 2007 to October 2008*)

There is no exact date for the beginning of the crisis in Spain. The first warning signs came, as in the rest of the world, in August 2007, with the crash of the mortgage backed securities (MBS) market in the US and the associated turbulence in the international credit markets. That autumn saw the first indicators of a deteriorating economic situation in Spain, especially in the employment figures, which saw a slower rate of growth than in third quarter, with unemployment increasing by over 30,000 to 8,03 per cent (*Instituto Nacional de Estadística* [INE], 2008). The situation would deteriorate quite rapidly over the following months. From the second quarter of 2007 to the second quarter of 2008 unemployment increased by over 620,000 and the unemployment rate increased from 7.95 per cent to 10.44 per cent. The first signs of trouble in the housing sector also became apparent with the collapse in July 2008 of *Martinsa-Fadesa*, one of the largest construction firms in the country.

Despite this evidence of a worsening economic situation, the government did little to respond to it. For example, as early as August 2007 a senior member of the President´s Office[1] had expressed his worries about a serious potential slowdown to Vice-President Solbes, only to be told that the crisis was unlikely to have a serious impact on Spain and that, although there was likely to be a slowdown, it would be moderate. Mr Solbes, according to this source, was of the view that it was an American problem, arguing that it emanated from the nature of the American mortgage market and that the Spanish mortgage market was completely different and was unlikely to be affected. Various other ministers who spoke with Mr Solbes at the time agreed with this description of events.[2] One categorically affirmed:[3] 'neither Solbes nor Fernández Ordóñez [Governor of the Bank of Spain] ever mentioned before 2008 the possibility of a serious crisis'. In fact, a high-ranking member of government with senior responsibilities at the Ministry of Economy and Finance has acknowledged that they underestimated the depth of

1 Research interview.
2 Research interviews.
3 Research interview.

the crisis:[4] ´We knew there would be a slowdown, but no one expected the crisis to have the depth and length it eventually had’.

Yet Mr Solbes was not alone in his downplaying of the economic perils the country was facing. The President´s Economic Office was also slow to acknowledge the oncoming crisis. Its Director, Miguel Sebastian, was known to be the economic advisor closest to the President and, according to numerous accounts, the most influential in shaping his opinion, and thus played a key role in downplaying the gravity of the situation in its early stages. A senior official in the President´s Office and also one of his closest political advisors recalled[5] that they would express their concerns to the President about the slowdown and he would repeatedly refer to Mr Sebastian to counter their worries. A senior figure in the President´s Economic Office, also close to the President, admitted during interview[6] that his department underestimated the consequences the American subprime crisis could have in Spain, referring to factors such as the resilience of consumption as evidence that the Spanish economy did not face any serious difficulty. However, he claimed[7] that their failing in this respect was not as marked as that of Mr Solbes: ‘The last person to accept that there was a crisis was Solbes’.

The Ministry of Labour, as one of its senior officials has admitted[8], also dismissed the worsening employment figures as indicative of nothing more than a temporary slowdown after years of high employment growth, without giving due consideration to the structural nature of the worsening employment situation, obviously tied to the dramatic slowing of the construction sector. President Zapatero himself shared this attitude of denial. In a meeting of the Spanish Socialist Workers´ Party (*Partido Socialista Obrero Español* [PSOE]) executive committee in early 2008 to prepare the strategy for the forthcoming general election, the issue of the crisis was raised, but the President had, according to a senior official present,[9] an ‘almost virulent reaction’, claiming that it was all an artificial creation and that the

[4] Research interview.
[5] Research interview.
[6] Research interview.
[7] Research interview.
[8] Research interview.
[9] Research interview.

best proof of this was that Spain was going to close 2007 with the best economic indicators in its recent history.

The question of why the government did not react more swiftly when the first signs of the slowdown became apparent in late 2007 is difficult to answer but it is clear that external constraints cannot properly account for it. While it is true that at this point one of the external factors that would later prove to be one of the most forceful constraints – bond market pressure – was not in play, by this stage international actors were, nonetheless, starting to express their concern at the lack of reaction by the government. For example, in the review of the National Reform Plan conducted by the European Commission (2007: 61) in December 2007, officials warned about the various disequilibria developing in Spain, and specifically about the high current account deficit (already 8.5 per cent) and the low levels of productivity and competitiveness. Such international pressure would actually have provided a degree of cover for the government to adopt some of the unpopular measures it had committed to taking in its manifesto. Blaming difficult decisions on the European Union (EU) has after all been a recurrent strategy for national governments across Europe. And yet the government did not adopt such reforms. Furthermore, even if these imbalances were not addressed, an acknowledgement of the crisis, and of its potential seriousness, was well within the government´s competence. And yet the government chose to downplay it. If external constraints were not behind the downplaying of the crisis, what other factors explain the government´s attitude? A careful analysis of this stage of the crisis points to a number of key domestic political factors that can at least partially explain it.

Electoral considerations were a first critical factor that influenced the government´s reluctance to accept the gravity of the crisis. In March 2008 the Socialist government faced a general election and its economic record until just a few months before had been enviable: four years of high growth that had led to the lowest unemployment figures and the first fiscal surplus in the country’s recent history. The PSOE, consequently, fought that campaign on the key message of its ability to run the economy and any acknowledgement of serious economic problems would have undermined that message.

The electoral campaign also witnessed some electorally motivated policy decisions that would come to shape the international perception of how the government managed the crisis and the reaction of investors to it. One of the most controversial was the 400-euro income tax credit, announced by Zapatero during the campaign, and justified as a way to stimulate consumption and demand but obviously politically motivated. Not only was it popular but it also helped the government counter opposition from other left-leaning parties which, pointing to that year´s budget surplus, demanded an increase in public expenditure to finance improved social services.[10] The tax credit was adopted despite at least one senior minister expressing privately to the President his opposition to this measure.[11] A second measure with clear electoral considerations in mind was the scrapping of the *impuesto de patrimonio*, or wealth tax, announced during the electoral campaign and finally enacted in April 2008. When asked during research interview about economic measures that had been politically motivated, a senior member of the President´s Office responded: ‘obviously, the scrapping of the wealth tax’.[12] And in July of the previous year the government had announced another major spending initiative, a 2,500-euro benefit for each child born. Together, these decisions painted a picture of fiscal laxity in the face of a deteriorating economic situation and of a government unwilling to take difficult decisions to contain public spending that was to haunt the government during the whole management of the crisis. As a former Spanish Socialist government minister in a senior post in the European Commission at the time conceded, the perception in Brussels was that the government was ‘in denial’.[13]

The imminence of the general election also predisposed President Zapatero, according to sources in the President´s Office,[14] to believe information that allowed him to confirm his preferred view that the crisis would be short, like the *dot.com* crisis of the late 1990s, as it would of course have been extremely risky to

[10] Research interviews.
[11] Research interview.
[12] Research interview.
[13] Research interview.
[14] Research interview.

call the elections in the midst of a serious crisis.[15] Finally, the voices of key people in the financial sector suggesting that, as described in the previous section, the crisis would be a short one and no drastic measures were necessary were also instrumental in promoting this attitude of denial at this early stage, according to sources in the President´s Office that acted as an informal channel of communication with financial executives.[16] In sum, electoral considerations seem to have been at play, not only in policy decisions, but also in a certain attitude of denial by the President. As a senior official in the Bank of Spain, close to the PSOE, put it:[17]

> Zapatero´s error is not that he recognised the existence of the crisis too late, but rather that he convinced himself, because it was in his interest, that Spain´s problems were mainly caused by the international financial crisis and he did not want to accept that there was a domestic problem, what I call the national crisis, that we would have had to face even if we had not had an international crisis. He wanted to believe, and he projected to the public, that once the international crisis had resolved itself, the Spanish economy would also recover.

The PSOE went on to win the March 2008 election. The victory was, however, bittersweet, as the party again fell short of an absolute majority. Securing sufficient support in Parliament to be reappointed required President Zapatero to build a new coalition, a task that would prove to be another decisive issue in the management of the crisis.[18] During its first term the PSOE had been able to rely on the support of *Esquerra Republicana de Catalunya* (ERC), a left-wing nationalist Catalonian party, for most of its progressive social policies. By the end of the four-year term, however, this partnership had ended acrimoniously as a result of tensions over the negotiation of Catalonia´s new statute of autonomy. The PSOE had to look for parliamentary support in *Convergencia i Unió* (CIU) and *Partido Nacionalista Vasco* (PNV), the conservative nationalist Catalonian and Basque parties respectively. Backing for its policies was much harder to obtain with them, since they were ideologically not aligned with the PSOE and the concessions demanded were usually for more self-government. As a senior official

[15] Research interview.
[16] Research interviews.
[17] Research interview.
[18] For an extensive academic discussion see Field, 2013, and Calvo, 2014.

in the President´s Office acknowledged,[19] this was increasingly difficult after Catalonian autonomy had become one of the most divisive issues of the first term.

The election´s victory honeymoon was short-lived, as it immediately became clear that economic clouds were gathering. Surprisingly, the attitude of the government did not change much. Some initial measures were taken: a plan to encourage hiring with subsidies to employers and a package of credit guarantees in support of small and medium-sized enterprises (SMEs) in April; an austerity package concentrated on the freezing of compensation for senior public officials and a set of measures to foster business activity with initiatives such as the elimination of red tape in the establishment of new firms in June; and a plan to subsidize the car replacements in July. Yet, despite these measures, the public pronouncements of the President and his economic team kept downplaying the nature and impact of the crisis, even though economic indicators, especially those on unemployment, were deteriorating rapidly. The third quarter of 2008 saw an increase in the unemployed of over 217,000 from the previous quarter and the unemployment rate climbing to 11,3 per cent, from 10.4 per cent (INE, 2008).

One of the most controversial aspects of the early stages of the crisis was the President's refusal to utter the word 'crisis', which gave the impression of being in denial about the quickly deteriorating economy. External constraints, financial or institutional, were clearly no obstacle to acknowledging Spain´s vulnerability to a crisis, given its dependence on foreign credit. In fact, it would have gone some way to addressing the criticisms that, as described above, Spain was starting to hear from its EU partners and international investors for not accepting the depth of the crisis. While the reason for not admitting it before the election might have been understandable from a political perspective, many, even in his own ranks, grew increasingly frustrated at his refusal to face reality and call the crisis by its name even after the elections, as confirmed by senior members of his government and his political staff.[20] Yet, on closer examination, a number of factors help explain why the President, and his government, adopted this attitude.

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[19] Research interview.
[20] Research interviews.

A first reason was the need to maintain credibility with the electorate**.** The PSOE had just won an election on the assurance of economic competence and any acceptance of a serious crisis would have undermined this message. The government was assisted by the fact that, even in the first half of 2008, most analyses still predicted a decent level of GDP growth for Spain. In May 2008 the consensus forecast of *Funcas* (2008), a collection of economic indicators from a number of respected sources, was still a 2.2 per cent GDP growth for 2008 and 1.7 per cent for 2009. The International Monetary Fund (IMF) issued similar up-beat predictions and, while it revised them downwards throughout the year, in its April outlook it still estimated a 1.8 per cent growth for 2008 and 1.7 per cent growth for 2009 (IMF, 2008). The Bank of Spain was even more optimistic. In April 2008 it estimated that growth would be 2.4 per cent in 2008 and 2.1 per cent in 2009.

A second reason was persistent disagreement, most noticeably between the President´s Office and Economic Office, the Bank of Spain, the Ministry of Economy and Finance and other ministries with economic responsibilities, such as the Ministry of Labour and the Ministry of Trade and Industry. These differences in opinion were profound, especially when it came to the possible depth and length of the crisis. The perception that Mr Solbes and his team at the Ministry of Economy and Finance were complacent and underestimated the potential gravity of the crisis was widely shared among members of the government interviewed for this dissertation[21]. Yet Mr Solbes was not alone in this nonchalant attitude to the dangers of the storm that was brewing across the Atlantic. The Bank of Spain, another key actor that could have sent early warning signals, also failed to do so well into 2008, allowing the President and the Ministry of Economy and Finance to maintain their optimistic discourse. Its 2008 annual report, published in early 2009, predicted gradual recovery ‘towards the end of 2009 or in 2010’ (*Banco de España*, 2009: 22).

[21] Research interviews.

Various government officials, including Mr Solbes, have stressed the role also of the President´s Economic Office in leading the President to underestimate the crisis during this period. While admitting that he himself did not recognise the depth of the crisis even at this stage (Solbes, 2013: 350), Mr Solbes has acknowledged that he faced a constant struggle to convince other members of the government, not least the President and the Economic Office, of the need to contain public spending in the good times in order to have fiscal room for manoeuvre if and when the crisis hit. A top official at the Ministry of Economy and Finance with direct access to the President confirmed this view:

> I tried to instil in him [President Zapatero] an understanding that during the last few years the country had experienced the largest fluctuation in capital distribution in its history and a lot of that capital had gone to the construction industry and we had built houses, highways and airports that were completely useless. Although I was very worried at the time, my perception always was the President did not share my concerns and my sense of urgency and I probably failed to transmit to him the gravity and urgency of the situation.

This points to an important reason why these divisions in the cabinet were important: they were a crucial factor in not responding more swiftly or forcefully in the early stages of the crisis. Government officials across various departments[22] are highly critical of the Ministry of Economy and Finance for blocking any attempt to take serious steps and undertake reform because it did not accept the dimension of the crisis even after the March 2008 general election. A clear example of this came with the Ministry´s reluctance to accept that credit was already becoming increasingly difficult to obtain for many businesses during the second half of 2008. A revealing anecdote related to events in the summer of 2008 substantiates this criticism. The Ministry of Industry and Trade had created the *Plan Soria*, a plan to encourage industrial projects in the province of Soria where the government would guarantee loan repayments. On a trip the region the Minister, Miguel Sebastián, found out that not a single project had been able to secure finance from the banks. He was incensed as, with government guarantee, they were almost fail-safe. But it was proof that the banks were just not lending, even when the projects were guaranteed by the state. Yet, when he attended the

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22 Research interviews.

Inter-ministerial Commission for Economic Affairs later that week, the officials from the Ministry of Economy Finance, including Mr Solbes, insisted that credit was available and difficulties in obtaining it were related to the quality of the demand. According to sources familiar with the event[23] this episode was an inflection point, as it led President Zapatero to realise that the credit crisis was far deeper than he thought and that ‘Solbes was not taking action, that he was overwhelmed or paralysed’. Contrary to this view, Mr Solbes has claimed in his memoirs (Solbes, 2013) that he was well aware of the dangers the crisis posed, had an action plan, and it was the President´s refusal to heed his advice that led to his resignation.

This lack of action was not only the result of internal division within the government but also of an ineffective decision-making process. A high-ranking official in the President´s Office, who was closely involved in many of the President´s important decisions,[24] claimed that Zapatero would often base his relaxed views of the gravity of the crisis on anecdotal evidence provided by close *confidants*. The poor quality of advice often received from economists or financial experts who clearly were also unable to predict the crisis or its implications added to the problem. The issue of the poor reliability of experts’ advice is of course not confined to Spain, but it certainly offered the President a perfect cover for his unconcerned stand. A senior member of the President´s Office, who was often present when such advice was offered to the President, complained:[25]

> If the government seeks counsel from technical experts and what it gets are absolutely contradictory inputs it really defeats any purpose such advice may have and one cannot expect the government actually to be ahead in terms of its decisions if not even the experts can agree on what the situation is.

The unreliability of the advice received was compounded by another important factor: that President Zapatero, like every other former Spanish President, had no previous formal training in economics. According to some people close to the President, this was an important factor in his inability to deal with the crisis more effectively. As one of the senior figures in charge of economic affairs for the PSOE

[23] Research interview.
[24] Research interview.
[25] Research interview.

while in opposition and who interacted closely with Zapatero put it:[26] 'in my experience, the subject intimidates politicians with no training in economics. Zapatero was no exception'. Furthermore, by mid 2008, this official recalled,[27] Zapatero was beginning to realise that the issue that had allowed him to ride his first term successfully, management of the economy, was turning sour and, while he had seen himself perfectly capable of dealing with issues such as negotiations with the nationalists or social policies, felt far less confident in this realm.

One final political factor contributed to the President´s attitude of downplaying the crisis: the fear that acceptance of it would undermine confidence among consumers and investors and make the crisis a self-fulfilling prophecy. Rodríguez Zapatero (2013: 201) clearly acknowledged in his memoirs that this played a key role in his underestimating of the crisis and other government officials interviewed for this project shared this view.[28]

However, by mid 2008 the President was under heavy pressure to accept Spain´s economic difficulties and utter in public the word 'crisis', as the opposition had become effective in painting a picture of a government that was deceiving public opinion and blind to evident fact. The number of voters who said they had voted for the PSOE in the general elections and would do so again dropped by 15 percentage points in barely thee months following the elections (*Centro de Investigaciones Sociológicas* [CIS], 2008). The electorate was losing trust in the government´s ability to manage the economy and witnessed the obvious absence of a plan to deal with the crisis, despite the government´s attempt to blame the situation on the global financial markets.[29] The President himself would come to acknowledge, two years later, that he had been too late in publicly accepting the existence of the crisis (Rodríguez Zapatero, 2013). Finally, in June the President admitted that growth would be under 2 per cent but it would not be until July 2008 that he would finally use the word *crisis* during a TV interview.

[26] Research interview.
[27] Research interview.
[28] Research interviews.
[29] For an extensive discussion of why it made sense to do so see Fernández-Albertos, 2013.

In sum, the early stages of the crisis, before October 2008, were characterised by downplaying the effect that the international crisis could have in Spain, an attitude that would come to shape the management of the crisis all along. As the evidence provided above indicates, domestic political factors played a key role in this dynamic. These were of course not the only factors shaping the response: external constraints also played a role. Yet the management of the crisis in this early period cannot be understood without reference to domestic political factors. Electoral considerations forced the President to maintain an excessively optimistic message and project an image of denial. The absence of a parliamentary majority and of reliable coalition partners hindered more decisive action. Disagreement in the cabinet as to the gravity of the crisis delayed the response, as did an ineffective decision-making process, a problem to which the President's lack of knowledge and experience of economics contributed.

3.3. Reaction: financial sector support and stimulus *(September 2008 to mid 2009*)

While by the fall of 2008 the government had admitted the crisis and the seriousness of the downturn, its strategy was still very much that of presenting it as a moderate downturn caused by the international credit crunch. Yet attempts to downplay the importance of the crisis were rendered useless by the implosion of the financial markets in September 2008, which saw all the pressures that had been building over the international financial system come to a climax. The collapse of various financial institutions in the US and the equivalent of a run on the money market funds led the global financial system, in the words of the then head of the IMF, to 'the brink of a systemic meltdown' (British Broadcasting Corporation (BBC), 2008).

The virulence of the global markets´ crash and the credit crunch that ensued took the Spanish government by surprise and awoke fears for liquidity in the Spanish financial system. The stock market suffered serious losses, dropping by over 9 per cent on a single day on 10 October and by over 21 per cent in that week. Banks were particularly hard hit, with even the two largest, *Banco de Santander* and

Banco Bilbao Vizcaya Argentaria (BBVA), dropping both by 12 per cent on the same day and losing, by the end of the week, around a quarter of their market capitalisation (26.8 per cent BBVA and 24.1 *Banco de Santander*) (*Invertia,* 2016). The collapse in their market value was a sign of the difficulties the sector was facing. As in the rest of the euro zone and the US, interbank credit was quickly drying up and repo rates substantially increasing for Spanish banks (Hordahl and King, 2008; Ayuso, 2013). The psychological impact created by the collapse in the markets and the fear of bank runs forced the government to react. The response had two main components: actions to prop up the financial sector and a fiscal stimulus to counter the drop in private demand brought about by the credit crunch.

3.3.1. Financial sector support

Most western governments moved swiftly to take measures to support their financial systems and Spain was no exception. On 7 October 2008 the government adopted a number of emergency measures, the two most important being the increase in the level of guaranteed deposits to 100,000 euros and the creation of a 30-billion-euro fund to buy non-toxic assets from financial institutions in order to facilitate liquidity and ameliorate the global credit crunch and virtual shutdown of global credit on which Spain, with its significant current account deficit and high external financing needs, was so dependent.

While the decision to act was obviously driven by the international financial situation**,** the way in which it was taken and the shape the final measures took were shaped by domestic political considerations. The meeting at which the decision to lift the deposit guarantee limit was taken, as recounted by government officials[30] that were present, serves to illustrate a number of these factors. The government was under heavy pressure from senior figures in the financial sector to act quickly, with the President taking direct telephone calls from senior banking executives. Various government officials mentioned[31] Emilio Botin, the powerful

[30] Research interviews.
[31] Research interviews.

Chairman of *Banco de Santander*. The proposal that had been submitted by the technical advisors had suggested raising the guaranteed funds to 50,000 euros. Vice-President Solbes informed the President that some EU states had raised the protection level to 60,000 euros, some to 80,000 and others to 100,000 euros. The President intervened, insisting that Spain´s prestige was at stake and that, as the fourth largest euro zone economy, it could not set a lower limit than its peers. When the Vice-President suggested setting it at 80,000, weary of the financial implications, the President retorted that it should be 100,000 euros to be 'at the top of the league', as a source present at the meeting recalled.[32]

While it is certainly true that once Ireland moved to set the limit at 100,000 euros there was a risk that there would be capital flight within the euro zone to the country with the highest level of protection, it seems obvious from the account above that this was not the only reason motivating and shaping the decision. Two highly political factors were crucial for the President. Firstly, the swiftness of the response is illustrative of the pressure of organised interests, in this case a financial sector faced with increasing financing difficulties and collapsing market values, and which, as we shall see in the next chapter, has been shown to be highly influential at various moments in this period of the management of the crisis.[33] One of the President´s closest economic advisors and himself formerly a banking executive, claimed that 'we were in the hands of the banks',[34] in an assertion which, while clearly excessively dramatic, is illustrative of the fears banking executives were instilling in the government and the President himself of the consequences of a sudden credit stoppage and the collapse of the financial sector.

A second political factor that influenced the decision was the President´s desire that Spain come across as a serious international player. In fact, the preoccupation with 'national prestige' was an ever-present factor in the mind of

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32 Research interview.
33 Santos, 2014; Flishman, 2013; Fernández-Villaverde et al., 2013; Royo, 2013, and previously Pérez, 1997, have all provided academic analyses of the enmeshing of the banking sector and politics in Spain.
34 Research interview.

President Zapatero that shaped economic decisions as much as technical aspects, according to senior advisors to the President.[35] While present 'in all leaders in my experience', claimed an official who held senior roles within the Presidency with former socialist President Felipe Gonzalez as well as with Mr Zapatero, 'Zapatero was particularly subject to this pressure'.[36] This episode is also illustrative of an unorthodox decision making process. What is striking, and especially in this period of Zapatero´s presidency, is the chaotic manner in which decisions seem to have been taken, according to many of the officials interviewed, including some who had served in previous administrations and were close observers of presidential decision-making.[37]

The need to try to convey an image of being an important player in the world, with the domestic political electorate in mind, was also apparently vital to Spain´s enormous diplomatic effort to take part in the G20 summit in Washington DC on 14 November, to which Spain had not originally been invited, and where a call for fiscal stimulus to counter the effects of the crisis was made. President Zapatero (2013) himself has described the importance he placed on securing an invitation and the lengths to which he went to secure it. This event is significant since it highlights a number of factors that help explain subsequent decisions by the Zapatero government. Firstly, the invitation to the G20 summit allowed Zapatero to show to his domestic audience that Spain 'mattered' in the international arena, but that in turn required him to show that the invitation had not been a mistake and that Spain was capable of acting decisively. An economic advisor close to the President described it in the following terms:[38]

> Spain´s stimulus package comes out of the G20 summit, where a stimulus consensus developed because there was a collective global consciousness that the global economy was heading towards a 1929 depression and that markets wanted a stimulus plan. You have to remember that governments are always very sensible to markets, sometimes a bit too much in my view. And at the time markets rewarded those countries that came up with a larger stimulus package or acted more quickly, so I think the President had this inclination to be the best pupil in the class and show that we were

[35] Research interviews.
[36] Research interview.
[37] Research interview.
[38] Research interview.

> capable of quickly putting in place a stimulus plan which, not only in its design but also execution, would have a quick impact.

Secondly, the summit gave cover to the President´s ideological and political predisposition to public spending. It is true that at the time all international economic and financial organisations were calling for such a fiscal stimulus. It was not only the G20; the EU´s own Economic Recovery Plan from November 2008 cited two main priorities, the first of which was for EU members to engage in a 'major injection of purchasing power into the economy, to boost demand and stimulate confidence' (European Commission 2008: 2). Yet this international call for fiscal stimuli was naturally music to a socialist President´s ears. The funds served to finance a number of the government´s domestic political objectives, from conducting an active industrial policy by supporting two key sectors, tourism and car manufacturing, to increased expenditure for the unemployed. As an official in the President´s Economic Office recalled:[39] 'When one sees that the country is destroying 40,000 jobs a day you are desperate to try to do something'. There was in fact a politically driven urgency to 'throw money' at the problem. 'In late 2008 and early 2009 there was an attitude of "lets spend as much as we can", it was madness really', one of the deputy Director Generals at the President´s Economic Office recalled.[40]

3.3.2. Stimulus: the *Plan E*

It was in this context that on 27 November President Zapatero announced in Parliament (*Congreso de los Diputados,* 2008) a set of emergency measures aimed at providing an economic stimulus and, in particular, at dealing with the massive increase in unemployment. What would be formally labelled as *Plan E* the following January, was launched. There were various components to the plan. Firstly, a significant fiscal stimulus through an increase in public expenditure, channelled through two new funds: an eight-billion-euro Local Investment Fund (*Fondo de Inversión Local*) destined for infrastructure works at local level and to

[39] Research interview.
[40] Research interview.

be spent by local authorities, and a three-billion-euro State Fund for the Economy and Employment (*Fondo Estatal de Dinamización de la Economía y el Empleo*) that was to be disbursed through central government. Two further support plans for specific sectors were also announced, one for the automotive sector, the other for the tourist industry. These measures were complemented by a program to facilitate liquidity up to 47 billion euro through the credit lines of the National Institute of Credit (*Instituto de Credito Oficial* [ICO]).

This fiscal stimulus package was, of course, very much a result of the impact of external factors**,** not least the call to action at the G20 meeting and of many other international economic and financial organisations. Yet what external constraints cannot explain is the way the plan was designed and implemented, which in many ways went against the kind of measures that international organisations such as the IMF (2008) or the Organisation for Economic Cooperation and Development (OECD) (2007) had been demanding from Spain. A stimulus package driven by the priorities expressed by these organisations would have led to the funds' being devoted to remedying Spain´s structural deficiencies, increasing, for example, expenditure in research and development or education in order to boost Spain´s chronic productivity problems. While the need expediently to boost consumption and investment in order to deal with the sudden drop in demand experienced in late 2008 might have justified spending in less strategically effective areas, it would certainly not have favoured channelling the brunt of the funds to the construction sector and infrastructures, where it was clear to international observers the country had over-invested. And yet that it is precisely what happened. Such an outcome is, however, easier to explain when domestic political factors are brought into the equation. A close analysis of the design and implementation of the *Plan E* describes a process, as we shall see, shaped by domestic politics as much as economic considerations.

Firstly, the fiscal stimulus that the *Plan E* represented was not only well aligned with ideological inclinations towards public expenditure of the PSOE government but it of course also gave international cover to a measure with clear party and political benefits to the government. As one of the most senior figures at Ministry of Economy and Finance in the last years of Zapatero´s administration acknowledged:[41]

> In late 2008 and early 2009 the message that was coming from outside was that the global economy was in dire straits as a result of the US-originated credit crunch and that the most important thing was to take measures to sustain aggregate demand. This coincided with a moment in Spanish history when we had accumulated many disequilibria and one could see that we would need to undertake measures different from simply adopting a fiscal stimulus. But the external environment allowed the government to do two things. Firstly, not properly to acknowledge the crisis, in order to avoid the need to undertake painful measures, because the argument could be made that the factors that had caused the crisis, namely subprime mortgages, were not present in Spain. And secondly, to justify an increase in public expenditure and in demand-sided policies, which in reality were not appropriate for Spain, as we did not have a cyclical but a structural crisis.

Secondly, the design of the plan came from the political much more than the technical sphere, from the world of 'Serrano, Zarrías, Chaves, etc.' as one source in the President´s economic team critically put it,[42] referring to powerful political figures in the party with strong connections to its regional and local chapters that would benefit from the plan. The role of the Ministry of Economy and Finance was far weaker than it had hitherto been, which is in itself an indication of how management of the crisis was already being handled more directly by the President and political figures around him. While in the first term President Zapatero had allowed Vice-President Solbes a free hand in running the economy, *Plan E* marked an inflection point. In the words of a close advisor to the President: 'at some point, for whatever reason, the President took control. I don´t know if it was because he saw that Solbes was overwhelmed'.

A revealing anecdote throws some light on possible reasons for this and is testament to how personal considerations shaped economic policy outcomes. It is a significant yet little known fact that, after all the effort to get Spain on to the G20, Vice-President Solbes decided not to attend the G20 preparatory ministerial summit in Washington, sending a deputy in his place. Yet, as he was not of

[41] Research interview.
[42] Research interview.

ministerial level, he was not allowed in the room. According to a senior member of the government close to the President,[43] Zapatero did not understand Mr Solbes´ decision and from that moment onwards there was a gradual split between them, which led to the President's assuming the leadership in economic affairs, and which eventually led to Solbes' resignation. Whether or not this was the turning point, from the *Plan E* onwards the President took a much more hands-on approach to the management of the economy.

Thirdly, to the architects of the plan, more preoccupied with politics than with economic efficiency, the stimulus package did not have any sort of strategic purpose but was rather an instrument for creating emergency employment and dealing with the more politically costly aspect of the sudden collapse in economic activity, mainly in the construction sector: unemployment. A senior official in the Ministry of Labour during this period recalled:[44]

> At the time we were facing an economic and social emergency. The level of job destruction was terrible so we designed something simply to try to get people to work and put a salary in their pockets. From that point of view it made sense that expenditure should be directed to this sector, given that most of the employment losses were in the construction sector.

In fact, it soon became obvious that the expenditure was both excessive and difficult to justify in economic terms, at least to increasingly worried European Commission officials,[45] as it took the public finances from a budget surplus in 2007 to an 11.2 per cent deficit in 2009. Both the media and economists were soon characterising the *Plan E* as shortsighted Keynesian expenditure (Mallet, 2009), devoted to activity with little long-term benefit. As one minister himself admitted it:[46] 'it was just repaving streets and squares; a strategy of throwing money at the problem and hoping the country would get out of the recession soon'.

In the eyes of the government the Plan E was not such a misguided response. The concern about unemployment did not only have a social logic but also a

43 Research interview.
44 Research interview.
45 Research interview.
46 Research interview.

financial one According to figures from the Ministry of Labour,[47] *Plan E* created over 400,000 jobs in a single-year. Considering that the average monthly cost of an unemployed person to the state was at the time around 1,100 euros, the plan generated net savings to the state of at least 4.4 billion euros, in terms alone of what was saved in unemployment costs. This focus on providing short-term jobs was also the result of the mistaken assessment that the recession would be short. However, such an assessment was common at the time and, had it been correct and growth returned early, the fiscal stimulus the Plan E entailed would not have had an insurmountable impact on the public finances. As a senior member of the government intimately connected with the execution of the plan explained:[48]

> If you believe that the crisis is going to be a short one, then your sole aim is to offer employment during a short period of time and there is therefore no point in designing the plan for larger projects.

The importance of regional politics was a fourth factor that clearly determined the design and scope of *Plan E* (Calvo, 2014). One of the most striking aspects of the initiative was the decision to disburse the majority of the funds through local authorities rather than national ministries or regional governments. It was not an obvious decision. Most public spending in Spain is administered through either central or regional government and local authorities often lack the capacity to manage large amounts of public investment. Furthermore, local authorities had been the level of administration most affected by corruption, as it was in them that administrative controls were weaker. According to sources personally involved in the decision,[49] there were various reasons for it, all of them clearly determined by domestic politics and which showed the central role played by regional politics. The first was that, with the boom of the preceding years in investment expenditure and EU structural funds there was really no capacity to manage more expenditure projects at national level. The second, in yet another sign of the importance of personal factors in the response to the crisis, was the influence exercised by Celestino Corbacho, at the time Minister of Labour. Having been a mayor himself prior to being appointed minister, he was adamant that the funds could be more

[47] Research interview.
[48] Research interview.
[49] Research interview.

effectively deployed through local authorities, and he was instrumental in persuading the President to go down this route. The third reason was that, after a first term marked by the controversy regarding the Catalonian issue and the criticism for devolving too much expenditure capacity to the regions, giving them even more funds to spend would have been politically toxic. As a top official among the President´s political staff acknowledged,[50] 'giving it to the local authorities then made more political sense'. And the fourth reason, as this same source admitted, was that, while most regional governments were in the hands of the opposition, local authorities were more evenly split, with a considerable number held by the PSOE. Dispensing *Plan E* funds through local authorities meant channelling money to the local chapters of the party at a time when the regional and local elections were just a few months away.

Finally, *Plan E* was also illustrative of how a chaotic decision-making process affected the management of the crisis. According to a high-ranking government official who took part in the decision,[51] 'what was originally planned to be five billion euro ended up at eight billion simply through a chaotic exchange of telephone calls'. That such an important stimulus package was concluded, not on the basis of technical analysis but, in the last instance, by haggling between the President and his Minister of Economy and Finance under time pressure, is testament to the relevance of the decision making process in the way the crisis was managed. According to senior sources from the President´s Office directly involved in the decision-making process:[52]

> It was really done like that, on the go, with Solbes in Brussels, where a figure had to be given, and the President and us here in a room in the Presidential complex. It was a really chaotic situation. Zapatero was asking Solbes to increase the amount and it became almost like an auction. The President asked for ten billion and Solbes said, no, eight billion… And that is the way it was decided.

In sum, the above account provides ample evidence of the significant role that domestic political factors played in shaping the government´s fiscal stimulus in

[50] Research interview.
[51] Research interview.
[52] Research interview.

response to the crisis. First and foremost was of course the political eagerness of the PSOE government to increase public expenditure in response to the G20 call for fiscal stimulus, something a Socialist government was always going to be ideologically keen to undertake. Secondly, the G20 provided international political cover for adoption of stimulus policies in order to address the destruction of employment that was fast becoming the government´s main political problem. A minister in Zapatero´s government, and close *confidant* of the President, also pointed to Zapatero´s political character, defining him as ‘a reformist but keen spender’, as an important factor behind the eagerness with which he committed himself to the fiscal stimulus.[53] And fourthly, the stimulus served as a mechanism by which to channel funds to local and regional authorities, many of them in Socialist hands, thus serving a clear political purpose.

3.4. Early reforms (*mid 2009 to May 2010*)

By the spring of 2009 the severity of the crisis was beyond doubt, as the global credit crunch struck with greatest severity, leading to negative growth in the third quarter of the year (INE, 2009), which would eventually come to mark the beginning of a recession that would last six quarters until early 2010. The government realised that fiscal stimulus would not suffice and that some substantial reforms were inevitable. Structural reform was now the political mantra.

There were four initial reasons for this change of attitude. Firstly, there was the persistence of the economic downturn and the realisation that there were significant disequilibria in the Spanish economy that were hampering growth; in other words, Spain had its own domestic crisis beyond the credit crisis. Secondly, there was a gradual recognition that the public was disapproving of the management of the crisis and that the government had to be seen to be doing more. The pressure for reform had built up not only from the opposition but also from the business community (*Expansion,* 2009), the media and public opinion in

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[53] Research interview.

general, as shown by opinion surveys (CIS, 2009). Thirdly, membership of the European Monetary Union (EMU) meant it was not possible to devalue the currency to deal with the recession and only through a process of internal devaluation was the necessary reduction in unit labour costs required to recover competitiveness achievable. And fourthly, by this time the first concerns about budget deficits were starting to be voiced by the European Commission, OECD and IMF (2009), as well as by international investors. Evidence of the market reaction came in the rise in Spain´s bond spread from the autumn of 2008, a reflection of investors´ increasing concerns about the government´s inability to curb the deficit and especially on the long-term expenditure trajectory, with particular reference to the generous pension system, as one of the Directors General at the President´s Economic Office, who was often responsible for meeting international economic analysis and investors, confirmed.[54]

In sum, the change of direction was caused by a combination of domestic and external pressures. Yet, while the latter were starting to be noticed, at this stage they were, according to some of the President´s closest advisors, still not determinant, and it was domestic considerations that weighed more heavily in the President´s decision to change direction. According to a high-ranking member of the President´s Office:[55]

> Zapatero talked to people in the country who told him that we had to change the growth and employment pattern; that we could not rely solely on tourism and construction.

A minister in charge of one of the key portfolios, who was also a senior Socialist figure, recalled how 'there was pressure from all sides in the nation to undertake reforms, and that was the key reason behind Zapatero´s change of strategy'.[56] The pressure for reform led the government to act. It is interesting to note that this political pressure trumped considerations regarding the negative economic impact that structural reforms were likely to have. In any case, this new spirit of reform materialised in four major initiatives: the Sustainable Economy Law (*Ley de*

[54] For an alternative view see De Grauwe and Ji, 2013.
[55] Research interview.
[56] Research interview.

Economía Sostenible [LES]), the labour reform, the financial reform and the pension reform, which were to be implemented gradually and at different times until the end of the PSOE´S time in office.

3.4.1. The Sustainable Economy Law

Neutralising accusations of an insufficient reaction to the crisis was President Zapatero´s main goal when, during the Debate on the State of the Nation on 12 May (*Congreso de los Diputados,* 2009), he surprised the opposition with the announcement of a large package of measures aimed at dealing more aggressively with the crisis. Probably the most important one was the scrapping of the tax credit for first residency mortgages for all but those with the lowest income. The corporate tax rate was reduced by five percentage points for firms with fewer than 25 employees that maintained or increased their workforce, subsidies were announced for the purchases of cars and a streamlined process for setting up a business in 24 hours was announced, not for the first time. A commitment to reign in expenditure was made, promising to cut one billion euro in public expenditure. The barrage of announcements also included the promise of no fewer than fifteen new laws, including measures to reform the electricity market, to liberalise professional services, and to allow extended retail opening hours (*Congreso de los Diputados,* 2009). But the most ambitious of them all was the LES, which had the objective, in the words of the President of 'fostering a new productive model' (*Congreso de los Diputados, 2009*). It had four parts (Ortega and Pascual-Ramsay, 2012). The first put forward the 'vision' of the 'sustainable economy' to which, in the government´s view, the country must change. The second part identified the reforms that would be put in place to achieve these objectives. The third identified the budgetary means to finance these reforms and the fourth and final section set the negotiating framework to try to ensure that a wide consensus was achieved for these reforms.

Yet, for all its ambitions, the LES and accompanying initiatives failed to have any significant impact.[57] The reasons for this failure were various, but a number of factors stand out. Firstly, the law´s design and implementation were flawed. Rather than offering an integrated package of strategically designed reforms, the different ministries ended up using it as a vehicle for securing the passage of legislation they had hitherto had difficulty in getting through Parliament. As a result it mainly served to repackage many of the initiatives that had already been announced or were in the pipeline. Also, as with so many of Zapatero´s measures, this initiative withered away due to a lack of proper implementation. It failed to be communicated effectively to the public, who saw it as more of the patched reaction that had come to characterise the Socialists' response to the crisis (Ortega and Pascual-Ramsay, 2012).

Secondly, there was strong opposition from many organised interests. The civil service, for example, was instrumental in opposing measures to streamline and simplify administrative procedures and make it easier to do business. As a minister closely involved in this reform recalled:[58]

> When trying to make it easier to set up a business the strategy was to offer different avenues of completing the process and let the public decide, but the civil servants at the Ministry of Justice made it impossible.

The lobbying efforts of the private sector were also critical in stifling attempts at reform. In Spain many sectors are heavily dependent on the public sector,[59] which means that large corporations tend to have a close relationship to the government and are able to influence policy, as two figures well positioned to evaluate such practices in the Ministry of Economy and Finance and the Ministry of Industry and Trade have acknowledged.[60] The extended 'revolving doors' practice allows this influence often to come through top civil servants that have left their public position to work in industry. Recent cases include the Deputy Governor of the

[57] For a critical assessment of the LES and its flaws see Fernández-Villaverde et al., 2010.
[58] Research interview.
[59] For a historical interpretation of how this affected the origins and management of the crisis see for example Hopkins, 2013, 2015.
[60] Research interview.

Bank of Spain's moving on to a private bank or the hiring of a senior official of the national energy regulator by *Avertis*, a company with interests in the energy sector. The influence of the corporate sector was critical, for example, in the failure to adopt meaningful measures to create competition in many sectors. Corporatism has been a longstanding problem in Spain, as was examined in Chapter 1, and was acknowledged by one of the most senior members of the government in charge of a key economic portfolio, complaining of how the design of the President´s Office, with the President´s Economic Office reporting directly to the President, had opened the door even more to these practices:[61]

> There is always a capture by the business' oligarchy. There are two types of firm: those that need the government and those that don´t. It was a mistake to set up the President´s Economic Office as it was. It became a channel for business influence. It was a mistake to leave that avenue open, because at the ministries people have experience in dealing with lobbying pressures. A clear example of this was the electricity sector and renewables, and the influence they were able to exercise over the President through the President´s Economic Office.

A third factor that helps explain the failure of the LES was the lack of a parliamentary majority supporting the government. In the words of the key liaison of the President´s Office with the parliamentary party:[62]

> Often the influence of business and other vested interests is through its lobbying of the different parties in Congress, with different sectors lobbying for specific changes to norms. We had to do a lot of this because we did not have a majority, so to satisfy those parties that would support each vote, and who represented firms and sectors that were important in their region. It became very difficult to maintain the original objectives.

Beyond these various domestic factors there were of course some external constraints that also played a role in explaining the adoption of the LES. As mentioned above, international institutions, such as the IMF and the European Commission, as well as investors, were influential in exercising pressure to adopt a more decisive response to the crisis. *Plan E* was perceived as having led to excessive and ineffective spending and Spain was no longer seen as the

[61] Research interview.
[62] Research interview.

economic miracle it had once been. The first troubles with the banks had dented confidence in the country´s economy. And, while the decline in GDP was far less than in other EU economies, the long-term expenditure trajectory and heavy dependence on foreign finance was enough for the bond spread to have climbed significantly in the early part of the year, reaching a record 124 basic points on 16 February, from hardly ten basic points at the start of the crisis in the summer of 2007 (*Expansión,* 2015). Fears of contagion after the announcement of the true scale of the Greek deficit in October 2009 and doubts about the health of the Spanish financial system added upward pressure to the bond spread. It reached its highest level of that period on 21 January at 122 basic points and hovered around that level until late February 2010, but commenced a steady decline after that, thanks to the improvement in the global economy and the easing of tensions in the global financial markets. By August 2010 it stood at 50 basic points, its pre-October 2008 level.

These external factors did indeed contribute to building an environment of pressure that forced the government to act. But they are less apt to explain how the LES came about and why it failed. For example, while it is true that the increase of the bond spread had been a motivating factor when the decision was taken to change towards reform earlier in the year, if the increase in borrowing costs had been the main reason to act, it is unlikely the government would have decided to launch the LES precisely when the pressure on the spread was receding. Furthermore, the international pressure was clearly not sufficient for the government to complete the reforms. The failure to do so had more to do, as has been shown above, with domestic political factors like its poor design, the lack of serious political will to pursue its objectives, the lobbying efforts against it of the sectors affected and the absence of a parliamentary majority. Politics was therefore crucial in explaining the outcome of the LES, quite independently of external constraints.

3.4.2. The first reform of the financial sector

The following month, June 2009, saw the government take another significant policy decision, with its first actions to reform the Spanish financial sector. When the financial crisis showed its first signs in 2007, the reaction of the Spanish authorities was one of confidence with respect to the country´s financial system.[63] President Zapatero and Vice-President Solbes regularly spoke of the Spanish financial system as being 'one of the strongest in the world' (*El Mundo,* 2008). Their view was confirmed in the late months of 2008 and early 2009 when, after the collapse of Lehman Brothers, financial institutions all over the developed world had to be bailed out but not a single Spanish financial institution had to be rescued. The comments of a senior member of the administration who had a key role in the financial sector reform summarised this attitude well:[64]

> We honestly […] thought that the financial system was in a much better state than it actually was. That was our starting point, and I assume also of the Bank of Spain, because that is what they said publicly. When I hear Solbes say the financial system is in a good state, I believe him. When we have the stress tests saying that overall things are fine, beyond specific needs here or there, I believe it.

This confidence would, however, prove to be counterproductive. The Spanish government, the Bank of Spain and the financial institutions themselves had put their faith in the crisis being short, hoping provisions would be gradually consumed without need for recapitalisation, at a time when US and European banks were already busy buttressing their capital bases. But that was of course not how events turned out, and once the recession prolonged its grip, property developers started to go bankrupt, unemployment continued to rise and mortgage defaults spiked. The large banks, like *Banco de Santander* and BBVA, did not face capital shortages, as they were well diversified and could count on the profits from emerging markets, such as Mexico and Brazil, where they had a strong presence and business was less affected. But the small and mid-size banks and most especially the *cajas*, the idiosyncratic Spanish regional saving banks, did start to

[63] Research interviews.
[64] Research interview.

feel the effect.[65] In March 2009 the *Caja Castilla la Mancha*, a mid-sized *caja*, became the first financial institution to be bailed out. Remarkably, its failure came as a surprise to the government, according to various senior officials interviewed, [66] a first sign of the questions that would come to be asked about the effectiveness of the Bank of Spain's regulation and supervision. Although the rescued *caja* was small, its effect was significant as it brought international attention to the hitherto little known system of *cajas*, as confirmed by a former Spanish socialist minister who at the time held a senior position in the European Commission and by an official at the European Central Bank (ECB).[67] By June 2009 confidence in the system was weakening, not least internationally, and the government was forced to adopt the first significant financial reform, namely the creation of the Fund for Orderly Bank Restructuring (*Fondo de Reestructuración Bancaria* [FROB]). Its purpose was to provide funds to facilitate the process of mergers and IPOs that was taking place among the smaller financial institutions, especially the *cajas*, in the face of mounting losses and to help recapitalise them.

The pressure exercised by external constraints in shaping these early stages of the management of the financial sector reform is obvious. Had it not been for the global credit crunch, Spanish financial institutions, and especially the *cajas*, would not have experienced the problems they did, at least at that stage. Furthermore, mistrust in the financial system was one of the factors that most undermined market and EU confidence in the Socialist management of the crisis (Bastasín, 2012). The doubts about the solvency of the financial system, and the risk that the state would have to step in to bail out institutions, fed sovereign risk, leading to a substantial increase in the sovereign bond spread in late 2008 and early 2009, as we have just seen, which in itself made credit to banks more expensive, thus increasing their risk of default, creating a vicious circle. International preoccupation with the system was already significant by mid 2009 and it only got worse as the crisis proceeded. A top official in the European Commission

[65] For a detailed account of the various aspects leading to the crisis of the *cajas* see Carballo Cruz 2011, Ruiz et al 2015, Fernández-Villaverde et al., 2013 and Cuñat and Garicano, 2010, as discussed in the literature review.
[66] Research interview.
[67] Research interview.

recalled[68] how colleagues in Brussels found it difficult to understand the attitude of denial with respect to the problems in the Spanish financial system, which contributed to undermining their confidence in the ability of the Zapatero government to manage the crisis effectively. The European Commission, IMF and international investors increasingly called for substantial reform and recapitalisation, and yet reform was slow, piecemeal and never sufficient to address the concerns of investors and external institutions. A number of domestic political factors can help explain why.[69]

Firstly, the *cajas* had a very strong regional presence and had traditionally been the financial instrument of choice to finance regional development, both public and private. This led to their being very exposed to politically driven public investment, such as that for costly and unsustainable public infrastructure of dubious financial return. When losses started coming their way with the puncturing of the housing bubble and depletion of their capital cushions it was difficult to recapitalise them, since their dated legal structure nominally had them incorporated as foundations with no capital, just reserves and this legal structure prevented them from tapping the markets for capital. This was one of the most damaging aspects of the crisis, according to a top official at the ECB,[70] and one that obviously originated in a domestic institutional factor, such as the nature and workings of the *cajas*.

Added to that were all the difficulties brought about by the influence of politics in their governance. As previously explained, the boards of the *cajas* included, by law, representatives of local government, as well as other social agents such as the trade unions. The heavy politisation of these boards not only led to poor management in the run up to the crisis, but made it also more difficult to reshuffle them and reform the *cajas* in the absence of pressure. This was in contrast with the *Landesbanken* in Germany, which were urgently recapitalised when facing imminent demise. A high-ranking official at the Bank of Spain put it bluntly:[71]

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[68] Research interview.
[69] For a detailed account of the management of the Spanish financial crisis see Otero-Iglesias et al., 2016.
[70] Research interview.
[71] Research interview.

> Spain has had three crises: the housing bubble, the international financial crisis and the euro zone crisis. The normal thing would have been for the Spanish financial system to collapse completely, like the Irish. And yet not a single bank, which was about 50 per cent of the financial system, had to be bailed out. They did not require any public funds, which is unheard of in the countries that had a bubble (the US, Ireland). So where was the problem? In the *cajas*. And here, politics was clearly key. Politicians ran them; it was politicians that made the appointments. And even then, only half of the *cajas* had problems, mainly those in the regions governed by the two largest parties, the PP and PSOE, and where the *cajas* served more clearly as instruments of corporatism.

Furthermore, party politics made it even more difficult to intervene. With the exception of *Caja* Castilla *La Mancha*, all of the c*ajas* that faced difficulties were in regions governed by the opposition Popular Party (*Partido Popular* [PP]) and it was this party that controlled their boards. It was therefore very difficult for the government to intervene without this being seen as a political attack on the opposition, as a key member of the government´s economic team with responsibility for financial affairs confirmed.[72]

Politics, in sum, was a crucial determinant in the failure to act sooner, aggravating the poor supervision to which the *cajas* had been subject. An official at the highest level of the Ministry of Economy and Finance acknowledged that the *cajas* were not really on the radar screen until the problems were obvious and, implicitly, recognised a certain failure of senior government officials to act sooner:[73] 'because of governance reasons or whatever, there was less attention paid to them when it came to control and supervision; that was at least my perception'. Another reason for the lack of early reform, as the work of Woll (2014) would have predicted and indeed Otero-Iglesias et al. (2016: 57) have shown was at play in the Spanish case, was the financial sector´s 'power of inaction'. According to this view, financial firms, knowing that governments are understandably reluctant to liquidate a significant part of the banking sector, delay painful measures and only contribute to a solution, usually through mergers, once governments have pledged significant amounts of public money for the process.

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[72] Research interview.
[73] Research interview.

Failure to regulate and supervise effectively the *cajas* points to a wider and probably the most important factor in the management of the financial reform: the clear diagnostic mistakes by domestic institutions, especially the Bank of Spain and the Ministry of Economy and Finance, not only prior to but also throughout the crisis (Otero-Iglesias et al., 2016). The role of the central bank has certainly been controversial and, to many of the protagonists, very poor. This negative view of the Bank of Spain´s role is remarkably widespread. A minister who was central to the government´s economic agenda[74] was adamant that the Bank of Spain 'was absolutely wrong in [its] diagnosis'. Similarly, a senior Spanish official at the European Commission recalled[75] how every time the Minister of Economy and Finance, Elena Salgado, visited Brussels "she had a very hard time because she could not really offer coherent explanations on the state of the financial sector'. A senior member of the President´s Office was just as critical:[76]

> The role of the Bank of Spain in the crisis is to me incomprehensible. It is worrying because it questions [its] competence. Throughout the whole of the last term in office the Bank talked about labour reform much more than about what it should have. I knew well Solbes and Salgado [the two successive Ministers of Economy and Finance] and they would not lie to me. The problems with the financial system went undetected by the Bank and the Ministry to which it reported.

While, as a top official at the Bank of Spain argued,[77] 'it is the responsibility of the Bank of Spain, as an independent entity, to tell the government about dangerous imbalances, so we had to talk about the labour market', many blame the Bank of Spain for being too focused during the crisis on pressing the government to undertake structural reform, especially of the labour market, while not paying sufficient attention to its primary area of responsibility, the financial sector, and failing to supervise it effectively. As the supervisor, it was the Bank that had the best information on the risks and the real health of a financial system that was

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[74] Research interview.
[75] Research interview
[76] Research interview.
[77] Research interview.

badly affected by the bubble. A senior member of the Bank who had also held responsibilities at the President´s Economic Office, admitted:[78]

> The Bank reacted late. It put too much emphasis on criticising institutional and governance issues, setting the *cajas* against the banks, and failed to get a good overall view of the general economic downturn and how this was going to affect the balance sheets of all institutions. For example, the idea of a bad bank, which was finally set up in 2013, was already discussed in 2008 and 2009 and the Bank saw no need to set it up.

The accusation of negligence levelled against the Bank of Spain extends to the Ministry of Economy and Finance, the government department most closely associated with it. According to officials at the highest level of the President´s Office,[79] as late as January 2009, Vice-President Solbes submitted to the President and the cabinet a briefing in which he set out what he thought were the key issues and decisions to be taken to manage the crisis and, in that document, 'there was not a single word about the financial system'. According to various accounts,[80] Mr Solbes did receive some worrying reports from the Bank of Spain during his first term of office but with the appointment of his friend and ally Fernández-Ordóñez as governor he distanced himself from keeping an eye on the financial sector, delegating the task to him. The problem was of course that acknowledging banks had been careless in their lending would imply admitting its own supervisory failure, which the Bank and his governor were understandably reluctant to do. One of Minister Solbes' deputies acknowledged[81] that 'it is clear the government could and should have been more demanding of the Bank of Spain', while another official at the highest level of the Ministry, traditionally consensus-driven, admitted that relations between the Ministry and the Bank of Spain were not as good as they should have been:[82]

> It did not bother me so much that the Bank spoke about non-financial issues. Mervin King also made economic policy recommendations. But it is true that there was an excessive fixation with the labour market, with a specific model in mind, and that is a different story. It just did not look good

[78] Research interview.
[79] Research interview.
[80] See for example Ekáizer, 2012.
[81] Research interview.
[82] Research interview.

> that the Bank spoke so much about the labour market and so little about the financial sector.

This of course also influenced Zapatero´s view of the crisis. According to one of his closest economic advisors:[83]

> Until the end Zapatero was convinced that the only problem was the small *cajas* (…). I think Zapatero was misled by the banks, but also by the Ministry and the Bank of Spain. Because even if our banking system was very diversified and internationalised, with the size of the bubble we had, it was impossible for the banks not to be affected.

In fact, according to some sources, President Zapatero had wanted reform of the financial sector to be undertaken earlier, when the first signs of problems in the sector were becoming apparent, but Vice-President Solbes and the Governor of the Bank of Spain prevented this, something the President accepted because 'he was profoundly respectful of the independence of the Bank of Spain', according to an official in the President´s Economic Office.[84]

The lobbying efforts of the financial sector also played a role in the conduct of the Bank of Spain and the government's underestimating the problems of the sector and are another of the key factors that shaped the management of the financial reform. Interestingly, and according to interviews with senior officials,[85] this influence was more subtle and indirect than could is often assumed to be, yet not less significant. Financial executives influenced events both through the Bank of Spain and through their direct relationship with the government. On the former, the figure of the governor has been the subject of much controversy. From his appointment doubts were raised about his suitability for the post. A former Secretary of State in the previous Socialist government, and a key ally of Mr Solbes, Mr Fernández Ordóñez was the first Governor of the Bank of Spain to be a member of a political party, in this case the PSOE. It was not only his political affiliation, but also doubts about his qualifications for the job that generated unease. According to some of his critics, including one of the most senior

[83] Research interview.
[84] Research interview.
[85] Research interviews.

economic ministers in the government,[86] he did not have sufficient knowledge of financial issues. This was important because it meant he had to rely on the views of the banks and the counsel of the staff at the Bank, often *colonised* also by the financial sector. In the words of this minister:[87]

> He was a great microeconomist, with very good knowledge of issues relating to competition, the energy sector, etc. But he knew very little about finance, so he really was in the hands of the financial institutions.

It is probably inevitable that the head of a central bank be susceptible to the arguments of those with whom he engages daily and somewhat 'colonized' by their views. As a top official in the President´s Office who has been in a privileged position to observe the lobbying efforts of different sectors for over twenty years has said,[88] there is always an 'ideological alignment' with certain pressure groups in virtue of the portfolio they are in charge of. Yet in the case of Governor Fernández Ordóñez, he was seen by some not only as downplaying potential threats to the system´s stability, but acting in tandem with the financial sector in pressuring the government to adopt deeper economic structural reform in other realms and in effect deflecting attention and delaying the necessary reform of the financial sector.

Financial executives also lobbied the government directly. As various senior government officials acknowledged,[89] the President listened to many industry executives, especially Mr Botin (the Chairman of Banco de Santander) and Mr Faine (Chairman of *La Caixa*, at the time the second largest *caja* and one of the largest lenders in the country), but also others, like Miguel Blesa, the Chairman of *Caja* Madrid, which would end up being the largest Spanish financial institution rescued. Their influence on the government, and especially on President Zapatero, was substantial, according to various sources in the President´s Office who had direct observation of this.[90] This influence was, however, often more indirect than direct, not so much opposing specific measures but more shaping the

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86 Research interview.
87 Research interview.
88 Research interview.
89 Research interviews.
90 Research interviews.

key decision-makers' views, not only the Governor´s but also the President´s. In the worlds of a close aide of the President who would often be present in these meetings:[91]

> There is an influence of organised interests, but it is not an automatic tit-for-that. It is a general kind of relationship, an understanding that if you help me then you can count on me to help you.

This view was shared by one of the top officials at the Ministry of Economy and Finance who also dealt closely with the financial community:[92]

> It is true that some senior executives had a direct line to the President. They did use it, but only on key occasions when they really felt they had to, probably less than people think.

A senior official at the Bank of Spain has admitted that even the Bank itself often sided with the banks on controversial issues. Referring, for example to the controversial support of the government on tax breaks for foreign acquisitions which benefitted firms like *Banco Santander* but which the European Commission ended up ruling as contravening EU rules, this official said:[93]

> Spain has been very generous with the banks in the past with issues such as state assistance. And the Bank of Spain defended many of these things. It brought out a note defending the *Fondo de Comercio*. It was shameful (…). I am not clear why the banks are so influential, as they are not monopolistic, actually some fail.

This lobbying, however, had its limitations. The banks' interests were sometimes at odds with those of other business sectors. In the case of the housing bubble and associated toxic assets, businesses pressured the state on opposing sides of the argument. The creation of a bad bank was a clear case in point, as explained by a senior official at the Ministry of Economy and Finance who was intimately involved in discussion of this potential solution:[94] 'If you create a bad bank, the interests of the developers and the banks are often at odds'. The exertion of pressure also went both ways, and the financial sector often found itself having to

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[91] Research interview.
[92] Research interview.
[93] Research interview.
[94] Research interview.

accommodate and facilitate political decisions taken by the government that were not in its interest. For example, politics played a key role in forcing the banks to purchase Spanish sovereign debt and to accept recapitalisations using the Deposit Guarantee Scheme (*Fondo de Garantía de Depósitos*), which in Spain is funded by the banks and which contributed 25 per cent of the FROB. A top executive at the Bank of Spain was clear on this:[95]

> In the recapitalisation of the bank politics was also important, because it was a political decision by Campa [Secretary of State for the Economy] and the banks had to be persuaded, since it was their money. The argument was that they would benefit from the restructuring of the system as they would be left with fewer competitors, so they should also pay.

Certain episodes were, however, indicative of a special relationship between certain financial executives and the government. The most striking was probably the decision by the government to grant a pardon to Alfredo Saenz, CEO of *Banco Santander*, who had been convicted of the use of privileged information. According to a senior government official close to the President[96] it was a sign of how close the relationship between the financial sector and the government was: 'If the President granted the pardon, he knew he would be able to count on Mr Botin´s help when needed, even if the matter had not been explicitly discussed between them'.

One final factor that most certainly conditioned the management of the financial sector reform was the political cost that some of the reforms entailed. Although with hindsight the need to recapitalise the *cajas* and some of the banks might seem obvious, it was at the time politically very difficult to use public funds to bail out financial institutions. A high-ranking official at the Ministry of Economy and Finance explained further political difficulties:[97]

> We did not act earlier because it was not politically feasible to do so. When the credit difficulties became unbearable we had to act and we set up the FROB; we had to put up 90 billion euro. That is nine per cent of our GDP. It would have been politically impossible to establish it earlier or when the

[95] Research interview.
[96] Research interview.
[97] Research interview.

> problem was not apparent. Then, a second, bigger problem came, which was related to the *cajas*, and how many of them were not feasible. But most of these were in regions governed by the PP, which made it difficult for us to act, because we did not have the legal means and because we were accused of using it as a political tool. Finally, there was of course the danger of our intervention's leading to a lack of confidence in the banking system, at a time in which the euro and sovereign crisis already had the country on the edge.

In addition, the government was under constant attack from the opposition, which continued even at the risk of weakening the country's international image, something of which a senior official at the Bank of Spain was particularly critical:[98]

> During the crisis we implemented a traditional financial crisis management, of which we had experience here from the late 70s. You don´t allow banks to fail because it is too expensive. You group them, you put some money in and you change the managers. So overall the Socialist government and the Bank of Spain did not do such a poor job. And yet a campaign to attack us was launched by the opposition, something that has not happened in any other country. Why did the PP do it? In my view, they did so simply to gain a political advantage. The PP was very destructive in that sense.

To summarise, the above analysis paints a picture in which domestic political factors were vital in shaping this first reform of the financial sector. The influence of political parties in the governance and financing decisions of the *cajas* was instrumental in explaining the weakening of these credit institutions and their resistance to reform. The failure of the Bank of Spain to supervise the sector effectively and the dysfunctional role played by its very political governor, fuelling disagreement with the government by his attention to other structural reforms while risks in the financial sector went undetected, also explain the strained relations between the President and his economic advisors on the one side, and the Ministry of Economy and Bank of Spain on the other, which did much to prevent more effective reform. The Bank of Spain also acted as a channel of the influence of the financial sector, which succeeded in leading the government to downplay for a long time the problems that affected the sector, also of course with the aid of the direct relationship of some financial executives with the President. Finally, the political cost associated with large state assistance to banks was

98 Research interview.

another key factor that explains the reluctance of the government to act, as was the difficulty in dealing with problematic *cajas* in the hands of the opposition without being accused of using the reform politically to attack the opposition. In any case, by the time these first steps were taken to try to strengthen the sector doubts had already been sowed within the international community, something that would prove to be a persistent source of vulnerability throughout the rest of the crisis.

3.5. Conclusion

The first three years of the crisis, starting in mid 2007, saw an evolution in the attitudes of the government, from an initial downplaying of the crisis, to an acknowledgment of its impact but blaming international factors, to an acceptance that Spain had its own structural problems that needed addressing. These phases were accompanied by differing responses: from early inaction, to an internationally backed fiscal stimulus, to, in the later stages, some lukewarm attempts at structural reform. External constraints played a significant role in shaping the government´s management of the crisis throughout these distinct phases. As early as 2007 the European Commission had warned Spain about the serious imbalances developing, adding to the pressure on the government to act. The implosion of the global financial crisis in the autumn of 2008 and subsequent credit crunch led to a recession that forced the government to acknowledge the gravity of the crisis and adopt the first measures, including those in support of the financial sector. The fiscal stimulus that followed was a direct response to the G20 call to pursue expansionary measures. The limitations that EMU placed on economic policy, most importantly the impossibility of devaluing, led to some of the early structural reforms in 2009. Some early austerity measures adopted at the same time were a direct response to the increasing concern of the European Commission at the ballooning deficit and the increasing pressure on international bond investors on Spanish sovereign debt. Concerns by European Commission and ECB officials on the vulnerability of the Spanish financial sector, and especially on the opaque governance of the *cajas* system and their exposure to the bursting of the housing bubble and ability to raise capital to deal with nonperforming loans, contributed to the Spanish government undertaking some early reforms of the sector, as did the pressure of international investors who factored this financial risk in the bond spread of sovereign debt.

Yet what the analysis conducted in this chapter helps us understand is that domestic political considerations also influenced the response and often trumped economic factors and external constraints. Most importantly, electoral and public opinion considerations were clearly at play in the months before the March 2008 election, when the government was keen to preserve the image of a good economic record gained over the previous four years, and thus had a strong incentive not to acknowledge the weaknesses the economy was already showing. Ideological predisposition towards public expenditure obviously facilitated the fiscal stimulus that marked the initial response to the crisis. And party pressures were clearly relevant in many of the decisions, such as that to disburse the fiscal stimulus through the local authorities, where the PSOE had a strong presence.

The nature of certain domestic institutions also played an essential role. The decentralised Spanish public administration was essential to explain the manner in which the fiscal stimulus was disbursed and the political governance of the *cajas* was a key determinant in delaying the financial sector reform. Parliamentary dynamics were also relevant, as the absence of a parliamentary majority made it difficult to embark on politically costly reform. Furthermore, the pressure of organised interests was present at various stages. The heavy concentration of the *Plan E* stimulus in construction projects or the slow and timid early financial reform cannot be understood without reference to the pressure exercised by the representatives of these sectors. The financial sector also exercised significant pressure on the government to try to shape financial regulation.

Finally, a disorganised and often ineffective decision-making process seems to have been a hallmark of the Zapatero administration throughout this period. This was both cause and consequence of the disagreements in the cabinet, which certainly conditioned the response, both in the assessment of the gravity of the crisis and in the measures adopted, such as the fiscal stimulus, the LES or the financial reform. Personal characteristics often contributed to this inefficient decision-making process and were important factors in explaining the outcome, from Zapatero´s lack of economic experience to Solbes' excessive conservatism when it came to structural reform or Fernandez-Ordóñez´s idiosyncratic approach to his role as Governor of the Bank of Spain.

In any case, this phase of stimulus and early reform in the management of the crisis was still the child of the Keynesian approach that had dominated the earliest phase of the crisis. But by mid 2010 the wind had changed. The Greek crisis had focused attention on the budgetary challenges faced by other EMU states. Contagion was spreading, with the bond markets significantly increasing the risk premium on Spanish debt. The pressure on Spain started to increase, both from the markets and its European partners. This was the context for the sudden change of direction in the management of the crisis that took place in May 2010 and which is the subject of the next chapter.

Chapter 4. The euro zone crisis (I): austerity and reform

(May 2010 to April 2011)

4.1. Introduction

Mid-2010 marked an inflection point in the management of the crisis, caused by a change in the nature of the international crisis. Until then the crisis had been mainly financial, affecting mostly developed economies, and had led to a deep but short recession addressed with fiscal stimuli. Yet by early 2010 there was increasing concern at the deterioration of public finances, especially in the euro zone periphery, as a result of both the drop in revenues associated with the decline in economic activity and the high levels of public expenditure caused by the fiscal stimulus and the bailout of financial institutions.

This incipient sovereign debt crisis would find its centre stage in the euro zone and its catalyst in the Greek budgetary crisis. Ever since in October 2009 the Socialist government of Georgios Papandreou had acknowledged that the country´s budget deficit for that year could be as high as 12 per cent of GDP, in contrast to the 3.7 per cent estimate of the former centre-right government, doubts had been accumulating over Greece´s public finances. While initially denying the need for any external help, after repeated downgrades and worsening financial perspectives, the Greek government finally announced on 23 April 2010 its acceptance of an aid package financed jointly by the European Union (EU) and the International Monetary Fund (IMF).

Yet the EU´s response to Greece´s difficulties was slow and insufficient. The unwillingness of a number of euro zone members, especially Germany, Finland and the Netherlands, to offer the necessary funds to deal forcefully with Greece´s problems sent a signal to bond investors that the assumption that all euro zone public debt was safe was could be questioned. Markets reacted by increasing substantially the risk premium on Greek sovereign bonds. More worryingly, these doubts spread to the sovereign debt of other peripheral European Monetary Union (EMU) states, most notably Ireland and Portugal but also Italy and Spain.

Underlying this response was the position of Germany and its allies in the EU Council, who viewed Greece´s difficulties as the result of fiscal irresponsibility (Hopkins, 2013) and were particularly concerned about the moral hazard of assisting Greece and other peripheral euro zone states. As a senior Spanish figure in the European Parliament well versed in Spanish and EU politics observed:[1]

> When Greece´s problems erupt it is the realisation of their [northern European euro zone members'] worst dreams. All they had feared could happen was happening and was doing so in a country than synthesised the fear of what they said all along could happen: fiscal indiscipline, loss of competitiveness, budget tricks and loss of control by EU institutions, etc. So Greece becomes the perfect justification for a diagnosis of the crisis that justifies the architecture they had built, even if the diagnosis is wrong. If the crisis had started in Ireland instead of Greece, just a few months later, then they would not have been able to build such a narrative. But they did, and the answer was obvious: if they have misbehaved, before helping them they have to be punished so as to avoid any moral hazard. That was the German and northern European attitude: we will have to bail them out for the sake of the euro, but not before we punish them. And the evidence is the punishing interest rates of the first aid package to Greece. I think this attitude paralysed the EU during a crucial time period.

Just as importantly, the Greek difficulties highlighted the deficiencies in EMU´s architecture described in Chapter 1, especially the absence of a lender of last resort and of a crisis resolution mechanism. Since the inception of the common currency the sovereign debt bond spreads of euro zone members had converged substantially. For example, interest rates on 10-year Greek government bonds declined from 20 per cent in 1994 to 3.5 per cent in 2005 (Gibson et al., 2011). There were a number of reasons for this. The first was the assumption that the single market would eventually lead to a convergence of fundamentals. The second was the conviction that, even though the Treaty on the Functioning of the European Union (TFUE) expressly prohibited the monetary financing of sovereign debt by the ECB (Article 23) and the bail-out of a member state (Article 25), euro

[1] Research interview.

zone members would stand up for one another in case of difficulty. The events of 2010 put a question mark on this assumption.

The absence of a crisis resolution mechanism became especially problematic, as the response to the Greek crisis entailed constant political negotiation in tense circumstances and with domestic pressures, not conducive to agreement on such sensitive issues. As a member of President Zapatero´s economic team who was a recurrent presence at many of those meetings recalled:[2]

> The first reaction to the Greek crisis is clearly driven by national political considerations. When other member states realise the dire straits that Greece is in, it becomes clear that it will need assistance. But, of course, those funds have to come from national budgets, which becomes a political issue at home. And that is where there is a request for the countries of the periphery to make an extra effort in the adjustment, to compensate the political cost at home of the northern countries. All these are very political decisions, driven by political criteria at the highest level. A confluence of political compromises underpinned by a minimum economic analysis.

The euro zone woes quickly started having a detrimental impact on the Spanish economy, which had already been deteriorating steadily during 2009. The decline in fiscal revenues together with the fiscal stimulus implemented in late 2008 had led to a budget deficit of 11 per cent. Even though the European Commission had given Spain extra breathing room by granting it one more year, until 2013, to reach the 3 per cent deficit limit (Royo, 2013: 64), the government had been forced to adopt a first austerity plan amounting to savings of 5 billion euro to meet the revised target. In the first quarter of 2010 the economic situation improved slightly, with GDP growing 0.1 per cent, marking the official end of the recession but with only anaemic growth. Yet it was precisely at this time that contagion from the Greek crisis started to take its toll. Spain was starting to see the downside of euro membership.

By 2010 it was also clear that the euro had not led to the convergence in fundamentals that many had predicted and the design problems in EMU were leading to negative externalities that were starting to have a detrimental effect on

[2] Research interview.

Spain. This added to Spain´s existing woes. In particular, the state of its public finances and financial sector were the subject of ever-increasing concern to foreign investors (*The Economist,* 2010). Deteriorating confidence in Spain´s finances led to a first warning signal on 4 February, when the IBEX-35, the main index of the Madrid stock market, dropped almost 6 per cent in one day as a result of investors' uncertainty about the state of the public finances and the risk of contagion from Greece and Portugal. The quickly deteriorating situation took a turn for the worse on 4 May when rumours started spreading that Spain would ask the EU and IMF for a 280-billion-euro bailout (Leon*,* 2010; *Expansion,* 2010). Although there was no truth in them, the event marked a turning point with respect to confidence in Spanish debt sustainability. From then on, for the remainder of the Socialist management of the crisis, Spain would live under the constant shadow of the possibility of a bailout.

It was in the context of the convergence of these forces – Greek contagion, the ineffective European response to the Greek crisis, deficiencies in the euro architecture, Spain´s structural growth problems and increasing fiscal woes – that, on 12 May 2010, the President announced to the surprise of Parliament a series of austerity measures that constituted a dramatic U-turn in what hitherto had been a staunch defence of a social democratic platform substantiated by increases in social spending. It was this decision more than any other that would come to define the management of the crisis by the Spanish Socialist Workers' Party (*Partido Socialista Obrero Español* [PSOE]) and which has more widely been presented as evidence of the trumping of domestic politics by external forces.

4.2. The May 2010 U-turn

The month of May had started with the European Council's finally approving the First Economic Adjustment Programme and associated financial assistance package for Greece. The negative reaction of European stock and bond markets signalled, however, that bond investors already considered this too little too late. Following further weeks of tension in European markets, an emergency meeting of EU leaders was arranged on the weekend of 7 May to deal with the worsening

Greek crisis. It was clear that unless a more robust response by the EU as a whole was offered, the following Monday could prove to be a turning point in investors' confidence in the resolve of EMU members to stand behind one another and guarantee the euro´s survival.

At the informal meetings just before the summit, both President Sarkozy and Chancellor Merkel told Rodríguez Zapatero (2013: 86) that they considered the situation to be very serious and that, while an agreement to provide a more robust answer was possible, it would also be necessary for all states, and especially those about which investors were showing more doubts, to do more in order to restore confidence. Yet Zapatero did not expect to be asked for any specific measures beyond a generic commitment to deficit reduction (ibid.: 93). The summit ended with a general agreement to build a permanent response mechanism but left the details to the subsequent Eurogroup ministers meeting on Saturday 8 and Sunday 9 May. President Zapatero left the meeting with the conviction that, despite the recent drop in investors' confidence, Spain´s position as a trusted euro zone member was safe. As he has himself recollected (ibid.: 93):

> My analysis until Sunday the 9th led me to think that we were not as a country in any real danger, given that the state of the financing of our sovereign debt (…) indicated that our point of departure was very solid and that, therefore, we would have the capacity to adapt to a more demanding environment.

It was during the Eurogroup ministers' meeting that agreement was reached to create the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) to provide assistance to euro zone members in difficulty. In return Germany and its allies in the Council demanded measures from those states that were deemed to be facing more growth and fiscal difficulties, Spain among them, to ensure that their finances were set on a credible path. In particular, concrete and substantial deficit reduction commitments were called for. The move was also very much motivated by the need to show to their own domestic electorate that the financial assistance had significant strings attached and potential recipients would not be allowed to keep pursuing what were perceived, correctly or not, as fiscally irresponsible policies (Newman, 2015). The agreement involved a hectic and disorganised process, with Minister of Economy and Finance Elena Salgado in Brussels consulting over the telephone with President Zapatero and a handful of other trusted advisors. In the end, Spain committed to reducing its public deficit by 1.5 per cent of GDP in 2010 and 2011. As a senior member of the President Economic Office who was involved in the discussion recalled, this was very much a political decision:[3]

> In our case at a political level the agreement was given by the President. Then Salgado stayed behind to work out the details. From that political decision then followed the technical work of whether the adjustment had to be 1.5 per cent or 2 per cent. But the decision was also political; I never saw a technical paper saying that the optimum was 1 or 2 per cent.

Spain´s acquiescence in the deal, which implied serious spending cuts, was, according to those present, driven by President Zapatero´s resolve that Spain should be seen as playing its part in supporting the euro. As we shall shortly see, this absolute commitment to being a responsible and trusted member of the European project was a defining trait in the Spanish government´s management of the crisis. But there were other domestic political factors that played a vital role, as the following account shows.

On the morning of Monday 10 May the President gathered with a small group of trusted advisors to decide which budget cuts would have to be implemented to reach the reduction of 15 billion euro in expenditure that Spain had agreed to, 5 billion in 2010 and 10 billion in 2011. The measures represented a complete U-turn on the policies, focused on increased public spending, that had until then constituted the hallmark of the Socialist government. The key measures that were finally agreed were an average reduction in the pay of civil servants of 5 per cent; a freezing of pensions in 2011, with the exception of minimum pensions; the scrapping of the 2,500 euro payment for each child born, introduced in 2008; a reduction in the price of medicines paid to suppliers; a 6 billion euro cut in public investment; a decrease of 600 million euro in foreign aid; doing away with the transitory regime for early retirement that had been introduced in 2007; and scrapping the retroactive application of social care subsidies under the recent Law

[3] Research interview.

for the Care of Dependants (*Ley de Dependencia*) (*Congreso de los Diputados,* 2010a).

It is notable that, although the specific measures for adoption were hastily chosen, these and other possible policies had been designed, and their effect assessed by the technical staff at the Ministry of Economy and Finance during the preparatory work for the 2010 budget, as an official involved in preparing these measures confirms.[4] In other words the financial and political implications of each were well understood. According to those present during the discussion and some of those that prepared the briefs,[5] the decision as to what measures to adopt was certainly driven in part by the need to satisfy Spain´s EMU partners, with measures that would be quick to implement and leave no doubt as to their effect on deficit reduction, thereby regaining the trust of investors. But it was also very much driven by domestic political considerations. As a senior official in the President´s Office who was involved in the process recalled:[6]

> When Elena [Salgado, Minister of Economy and Finance] came back from Brussels we sat down and started to analyse all the possible measures. And we did so, to be honest, considering first and foremost what their domestic political impact would be, as well of course as the potential savings they could yield. For example, we considered the possibility of a small charge for medical treatment, but it was immediately ruled out because of the political impact it would have on our electorate.

According to various other sources familiar with the process,[7] a key driver in the decisions was the desire to concentrate the impact on as few sectors as possible, and thus try to minimise the political and electoral cost to the government. By concentrating the brunt of the costs on public servants and pensioners, the government managed to avoid measures that would most have burdened the population, such as the co-payment for health treatment in the National Health System referred to in the quote above.[8]

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4 Research interview.
5 Research interview.
6 Research interview.
7 Research interviews.
8 Research interview.

An important outcome of this strategy was the decision to freeze all except minimal pensions, probably the most controversial decision taken. According to President Rodríguez Zapatero (2013: 77), this decision was taken because he was aware that Chancellor Merkel would see it as a clear commitment to reduce the deficit and because Spanish bond-holders had repeatedly pointed to pension spending as one of their key concerns when it came to assessing the ability of the state to serve its debt. However, various members of the President´s political staff closely involved in the decision[9] pointed out that, in deciding to include pensions in the spending cuts, an important factor was that pensioners were more likely to vote for the conservative Popular Party (*Partido Popular* [PP]) (Fernández-Albertos, 2014). In fact, they had done so again in the previous elections in 2008 even though the increase in pensions had been unprecedented in the previous four years. In other words, the assessment of President Zapatero and his aides was that the electoral cost of such a decision would be less than that of other alternatives because those affected were not among the groups of core PSOE voters. A member of President Zapatero´s inner decision-making circle at the Moncloa Presidential Palace recalled this episode well:[10]

> There was an interesting political phenomenon: during the first Zapatero term pensions were increased at the highest rate in modern Spanish history. And yet our voting intention among pensioners did not increase; it actually decreased slightly. This fact weighted heavily when taking the decision. We thought that we were not going to win anything politically by sheltering pensioners from the cut and that they were not going to punish us much more. And, socially, we thought it was much harder on pensioners to have to pay for health services than to have their pensions frozen. (…) We also wanted to minimise the number of collectives affected by the cuts.

This shows that, even though Germany and its allies in the Council managed to impose fiscal adjustments, the specific form that these took was significantly shaped by domestic electoral cost calculations.

The decision on which measures to adopt was driven not only by political cost considerations but also by ideology. The decision to protect the National Health System is a case in point. For most PSOE leaders universal free health-care was

[9] Research interview.
[10] Research interview.

sacrosanct, any measure that would imperil it anathema. Ideology may also have played a role in a different way. Although the request for Spain to take tough measures was always justified by its EMU partners in terms of the need to strengthen the credibility of the euro zone, there was also a sense among government members in Spain that the country was being especially punished because of its left-leaning government and the appeal that the social policies of Zapatero had awakened in Europe in the previous years. For example, a senior minister and close *confidant* of the President recalled:[11]

> I remember a summit we had at the beginning of the Spanish EU Presidency in early 2010 at which a senior German socialist figure told me to tell Zapatero that they were going after him [the German government] because he was the only charismatic progressive leader of one of the big European countries.

Political stability was another key factor that motivated the government´s acceptance of such tough measures. According to high government officials,[12] the President´s top team was clear that, if the measures were not adopted, it would have been almost inevitable to call a general election, faced with the real prospect of a bailout. However, under such market pressures, in the two months before the elections could have been held, the country would, in the words one of these officials,[13] 'have gone down the drain'.

Finally, the high political cost the decision had for the government, which has helped shape the prevailing narrative of the measures of 12 May as a traumatic external 'imposition', had a lot to do also with the poor manner in which the decision was taken and communicated to the public that had become customary with the Zapatero administration. In the words of one the most senior members in his own staff:[14]

> He [President Zapatero] did not manage it properly at a political, internal level. A clear indication of the internal disarray is the fact that, I can tell you, of the 15 ministers probably 11 had no idea, had not been consulted or

[11] Research interview.
[12] Research interview.
[13] Research interview.
[14] Research interview.

> even informed of the measures, and learnt about them listening to the President announce them in Parliament.

A respected economic analyst at one of the nation´s main newspapers concurred with the view that the ill-planned manner in which the decision was communicated compounded the effect of the measures themselves:[15]

> The problem really was the way Zapatero communicated the decision. It is incredible he disposed of such a grave and momentous announcement just by monotonously reading two pages in Parliament. That was incompetent. In such a situation you have to go on TV, all stations, and explain it i more solemnly. But the way he did it, the way he staged it, was a disaster.

Other government officials point to the poor decision-making process as a sign of a deeper problem: a lack of political insight. A senior Socialist official who had been part of Zapatero´s economic team for years was particularly damming of the President´s inability to see the clouds that were gathering in that month of May:[16]

> Zapatero, just as Rajoy later, was never really fully aware of the true dimension of the problem he was facing; they did not have the capacity really to analyse the problem until it was too late.

Although the domestic political factors outlined above were significant in shaping why and how the measures were adopted, they could not neutralize the fact that the latter were perceived by the citizenry as imposed from outside, a view which, as Fernández-Albertos (2013) has explained, the government also had an interest in promoting, as it helped shift the blame for the crisis to external culprits and away from the government. As a minister with one of the social portfolios trenchantly expressed it:[17] ‘They were imposed on us and, in my view, were a clear infringement on our sovereignty’.

In large measure because of this perception, the political fallout from the decisions was dramatic. Although Spain had not yet been ‘invited’ to accept a bailout at this stage, President Zapatero was forced to frame this decision as a ‘sacrifice’ he and his party were willing to make for the sake of avoiding such a bailout as well as

[15] Research interview.
[16] Research interview.
[17] Research interview.

preserving Spain´s status as a responsible EU member. In what was probably the most remarkable statement to this effect, President Zapatero declared, during the debate on the State of the Nation on 14 July (*Congreso de los Diputados*, 2010b: 20):

> I will take the decisions that Spain needs, even if they are difficult. I will follow that path no matter how costly it is and no matter how much it costs me…. If there is a contradiction between the interests of the PSOE and what Spain needs, I will opt: for what Spain needs. … We need to fulfil our commitments to Europe; we need it to strengthen confidence in our economy and maintain the trust of investors and of course to transmit an image of stability; we need it above everything else in order to continue strengthening our productive system and preserve our welfare state. It is not easy for a government to address Parliament and the citizenry in such a way, and even less so for a government that has persevered during the years of economic growth in trying to improve the state of all its citizens and especially of those less well off.

This would become a recurring trend: an absolute commitment to membership of EMU and avoidance of a bailout, no matter what the consequences. As we shall see in the next section, a number of political factors shaped this attitude.

In sum, the decision to adopt the May 2010 cuts was certainly driven to a very significant extent by a number of external forces. Firstly, there was the pressure exercised by investors, which had started increasing the risk premium on Spanish debt, as a result of the contagion of the Greek crisis. And secondly the pressure of Spain´s EMU partners, most notably Germany and its allies on this issue in the European Council, who demanded fiscal consolidation measures in return for creating a more robust mechanism that could send a firm signal of commitment to EMU and therefore stop the spread of the erosion of trust to Spain. It is on the basis of this decision that most of the existing literature on the management of the crisis has predicated the thesis, as shown in the literature review (Armingeon and Baccaro, 2012; Hopkins 2013, 2015; Royo, 2013, 2014; Torreblanca, 2014; Sanchez-Cuenca, 2014), that domestic political capabilities were rendered useless during this episode. However, as shown in the above account, domestic political factors played an essential role in both the government´s willingness to accept the fiscal adjustment and the form that this adjustment took.

Firstly, while it is true that the decision to adopt austerity measures of significant scale was forced upon the government and that, as discussed in Chapter 1, the bond spread has been shown (De Grauwe and Ji, 2013a, 2013b) to be more closely correlated with euro zone systemic risk than with national macroeconomic variables. Furthermore, the reason Spain had put itself in such a weak budgetary position as to make itself vulnerable to such impositions was mainly, if not almost exclusively, the outcome of domestic political factors, especially the failure to adopt a debt consolidation plan to accompany the fiscal stimulus announced in late 2008 which would have sent a signal to investors of commitment to sustainable public finances. In other words, when assessing the factors that forced the Spanish government to adopt these undeniably unpopular measures, it is important to analyse them not only at the time they were 'imposed' but also in a wider time period. As acknowledged by a minister in Zapatero´s cabinet, probably the best positioned to assess this process:[18]

> We entered the crisis in a relatively comfortable situation. Then things got worse because the crisis went further than we had expected, because we probably managed some things wrongly and because Europe managed the crisis poorly (…). But in 2008 our public debt was still around 40 per cent of GDP; we had a margin of 30 percentage points to get to the European average, so we were well prepared to face even a very serious fiscal crisis. The problem arises in 2009 when Zapatero unleashes a number of expenditure policies, driven by purely domestic political motives, which take the deficit up to 11 per cent. Even then you could have argued that you had 6 or 7 deficit percentage points more than you are allowed because of the response to the crisis and the G20 Washington agreements. The problem is that it is not the same going from a public debt of 40 per cent to 50 per cent but providing a credible plan explaining how you are going to stabilise your fiscal position than going from 40 to 50 per cent and not saying anything. The message you are sending to the markets is that you are going to continue with an 11 per cent deficit and all of us who are in this business know that to go down from 11 to 3 per cent is very complicated and if you allow the 11 to remain, then it will become structural and will be extremely difficult to tackle later.

This minister is clear. Even while the May 2010 austerity U-turn was certainly made in response to pressure from other euro zone members, the chief reason that caused it, concern at the state of public finances, was very much the outcome of domestic political decisions during the previous months that allowed the public

[18] Research interview.

finances to get out of control. In other words, when a dynamic rather than static analysis is conducted, the fact that Spain arrived at May 2010 with such precarious and worrying budgetary figures as to be vulnerable to demands form its euro zone partners and to the increase in the bond spread was to a very significant extent the result of domestic political decisions. Observing from Brussels, a senior European Commission official with long-established ties to Spain subscribed to this conclusion:[19]

> Pedro Solbes is in the last few months a weak minister. He is then replaced by Elena Salgado, who is seen as even weaker. Meanwhile, the Governor of the Bank of Spain is distracted with other things, talking about the need to reform the labour market instead of supervising effectively the financial system. So the whole situation is really out of synch. And it explodes with the public debt crisis and the decisions of May 2010. The reason is obvious. This is a country that comes from very low levels of public debt, the fiscal stimulus of 2009 increases substantially and puts it on an upwards trajectory, which adds to the already very high levels of private debt, the increasing bond spread, rating downgrades, increasing difficulties in accessing external financing at a reasonable cost, etc. So May 2010 is not just an external imposition; it is the first awakening to a set of domestic problems that had been brewing.

Secondly, the choice of which measures to adopt was very much the outcome of considerations regarding political and electoral cost. The decision to concentrate the measures on as few segments of the Socialist electorate as possible is evidence of this. Thirdly, the decision was driven by the absolute priority to project Spain as a responsible euro zone partner that was prepared to do whatever it took to maintain the euro project alive, an attitude imbued by domestic political factors, from the desire to maintain the country's prestige to recognition of the importance, as an anchor of stability, that euro membership has traditionally represented in Spanish society and among all political parties.[20] As confirmed by one of the President´s closest economic advisors:[21]

> Zapatero never contemplated Spain doing anything that could lead to exiting the euro unilaterally. He did worry that as a result of Spain´s problems, and of other countries like Italy, the whole euro project would be put in danger.

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19 Research interview.

20 For a fuller explanation of these factors see, for example, Hopkins, 2013.

21 Research interview.

And fourthly, the perception of the adjustment measures as a heavy burden externally imposed was very much shaped by an interest in blaming external scapegoats as well as by the poor manner in which the measures were decided and communicated. The pension adjustment was a case in point. The announcement was so unexpected and poorly explained that it left an initial but lasting impression among the public that it would involve a cut in pension benefits, when the reality was that the decision was to maintain the increase in basic pensions and only freeze the annual inflation adjustment for the rest, rather than reduce them. Yet, as one of the senior member of government directly responsible for the design of the austerity package acknowledged:[22]

> The pension reform was explained horribly wrongly. We used a very delicate word, probably in order to sell it effectively to the external audience, but which did not accurately reflect what we had adopted.

Whether this ineffective communication was caused by the government´s customary chaotic decision-making process or actually reflected a lack of understanding and ability to deal with the problems it faced is open to question. But what is clear is that a difficult set of measures was made far more damaging for the government by the manner in which the communication was managed, one last instance of how political factors clearly determined the management of this phase of the crisis.

4.3. The reform of the labour market

Barely a month after the May 2010 U-turn the government took another major decision: to reform the labour market. If there was one reform, or lack thereof, that by mid 2010 had come to symbolise the slow response to the crisis, it was the labour reform. As explained in Chapter 2, and authors like Bentolila et al. (2012a, 2012b) have analysed in detail, the Spanish labour market had for decades been highly inefficient. Even after fifty-two consecutive quarters of growth over two per cent up to 2008, unemployment never dropped below eight per cent. Yet the

[22] Research interview.

dramatic increase in employment that accompanied the housing bubble took away the pressure to undertake reform. However, by 2010 the recession and the bleak growth prospects made that pressure impossible to ignore. Unemployment was rocketing and the need to act had become paramount. The President had announced the government´s commitment to undertaking labour market reform in 2008, but crucially he had publicly declared that he would only enact a reform if previously agreed upon by both unions and employers. He justified sticking to this commitment, even in the very changed circumstances of the crisis, stating that he wanted to give social dialogue a chance. But it did not work and after almost two years without an agreement, the government finally felt the need to act and introduced the reform on 16 June 2010. Adopted by emergency royal decree to send a signal of decisive action, it took effect immediately, although it would only be enacted in its final form by Parliament in September of that year, with some minor changes in exchange for the support, through their abstention, of the PNV and CiU, the Basque and Catalonian nationalist parties.

The reform had three main components (*Boletín Oficial del Estado*, 2010a). Firstly, it relaxed restrictions for the general applicability of a new type of contract with lower dismissal costs, reducing the latter from 45 to 33 days. Secondly, it made redundancies easier for employers by making economic losses a lawful reason for dismissal. And thirdly, it weakened collective bargaining, by extending the scenarios where firm-level agreements could trump sectorial. Although it was a far weaker reform than had been demanded of the government from many quarters, the unions were fundamentally opposed to it. They accused the government of weakening labour protection rights at a time in which the workforce was becoming increasingly vulnerable as a result of a crisis for which they had no responsibility, and saw the reform as opening the door to further job insecurity. This opposition led to a general strike in September 2010 that was not particularly successful. Unemployment kept increasing in the following months but the government resisted calls for further reform. By the time the PSOE left office in December 2011 labour market liberalisation was the most important and urgent reform expected of the new conservative government.

The failure to adopt a more substantial labour reform remains one of the big questions of the Socialist management of the crisis. There was certainly strong international pressure to act. Following its 2008 Article IV Consultation with Spain, published in April 2009, the IMF (2009: 1) stated clearly that Spain required 'vigorous labour market reforms to improve competitiveness, reduce the inflation differential with the euro area, and increase productivity', and went into substantial detail on what measures were required:

> For instance, wage indexation is inconsistent with membership of a currency union. Reducing labour market segmentation, caused by the separation of workers into those in permanent versus fixed-term contracts, is also necessary to allow well-trained young workers to move into higher-paid, permanent jobs. Finally, opt-out clauses in collective labour agreements should be invoked earlier than is now the case, so that companies have a better chance of surviving a downturn and protecting jobs. (ibid.)

Within the EU institutions and other European capitals, especially Berlin, there was also an increasing wariness about the level of unemployment in Spain. These worries arose not just out of solidarity. In a context in which the average unemployment rate in the EU was 10 per cent (Statistical Office of the European Union, 2014), Spain, already close to 20 per cent, was clearly an outlier. While in the past Spain´s unemployment levels had been purely a domestic problem, the advent of EMU and the effect that unemployment could have on the Spanish financial system threatened to be a destabilising factor for the whole of the EU. This meant that the problem was no longer only domestic.

Finally, as we have just seen, by June 2010 concerns about the sustainability of the public finances of the European periphery, including Spain, were increasing among bond investors. The significant increase in the bond spread, which reached its euro era historic high of 209 basic points in the days before the announcement of the reform (*Expansión*, 2015) is clear evidence of this. The concern of international investors had of course to do with the sudden increase in public expenditure, caused in part by the massive increase in unemployment benefit costs, which had led to a public deficit of almost 11 per cent in 2009, but also to concerns about the country´s growth potential to repay its debt and absence of structural reforms to deal with the country´s imbalances. The labour market was the most often cited.[23] Given Spain´s dire need of access to international credit markets it was obviously in its best interest to adopt substantial labour reform that could send a signal in the direction that investors were demanding.

Yet the reality is that the reform adopted by the government was far less profound than international pressure had demanded. Had international pressure really been the driving factor, the reform would have taken a different shape. Firstly, it would have been completed sooner, as it was seen as key to redeeming Spain´s economic woes that were starting to have a destabilising effect in Europe. And secondly, and most importantly, and for the same reason as above, it would have been far more profound. The question therefore remains: if the government´s reforming credentials and confidence of international institutions and investors depended to a significant extent on undertaking substantial reform, why did the government not undertake it? A number of domestic political factors can help explain why, and go to show how, in the absence of a bailout, it was these domestic factors that were the key forces that shaped the government's management of this aspect of the crisis.

The first and most obvious was the self-imposed commitment, mentioned above, to undertake only a reform agreed upon by trade unions and employers' representatives. It is quite remarkable that the President would make approval of such an important reform, which was likely to harm the interests of trade unions, conditional upon their prior acceptance of it. As a secretary of state at the Ministry of Economy and Finance said,[24] 'it handcuffed the government'. Paradoxical as it may seem, there were a number of reasons for this. Probably the most important was the ascendancy that trade unions had over the government in general and the President in particular, through various mechanisms. At one level, the President had close personal relations with trade union leaders, who significantly influenced his view of the labour market. In the words of a close ally of President Zapatero in

[23] Research interview.
[24] Research interview.

his years of opposition and minister during the first Socialist term:[25] ‘Zapatero was indeed very influenced by the trade unions, and in particular by Cándido Mendez’, Secretary General of the General Union of Workers (*Unión General de Trabajadores* [UGT]), the country´s second largest trade union. A secretary of state in the Ministry of Economy and Finance also referred to Mr Mendez as a ‘Vice-President in the shadows’.[26]

President Zapatero was also ideologically close to the trade unions. In the words of a senior member of the President´s Office[27] ‘Zapatero certainly felt closer to the unions than to business, as he saw himself as a representative of the workers’, a point also made by one of the highest-ranking officials at the Ministry of Economy and Finance:[28]

> The great problem with Zapatero is that he saw himself as the defender of the unions’ interests, not least because he thought he was President thanks to them. My first big fight came when he announced that he would not agree to any labour reform the unions did not find acceptable.

Many other government members were also, for historical and understandable reasons in a socialist party, closer to the trade union world than they were to business. In the words of a union member and later Minister of Labour:[29]

> Zapatero had good relations with the trade unions; we all had because of our political past. We had also put in place a lot of good social policies from 2004 to 2008, so until then they looked upon the PSOE government with sympathy.

Finally, there was a constant preoccupation with having the trade unions on the government´s side, or at least not provoking active opposition, as there was always the underlying menace of a general strike. This same minister ascribed Zapatero´s close relations with the unions less to personal or ideological reasons and more to these tactical considerations:[30]

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25 Research interview.
26 Research interview.
27 Research interview.
28 Research interview.
29 Research interview.
30 Research interview.

> I don´t think it is fair to say that Zapatero was hijacked by unions. The issue is that he was aware of the electoral cost of having the unions against you. We know from historical experience that when the unions call a general strike against a left-wing government it always leads to right-wing governments. So that is why Zapatero wanted to keep a level of agreement with the unions, but it is not true that they are responsible for the way the crisis was managed.

This closeness to the unions is key to understanding why a more substantial reform was not adopted, as the unions were completely opposed to it. The first reason was, of course, ideological. Trade unions were against any measure that would diminish employment protection, as, in their analysis, the origins of Spain´s unemployment were to be found less in the protective legislation and more in the abuse of this legislation by business. Attempts to make the labour market more flexible by decreasing labour protection had been the source of previous confrontations with socialist governments. A former minister in the Socialist government in the 1980s who is still active in Spanish politics described how President Felipe González was forced to change his economic policies after the first general strike of the democratic period and adopt a much more expansionary fiscal policy than his economic team had recommended.[31]

However, it is notable that this ideological opposition to reform was held not only by the trade unions. Ministry of Labour officials refused to accept the analysis extended among economists and international institutions that the labour legislation was one of the key causes for Spain´s employment woes. A Minister of Labour in Zapatero´s government said: ‘I am not one of those that thinks that in Spain there was a problem with the cost of firing’[32]. As evidence of this he cited the fact that three quarters of Spain´s unemployment during the crisis took place in the construction sector, which was obviously very vulnerable to a downturn:[33]

> The sector went from 800,000 jobs in 1984 to 2,700,000 in 2007, and by 2015 it had gone down again to around 900,000. But, as I say, when the crisis struck, we had 2,700,000, and another half a million of indirect jobs,

[31] Research interview.
[32] Research interview.
[33] Research interview.

so we knew that if the crisis struck, as was probable, we would have a deep employment crisis. That much we certainly knew.

Ideological doubts about the merits of some of the measures demanded by the business community, especially the lowering of dismissal costs, came not only from the Ministry of Labour. An official at the highest level of the Ministry of Economy and Finance also expressed her doubts about views that placed Spain´s labour market´s dismal performance solely on the cost of dismissal:[34]

> No one can tell me that in this country it was not easy to dismiss when in the previous quarter 700,000 have lost their jobs. Therefore, dismissing can be neither expensive nor difficult. Because at the time the discussion was really about making dismissal cheaper; that what was people meant when they spoke of labour reform.

The second reason for the unions' opposition to the reform was that, in the words of a senior official at the Ministry of Labour,[35] 'the trade unions did not understand the gravity of the situation'. The unions underestimated the anxiety that was taking hold of public opinion and the increased calls on the government to do whatever it took to stem the dramatic rise in unemployment.

The opposition of organised interests to the reform was not limited to the trade unions. Employer representatives also played a key role in placing obstacles. The main employers' association, the Spanish Confederation of Business Organisations (*Confederación Española de Organizaciones Empresariales* [CEOE]) had a strategic interest in opposing an agreement, as it could help expedite the loss of power by the PSOE and the arrival of the PP, much more aligned with their interests. Furthermore, the personal circumstances of the people involved also proved to be crucial. The CEOE was headed by Gerardo Díaz Ferrán, who was at the time facing serious financial difficulty with his companies and accusations of corruption that would eventually lead to his conviction and imprisonment. According to various government officials[36] Mr Díaz Ferrán´s tough stance in the labour reform negotiations was in no small part aimed at forcing the

[34] Research interview.
[35] Research interview.
[36] Research interviews.

government to assist him with his private difficulties. A senior member of the President´s Economic Office complained:[37] 'the head of the CEOE had his own personal problems with the law and he put this before the general interest by refusing to help with the labour reform'. Various government officials agree that it was an unfortunate coincidence, and one that certainly influenced events, that at that crucial time the CEOE was headed by someone who was not a trusted partner and had no interest in reaching an agreement. In the words of a senior official at the Ministry of Labour:[38] 'in order to persuade you need someone at the other end that is prepared to listen: you can´t persuade someone that has closed ears'.

Trade unions and employer associations were therefore unified in their opposition to the reform. And beyond their particular interests and reasons for their position, there was another common thread: corporatism. As seen in Chapters 1 and 2, and analysed among others by Fishman (2013), Hopkins (2011, 2012) or Molinas (2013) the heritage of the francoist dictatorship has led to an economic structure in Spain in which, to this day, there is a deep enmeshing of the public and the private. Trade unions are not exempt from these dealings. For example, a well-known practice has been for the different governments since the transition to democracy to allocate to the unions the funds for vocational training as an indirect way of financing the trade unions. One of Spain´s preeminent economic commentators subscribed this point:[39]

> Trade unions played a positive role through the transition to democracy by helping to keep wages contained when it was needed. The price to pay was maintaining corporatist structures that were a bit obsolete.

Therefore, even if they had competing objectives, this corporatism led to a vested interest among trade unions and business representative organisations in maintaining the existing institutional structures, for example when it came to collective bargaining. As a senior economic policy-maker who has been at the

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37 Research interview.
38 Research interview.
39 Research interview.

centre of Spanish politics since the 1980s and knows well the workings of the Spanish economy put it:[40]

> Unions and business organisation have the same origins, the dictatorship´s 'vertical unions', so they share an interest in maintaining these structures. Social dialogue and collective bargaining are ways of their securing control of the system and it is always difficult to break.

Opposition to the labour reform came not only from these organised interests but also from within the ranks of the PSOE itself. The labour reform had become associated with the 'neoliberal' agenda of the Spanish right and to many in the party agreeing to a reform that would undermine workers' rights was not only going against principle but also political suicide. President Zapatero himself had said, not only in opposition but also in government, that workers' rights would never be weakened under his presidency. His opposition and that of the party to fundamental reform were therefore firm and longstanding. As a minister in his government, who for years was also one of this closest economic advisor years and knew his thinking on the matter well, said:[41]

> Zapatero´s opposition to the labour reform was really political. He was open to other reforms that were politically costly, but not to this one. Even after 2010, when he has paid the political price for change in his policies, he was still against it.

Another senior member of the President´s economic team who was a key figure in the negotiations shared this view:[42]

> The weak reform of the labour market was clearly a political decision. Unlike the pension reform, when it came to labour reform the economic team was unable to persuade the President. The political cost he perceived was just too high.

There was also a concern among party officials[43] that structural reform could harm consumption, reinforcing the recession. This also suggested an ideological division. While technocratic staff tended to favour supply side reforms, the

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40 Research interview.
41 Research interview.
42 Research interview.
43 Research interview.

pressure from the political quarters was always for demand-side measures that would, it was argued, increase economic activity and job creation.

Beyond the role of organised interests, ideology or party preferences, another factor that is critical to understanding why the labour reform was managed as it was is the absence of a parliamentary majority. The PSOE now relied on the support of the PNV and CIU, the Basque and Catalonian nationalist parties, who demanded concessions of greater decentralization, which were politically very difficult for the government. Furthermore, these centre-right parties were generally in favour of greater labour market flexibility, so any agreement would have taken the government even farther away from the unions. In the view of one of the ministers involved in the negotiation:[44]

> Had the government had an absolute majority, the reform would have been different. It would have avoided a general strike, not because the reform would have been weaker but because we would have been able to compensate for it in other areas.

One last factor that influenced the management of the labour reform was the divisions among government departments and the chaotic decision-making process this led to. As could be expected, the Ministry of Economy and Finance was more in favour of deeper reform than was the Ministry of Labour, traditionally the representative in government of the interests of the trade unions and with close ties to them. Disagreement was therefore to be expected. A Minister of Labour, for example, complained that the Ministry of Economy and Finance did not allow the necessary flexibility to reach an agreement:[45]

> They were too orthodox. They did not see, for example, the value of spending money on employment services. Spain has 7,500 civil servants devoted to it, France 35,000. Adding 3,000 cost 90 million euro, while we spend 30 billion euro in employment benefits. But it was very difficult to obtain. Why? Because of a serious lack of understanding of how the employment market works. They only cared about the cost of firing and of unemployment benefits. During a cabinet meeting we spent over one hour arguing whether to raise the minimum salary by 1.2 or 1.3 per cent.

[44] Research interview.
[45] Research interview.

What was more unusual and proved detrimental to the prospects of a more effective reform was the way in which these disagreements were managed. A senior member of the President´s political staff recalled[46], for example, how the President would organise meetings with trade unions and the Ministry of Economy and Finance and side with the unions during discussion, weakening the position of his own minister. This idiosyncratic approach to the management of the reform was well illustrated by an episode recounted in similar terms by two senior members of the President´s economic team.[47] During internal government discussion on the key measures of the labour reform, the more reform-minded staff had been defending the idea of introducing a single contract of employment to replace the many existing. Trade unions had traditionally been against it as they saw in it a mechanism to lower dismissal costs for a large segment of the work force. The Ministry of Labour had also been adamantly against it, according to one of its senior officials.[48] It cited doubts about its constitutionality, claiming that it undermined the principle of collective bargaining inscribed in the Constitution, although the real reason had more to do with an ideological stand. As has been described, the Ministry was imbued with an approach to labour relations heavily influenced by trade unions. Valeriano Gómez, the Ministry´s number two during the first term and who would go on to become Minister of Labour in the last years of the second term, was himself a member of UGT, the country´s second largest trade union. Celestino Corbacho, the minister at the time, was however not as greatly influenced by trade unions, and although publicly against the single contract, had privately expressed his willingness to consider it.[49] The staff at the President´s Economic Office took a favourable view and intended to persuade the President to incorporate it in the labour reform. According to those closely involved in the process,[50] the day prior to the reform text's being taken to the council of ministers for approval and being publicly announced, the head of the President´s Economic Office asked a senior member of his staff to work with the Ministry of Economy and Finance to prepare a proposal for the inclusion of the single

[46] Research interviews.
[47] Research interviews.
[48] Research interviews.
[49] Research interview.
[50] Research interviews.

contract in the labour reform. A brief was presented to the President, who, according to these sources, was enthusiastic about it and ordered it to be included in the reform, unknown to the Minister of Labour. That night a meeting was convened, headed by the President´s Chief of Staff, to finalise the details of the labour reform. Once the officials of the Ministry of Labour had left the room, the issue of the single contract was raised. At that time Mr Campa, Secretary of State for the Economy, arrived at the meeting and was told about the proposal, of which he was unaware. He expressed some hesitation, the result as much of surprise as reluctance to support the idea without having had time to consider it. A senior member of the President´s political staff, who was known by the economic team to be sceptical of the idea, took advantage of the situation to express his own doubts. At the same time, according to these sources, Mr Corbacho was informed of the proposal. On learning of it, he threated to resign publicly the following day. The reason he offered was that such a measure was sure to lead to a general strike and he could not support such a policy. Yet, according to officials familiar with his decision,[51] the reaction was driven just as much by his anger at the way the process had been managed and the need to defend his political authority against what he saw as the economic team´s attempt to act behind his back. The above is a good example both of how the pressure of organised interests, a chaotic decision-making process and personal considerations shape the content of the reform and led to its being far weaker than international institutions such as the IMF were demanding.

One final factor for explaining the refusal of President Zapatero to impose a more aggressive reform was his consensus-oriented personality. According to a minister in his government:[52] ‘Zapatero believed in social dialogue and he encouraged his ministers to practice it’. He believed in it even to the point of being naïve, according to more critical officials:[53] ‘He had this naïve optimistic view that we could achieve anything we wanted’.

[51] Research interview.
[52] Research interview.
[53] Research interview.

To summarise, the above account shows how, while external constraints, most notably the incipient euro zone sovereign crisis, clearly influenced the government´s timing in finally bringing about the labour market reform, the actual content and limited scope of the reform owes much to a number of domestic political factors. First and foremost was the influence of influence of organised interests, mainly the trade unions and the employers' organisations. The opposition of the trade unions was for obviously corporatist reasons, but they also had a firm and long-established ideological view that the way to deal with unemployment and get a more effective labour market was not by making it more flexible. What is even more important is that many members of government, including the President and those that led the Ministry of Labour, shared this view, even if in a more qualified manner. The personal characteristics and judgement of the key protagonists were also important. President Zapatero was someone who clearly had a very consensus-orientated approach and this led to the loss of two precious years. For his part, the head of the CEOE at the time was, for the reasons explained above, an almost impossible partner with whom the government could have reached an agreement. Ideology was also clearly at play, conditioning the views not only of the trade unions but also of senior government members. Parliamentary dynamics were clearly also key. The absence of an absolute majority clearly conditioned the ability of the government to make the reform more palatable by creating a more integral reform that could have granted concessions in other areas. Finally, the often-chaotic decision-making process, while not in itself being an obstacle to the reform, did prevent it from being designed and planned in a more functional manner.

4.4. The threat of a bailout

The May 2010 decision had inaugurated a period of austerity for Spain, driven by an overarching aim: in the words of President Rodríguez Zapatero (2013: 107) himself, 'after 12 May the big priority became to avoid a bailout of the country'. Such a scenario became increasingly likely as 2010 progressed, mainly as result of the troubles in the euro zone, paradoxically coinciding with the Spanish presidency of the EU.

By June the effect of the creation of the European Financial Stability Facility (EFSF) had disappeared and investors' lack of confidence in Spain returned, compounded by the woes of the financial sector, which on 22 May had seen a second *caja*, *Caja Sur*, bailed out. The passing of the labour reform did nothing to stem the loss of confidence in Spain's economic prospects. The Spanish risk premium kept rising and by 17 June it reached 211 points (*Expansion,* 2015), despite the labour reform's having been announced the previous day.

During the month of June rumours started to appear again in the international press regarding the supposed imminence of a bailout of Spain. Although such a request had not really been made at that stage, the first such unofficial suggestion did actually come just a few days later, during a private visit of the then IMF Managing Director, Dominique Strauss-Kahn to the Moncloa Presidential Palace after the meeting of the European Council on 17 June. According to President Zapatero (2013: 56), at that meeting Strauss-Kahn suggested for the first time that Spain accept a precautionary credit line, arguing that such a move would help ease tensions building up against the euro. President Zapatero firmly rejected this request. His argument was that Spain´s fundamentals were solid and that, if Spain were to accept a bailout now, it would imply that the sacrifices that had been asked of the nation in the measures announced the previous month were in vain. However, and according to a number of those involved in the decision, the reasons for the refusal even to contemplate a bailout were far more complex and often of a domestic political nature.

Firstly, there was of course the issue of the social costs a bailout would entail. By then the government already had evidence of the impact bailouts had had in Greece, Ireland and Portugal. As a senior figure in the government´s economic team who was intimately involved in this issue said:[54] 'the social cost for the country weighted heavily on all of us; we had the absolute conviction that it would take over 20 years to come out from such a bailout'.

[54] Research interview.

Secondly, the government worried about the political cost that a bailout would entail for the government and for the PSOE. As one of the senior staff at the Ministry of Economy and Finance who played a leading role in negotiations with the European Commission noted:[55]

> All of the political parties that took part in a bailout (…) have been wiped out: in Ireland, Papandreou in Greece, and Socrates in Portugal. The political consequences, from the point of view of a political leader, have not only to do with the stigma; it is also about his or her death as a political leader and possibly of his party.

That, in his assessment of the bailout, political and not only economic considerations weighed heavily on Zapatero, was corroborated by a senior socialist figure then out of the government but who knew the President well having been part of his close team for many years:[56]

> I have no doubt in my mind that the main reason why Zapatero opposed a bailout was one of prestige and power dynamics, and not the cost of the bailout. He, and Minister Salgado, sold their decision to impose the May 2010 cuts with the argument that had they refused a bailout would have followed which would have eventually led to deeper cuts. I have my doubts, because it is evident that in the case of Greece, Portugal and Ireland the problem was a budgetary one but in the case of Spain the problem was a financial one, and that is why eventually we did have a financial bailout, among other things because there was not enough money to make a budgetary bailout of Spain. That is why I think the decision is driven more by a question of power, of how Zapatero saw a possible bailout by the Troika in terms as a threat to his persona and his position in history. (…).

Thirdly, it is important to understand that, as already noted, Spanish membership of the European project has traditionally represented, for all parties, a symbol of Spain´s democratic normalisation after Franco´s dictatorship and been seen as an anchor of political stability and economic reformism and dynamism. As Hopkins (2015: 3) has explained, Spain joined the euro for the twin reasons of consolidating democracy and maintaining benefits from transfers. Consequently, remaining a model and respectable EU member has been a priority for Spanish governments of all colours. According to a socialist figure that has held senior

[55] Research interview.
[56] Research interview.

positions in both Spain and the EU,[57] the leading role that Felipe Gonzalez played in the construction of the EU also weighed heavily on the new generation of leaders like Zapatero. Because of this, doing whatever was necessary to be seen as a responsible EMU partner, capable of dealing with its own affairs without outside help, was a powerful driver of the absolute refusal to consider a bailout. In the words of a senior member of government at the Ministry of Economy and Finance:[58]

> For Spain it is an identity and historical issue. We have a national aspiration to be inside Europe that other countries don´t have. For Spain, I think, and for the current generation of leaders in this country, the weight of the past, of 98 [the regeneration movement of 1898], is a determinant motive to want to be part of Europe.

A direct consequence of this 'historical imperative', of needing to be seen as a good European partner, was the strategy set by the government to distinguish itself from other southern European countries also in difficulty. This refusal to be grouped with the southern states was in part driven by the attempt to decouple itself from other economies with worse fundamentals. But it was also driven by the desire to remain a model EU partner which, according to some of his advisors,[59] blinded Zapatero to what could have been a more effective strategy: joining Italy and other periphery countries to form a powerful southern block which would have had greater negotiating power, at least in the early stages of the crisis. In fact President Zapatero complains bitterly in his memoirs that even his own staff had fallen into the trap of framing Spain as part of this block when his office gave him a brief entitled 'Why Spain is not Greece' (Rodríguez Zapatero, 2013: 69).

A fourth consideration, closely related to the above, was the impact a bailout would have had in the self-confidence of the nation. President Rodríguez Zapatero (2013: 309) was adamant that 'a bailout would have implied (…) stigmatisation both by ourselves and the world'. Other government officials were of the same

[57] Research interview.
[58] Research interview.
[59] Research interview.

opinion, as described by a senior member of the policy planning staff at the President´s Office:[60]

> It was a decision driven by the need to maintain the trust of the country in itself. A bailout would have completely undermined the trust in the country of Spaniards themselves and also of those outside. It is a stigma that you would probably spend twenty years overcoming and would have had an enormous domestic political cost. That was key to the decision.

As the above quote suggests, the stigma that acceptance of a bailout would have represented weighed heavily on decision-makers. Even a Secretary of State at the Ministry of Economy and Finance, known for his pragmatic views, concurred:[61]

> The problem is that during the crisis the policy solutions were offered only to the 'badly behaved countries' and that had an intolerable component of stigma, which made it very difficult to accept. For example, the programme of debt acquisition in the secondary markets was only offered to the countries in difficulties while a program could have been designed to buy massively in the secondary market bonds of from all member countries. Conditionality was only imposed on the 'bad countries' and that goes completely against the spirit of the euro, which was a success at its creation precisely because it was led by the countries that were seen as 'good', not only by those who would benefit the most.

Related to the above were of course issues concerning what was perceived as an assault on state sovereignty and the importance of preserving it, often ignoring the consequences that membership of the euro zone implies. A Director General in the President´s Economic Office summarised well the view held throughout government when he asserted:[62]

> Of course a bailout was in the air, but there was common agreement, even without any economic estimates of the different alternatives, that that scenario was very negative, and not only in economic, but also in political and social terms. That is where the decision to avoid a bailout at all costs comes from; and from the desire of Spaniards to be able to choose freely in the elections a President rather than having one imposed as happened in Italy (…). Legitimacy is important: who are they, what legitimacy do they have, to take away our sovereignty?

[60] Research interview.
[61] Research interview.
[62] Research interview.

Sixthly, the position was certainly also driven by issues of the personality of the President himself and his conception of power. According to a senior political advisor at the Moncloa Palace:[63]

> A bailout would have implied for Zapatero negating himself. For all the difficulties of imposing the cuts of May 2010, he chose which cuts to make, so they were still within his control. But a bailout would have implied ceding control, and it would have affected those things that were sacred to the PSOE and to himself, such as core public services like health and education. This is why one of the decisions he delayed as much as he could until it became impossible to avoid was the scrapping of the 2,500-euro *baby-cheque*, because it was something he himself had implemented and its scrapping meant negating himself.

Closely connected to this issue was of course the lethal impact that accepting a bailout would have had on President Zapatero´s legacy. Many of those interviewed[64] agreed that this factor weighed heavily on his absolute refusal to consider a bailout and that a certain 'epic' strand of resistance characterised his behaviour in this critical phase of the crisis. Like any senior politician, Zapatero refused to contemplate a decision that would certainly have involved his political death and a serious stain on his legacy. A minister during Zapatero´s first term, who knew him well, having been part of the team that gained power with him, was clear about this:[65]

> For Zapatero, not being removed from power was an absolute. He had decided early on that he would leave at the end of his second term. But for him, as for every president, how he left power and how he would be seen by history were very important. By May 2010 he has seen the collapse of his two great dreams, ending ETA´s [Basque terrorist group] terrorism and strengthening the unity of Spain on a new basis, and now he sees that his only lasting positive legacy, a good economic record, is also collapsing because the crisis is far worse than expected. He sees the real danger of being removed from power and going down in history as a failed president. And that is unacceptable to him.

Seventhly, there was among the technical staff[66] an honest perception that, for Spain, the bailout design was fundamentally flawed, as it was designed to

[63] Research interview.
[64] Research interviews.
[65] Research interview.
[66] Research interviews.

guarantee access to the markets to finance the public debt whereas in Spain the main problem was one of excessive private debt and external financing. And, even in the worst circumstances, there was still a conviction that Spanish fundamentals did not justify a bailout. A high-ranking official at the President´s Economic Office was adamant:[67]

> Our refusal to accept a bailout came from two considerations. Firstly, that we were convinced that our fundamentals were solid and did not merit being bailed out. And secondly, political considerations of the enormous cost it would have for the country and also for the government.

Finally, it is indicative of how the factors driving the decision were much more domestic and political in nature than economic, that a senior source in the President´s Office confirms that never was any analysis conducted to estimate the potential cost of a bailout, even as a scenario exercise. This remarkable fact was confirmed by the two key members of Zapatero´s team that would have been at the centre of any such effort: a high official at the Ministry of Economy and Finance (‘No, the Ministry never did any scenario analysis to calculate the potential impact of a bailout’), and a senior member of the President´s Economic Office (‘It is true. We never made any estimate of the potential cost of leaving the euro. It is not an easy analysis to do but in any case it was never ever considered as an option’). [68]

In sum, the decision to avoid a bailout at all costs seems to have been driven, at least to a significant degree, by highly political considerations. This conclusion was well explained by a minister: [69]

> Yes, it is true; Zapatero became obsessed with the fact that politically it would be very negative for the country. In my view it is debatable whether having accepted a precautionary credit line would actually have been that bad. I understand what Zapatero did, to fight against the bailout, but I don´t know if I would have become so obsessed as he about it. He did become very obsessed and afraid of the political consequences. I was not so afraid then, I was more afraid early on, when I saw the mistakes we were making that eventually led us to such a vulnerable position. He was the other way

[67] Research interview.
[68] Research interviews.
[69] Research interview.

> around. He was not afraid at the beginning but he became much more afraid later on. It probably has to do with the fact that he is more political than I am and in the early stages, although the economic problems were brewing, they did not create any immediate political dangers. But by 2010 and 2011 the political dangers were very real. I assume that is what he was afraid of, having a serious confrontation in the country if we accepted a bailout.

4.5. Reform in a worsening euro crisis

In any case, Spain´s refusal of the precautionary credit line offered by Mr Strauss-Kahn was accepted and both the EU and the IMF came out in support of Spain and the adjustment measures it had adopted in May and its labour market reform. The pronouncements coincided with a reduction in the bond spread to 170 points by 20 June. In fact, Spain´s austerity drive was part of a larger trend. The G20 Toronto meeting held on 26 June marked the end of the fiscal stimuli era and made austerity mainstream, with the governor of the ECB, Jean-Claude Trichet, penning an op-ed in the *Financial Times* just a few weeks later, with the telling title of ‘Stimulate no more - it is not time for all to tighten’ (Trichet, 2010).

It was an unfortunate coincidence that such fiscal tightening took place just as the Spanish economy was regaining strength, growing 0.1 per cent during the first quarter of 2010 and thus technically emerging from recession. In fact, the government devoted the following months, when it appeared the worse of the storm had passed, to the twin goals of controlling the deficit and completing the reform agenda. As we shall see in the following paragraphs, these reforms were shaped by external forces but also by domestic political factors.

4.5.1. The second and third reforms of the financial sector

The government turned its attention first to the financial sector. In July 2010 the government approved the *Ley de Cajas de Ahorros* (*Boletín Oficial del Estado*, 2010b). The law was aimed at transforming the juridical nature of the *cajas*, allowing them to become public companies, raise their own capital in the open markets and compete freely with the banks without the legal and governance restraints they had faced until then. In essence the reform´s goal was to put an end to the idiosyncratic *cajas*' system and transform them into regular, market-disciplined, financial institutions.

The first ECB stress tests were conducted the same month. By then the worries about the state of the Spanish financial system were widespread and, in an attempt to use transparency as a way of calming international markets, the government and the Bank of Spain agreed to expose the practical totality of Spanish financial institutions to the stress tests. Only four small institutions were deemed to require recapitalisation, totalling 1.8 billion euro, a fact that reinforced the government´s complacent attitude. As one of the President´s senior political staff admitted:[70]

> The reform of the financial sector was not undertaken before because there was really not a realisation of the need to do it. The result of the stress tests was almost optimal.

February 2011 saw the third and last significant reform conducted by the Socialist administration in the financial sector, with the Plan to Strengthen the Financial System (*Plan de Reforzamiento del Sector Financiero*) (*Boletín Oficial del Estado*, 2011a). Its aim was to complement the 2009 reform, adequately recapitalise weakened financial institutions in line with the Basel III agreements finalised in December 2010 and try to put an end to the mistrust in the Spanish financial system. The following month the Bank of Spain published the results of its assessment in the application of the new capital rations established by the reform, identifying thirteen institutions requiring 17 billion euros and asking these institutions to submit capital raising strategies within a month, which they duly secured.

All these measures led to a reform that the government and the Bank of Spain considered sufficient. Yet that would of course prove not to be the case. International investors continued to have doubts about the solvency of the system, in particular its exposure to the property sector, not only mortgages but also loans

[70] Research interview.

to developers, and the value at which property assets were held in their balance sheets. In the first months of the PP government, a period that falls outside of the scope of this dissertation, the predicament of Spanish banks would significantly worsen. The bailout of *Bankia*, the third largest lender in the nation at the time, would be just the most dramatic signal in the path to a full bailout of the Spanish financial system in June 2012.

The measures taken to restructure and recapitalise the Spanish financial sector during this phase of the crisis were undeniably driven by external constraints, most importantly the relentless pressure of international investors, the constant menace of a bailout and the need to keep earning the trust of investors and EU partners. However, as was discussed at length in the preceding chapter and Otero-Iglesias et al. (2016) have explored in detail, a number of domestic factors are crucial to explaining why Spain conducted the reform in such a piecemeal and unsatisfactory way as in the end to prove inadequate and force a bailout of the sector. From resistance from the politically governed *cajas* to their reform, to the lobbying pressure of the financial sector and the failings of the Bank of Spain and its governor, domestic political factors are essential to explaining how the reform was conducted. It is illustrative of this that, even four years later, a senior official at the highest level of the Bank of Spain still defended the manner in which this aspect of the crisis was managed, with reasonable arguments:[71]

> Zapatero did not act late on financial reform, at least compared with the others. True, we estimated housing prices would fall by 18 per cent and they fell by 50 per cent. But all were wrong, not only we. And, even so, if at the time we had said that prices were going to fall by 50 per cent and banks had to provision for that, all banks would have had to be nationalised, which would have been very damaging not only politically but also economically. Instead we slowly raised the necessary capital for the system, over 160 billion euro, through a variety of mechanisms that had no cost for the taxpayer: emptying the *Fondo de Garantía de Depósitos*, getting capital from the *cajas*, and banks raising capital in the private markets.

[71] Research interview.

4.5.2. The 2011 budget

Another key chapter in the management of the crisis was to take place during the autumn of 2010 when, in October, the government negotiated the 2011 budget. A clear conditioning factor in this process, as acknowledged by President Rodríguez Zapatero (2013: 205) and many of those interviewed,[72] was the parliamentary arithmetic, reflecting the fact that Parliament was another key domestic arena where the management of the crisis played out. While the government had never enjoyed an absolute majority during its whole term, after the unpopular measures taken in May it had become much more toxic to support it. Having abandoned the social policies that had allowed the PSOE to count on the support of left-leaning parties in Parliament, the budget was the first occasion on which the government could fall. The most important partner was the PNV, the Basque Nationalist Party, as it was the only party with a significant number of votes that could support the government on specific issues and, with the support of other minor parties, build a sufficient majority for the rest of the term.

In the end it was indeed with the support of the PNV that the government was able to pass the budget as well as other key pieces of legislation in the following months, a crucial period in the management of the crisis. This support had much more to do with domestic political factors than with the undeniable external pressure the country was under. According to what President Zapatero has himself acknowledged in his memoirs, and corroborated by sources interviewed that were close to the negotiations,[73] the impulse that led the PNV –a centre-right party which in principle shared little ideological ground with the PSOE when it came to economic policy and which was actually the opposition to the PSOE government in the Basque country – to support the government was the shared view of the strategy necessary to bring to an end the terrorism of ETA. The PNV had an interest in the Zapatero government's remaining in office for this purpose and the support of its key economic policies was a price worth paying. It was therefore a domestically political issue, and one unrelated to economic policy,

72 Research interviews.
73 Research interviews.

which allowed the government to keep on track its economic policy and the commitments given to its EMU partners in terms of budget consolidation.

The passing of the budget gave the government room to manoeuvre and sent a message of confidence to international investors and EU partners at a difficult time, as the problems in Ireland were becoming more acute and would eventually lead to a bailout the following month. Yet the effect of the fiscal restraint measures started to show, leading to a decline in economic activity that made unemployment rise from 19 per cent in January 2010 to 20.3 in December 2010.

4.5.3. The reform of the pension system

The pension reform was the most substantial conducted by the Socialist administration during this period. Commitment to the reform was included in the Sustainable Economy Strategy as early as 2009 and by early 2010 the government, unions and employers started talks on the issue. An agreement was reached in January 2011 and the reform was finally enacted in August 2011 (*Boletín Oficial del Estado, 2011b*). It raised the retirement age from 65 to 67 and established a minimum of thirty-seven years of contribution as a requirement to qualifying for a full pension, which was to be introduced gradually with full effect scheduled for 2027. The contribution period was increased from the last fifteen years of employment to the last twenty-five years, increasing incrementally with a one-year increase every year until 2022.

The need for such a reform had been known for years, not least because of the demographic projections. The system had enjoyed a temporary reprieve by the 12-year growth cycle and the positive impact of the construction bubble, both through the increase of the population thanks to immigration and the increase in tax revenues. Yet there was wide agreement among all political forces that the system was unsustainable in the long-term.[74] Reform was also a recurrent

[74] For a detailed analysis of the imbalances affecting Spain´s pension system see Conde-Ruiz, 2015.

recommendation of institutions such as the IMF (2010: 17) and the Organisation for Economic Cooperation and Development (OECD) (2010b: 5). As with the rest of the reforms, pressure was not significant while Spain was experiencing its high growth cycle. But by 2009 questions were being asked about the capability of Spain to cut its deficit and service its debt. A senior member of the President´s Economic Office recounted[75] a meeting at the Moncloa Presidential Palace with representatives of the IMF in mid 2009 at which serious concerns were expressed at the expenditure trajectory implied by pension commitments. The IMF made it clear that a reduction in committed pension expenditure would send a clear signal to the markets that Spain was reining in its expenditure. This pressure increased exponentially during 2010, when contagion from the Greek budget crisis was leading international investors to look more critically at Spanish public accounts. Undertaking the pension reform was thus a way of showing the markets and Spain's EMU partners that the government was committed to budget stability in the long term, and that unions and businesses were on board. However, as we have seen, other reforms were also being demanded. The interesting question is why this reform proceeded while others stalled.

In answer to that question there is agreement among the various sources interviewed[76] that the pension reform succeeded because it was, perhaps surprisingly, more politically feasible, as it carried a less immediate cost than others. Reforms that entailed immediate expenditure reduction or loss of labour protection rights were very hard politically. Reduction of future pensions, while hard, did not have short-term consequences and was therefore more palatable politically than other options, especially if it was phased in gradually. As the President´s Economic Office´s representative in the reform negotiations recalled:[77]

> The political sell of the pension reform was not difficult and the politicians understood quickly. The key to the decision was the realisation that it was necessary to cut expenditure, as this was based on revenue the country would no longer have after the bubble. The problem with cutting current expenditure was the impact on the recovery and also the political cost. The only two large

[75] Research interview.
[76] Research interview.
[77] Research interview.

areas to cut were health and pensions and pensions was by far the politically easier as it was deferred to the future.

Other domestic political factors were also crucial in explaining the process and success of a reform that in other countries had proved much more politically controversial. As with other reforms, the role of organised interests, especially that of the trade unions, was essential. The President had been adamant again that any pension reform would require the backing of the trade unions. But by 2011 the unions were under pressure to play a more flexible and constructive role than they had in the labour reform. With their political power substantially weakened by their failed general strike the previous year and the economy in a far worse state, trade unions felt forced to be seen as contributing to the management of the crisis. Their agreement was facilitated by the willingness of the government to weaken some of the original goals of the reform (Abellán and Gómez, 2011). The government agreed to lower to 38.5 from the original proposal of 41 the number of contribution years required for workers to maintain the right to retire at 65. This meant that the number of people that would have to retire at 67 to obtain the maximum pension was significantly reduced. It also, crucially, meant that the core constituency of trade union members, older workers, greatly benefitted, as they tended to join the work force at an earlier age and thus had contributed to the system for more years than younger workers. The unions also obtained, in return for their agreement, concessions in other fields, such a commitment from the government to maintain a temporary emergency subsidy that had been established earlier in the crisis to provide a basic income for the unemployed who had consumed all of their regular unemployment benefit. The agreement with the unions allowed the PSOE to mend its relations with them in time to try to capitalise on this in the elections that were due to take place in December 2011. The weakened position of the trade unions, and concessions from the government to make the reform more palatable, explain that measures that in other countries such as France faced enormous resistance, such as the raising of the retirement age, were not an obstacle to the adoption of the pension reform in Spain.

The agreement was also due in no small part to the role of personalities. By late 2010 Juan Rosell had replaced Gerardo Díaz Ferrán as head of the employers' association, the CEOE. As reported in the previous section, Mr Díaz Ferrán´s attitude had been one of open hostility to any agreement with the government and the unions. The Minister of Labour at the time confirmed[78] that the arrival of Mr Rosell facilitated the agreement and was in his view evidence that the personalities of those involved in the negotiations ‘mattered a great deal’. The importance of the role played by Valeriano Gómez, the Minister of Labour, was also confirmed by other sources. For example, the representative of the Ministry of Economy and Finance in the negotiations was clear that ‘without Valeriano Gómez it is likely the reform would not have been possible’.[79]

In sum, while external pressures clearly accelerated the government´s resolve to undertake the reform of the pension system, resolution of domestic politics was essential to the government´s ability to undertake this reform and helps explain why this reform succeeded while others did not. The reform was back-loaded and did not entail any immediate financial or political cost to the government. The unions, in a weakened position and in need to show a more constructive image, benefited from being seen as having extracted valuable concessions from the government for its members. And the acquiescence of the political, union and business leaders involved was also essential to taking the reform to a successful outcome.

4.6. Conclusion

This chapter has chronicled the second phase of the management of the crisis after the initial stimulus-based response. In the process it has analysed the key factors that explain the government actions. Both external and domestic factors have been identified. The former were clearly significant, including the advent of the sovereign debt crisis in the euro zone, the EU´s increasing concern at the lack of progress in correcting Spain´s structural economic weaknesses and the

[78] Research interview.
[79] Research interview.

pressure of the bond markets, which materialised in an increase in the Spanish bond spread throughout 2010.

However, these external constraints provided a triggering context rather than shaping the content of the response itself. They explain the *when* but not the *how*. In other words, the content of the measures and how they were finally implemented were very much driven by domestic political factors. Considerations regarding political and electoral costs determined, for example, the measures chosen by the government to implement the austerity drive agreed at EMU level in 2010. Ideology and party considerations were vital in various phases, not least in the lacklustre motivation with which the government undertook reforms with which many within its ranks did not agree, most notably the labour reform. The corporatist nature of Spain´s political economy institutions, which, despite undeniable improvements since the transition to democracy, still hampered competition in many Spanish product and service markets, as Estrada (2009) has shown, provided ample opportunity for organised interests, especially the trade unions and the employers' associations, to condition reform, especially in the labour market, pensions and the financial sector. Parliamentary dynamics were also important and in particular the absence of a parliamentary majority which would have allowed the government to adopt a more comprehensive package of reforms to compensate the unions for the proposed liberalisation of the labour market. They also help explain how the government was able to pass critical legislation, such as the budget. Disagreement among government members led to ineffective decision-making throughout the crisis. The staunch opposition to a bailout was also driven by very domestic political factors, from the need, for electoral and historical reasons, to be seen as a model EMU member to Zapatero´s preoccupation with his legacy. In fact, the personal characteristics of the leaders involved in the negotiations were essential to understanding many other aspects of the management of the crisis in this period, such as the failure of the labour and the success of the pension reforms.

Chapter 5. The euro zone crisis (II): the reform of the Constitution

(April 2011 to December 2011)

5.1. Introduction: the return of the crisis

The relative calm that had prevailed in Europe since the Irish bailout in November 2010 came to an end in early April 2011, when fresh concerns about the state of the public finances of the euro zone periphery and the sustainability of the euro led to renewed uncertainty. On 26 April Greece announced that its debt- to-GDP ratio had reached 142 per cent, pushing the bond spreads of the European periphery even higher. This added to Portugal´s increasing difficulties in accessing financing, which led it to request a 78-billion-euro assistance programme, signing a memorandum of understanding the following May. The contagion from Greece and Portugal´s woes spread to Spain, with the bond spread increasing dramatically, from 175 points on 4 April to 407 on 4 August, when it reached its highest level since the adoption of the euro. This was fed also by doubts about the health of the financial system, which, despite the reforms, was still a source of concern, much more so after Moody´s had downgraded the rating of the over thirty Spanish banks and *cajas* on 24 March.

Despite Spain´s efforts since May 2010, the deteriorating situation in the euro zone was about to launch the country into another complicated phase. By May 2011 there were open discussions on a second programme for Greece and on 17 and 20 June the Eurogroup ministers met to consider this possible second package, a discussion that was eventually postponed until July. Yet, on the margins of the summit, Chancellor Merkel and President Sarkozy held a private meeting at which they agreed on the principle of forcing private creditors to assume part of the cost, a ‘bailing-in’, in this second Greek bailout. Markets reacted adversely to this possibility, as it opened the door to the restructuring of the debt of a euro state, which would set the precedent of the euro not being a safe investment zone.[1] The negative implications this would have for Spain were obvious and it is no surprise that President Zapatero vehemently opposed it, to little effect. By early July it was clear Greece could no longer face its debt repayments and a second bailout was required. Fears had extended to Spain and also Italy. On 30 June the Milan main stock market index fell by 5 per cent and the following day the Italian government announced a substantial adjustment plan. While Italy´s problems added to the turmoil in the euro zone, they were received with a certain relief in Spain, since the bailout of both states was clearly beyond the financial means of the European Union (EU) and this made a substantive political response to the crisis by Germany and its allies more likely.

The euro zone problems contributed to Spain's suffering a negative GDP growth rate in the second term of 2011, leading to a net negative growth in 2011 of 1 per cent. This double dip recession would last until the third term of 2013, making it the longest recession in recent Spanish history, with a loss of 5.1 per cent of GDP during nine terms of negative growth rates (*Instituto Nacional de Estadística* (INE), 2015). Unemployment rose to 20.7 by the end of the second quarter of 2011 and 21.8 by the end of the third quarter and would be at almost 23 per cent by the end of the year. It was in this context of declining wages caused in part by the labour reform (Baratas 2015: 84), increasing unemployment and economic hardship that the *indignados* movement of social protest developed, which would constitute another source of increasing social and political pressure for the government.

Under constant pressure to continue proving its reforming credentials to foreign investors and its European Monetary Union (EMU) partners, on 10 June the government implemented, unilaterally by decree, after four months of failed negotiation with unions and employers, a reform of collective bargaining that complemented the labour reform passed the year before. It (*Boletín Oficial del Estado*, 2011c) reduced the number of months required for renewal of agreements obliging arbitration and it allowed firm-based to supersede sectorial agreements on a number of key important issues, such as base salary, working hours, holiday

[1] Bastasín (2012) has provided a detailed account of this period and of the manner in which sovereign crisis and the financial crisis mutually reinforced each other.

entitlement and others. The reform was driven by the need to give both Brussels and international bondholders guarantees that Spain was continuing with the necessary reforms to stimulate growth and generate sufficient income to repay its debt, as confirmed by a senior official in the Ministry of Labour involved in the reform:[2]

> Yes, there were always these technical reports coming out from all these international organisations that said that the Spanish labour market was too rigid, that it had to be made more flexible and especially make dismissal cheaper and weaken collective bargaining (…) even though there was the firm conviction within the government that the labour reform was not going to stop the destruction of jobs.

This same official, however, was the first to acknowledge the limits of these external pressures and pointed to more domestic sources of pressure:[3]

> There were a number of converging pressures. Yes, there was pressure from the EU but after a certain time it really became an internal issue. The Spanish private sector was pushing hard for reforms and specifically for a further labour reform and eventually that sense of urgency starts to permeate society and there is a dynamic which is driven by business, the PP [*Partido Popular]*, the media… the pressure by then was overwhelming.

The tensions in Spain and the euro zone continued to worsen during the summer of 2011. In Spain the financial sector continued to be a source of concern, with the uncertain IPO of *Bankia*, the former *Caja Madrid*, the bailout of another small *caja*, the *Caja del Mediterraneo*, and the failure of five Spanish financial institutions in the stress tests results conducted by the newly created European Banking Authority, which required 1.5 billion euro to recapitalise them. In Europe the instability of the stock and bond markets forced a summit of Eurogroup leaders on 21 July. Agreement was finally reached on a more flexible deployment of the European Stability Fund (ESF), and especially the possibility of its use to recapitalise troubled financial institutions, but only after Germany and its allies had secured an agreement for the bailing-in of the private sector, by which private holders of Greek bonds would assume a loss of around 40 per cent on the nominal value of the bonds held (Council of the European Union, 2011: 2-3).

[2] Research interview.
[3] Research interview.

Although this private sector bail-in was supposed to be 'voluntary' the political pressures made it clear to all private investors that they were expected to sign up to it (Wolf, 2011). President Zapatero again sided with President of the European Central Bank (ECB), Jean-Claude Trichet, in opposing this move, for fear of contagion to Spain. But in the end he accepted, in part motivated by his wish to avoid more instability in the markets (Rodríguez Zapatero, 2013: 235), which would have in all likelihood affected Spain.

The result of the summit did however little to address investors' fears about Spain´s predicament. During the following ten days Spain´s bond spread increased 113 points. On 29 July, the day the President announced the forthcoming general election, the bond spread reached its highest historical level at 345 points. Fears were mounting that the spread would reach the dreaded 400 points, where analysts placed the inevitability of a bailout. It was in this difficult context that President Zapatero and his government faced another dramatic moment that would lead to a response which would represent the climax of the management of the crisis: the reform of the Constitution to inscribe a fiscal sustainability rule.

5.2. The reform of the Constitution

The euro and Spanish crises reached a new climax in August. The doubts about the sustainability of public finances of the European periphery and the sustainability of the euro were now directly affecting Italy and Spain. On 5 August Italy´s bond spread rose higher than Spain´s for the first time in the crisis, reaching 400 basic points. The situation in Spain was not much better. The main stock index in the Madrid exchange dropped over 3 per cent on Monday 1 August. The following day the bond spread went over 400 basic points for the first time. A former Spanish minister with a senior position in the European Commission recalled[4] a meeting around this time with President Zapatero and business

[4] Research interview.

leaders in which the latter complained bitterly about their financing difficulties, not just the very high interest rates but the near closure of the open credit markets.

By now President Zapatero had decided that only ECB intervention to buy Spanish sovereign debt in the secondary market could stabilise the situation (Rodríguez Zapatero, 2013: 236). During the following three days the President went into a frantic round of calls to rally support for his call for ECB intervention and for the central bank to agree such a move at its 4 August governing council. However, the ECB did not act. On Friday 5 August the Spanish bond spread opened at 417 basic points, a level which was widely considered unsustainable. On that day President Rodríguez Zapatero (2013: 237) held various discussions with national and international leaders, but one in particular would prove crucial: his call with ECB President Jean-Claude Trichet. In his memoirs President Rodríguez Zapatero (2013: 238) has described the call in detail and the cryptic messages both men exchanged in order to preserve, at least formally, the independence of the ECB. During the call Zapatero described a number of savings measures the government was prepared to implement immediately to shore up confidence in the country, as well as further action on the labour market and measures to link salary increases to productivity. They were all substantial, although they did not reach the level of the May 2010 measures as, according to Zapatero himself ‘it was neither fair nor politically feasible, given the parliamentary situation we had’ (Rodríguez Zapatero, 2013: 239). The President suggested that in return the ECB should take whatever measures were necessary to support Spain but President Trichet expressed the need for the government to reassure bond investors of its real commitment to reform.

An agreement was reached privately to exchange letters. President Trichet and Governor Fernández Ordóñez addressed a joint letter to President Zapatero describing in substantial detail the reforms and adjustment that in their view Spain required and urging the Spanish government to act swiftly. A senior official at the Bank of Spain intimately involved in writing the letter recalled the difficult circumstances in which it was drafted:[5]

[5] Research interview.

> Trichet had pressure from Germany not to buy sovereign debt but he understood something had to be done. Yet what he told me was that his concern was that if he did buy debt, then it would take away the pressure from Italy and Spain to undertake the necessary reforms. But he faced a very important issue: could the ECB take monetary policy decisions conditional on whether a country does so and so? Obviously not. So Trichet came up with this idea of sending a letter telling them what he thought should happen. (…). Trichet could not have that discussion because any lead would have risked accusation that he was subjecting monetary policy decisions to political discussion. We told the government: if you make a gesture, and we gave them advice as to what they should do, we can get the ECB to buy debt, which is on the limit of the ECB´s statue. But yes, had we not sent that letter and the Spanish government accepted in principle its conditions, the ECB would have never bought the debt, given the pressure from Germany, the Netherlands, etc.

The letter, which was strictly confidential at the time but has since been published (Rodríguez Zapatero, 2013: 248), called for measures in three areas: further improvements in the functioning of the labour market, ensuring the sustainability of public finances and product market reforms, to be implemented by the end of August. It fell short, naturally, of offering any action by the ECB in return for the implementation of these reforms, referring only to the:

> Very high responsibility of the Spanish government "at the current juncture" and how their adoption "should lead to high benefits not only for the Spanish economy but also for the euro area as a whole". (ibid.)

However, Trichet was well aware that the *quid pro quo* would be a sustained buying of Spanish debt in the secondary markets to bring down the bond spread. As a senior official at the Bank of Spain who was personally involved in the process confirmed:[6] 'of course there was a direct relationship between both issues, although if Trichet were to be asked he would deny it'.

The ECB letter is also remarkable for the level of detail and degree of interference in domestic affairs to which the ECB was prepared to go. Nothing in the ECB mandate comes close to granting it authority to suggest, for example, the shape

[6] Research interview.

collective bargaining should take in a country. A high-ranking government official who was at the centre of the correspondence was scathing in his criticism:[7]

> The letter by the ECB reflected an acute lack of political sensibility towards the government. Firstly, there is the question of what competence the ECB has to make demands in areas completely outside its realm of responsibility. And secondly, it lacks an awareness of the political economy situation. Of course we would have also liked to have advanced more on collective bargaining reform, but we had no majority in Parliament and not even the Basque or Catalonian nationalists, who had supported us in other economic reforms, were prepared to support us on such a move.

Furthermore, none of the measures was neutral or casual; they had important ideological consequences. This was the case not only on the major measures such as the calls for further labour market liberalisation, but also for apparently minor reforms, such as the calls for the flexibilisation of the rental market. This measure, a long-standing request of organizations such as the International Monetary Fund (IMF) or the Organisation for Economic Cooperation and Development (OECD), was symptomatic of this ideological bias, in the view of a Socialist policy-maker familiar with the issue:[8]

> Trichet does not come with the suggestion of the reform of the rental market by himself, it is actually suggested to him by those in favour of radical liberalisation in Spain. He says, “now that Spain is in its knees we can impose it”.

In his response the following day to the ECB letter President Rodríguez Zapatero (2013: 252) detailed the additional savings to be introduced: a reduction of 2.4 billion euro in medical prescription costs, 2.5 billion from increased efficiencies in the collection of corporate taxation and 2 billion euro from the sale of part of the radio electric spectre. With regard to the labour market, the most politically toxic issue domestically, it is significant that the President did not agree to any new measure, despite the enormous pressure he was under and how high the stakes were. He limited himself to reminding Mr Trichet of the wage bargaining reform the government had just passed and offered a general commitment that the government would keep studying changes to the labour legislation to secure its

[7] Research interview.
[8] Research interview.

greater flexibility. He also stressed that unions and employers had signed a commitment to decouple wages from inflation increases for the next three years and that the government would work to make this permanent. But going beyond this was out of the question, according to a high-ranking official at the Ministry of Labour:[9]

> The ECB and the Bank of Spain wanted us to pass reforms of the labour market that were constitutionally impossible, like an extraordinary contract independent of collective bargaining. We did go as far as we could, for example making it illegal to chain temporary contracts, in order to avoid doing things that would have certainly been ruled unconstitutional, like a labour market where basic tenets like the minimum salary and collective bargaining would have been de facto scrapped. Many of these reforms had been suggested to Trichet by Governor Fernández Ordóñez, who on many issues was more fundamentalist than Trichet.

The unwillingness to undertake some of these reforms was also based on the government´s conviction that the issues that Spain was being asked to address had little to do with the euro crisis and were much more directly related to EMU´s flaws. Again, in the words of the same official:[10]

> The reforms we were being asked to pass were not related to what had caused the euro crisis, which had more do with the fragmentation of the euro zone and inadequate fiscal and monetary policies.

Nevertheless, throughout the response letter there were vague commitments to further measures reaffirming the commitment of the Spanish government to fiscal sustainability. As we shall see shortly, the way in which the President provided these guarantees, besides the specific fiscal consolidation measures that had already been prepared, had little to do with what the ECB had asked, and the response would be driven mainly by domestic political considerations.

Probably the most controversial part of the letter came at the end where the President openly requested the ECB to buy Spanish sovereign debt in the secondary markets, bordering on an infringement of the ECB´s right to independence. It stated that:

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[9] Research interview.
[10] Research interview.

> The Government of Spain considers that the European Central Bank can play a crucial role in the reduction of the tensions [in the markets] through the acquisition of Spanish public debt in sufficient volume to stabilise the markets and ensure the correct functioning of the transmission mechanisms of monetary policy. (Rodríguez Zapatero, 2013: 257)

President Zapatero acknowledged (ibid.) that his insistence was on the borderline of what was acceptable but was still determined to press his case:

> I thought I should make that explicit declaration (…). The ECB must be independent but it cannot be indifferent. A government with whom rests final responsibility for a nation must employ all the remedies within its reach, even more so if it operates within the limits of a monetary union. I don´t know if this contravenes the rules of independence of central banks. But I have no doubt that it does not contravene the rules of common sense and of democratic responsibility, that of my government in this case.

The letter concluded by announcing that two extraordinary meetings of the Council of Ministers had been arranged for the month of August for the government to take further actions to instil confidence among investors. This was highly unusual in Spain as August is traditionally a holiday month, especially in politics, but the government was keen to impress upon Mr Trichet the message that the government was taking forceful action.

The exchange of letters had the desired effect. The following day, Sunday 7 August, the ECB´s Governing Body announced (ECB, 2011) that it would be implementing its Securities Market Programme, through which it would be acquiring in the secondary markets sovereign bonds of countries in difficulties, and the following day the ECB started buying Spanish and Italian public debt (Reuters, 2011). Although it could not be publicly acknowledged, a senior official at the Bank of Spain with a personal role in the process was unambiguous that:[11]

> It is evident there was a direct relationship between the Spanish government's taking measures and the ECB's buying or simply announcing it was going to buy Spanish debt.

[11] Research interview.

But what was not known at the time was that the exchange of letters was to lead to a far more far-reaching development. On 19 August the government approved a decree to implement the saving measures it had committed to, which amounted to around 0.5 per cent of GDP (*Boletín Oficial del Estado*, 2011d). On 23 August the decree was tabled in Parliament for its debate and vote. President Zapatero defended the motion personally and during the debate he announced the surprise measure that would come to define the last months of the management of the crisis (*Congreso de los Diputados*, 2011a): the reform of the Constitution to incorporate a fiscal sustainability rule.

Unlike in other countries like Germany, reform of the Constitution has been rare in Spain. The reason for such caution is obvious. Spain´s turbulent history in the first half of the 20th century, culminating in the fascist *coup d'etat*, the civil war and forty years of dictatorship, had left a country profoundly divided. The Constitution of 1978 was a fragile compromise, underpinned by weak democratic institutions. Some anchors of stability, namely the Constitution and the Monarchy, were essential. For this reason, reform of the former was made particularly burdensome, requiring a two-thirds majority in Congress and, for the core articles, the dissolution of Parliament and approval by referendum of the reform, prior to the constitution of a new government. In fact, since its enactment in 1978, the Constitution had only been reformed on one occasion, and then only to reflect a development for which there was almost universal consensus in the nation: Spain´s accession to the EU in 1986. The Spanish Socialist Workers' Party (*Partido Socialista Obrero Español* [PSOE]) had won the 2004 election with a pledge in its manifesto (PSOE, 2004) to reform the Constitution to accommodate the demands of Catalonia and the Basque Country for increased self-government. However, opposition of the Popular Party (*Partido Popular [PP])* made it impossible and President Zapatero did not insist as, himself a professor of Constitutional Law, he was respectful of the 'sacrosanct' nature of the Constitution and understood it could only be reformed with ample consensus.

It was against this background that President Zapatero´s decision, through an urgent procedure in Parliament, to reform Article 135 of the Constitution in order to incorporate a 'golden rule' of fiscal sustainability came as such a surprise. The process by which the President reached this decision is remarkable, and offers an insight into how momentous policy changes can be the result of highly personal political decisions. According to officials intimately involved in the process,[12] the ECB letter had been accompanied by oral discussions. These set very specific deadlines by which, if the agreed reforms had not taken place, the ECB would immediately stop buying debt. The first date was 16 August, and by that date the fiscal adjustment measures had to be implemented. An extraordinary meeting of the Council of Ministers had been set weeks before for the second week in August, a rare occurrence in the vacation month, motivated by the gravity of the economic situation. This gave the government the chance to approve the measures at that meeting. But the government was then left with the second deadline, 29 August, by which it was expected to implement the labour reform. A senior source recalls how, after the first meeting of the Council of Ministers, a few close aides stayed behind with the President, deliberating what would happen, because it was impossible for the government to do what the ECB had asked, since it represented a complete dismantling of Spain´s labour market relations. And yet if the government did not deliver by 29 August, the ECB would cut the country´s lifeline. The recollection of one of the highest-ranking officials at the President´s Office of what happened during the next few days was remarkable:[13]

> There followed a few days in which nothing happened and then, suddenly, Zapatero came up with his idea of reforming the Constitution. It was a very personal decision. I don´t know who he spoke to in those days and how he reached his decision, although I have my suspicions. I think he probably also drew some 'inspiration' from comments made by Merkel at a meeting she had with Sarkozy on 16 August at the end of which she made some comments about the importance of including in the law fiscal sustainability. But I can tell you that the decision to reform the Constitution was a very personal one, driven by political considerations and taken in a very idiosyncratic manner. It was most definitely a political manoeuvre, and a smart one, although poorly implemented.

The decision sent shockwaves through the PSOE and its electorate, and was vehemently criticised, both for its form and the substance. On the latter the idea of limiting constitutionally the state´s scope for public spending was anathema to

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12 Research interview.

13 Research interviews.

many Socialist government and party members, and also to many in society. A senior economic figure in the Socialist party put it bluntly:[14]

> There is also an ideological issue here, or if you want, an absence of intellectual clout. Most of the people around him [President Zapatero] (…) don´t realise that what they have accepted is something socialists have been trying to fight against for thirty years. To limit the margin of action of the government, to the point of including limits in the Constitution, is unacceptable.

Others, however, suggest that the reform did not represent a significant ideological shift for Zapatero, as he was part of a new generation of socialists who, until the crisis hit, had felt more comfortable with fiscal rectitude. As a Director General at the President´s Economic Office said:[15] 'Zapatero internalized it [the merits of fiscal sustainability] from the beginning and that was a significant step forward with respect to previous socialist governments'.

However, even more damaging than the substance of the reform was the manner in which the Constitution was changed: in a matter of weeks, without any political discussion or public consultation and through the emergency legislative procedure in Parliament. The recollection of a close aide of the President, who played a key role in those days, was illustrative:[16]

> When he first called me to his office and told me we were going to reform the Constitution my initial reaction was to tell him it was a mistake, on many levels: with the substance, the timing, the manner. The political management was disastrous, and led, not only to immense discontent within the party, but to the refusal of any other party beyond the PP to support the motion in Parliament, including the PNV [*Partido Nacionalista Vasco* (Basque Nationalist Party)], who had been the party that had supported us in Parliament throughout the last stages of the management of the crisis.

This poor decision-making and implementation process had become more acute as the crisis progressed and affected the quality of the final policy solutions. But it probably reached its most dysfunctional level with the reform of the Constitution,

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14 Research interview.
15 Research interview.
16 Research interview.

as shown by the account of how the actual draft of the new articles was put together, by a senior policy-maker at the Ministry of Economy and Finance who played a key role in the process:[17]

> In the first stages of the crisis, when we still had time to analyse things, we had many of the measures and their implications studied, but as the crisis progressed and we had more and more fires to respond to, we obviously had more problems. For example, when it came to the reform of the Constitution (…) we had been working on issues related to budget sustainability, like the draft of the Budget Stability Law where we were going to introduce some new measures, but we really had no warning that it would go as far as reforming the Constitution, not at all. In fact (…) when I was told and I had urgently to contact the commercial attaché of our Embassy in [confidential] and ask him to send us a translation of the relevant section [of the fiscal golden rule] in [that country´s] Constitution where this was specified and then, following from this and our technical briefs, I had, over the telephone, to work with those that were actually drafting the new article of the Constitution.

Even more remarkably, unknown to his own ministers, members of parliament, and having consulted with only a handful of trusted advisors, Zapatero had actually reached out to the leader of the PP, the main opposition party, with his proposal just six days before. The reform could not have been more welcomed by the PP. It supported the position the party had been defending in favour of more fiscal prudence but, more importantly, the PP knew that it would drive a serious ideological wedge among socialist voters.

The debate took place on 30 August and, having secured the support of the PP, the motion easily achieved the three fifths of favourable votes required on the final vote on 2 September. The provisions of the reform were profound. While the original Article 135 of the Constitution had just stated the right of the state to issue public debt (*Constitución Española,* 1978), the new article established some substantial new principles (*Boletín Oficial del Estado*, 2011e*).* Firstly, it stated that all public administrations would govern their actions by the principle of budget stability. Secondly, it prohibited both central and regional governments from incurring in public deficit and debt larger than that established by the EU. Thirdly, it called for a law to establish the maximum annual structural public deficit allowed.

17 Research interview.

The law, which would eventually be passed by the PP government in 2012, set that limit at 0.4 per cent of GDP. Fourthly, it established that interest payments for issued debt should be included in all budgets and should be given priority over any other expenditure. And fifthly, it stipulated that both public deficit and debt limits could only be exceeded in the event of natural catastrophe, economic recession or emergency, and would require the approval of an absolute majority in Congress.

The prevailing understanding at the time, and then enduring, was that the reform of the Constitution was the result of external pressures, most notably the ECB´s. In fact, prompted by the secrecy of the letter exchanges between the ECB and the government, there were widespread accusations of having reformed the Constitution directly at the request of the ECB. A headline in a national newspaper at the time read: '*The government admits that it changed the Constitution at the request of the ECB*' (Santos, 2011). Even the PSOE´s own parliamentary party, in trying to find culprits behind whom to shelter from the chorus of criticism, sought to blame external forces. In defending the motion for the constitutional reform in Parliament, the PSOE speaker, José Antonio Alonso, blamed market pressures: 'I tell you that the tensions in the markets have reached such a level that they put at risk the social policies we have implemented. That is the reality' (*Congreso de los Diputados, 2011b*).

The reality was, however, very different. While, as we have seen above, it is undeniable that the government was under strong external pressure to act, the reform of the Constitution had never been an explicit or even implicit demand of the ECB, the European Commission nor any other EMU partner, including Germany, as President Zapatero himself was later to acknowledge (2013: 260):

> The reform was not the outcome of an imposition, not even a suggestion, of any European authority (…) Neither in the [ECB] letter nor any other written or verbal communication was the government of Spain asked to reform the Constitution to incorporate 'the golden fiscal rule' (…). It was an autonomous decision.

In fact, as shown above, the measures that the ECB requested were very different, and called most importantly for further reforms of the labour market. As

President Zapatero himself has confessed, and other officials have confirmed,[18] the decision to reform the Constitution was personal and the reason chiefly to find a reform that would have as limited a political cost in the short term as possible. In his memoirs the President admits (Rodríguez Zapatero, 2013: 261) that he decided on the reform of the Constitution because, of the available options available to send a firm message to the ECB and to recover the trust of the international investors, this was the one risking least political damage:

> I thought the constitutional reform was one of the few that I could use to have the desired effect: to reduce significantly that risk [of a bailout], with the least cost or additional sacrifice for our country.

In other words, while the motive was certainly external pressure, the choice of instrument with which to respond was autonomous and driven by domestic political considerations. This account is confirmed by a number of sources interviewed for this dissertation. A privileged observer of these events, with a senior position at the Bank of Spain that allowed him direct participation in the discussion, was unambiguous:[19]

> The reform of the Constitution was neither in the letter nor ever discussed. It was something the President came up with by himself, and I think incorrectly. You can´t introduce a reform of the Constitution like that, in just a few days and without a wide-ranging consensus. But I think by then President Zapatero was just in full swing and wanted to show that he was as reformist, but, of course, with something that was politically far easier than labour reform.

Similarly, a senior member of the President´s Economic Office remarked that:[20]

> It was impossible to pass a labour reform at that moment; we did not have enough time (…). Regardless of its electoral cost, it could not be done. On the other hand, the reform of the Constitution seemed more politically feasible.

In fact, some even cast doubt on whether external pressures were really as great an influence on President Zapatero as has been claimed. A close aide of the

[18] Research interview.
[19] Research interview.
[20] Research interview.

President, who worked closely with him at the Moncloa Palace during this period, while acknowledging that the Spanish government was forced by the ECB to act, was clear that the President felt he still had a significant degree of autonomy in choosing how to react to that pressure:[21]

> The ECB letter certainly asked the government to take a series of measures in order to buy Spanish debt, especially asking for a fiscal adjustment and a new labour reform. But what I saw was that Spain acted autonomously in a context in which, it is true, you are not altogether free, but you do have a degree of freedom of action, and the President decided not to respond to that request for an additional fiscal adjustment or a new labour reform but pulled out of the hat the reform of the Constitution, a reform which had a zero immediate social cost, unlike the other two alternatives.

In sum, while it is true that the need to act was the result of pressure of the markets, the ECB and the EU´s Fiscal Stability Treaty (or fiscal compact), the particular form the response took was very much driven by domestic political considerations. The aim was to adopt the solution that, while sufficient for the ECB (and Germany), would have the least immediate political and electoral cost to the government in the forthcoming elections. While the fiscal compact had indeed established budgetary constrains on EU members, there was nothing in it that forced such guarantees to be provided through their inclusion in the Constitution. The choice of such a radical measure was, as shown above, far more the result of opportunistic domestic political considerations.

Eventually President´s Zapatero´s gamble paid off. President Trichet and Chancellor Merkel accepted the reform of the Constitution, together with the rest of reforms, as a sign of Spain´s real commitment to reform. In the case of the former, what tilted the balance was probably the realisation that it was unrealistic to expect a second labour reform barely a year after a previous one that had caused a general strike and just a few months away from a general election. And in the case of Chancellor Merkel, it was probably decisive that the 'fiscal golden rule' that Zapatero enacted was one which Germany had itself enshrined in its Constitution and which the Chancellor had called for other European partners to

[21] Research interview.

adopt. The willingness of President Zapatero to comply was obviously well received and the support of the ECB and the EU was forthcoming.

5.3. Epilogue: the G20 Cannes summit

Following the ECB´s action, the pressure on Spain abated during the remainder of the month of August. Yet from September onward the bond spread started to climb, reaching a maximum of 359 basic points on 20 October. Spain was again suffering contagion from a troubled international situation. Firstly, there were lingering doubts about the political commitment and availability of the necessary fiscal and institutional infrastructure at EU level to deal with the ongoing euro crisis. And secondly, the global economy, and the European periphery in particular, were suffering from a second economic downturn.

Spain was again the focus of renewed attention and concern over the state of its financial system and its public debt, both intimately connected. This was for good reason, as the troubles in the financial sector continued. On 30 September the Bank of Spain announced the bailout and nationalisation of three more former *cajas, Catalunya Caixa, Novacaixagalicia and Unnim*, and an injection of almost five billion euro. The pressure continued to build when on 19 October Moody's downgraded the debt of ten Spanish regions.

Worries concerning the euro zone increased considerably a few days later when Greek Prime Minister Papandreou announced he would be submitting to referendum the second EU assistance programme agreed on 26 October, which asked for substantial savings from the Greek government and, for the first time, had called for the 'voluntary' contribution of the private sector, in return for the increase in the European Stability Mechanism funds to one billion Euro. It was in this context of renewed pressure on the European periphery that the last substantial chapter of the Socialist government's management of the crisis would be written, with Zapatero´s attendance at the G20 Cannes summit on 3-4 November.

The Cannes summit took place, as described, amid serious concerns about the European periphery. Yet, unlike the previous August, this time it was Italy that was the main focus of attention. The decisive actions taken by the Spanish government in August, and especially the reform of the Constitution, had sent a signal of determination to act that investors, analysts and EU officials found lacking in Berlusconi's government. However, this did not prevent German Chancellor Angela Merkel's unexpectedly confronting President Zapatero in the preliminary fringes of the formal meeting and, according to Rodríguez Zapatero´s account (2013: 290), directly asking him whether he would be prepared to accept an IMF precautionary credit line of 50 billion euro, with Italy also accepting one for 85 billion euro. The suggestion was firmly rejected by Zapatero, on the familiar grounds that Spain had already adopted ample reform that had led to recovery of trust by investors, that Spanish financial institutions had been appropriately recapitalised and that the Treasury was having no difficulties in financing itself. Zapatero also added a brazenly domestic political argument, namely that since Spain was immersed in the campaign for a general election, it was unthinkable that the government could accept a bailout. Chancellor Merkel was understanding of the arguments, at least according to the account of President Rodríguez Zapatero (2013: 291), and accepted his refusal to accept the credit line.

This veiled request was the third and last time in just over a year that Spain had been asked to accept a bailout. At a private dinner organised the following night to try to offer an image of action in the face of renewed uncertainty in the markets by the members of the Eurogroup, EU officials and President Obama, the main focus of attention would be Italy, which resisted strong pressure to accept a bailout (Rodríguez Zapatero, 2013: 292). Prime Minister Berlusconi succeeded in avoiding it but had to accept oversight by the troika of his government´s reforms, a sign of loss of trust in his administration that would shortly after lead to his resignation and his replacement by a technocratic government led by Mario Monti.

The contrast between events in Italy and Spain is informative for the argument this dissertation has pursued. Both President Zapatero and Primer Minister Berlusconi faced similar demands from the ECB, and ultimately from Chancellor Merkel, to undertake important reforms in return for ECB support. Zapatero responded constructively to the ECB´s August 2011 letter, even if he did not concede further labour market deregulation, by offering a serious set of reforms, including that of the Constitution, in the same spirit he had shown in undertaking the necessary measures since the May 2010 austerity U-turn. By contrast, while the Italian Prime Minister also accepted many of the reforms suggested in the ECB letter, Berlusconi´s refusal to give in to ECB pressure to undertake pension reform, together with what was perceived as lack of serious commitment to undertake serious reforms, is likely to have been behind the ECB´s sluggish purchase of Italian bonds and Chancellor Merkel´s stronger pressure on Berlusconi, which eventually led to his downfall. In other words, the ECB and Chancellor Merkel responded very differently to the domestic political judgement of Zapatero and Berlusconi, accommodating the former but not the latter. That two states faced with similar external pressures ended up with different outcomes must therefore warrant a more exact analysis than the claim that external constraints rendered national responses irrelevant. While the episode does show the importance of external pressures, it also shows that divergent domestic political responses, in this case the determination observed in President Zapatero, were correlated with the different outcomes and might have played a significant role in them.

On 20 November the conservative *Partido Popular* would win the general election, giving way to a new chapter in the management of the crisis that falls outside the scope of this dissertation. That the PSOE came to the end of its tenure without suffering a forced replacement of its government, as in Greece and Italy, or a bailout, like Greece, Portugal or Ireland, was, in the eyes of President Zapatero, a sign of its partial success (Rodríguez Zapatero, 2013: 126). It can also be seen as evidence that, despite enormous external pressures, domestic political decisions did matter.

5.4. Conclusion

Analysis of the management of the crisis in the crucial last year of the Socialist government has shown that the interaction of external and domestic factors during this period is a contentious issue. Yet what emerges is not a picture of harsh measures imposed from the outside, but a decision-making process shaped by a complex set of factors, both external and domestic. It is certainly true that many of the measures were adopted in response to external market and political pressures. However, it is also true that domestic factors were determinant in shaping those responses.

The influence of these domestic political factors was clearly at play in the two defining moments of the management of the crisis in this crucial last year: the refusal to accept a bailout and reform of the Constitution. As a senior economic advisor to the President acknowledged:[22]

> The reforms and the austerity measures were clearly influenced by the pressure from outside, but the ambition and the way in which they were conducted was very much the outcome of domestic politics.

A senior official on the political staff of the President´s Office, a privileged platform from which to observe these events, shared this view:[23]

> The decisions were often very personal, driven by personal values and biases, for which support was then sought from the technical staff, and not the other way around.

A subtle but important conclusion of this account is that even in the most pressing circumstances the Spanish government retained a degree of autonomy, or at least a capacity to reject the proposals most detrimental to its interests and to choose the manner of response to external pressures for fiscal adjustment and reform. It is a view shared not only by all government officials interviewed,[24] but also by a senior official at the European Commission:[25]

> The pressure from Berlin or Brussels exists but a democratic government, unless it is in a desperate situation such as that of Greece, Ireland or Portugal, (…) always has some margin of action. Spain has never been in such a desperate situation to say "I give up, tell me what I have to do and I will sign (…)". It is true that if you are in a monetary union, no one is completely sovereign any more and if you have difficulty in accessing the

[22] Research interview.
[23] Research interview.
[24] Research interview.
[25] Research interview.

> markets to finance your sovereign debt, you do have a hand tied behind your back. But you still have your other hand. Yes, there were some very delicate moments, for example in June 2011, in which Spain needed help so as to not to have to pay impossible debt prices, but Spain is a country with more resources and negotiating power than Ireland, Greece or Portugal, so it can enter into a negotiation whereby maybe you ask me to do X to buy debt but I say that I am prepared to do Y instead, or where you ask me to introduce a new labour reform but I decide against it. You have to remember also that in 2011 everyone was looking at Spain and there was awareness in Brussels that if Spain went under, the whole euro project would be in danger, because then Italy could go and then France.

It must be admitted, however, that there is an alternative interpretation to Spain´s avoidance of a bailout. This would find the key explanatory variable in the incentive of the euro zone states and the ECB to find a solution for Spain and Italy that did not involve euro zone level funding – rather than the IMF´s –, given the cost of bailouts for these two states and the scale of exposure of French banks in Italy and German banks in Spain. It is probably no coincidence that most of the Securities Market Programme (SMP) went on purchasing Spanish and Italian bonds rather than any one else's (Bastasín 2012: 304).

In any case, another important conclusion of the analysis of this last episode of the crisis managed by the Socialist government is that the role of external institutions was less decisive than the existing literature has suggested (Armingeon and Baccaro, 2013; Hopkins, 2013, 2015; Royo, 2013, 2014; Sanchez-Cuenca, 2014)**.** The ECB was by far the most influential institution and it exercised its ability to buy sovereign debt in securing reform in August 2011. However, it was the Spanish government that decided the content of these reforms, and the most important request, for a further labour market reform, was ignored. The influence of other international organisations, like the OECD or the IMF, was significantly less. These institutions had some influence, often shaping the views of Spanish officials, as a senior political aide to Zapatero complained:[26]

> Our technical staff used the arguments of these institutions as a source of legitimacy and to exercise pressure on us, on the President and the political staff. But the President was well aware that it was just one side of the story. My perception is that Solbes, Salgado, and our technical staff internalised

[26] Research interview.

> to such level the messages and demands of the international financial institutions and the European Commission that, when they communicated them back at home, they exaggerated them. It was almost like a psychological mechanism by which they are conditioned, developing certain complicity.

However, from the account given above, it is obvious that, rather than changing the outcome, the recommendations of these institutions were used by the technical staff to push for measures they themselves espoused. Even those officials who were supposed to have been 'conditioned' are sceptical of the real influence these institutions exercised in the government´s decisions. The Director General in the President´s Economic Office who was often charged with meeting officials from the IMF and the European Commission was clear in this respect:[27]

> It is true that the influence of international financial Institutions like the IMF has been overestimated. Most of the time they would be telling us things we already knew. The moments when, in my experience, they really did have leverage were when our bond spread went through the roof.

In fact, a top official at the Ministry of Economy and Finance went further, suggesting that even among the more technocratic staff there were doubts as to how much these institutions were helping their case:[28]

> The role of international financial institutions has been positive, but not very helpful, just 'positive descriptive'. What I mean is that at the end of the day they said aloud what we already knew and in that sense we would have taken those measures anyhow because we knew those problems existed, but we would have done so at a different rhythm, and I am not so sure that their bluntness and their raising these issues publicly was very helpful, because the perception that it was being imposed from outside, even if it was not true, created resistance from the public.

A further conclusion drawn from the episodes recounted in this chapter is that the unpopularity of many measures was often aggravated by a very defective decision-making and communication process. According to a high government official who was at the centre of many of these decisions:[29]

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[27] Research interview.
[28] Research interview.
[29] Research interview.

> It is true that in those days events moved amazingly quickly and it was difficult to control them but in any case Zapatero is, personally and politically, a person who likes to do away with the established procedures when it comes to decision-making. It was not like this all the time, but it certainly was during the key moments and when extraordinary decisions were taken, like in May 2010 or in the summer of 2011 with the reform of the Constitution. My biggest conflicts with him came, not from having different criteria, because I understood my duty was to offer him my view but the final say had to be his, but from his whimsical disregard of proper procedure, to do whatever it was his fancy to do. It was most inefficient. It is my belief that if Zapatero had managed the crisis better, if instead of taking the decision so secretly, with just a few people and hijacking the information from his own government, he had gone out and spoken to the nation and explained the situation, saying that it was necessary to take those measures for the country´s sake, then the outcome would have been different.

Probably no one has summarised better the complex interaction of domestic and external factors during this time than President Zapatero himself. In his memoirs he first complains bitterly (Rodríguez Zapatero, 2013: 287) about the alleged trumping of politics by international financial markets and investors:

> In those forty-eight hours [during the Cannes summit] I was able to see, probably more clearly than at any other time, the limitations that political power has in the contemporary world when it comes to responding to the threats of the international financial system, the fears of investors, the state of opinion on the analysis or the ratings of the rating agencies.

Yet just a few pages later (Rodríguez Zapatero, 2013: 298) he admits that political agents and institutions are capable of overcoming external pressure of investors and financial markets:

> Politics cannot in any case elude its responsibility. Especially when, in my experience, the decisions taken by institutions can and did overcome the immense capacity of markets to determine the evolution of the financial world and the situation of countries and companies. [Institutions] could impose their will, of course, but only when these decisions were marked by their immediate and effective application, when they were not doubtful, when they were firm, when they were the expression of strength and authority. When political decisions are firm, markets quieten and lose their capacity to destabilise.

But it is telling that, despite the enormous pressures to which the Spanish government was subject during this period, all government officials interviewed for this project, without exception, hold the general opinion that if political agents act with determination, they are able to counter the forces of markets and investors. A senior minister who was at the centre of the management of the crisis and knows well its intricacies spoke for many when she said:[30]

> I don´t share the view that markets trumped politics during the management of the euro crisis. I think the problem had more to do with us politicians' doing too little too late. If in 2010 we had taken more decisive action on Greece, we would probably have saved ourselves a lot of trouble. And the proof is that the European debt crisis is solved when a gentleman comes along [Mario Draghi] and says that whatever has to be done will be done. So what we saw was not a case of political incapacity against the markets but just a political failure per se. I am absolutely convinced that institutions and political power can face down the financial markets if they really want to.

While the fact that Mr Draghi could successfully challenge (at least temporarily) bond investors and 'the markets' is of course very different from saying that national government can do the same and tells little about the capacity of the latter to do so, it is noteworthy that, even among the senior officials who were more heavily exposed to the external constraints during the latter period of the crisis, there was a widespread conviction[31] that *politics matter*, that it is political decisions and actions that, at the end of the day, shape events.

[30] Research interview.
[31] Research interviews.

Chapter 6. Conclusion

6.1. Introduction

The research question the dissertation has sought to answer is: *what role did domestic political factors play in the PSOE government´s management of the crisis in Spain and in its immediate* origins*?* Thus the dissertation has aimed not only to determine whether domestic politics influenced policy outcomes, which is hard to contest, but why and how. To do so it has analysed in detail, through in-depth interviews with the key decision-makers, the most relevant episodes and issues of the management of the crisis and its immediate origins.

This effort is framed within the scholarly debate on the autonomy of states in an age of global and European economic integration. As we have seen, criticisms of globalisation and European Union (EU) integration are often predicated on the claim that these processes have rendered states powerless and domestic political factors almost irrelevant in the response to the domestic economic and political impact of global forces. Examining the role that domestic political factors have played in the recent crisis in an important member of the European Monetary Union (EMU) such as Spain, and whether they played a significant role in defining the outcomes, can constitute a timely and relevant contribution to this debate.

The present chapter presents the final conclusions of the research. Section 7.2 provides a summary of the main findings. Section 7.3 considers the theoretical implications of these findings, in particular with respect to the predictive assumptions of the different international and comparative political economy research agendas outlined in Chapter 1. As with all research projects, this dissertation has its limitations and these are identified in Section 7.3. Some of these form the basis of recommendations for further research, which are discussed in Section 7.4, before Section 7.5 concludes the chapter and the dissertation with a brief restatement of the main conclusion and its potential significance.

6.2. Summary of findings

The detailed analysis conducted in this dissertation´s has shown first and foremost that the management of the crisis in Spain between 2007 and late 2011 and its immediate origins was a nuanced affair, shaped by both external constraints and domestic political issues. External factors were clearly relevant: global financial markets unleashed a credit crunch that not only led to a recession but precipitated the collapse of an unsustainable growth model. EMU membership and in particular its institutional design limitations, such as the absence of a lender of last resort, were critical in transforming an economic recession into a sovereign debt crisis and the advent of austerity policies. International investors exercised tremendous pressure on Spanish sovereign debt, creating the constant threat of a default. Some EMU partners, most noticeably Germany, imposed on Spain its diagnosis of the crisis as one caused by excessive profligacy in the European periphery, necessitating austerity policies and structural reform. And the European Central Bank (ECB) exercised significant influence in nudging the Spanish government towards fiscal discipline through its ability to acquire Spanish sovereign debt. In sum, these and other external constraints that have been highlighted during the dissertation significantly shaped the government´s response.

Yet what the research has also shown conclusively is that domestic political factors were also crucial in shaping the government´s management of the crisis, most notably in determining the specific measures that were adopted and their content. Systematic analysis of the evidence points to seven domestic political factors that were particularly influential and which were closely interrelated: i) electoral and political cost considerations, ii) party and partisanship, iii) ideological preferences iv) the influence of organised interests, v) domestic institutions, vi) ineffective decision-making, and vii) the judgement and personal characteristics of decision-makers.

Electoral and political cost considerations

Considerations of electoral and political cost of the measures adopted were the most influential domestic political factor that shaped the government´s response to the crisis. The electoral impact of the measures considered was ever present. Opinion surveys show that the state of the economy was a key factor in voters' decisions in the three elections (local, European and general) held during the period studied (*Centro de Investigaciones Sociológicas* (CIS), 2008, 2009, 2011). It is therefore not surprising that the failure to acknowledge difficulties or undertake much needed reforms can be traced directly to the Spanish Socialist Workers´ Party (*Partido Socialista Obrero Español* [PSOE]) government's concerns about the unpopularity of such decisions in the face of these various elections. For example, electoral considerations were clearly at play in President Zapatero´s refusal to accept the gravity of the crisis before the 2008 general election, a refusal that clearly conditioned the continued underplaying of its effect until the May 2010 austerity U-turn. Unwillingness to address the financial sector´s solvency problems, which were only acted upon with the first financial reform in June 2009 and not really tackled head-on until the Plan to Strengthen the Financial System (*Plan de Reforzamiento Financiero)* was put in place in February 2011, can also be explained in terms of concern about the unpopularity of using public funds to rescue financial institutions as well as the fact that the President had publicly asserted in 2008 that the Spanish financial system was in a good state, and acknowledging otherwise would undoubtedly have carried a significant credibility cost. Concerns about the political cost were sometimes obvious, such as the strong resistance to labour market liberalisation within large segments of the work-force that would have been harmed and the threat of a general strike until its materialisation in September 2010, and others more nuanced, such as the impact that reforms aimed at stemming the housing bubble would have had on the perceived stock of wealth of homeowners.

The pressure of the electorate explains not only why some measures and reforms were not adopted, but also why some were in fact undertaken. The May 2010 austerity measures, which carried significant political cost, can only be understood as a strategy to avoid the even larger political cost that a bailout, and *de-facto* loss of economic sovereignty, would have represented for the government, the PSOE and President Zapatero himself. The reform of the pension system can to a significant extent also be explained by the fact that, unlike some of the other reforms, it did not have an immediate impact in terms of loss of benefits and that the electorate it most immediately affected was not inclined to vote for the PSOE in any case.

Political cost considerations not only determined whether measures were undertaken but also drove the content of many of those adopted. The fiscal stimulus adopted in October 2008 was designed with a view to reducing unemployment and addressing the immediate political fallout of the crisis rather than with any strategic intent to address the structural weaknesses of the Spanish economy, such as low research and development investment. Calls for a budget consolidation plan to accompany this October 2008 stimulus plan that could reassure sovereign bond investors worried about future budgetary imbalances went unaddressed due to the political cost that even the mere announcement of such plans would have carried. Similarly, the decision to reform the Constitution in August 2011 as opposed to agreeing to further reforms of the labour market as the ECB demanded, was clearly driven by recognition that the former carried far less immediate political cost than the latter and that further liberalisation of the labour market would have been electorally lethal to the PSOE just a few months before a general election.

Finally, electoral considerations were also important in the constant efforts by the government, and in particular President Zapatero, to defend Spain´s international prestige and be seen as a responsible EMU member. These actions were clearly undertaken with the electorate in mind and with a view to strengthening the PSOE´s re-election prospects. This attitude was clearly influential in the government´s efforts to be a member of the G20, which in turn can be seen as the reason, at least in part, for three important decisions: firstly, the swift and large fiscal stimulus, which was intended to project an image of Spain as a leader in the response to the call by the October 2008 Washington G20 for a global fiscal stimulus to offset the effects of the crisis; secondly, the refusal to admit the vulnerabilities of the Spanish financial system at least until mid 2009, since its purported strength was a constant claim leveraged by President Zapatero to call for Spain´s admission to the G20; and thirdly, the government´s refusal to accept a bailout, as this would obviously have run counter to Spain´s efforts to be seen as a model EMU member.

Party and partisanship

Closely related to electoral considerations was the manner in which the response was shaped by party and partisanship considerations. The views of the party, channelled through senior government officials who were also senior party members, shaped the response at different stages. For example, party pressure was at play in an unwillingness, during the years leading up to the crisis, to take measures to cool the housing market that would have compromised the tax revenues that the housing bubble generated and which paid for the social services upon which, to a significant degree, the party and government´s popularity rested.

Of particular importance was the influence of regional and local PSOE politicians, a direct outcome of the decentralised organization that characterises the party. This was critical in allowing the construction and housing bubbles to develop, as construction became an increasingly important source of tax revenue and party funding, and local party officials had the legal authority to grant building permits, developing a perverse incentive to keep feeding the bubble. Furthermore, the influence of regional and local politicians in the governance of the *cajas*, and the many benefits the regional chapters of the PSOE obtained from presence on their boards, was a crucial obstacle to the reform of the governance of these financial institutions. The failure to reform the *cajas* not only contributed to the housing bubble in the run-up the crisis, since the *cajas* were responsible for a substantial part of the irresponsible lending that fuelled it, but was also a defining trait of the lacklustre reform of the financial sector that did so much to undermine the government´s efforts as the crisis progressed, and which also fuelled the sovereign debt crisis from 2010 onwards.

The footprint of the party can also be clearly seen in the design of many of the policies pursued in response to the crisis. A number of fiscally irresponsible measures, such as the 400 Euro tax rebate taken during the 2008 electoral campaign, were very much driven by a partisan claim. The design of the fiscal stimulus package was heavily influenced by the party apparatus and was much more closely aligned with party priorities than with economic or strategic considerations. Furthermore, that it was designed to be disbursed through local authorities, where the PSOE had a strong presence, as opposed to regional governments, most of which were in the hands of the conservative PP, also responded also to partisan interest.

Finally, the influence of the PSOE was probably most forceful in internal opposition to the labour market reform. A number of senior figures in the government, including the Minister of Labour Valeriano Gómez, had actually been senior union members and their diagnosis of the ills of the labour market and the reforms needed differed markedly from the liberalisation and flexibilisation agenda that the business community, the European Commission and the IMF advocated. The influence of the trade unions was also significant on other senior party figures, including President Zapatero himself. As a result, the party exercised an important role in delaying the labour market reform and, even when it took place, ensuring it was never as far-reaching as the business community or most economic experts advocated.

Ideological preferences

Party attitudes were driven of course in part by ideological preferences. These were probably most evident again in the opposition to further liberalisation of the labour market that dominated socialist thinking and which presented a significant obstacle to the necessary labour reform. There was a clear political commitment by the President and his two Ministers of Labour during this period to protection of workers´ rights against the liberalising reform demanded by the business community and international institutions. This commitment was grounded in strong ideological preferences. It is symptomatic that doubts about claims for the need of further liberalisation were held not only by the President and Ministry of Labour officials, closer to the trade unions, but also by senior members in the Ministry of Economy and Finance.

The large fiscal stimulus with which the government responded to the G20´s call for fiscal stimuli is another example of a measure very much driven by an ideological predisposition, in this case in favour of a Keynesian response. Furthermore, while the May 2010 austerity measures clearly clashed with the ideological preferences of the Socialist government, their design was clearly influenced by them, exemplified by the protection of healthcare and most other social services.

Finally, it is important to note that it was not only the government´s left-leaning ideology that shaped the response to the crisis. The dominance of a market-orientated ideology within the President's Economic Office and the Bank of Spain, the hegemonic source of economic analysis in the country, gave intellectual cover to some of the key reforms, such as the liberalisation, even if limited, of the labour market, the increase in the retirement age and future reduction of pension benefits brought about by the pension reform or the enshrining in the Constitution of a fiscal golden rule limiting the government´s ability to generate public deficits in the future.

Organised interests

These different ideological perspectives, together with the impact on their material interests, motivated the pressure exercised on the government by various organised interests, another key domestic political factor that shaped the management of the crisis. Various interest-based coalitions influenced government decisions. For example, the financial sector successfully lobbied the government and the Bank of Spain against more stringent regulation or an increase in provisions that could have slowed the pace of the credit boom that fuelled the housing and construction bubble in the run-up to the crisis. The government was also regularly warned by financial executives of the impact on the economy of actions that could weaken banks' balance sheets, such as forcing them to value property at market prices once the bubble pricked. And it was of course the lobbying by the financial sector executives that explains to a significant extent why the Bank of Spain was blinded to the sector´s solvency problems and why the sector´s reform involved such a protracted effort.

Banking was not the only sector that influenced government´s policy. Construction was also a source of pressure, constantly warning government members of the impact on jobs any efforts to curb the housing bubble would have. The sector clearly benefitted from the government´s decision to deploy the brunt of the 2008 fiscal stimulus to infrastructure spending. The influence in the policy decision-making process by other sectors that would have been affected by structural reforms, such as energy or many professional services, was also key in explaining why the much needed change in growth model that the Sustainable Economy Law of 2009 attempted did not take place. The role of the Spanish Confederation of Business Organisations (*Confederación Española de Organizaciones Empresariales* [CEOE]), the main business representative organisation, was also influential, not least in blocking the labour market reform, as it adopted a clearly confrontational attitude towards the government, but also in passing the pension reform when, under new leadership, it developed a far more conciliatory tone.

Finally, the trade unions were also a constant source of pressure on the government. Their influence was instrumental in ensuring that increasing labour market flexibility was not a priority of the Socialist government either in the years leading up to the crisis or in its early stages. Trade unions were also important in allowing the pension reform to advance, since by the time the reform was negotiated they had been significantly weakened by an unsuccessful general strike and concessions had been offered to them in return for their support.

Domestic institutions

The influence of these organised interests, as well as that of the party, was facilitated by the character of some Spanish domestic institutions. For example, the decentralised Spanish state and its administrative structure conditioned the response in various ways. Firstly, the high degree of economic management that decentralisation had bestowed upon regional governments was key in feeding the excessive investment in infrastructure as opposed to research and development or other more productive means, both before the crisis and in its early stages when the government put in place a fiscal stimulus. In fact, it was only this decentralised structure that allowed the government effectively to disburse the stimulus largely through local authorities. Decentralisation also enabled the institutional development of the *cajas* system. With their highly political governance, and serving as the source of finance for the local and regional chapters of the political parties, the *cajas* presented a significant obstacle to the much-needed reform of the financial sector.

The nature of Spain´s parliamentary system also limited the policies that the government was able to carry through Parliament. Zapatero´s minority government was the direct consequence of a proportional representation system that does not easily generate absolute majorities. This vulnerability in Parliament made it very difficult for the government to implement politically difficult measures. For example, the all-important austerity package enacted in May 2010 was approved with a majority of just one vote, even though failure to enact it would most likely have led to a sovereign debt default. Furthermore, the electoral system over-represents, for historical reasons, nationalist regions such as Catalonia and the Basque Country. That the two main Catalonian nationalist parties drifted towards an aggressive nationalist stance, which was incompatible with the government´s responsibility as holder of central authority, and demanded concessions on the nationalist front which were politically unpalatable to the Socialists, left the PSOE with only the Basque nationalist party as a reliable partner, exacerbating its weakness.

The role of other institutions such as the Bank of Spain was also crucial. Both before and during the crisis its diagnostic errors concerning the health of the financial sector and its failure to act accordingly were critical in delaying measures to reform the *cajas* and to force financial institutions to strengthen their capital bases. This in turn significantly conditioned the government´s ability to manage the crisis, as the risk of a financial bailout fed doubts about the sustainability of Spain´s sovereign debt, debilitating Spain´s negotiating position with its EMU partners.

Finally, the institutional arrangements that governed relations between the government and the private sector, such as the labour market legislation, corporate governance rules and vocational training regimes determined parts of the context within which the government acted in response to the crisis. For example, collective bargaining is enshrined in the Spanish Constitution, something which made it almost politically impossible, given the majority required in Parliament to amend the Constitution, to eliminate this mechanism as part of the deep liberalisation of the labour market that many economic experts and even the ECB demanded in 2011. This institutional mechanism became a channel through which the trade unions were able to condition the ability of the government to increase Spain´s deteriorating competitiveness in the run-up to the crisis or implement flexibility measures to keep companies from dismissing employees once the crisis hit in earnest.

Judgement and personal characteristics of decision-makers

For all the impact of the structural reasons highlighted above, agency was also a key explanatory variable and the judgement and personal characteristics of the senior decision-makers were an important determinant of how the crisis was managed. As Sprout and Sprout (1968: 33-34) have argued, the personal characteristics through which political leaders perceive and interpret reality can substantially shape the economic policy decisions for which they are responsible. The case of Pedro Solbes, Vice-President and Minister of Economy and Finance, is a good example. Renowned for his conservative character, he was a career civil servant always in favour of gradual change and not radical reform. He was also at the end of his career, which might have made him more inclined to a comfortable than a combative tenure. These traits made him resistant to the bold reforms, often also unpopular and politically costly, that Spain would have needed to deal with the imbalances in the run-up to the crisis, such as measures to curtail credit growth, the scrapping of the popular mortgage tax credit, the strengthening of competition regulators to foster competition and reduce inflation or a reform of the *cajas*.

The lack of appropriate expertise of the Governor of the Bank of Spain, Miguel Ángel Fernández Ordóñez, a renowned micro-economist but with little experience in the financial sector before being appointed, also played a key role in the central bank's underestimating the vulnerabilities of the Spanish financial system. The personal circumstances of other key actors were also important. For example, the hard-core resistance of the President of the CEOE, the business representative organisation, during the early part of the crisis, Gerardo Díaz Ferrán, to the labour market reform proposed by the government was driven to a significant extent by his attempt to use his negotiating power as a bargaining chip to persuade the government to drop the corruption charges against him for which he was later imprisoned.

But it was of course the judgement and personal characteristics of President Zapatero that most significantly shaped the management of the crisis. His perennial optimism underpinned his refusal to accept the gravity of the crisis in its early stages, not even uttering the word 'crisis' until the summer of 2008 when his unwillingness to do so had led to much criticism, and to ignore the early signs of crisis, from the unsustainability of the housing bubble, to the worsening job figures or to the problems in the *cajas*. His personal closeness to trade union leaders played a very significant role in his unwillingness to take more determined action on the reform of the labour market. His lack of action on this and other issues was also the outcome of his consensus-orientated disposition. Other aspects of his personality that influenced his management of the crisis were the tactical and short-term approach with which he often confronted complex problems, at least until the wake-up call that the need to adopt the May 2010 austerity U-turn represented; his tendency to affirm his power by controlling information and not sufficiently empowering his ministers, often to the detriment of the necessary economic reforms; the concern with his legacy, with respect to both the party and the nation; or his lack of knowledge of economics, which played a significant role in his not understanding the gravity of the situation sufficiently early. Finally, as with most political leaders, President Zapatero´s concerns about the legacy of his term in office weighed heavily in his decisions, not least in his refusal to accept a bailout.

Ineffective decision-making

These personal characteristics of the key decision-makers were behind one final domestic political factor of relevance: the ineffective decision-making process that was a hallmark of the Zapatero administration throughout the management of the crisis. The interviews conducted have painted a picture of a disorganised decision-making process where decisions were often taken by the President on the basis of anecdotal evidence or by consulting a small number of *confidants*, often bypassing the appropriate government procedures and departments. The chaotic way the fiscal stimulus was designed is a clear example of this, as was the fiasco surrounding the failed adoption of a single type of contract during the labour market reform discussions. Furthermore, the very defective communication process often worsened the unpopularity of many measures. The poor manner in which the May 2010 austerity measures were explained to the public is a clear example, since the government allowed the opposition´s message that pensions had been cut to take hold of public opinion, when the reality was that they had been frozen, after years of significant increases, and the minimum pensions had still been guaranteed a rise.

This inefficient decision-making was both cause and consequence of the disagreements within the cabinet, which certainly conditioned the management of the crisis, both in the assessment of its gravity and in the measures adopted to confront it. The different views within the cabinet regarding the likely length and depth of the crisis or the likelihood of a hard landing prevented more forceful action that could have helped stem the credit boom and associated housing bubble prior to the crisis. In the origin of this disagreement was a failure by Spanish policymakers to understand the implications of EMU. In fact, the management of the crisis was also characterised by serious diagnostic errors, often reflective of this poor decision-making process, from the initial denial of the gravity of the crisis and the vulnerabilities of the financial sector to the misunderstanding of EMU´s implications. The labour market reform was another area where these divisions played out between the officials at the Ministry of Labour, closer to the position of the trade unions, and that of the Ministry of the Economy and Finance and the President´s Economic Office.

In sum, the seven domestic political factors outlined above all significantly shaped the management of the crisis and of its immediate origins but did so in different manner, influencing different areas and to varying degree. The electoral and political cost implications were arguably the most important and were ever-present in the considerations of President Zapatero and his government, both in the downplaying of the crisis in its early stages and in modulating the austerity measures and reforms that followed. The manner in which these political and electoral costs were determined did, however, vary. The voice of the party was not always heeded, not least because of the total control that the President and his close allies had of the party apparatus, and as a result partisanship and party considerations did not always directly define the President´s calculations, as was clearly evidenced by the reform of the Constitution, taken with absolute disregard and at the expense of the PSOE's electoral interests. However, partisanship did directly influence the government´s actions on many occasions, for example through the influence of regional PSOE leaders on the *cajas*. And party preferences were in any case almost always embedded in the electoral and political calculations made by the President and government. Ideology often played a mediating role in this respect as, irrespective of the influence of the party, a shared ideological outlook meant that the political costs estimated by the President and members of his government were often aligned with party considerations. Some of the key responses adopted, such as resistance to liberalisation of the labour market or eagerness to respond to the G20´s call for a fiscal stimulus, were undoubtedly shaped by the left-wing ideological preferences of the President and other government members.

Other responses to the crisis can best be understood in terms of the role played by organised interests and domestic institutions. The influence of the former was particularly evident in areas where these material interests were affected and the representatives of the sectors had access and ability to influence the President or key ministers. The most obvious case was that of the financial sector, although the pressure exerted by energy, utility and construction firms was also intense. In a number of key developments, not least the reform of the labour market, the trade unions were highly influential, both through the institutional mechanisms that granted them leverage such as collective bargaining and through the strong connections they had to the Ministry of Labour and President Zapatero himself. The particular nature of some domestic institutions played an important role in providing the means by which these organised interests exerted pressure on the government, for example the political economy of institutions that drove industrial relations and which allowed both trade unions and business representatives to block the labour reform for a substantial period, each for obviously different reasons. Other institutional features, such as the role of the Bank of Spain in Spain, the decentralised Spanish administration or parliamentary system, were also important.

There were other responses to the crisis that interests, institutions and ideas cannot account for and that can be best explained by reference to the personal characteristics and judgement of key policymakers, most notably President Zapatero and Vice-President Solbes, but also figures like the Governor of the Bank of Spain. Although always difficult to measure, one of the findings of the dissertation is that this factor influenced the government´s response more than most theoretical frameworks which, as we have seen, focus on ideas, interests or institutions, allow for. Whether it was Mr Solbes´ conservative attitudes blocking necessary reforms, Governor Fernández-Ordóñez´s lack of banking experience contributing to the financial sector´s problems going unaddressed or President Zapatero´s perennial optimism nudging him to a denial of the gravity of the crisis in its early stages, personal characteristics were not at all insignificant in the management of the crisis. In fact, it was another of President Zapatero´s well known personal traits, his relatively chaotic approach to management, that partially explains the dysfunctional decision- making process, a factor that played a role in various key episodes, from the way in which the 2008 fiscal stimulus or 2010 austerity packages were put together, to the remarkable manner in which the President went about reforming the Constitution in late 2011.

6.3. Theoretical implications

The evidence uncovered in this research provides useful material in light of which to consider, in the Spanish context, the usefulness of the different Comparative Political Economy (CPE) research agendas considered in Chapter 1: institutional, interest-based, partisanship-based and ideational. It also provides valuable evidence to assess what the Spanish case can tell us about the economic discretion of states in an age of European and global economic integration.

Institutional political economy

Theories that privilege the role of institutions in shaping economic outcomes are consistent with the important role played by some key institutional arrangements in the management of the crisis in Spain. As seen in the previous section, institutional factors defined key drivers of the response to the crisis such as the role played by decentralisation, whether in the failure of the *cajas* system or the disbursement of the fiscal stimulus, the weak parliamentary support that the government could count on or failures in the supervision of the financial system by a key institution such as the Bank of Spain.

An institutional approach is of particular relevance to explaining how the corporatist nature of Spain´s political economy institutions was behind many of the imbalances that led to the crisis and conditioned its management. As argued by Molinas (2013), the political and institutional arrangements that came out of the transition to democracy were characterised by the collusion of political and economic elites, which led to the development of a rent-seeking and corporatist mode of capitalism. This was evident in the deep enmeshing of the public and private sphere that characterised corporate governance structures, with little accountability and weak competition regulators, and which allowed very imperfect competition in many important product and market services. This system allowed for a disproportionate amount of the growth to be syphoned to economic elites through mechanisms such as high prices due to lack of competition, vast overinvestment in infrastructure to the benefit of certain corporate sectors or corruption. The latter was in part facilitated by the system of blocked party lists, which was designed to strengthen political parties as a way to guarantee the stability of a then young democracy, but prevented party elites from being accountable to the electorate. The impact of these corporatist institutional arrangements was clear, as the evidence presented in this dissertation shows, in various dimensions of the crisis: the housing bubble, the outcome to a great extent of collusion between political elites which controlled the boards of the *cajas* and used their financing prowess to serve the interests of specific parties or firms; the effective resistance to reform of various sectors, including the construction, utilities and in particular the financial sector; and the manner in which the control that unions and business representatives had of industrial relations allowed for the labour market reform to be stalled, since it was in the interest of all parties, for different reasons, that it should not progress. In so far as these corporatist arrangements were set up by public and private elites for their benefit and to the detriment of the population at large, the Spanish case gives credence to Acemoglu and Robinson´s (2012) claims concerning the corrosive role of extractive institutions.

But it is the varieties of capitalism (VoC) approach that is, as we have seen, the most important research agenda when considering the role of institutions in CPE. According to the VoC literature (Royo, 2008), Spanish socio-economic agents had achieved a high degree of coordination despite the absence of formal coordination mechanisms that characterise coordination in coordinated market economies (CMEs). This was so because successful coordination is dependant not only on the coordinating mechanism but also on the actors´ interests and strategies, which in the Spanish case were conducive to coordination (ibid.). Even in the field of labour relations, where Spain certainly lacks the formal coordinating mechanisms of the kind found in CMEs, the tradition of social dialogue between government, industry and unions that has defined Spain´s political economy since the transition to democracy and the collective bargaining system that is enshrined in the Constitution, led to a significant degree of coordination. Because of these traits, the VoC literature identifies Spain as of a Mediterranean model (Royo, 2008), which combines some elements of both liberal market economies (LMEs) and

CMEs, but one that was not converging towards an LME prior to the crisis but rather retained important elements of coordination.

A VoC approach would have expected the response to the crisis to be consistent and shaped by Spain´s political economy institutional arrangements. And, in fact, to some degree it was. The initial fiscal stimulus was intended to promote investment in infrastructure and promote short-term hire, which reinforced the existing growth and employment models, based on low skills and productivity sectors and jobs (Royo, 2013: 240). In the banking sector, the initial response involved extensive regulatory intervention, which was in line with, and in fact strengthened, the model of strategic coordination between the state and the sector that had been in place prior to the crisis.

Yet, as Royo, who has probably been at the forefront of the application of the VoC model to Spain, admits, there are problems with this supposed fit. The response to the crisis, in particular through the increased liberalisation of the labour market despite strong opposition from the trade unions, seems to have taken the country precisely in the direction of LMEs, rather than reinforcing the Mediterranean model. Similarly, the restructuring of the Spanish financial sector, and in particular the disappearance of the *cajas*, weakened the strong coordination between state and private firms in the financial sector, undoing the highly *bankarised* Spanish financial sector, a key trait of its strategic coordination model.

In conclusion, the early response to the crisis was consistent with the assumption of the VoC approach, but not so much later developments. Furthermore, for all the ways in which these institutions might have constrained or conditioned the response, the Spanish case shows how the VoC model significantly underestimates the role of agency and the interests of the key actors. As Royo himself admits (2013: 241):

> The analysis of the Spanish experience with the crisis confirms the thesis that coordination is a political process and that strategic actors with their own interests design institutions (Thelen 2004). Institutional change is a political matter because institutions are generated by conflict, they are the result of politics of distribution, and, hence, they are politically and

> ideologically construed and depend on power relations (Becker 2006: 9) (…). In other words, institutional change is driven by politics (…). The crisis has had a profound effect on power relations and the interests of actors.

Interest-based political economy

There appears then to be a clear connection between institution-based and interest-based CPE approaches, which is clearly at play in the Spanish case. Many of the actors who were protagonists in the institutional analysis sketched above had strong material interests in shaping the policy response in their favour and interest-based approaches capture well how they shaped the origins and management of the crisis in Spain. The adoption of the euro created clearly defined winners and losers in Spain´s political economy and the defence of these interests is key to understanding interest-based dynamics in the run-up to the crisis. As Hopkins (2015: 11) has explained:

> The big winners from the resulting boom [of the adoption of the euro] were to be found in the sheltered sectors of the economy: construction, the services sector (…), and, of course, the banks. These sectors had every interest in blocking the kind of reforms that were necessary for the southern European economies to function within the single currency (…) Politically, the housing boom empowered the real estate and construction industries and deepened their often corrupt connections to political representatives, particularly local councillors who had control over planning and zoning decisions, and political nominees in regional banks.

It was these material interests that were behind the interest coalitions that shaped Spain´s political economy in the run-up to the crisis. As would have been predicted by the work of Gourevitch (1978, 1986), the arrival of the crisis fractured these coalitions. For example, the construction and financial sectors had mutually benefited from the housing boom, but once the bubble burst and the banks were left with a large number of toxic property assets on their balance sheets, the interests of the two sectors diverged. The setting up of a bad bank, which was discussed by the government in the early days of the crisis, would have been partially in the interest of the financial sector but certainly not of the construction companies, since it would have seen housing prices plunge.

The opportunity seen by business representatives to use the crisis and spiralling unemployment to pressure the government to liberalise the labour market also broke the tacit coalition of business representatives and trade unions that, despite its ups and downs, had characterised Spanish industrial relations since the transition. The unions and the CEOE had a common interest in maintaining the labour market regulation structure, especially collective bargaining, as they both benefited by it in so far as it gave them power and leverage. As explained earlier, this coalition can be traced to the francoist seeds of the corporatist model of capitalism that developed in Spain and which, through the social concertation model, was a hallmark of Spanish political economy. Consequently, while Spain´s formal institutional framework as per its VoC did not predetermine that coordination in industrial relations would take place, it was the interest of the key players that drove them in that direction. Once these interests markedly diverged, so did the coordination that had resulted from them. In sum, the interests of the private sector pressuring for labour market reform, overcame the tradition of strategic coordination that, with the exception of a brief period in the early 90s, had characterised Spanish industrial relations.

These material interests were also behind the strong influence exercised by the financial, construction or utilities sectors in attempting to neutralise efforts that they regarded as contrary to their interests and which partially explain the absence of reforms in the run-up to the crisis and the imbalances that led to Spain´s difficulties. In fact, the manner in which reform of the financial sector finally took place is also consistent with an interest-based template. Otero et al. (2016: 38) have applied Alesina and Drazen´s (1991) war of attrition model, discussed in Chapter 1, to explain the evolution of the financial sector reform during the crisis. According to this interpretation, the reform was delayed because of the divergent interests of the key actors involved – banks, *cajas*, the government and the Bank of Spain – with each of them attempting to shift to the other the burden of adjustment in a 'war of attrition' which only ended, in this case, with the intervention of an external actor, the EU, which forced the reform of the sector.

In sum, interest-based approaches are helpful to explain certain developments in the management of the crisis but fall short in others. On the one hand the interest of key stakeholders influenced the government in directions that would not have not been obvious given the country´s institutional set-up. While the latter often provided the means, it was the former that provided the motive. Furthermore, the predictions of interest-based approaches seem to be warranted by the Spanish experience, not least Gourevitch´s assumption of the relevance of interest-based coalitions and how crises change them.

However, it is clear that approaches that suggest that material interests are the key explanatory variables are not sufficient to explain fully the Spanish experience. The influence of organised interests was constrained by the institutions within which actors operated and by other domestic factors. For all of their opposition to them by organised interests, various key reforms, such as in the financial sector, the labour market or the end of the generous subsidies for renewables in the energy sector, did end up taking place. Similarly, a bailout might have been in the interest of many influential organised interests, not least the financial and construction sectors which would have seen their finance cost significantly reduced, yet other political factors led the government vehemently to oppose any bailout, such as the electoral cost it would have implied.

Partisanship-based political economy

The actors and interests driving the management of the crisis were not only material but also political and as such partisanship-based approaches can also be said to have been partially correct in their predictive assumptions. Party preferences and pressures can explain a number of key decisions, from the large fiscal stimulus to the lukewarm labour market reform. As suggested by Nordhaus' (1975) work on *political business cycles*, the electoral cycle was a key explanatory variable in the response to the crisis, most certainly in the underplaying of its gravity in the run-up to the 2008 election and the refusal to accept a second labour reform when demanded by the ECB in 2011 in return for the acquisition of Spanish sovereign bonds. Many of the decisions privileged the importance of employment over fiscal or inflation considerations, at least until the May 2010 U-turn, confirming the validity of Hibbs´(1977) hypothesis in this respect. Although not as important as other domestic factors, party pressure did, as shown in the previous section, play a role in some episodes of the crisis, in a way that is consistent with the work of Boix (1998). The management of the crisis is also consistent with what would have been predicted by approaches that, while maintaining the centrality of partisanship, see it conditioned by other factors such as the international economic context (Alt, 1985) or trade unions (Garret, 1998). As seen in the summary of findings, both of these factors significantly determined the management of the crisis, the former for example in how contagion from the Greek crisis led to the May 2010 austerity measures and the latter in the reluctance of the government to undertake a more profound reform of the labour market. Finally, approaches such as that of Galasso (2014) rightly predicted that, in times of crisis, left wing governments are more prone to undertake structural reforms. That was certainly the case with the PSOE in the management of the crisis in Spain as, despite serious reluctance, it did end up adopting some significant reforms, such as that of the pensions, the financial system or the fiscal sustainability golden rule in the Constitution.

As with material interests, partisanship approaches cannot however properly account for some of the most important measures taken by the government, and which were clearly against the political interests of the PSOE. The most remarkable example was of course the austerity measures adopted in 2010, which represented a departure from the commitment to social spending increases that had characterised the Zapatero administration until then and which ran counter to attempts to increase employment with expansionary policies which partisanship approaches would have expected a left-wing government to privilege. Another measure which does not tie well with a partisanship approach was the reform of the Constitution to enshrine a limit to public spending, something which had been anathema until then for the Spanish Socialists. Finally, the de-facto abolition of the *cajas* system took away a valuable source of power and income for the Socialists, as well as the rest of the parties, which explanations based on partisanship preferences would struggle to account for.

Ideational political economy

A first approach in this research agenda locates most explanatory power in how ideas are used to realise interests. Such a view fits various instances of the management of the crisis in Spain and its immediate origins. For example, an ideological commitment to economic redistribution through high levels of social expenditure served to realise the partisan interests of the PSOE and of President Zapatero in the years leading up to the crisis. Privileging social equality and investment in public services helped the government to push policies in response to the crisis, such as the fiscal stimulus of 2008, which satisfied its electoral interests. In other words, ideas became the means by which partisan interests could be legitimised.

In this utilitarian interpretation of ideational motives, epistemic communities play a key role and the dominant ideas within a given professional group are key in explaining the choice of policies. Such an approach is useful to interpret, for example, the role played by the Bank of Spain in the management of the crisis. As the hegemonic source of economic analysis in Spain, its market-orientated views provided intellectual cover for liberalising structural reforms beyond the financial sector. This is distinct from the interests defended by the financial sector, as in the case of the staff of the Bank of Spain it was driven more by an ideational framework than for advancing particular economic interests. Furthermore, the groupthink that dominated the institution is key in understanding its supervisory failures of the financial sector and other macroeconomic diagnostic mistakes that shaped the management of the crisis. Conversely, and as Fishman (2012) has argued, the absence of any distinct economic ideological foundation on the Spanish left can go a long way in explaining why the Socialist government adopted some of the orthodox policies that were being demanded by the troika.

Ideational frameworks that go beyond the instrumental use of ideas and point to ideology and culture as the primary cause of economic outcomes (Johnson, 1994; Sabel, 1995; Ziegler, 1997) also find relative confirmation in the Spanish crisis. For example, Spain´s past as a dictatorship has made the idea of the EU, in the eyes of the political and business class, the anchor of democracy and economic development. There was thus intense pressure on policy-makers, and especially on President Zapatero, to do whatever it took to remain a model EU member, which can help explain the government´s willingness to accept difficult measures such as the austerity policies implemented in 2010, even if it apparently went against the PSOE's electoral interests and ideological tenets.

Yet the role of ideas is insufficient to explain significant episodes in the management of the crisis when they were often trumped by the influence of interests or institutions. For example, approaches privileging the explanatory power of ideology cannot explain the many measures that ran directly against the government´s centre-left ideology, from the austerity policies established in 2010 to reform of the labour market or pension system, or the reform of the Constitution to establish limits to public expenditure.

In sum, the Spanish crisis has provided a useful illustration of how the different factors privileged by alternative CPE research agendas – institutions, interests, partisanship and ideology – were all present in the management of the crisis by the Spanish government and in fact reinforced each other. Such a dynamic points, at least in the particular Spanish case, to the futility of trying to find the key explanatory driver of political economy outcomes in one particular domestic political factor. While the different CPE approaches are all partially useful in explaining the management of the crisis in Spain, they are all insufficient in so far as they privilege a certain single factor to the exclusion of others that, in the Spanish crisis, were also important. The different CPE approaches are, in sum, all partially sound and related to each other. Institutions are shaped by confrontation in defence of material and political interests, which are in turn shaped by ideas.

Economic discretion of states in the age of globalisation

The discussion above has offered ample evidence of the relevance of domestic political factors when analysing the management of the crisis in Spain. The salience of the domestic dimension, and the defining role that the actions of the government had in defining the response to the crisis, point to the answer to the second theoretical debate introduced in the Introduction, namely that on globalisation´s impact on states' economic discretion. This dissertation´s findings indeed appear to indicate that, in the case of Spain, the state maintained a significant degree of discretion. As we have seen throughout the dissertation, while external constraints were ever-present in the management of the crisis, the PSOE government always had a significant margin of action, if not always on the timing and the necessity to act, certainly on the measures it adopted and their specific content. In other words, external constraints might have shaped the *when*, but not so much the *what* and the *how*. And even when external constraints influenced the content of the reforms, the final shape of many of the measures adopted was almost always significantly conditioned by domestic considerations.

This dynamic was evident in most of the key episodes of the management of the crisis. The first major decision adopted, the fiscal stimulus agreed in October 2008, was in its content and the way it was disbursed very much the outcome of the government´s domestic priorities. These were driven by the government´s electoral and partisanship interests, such as responding to the pressure of organised interests to devote a significant part of the stimulus to construction projects or for the funds to be disbursed through local authorities, where the PSOE had a strong presence and therefore much to gain politically. Following on this initial response, the government proved how relatively impermeable it was to external pressure to act as it continuously downplayed the gravity of the crisis and delayed taking substantial measures, despite increasing calls to do so. Those measures adopted, like the Sustainable Economy Law, were brought about much more by the domestic political pressure to be seen to be responding in some way to the crisis than by any external constraints. The measures taken to ensure bank lending and the bailout of various *cajas* showed how, despite the process of financial globalisation, actions to address the difficulties of financial institutions fell in Spain, as in most other EMU members, at least initially, on the shoulders of the state, exposing, as Thompson (2010:137) has argued:

> The limitations of much of the argument that globalisation has reduced the economic agency of states, and vindicated those who insisted that states were still crucial economic actors.

Even in the decision that could offer the more persuasive evidence that financial market pressure and EMU membership had come to trump the government´s ability to act, namely the austerity measures of May 2010, government´s discretion was ample, as was shown in Chapter 4. The choice of measures to adopt was very much the decision of the government and it was driven to a significant extent by domestic political considerations, such as protecting key social services like health-care that were crucial to the PSOE´s electorate. Another of the unpopular measures adopted, the labour reform, was, again, on close observation, less a radical reform imposed upon the government by external forces beyond its control than a relatively limited reform shaped by ideological factors and domestic organised interests that stopped well short of what would have been implemented had external pressures been inescapable. While it is true that, even if necessary, the reform might not have taken place had it not been for the external pressure, it is also true that, had the government been defenceless against these external forces, it would have been far more profound. Yet one more episode that shows that the Spanish government preserved its discretion to act was the refusal to accept a bailout. As discussed, Spain was asked on at least three different occasions to accept a bailout during a period of intense pressure on its sovereign bonds. The government resisted such calls driven, as we have seen, almost exclusively by domestic considerations.

Even in the reforms undertaken in 2011, in the midst of the most intense pressure from the euro crisis, the final measures were very much at the discretion of the government. The further reform of the financial sector was of course catalysed by the global financial crisis but, as explored in Chapters 3 and 4, the decisive factor that determined the content of the reform was the government´s reaction to domestic factors such as the unsustainability of the *cajas* system or the exposure of the banks to bad debts from the housing bubble. The pension reform was, far from an external imposition, the government´s autonomous response to deal with an unsustainable system for demographic and financial reasons.

Finally, the reform of the Constitution in mid 2011 offers another clear illustration of how the Spanish government retained its discretion to act in the most fundamental way, even when appearances would suggest otherwise. The letter sent by ECB President Jean-Claude Trichet in which, in a veiled manner, he suggested that ECB acquisition of Spanish debt was conditional on Spain's undertaking a number of key reforms would on paper appear to be the clearest example of loss of national economic sovereignty as a result of EMU membership. Yet the reality was, as explained in Chapter 5, quite different. While the reform to which the ECB attached more importance, and which it directly asked the government to undertake, was that of the labour market, the Spanish government opted for an alternative measure which had not even been mentioned by the ECB: the reform of the Constitution to incorporate a deficit limit. Such a measure was not only taken autonomously by the Spanish government, but was in fact driven mainly by domestic consideration, namely that such a reform did not entail any financial short-term cost and was deemed to be far less politically toxic than the labour market reform requested by the ECB.

In sum, this study of the Spanish management of the crisis suggests two main conclusions concerning the theoretical debates previously outlined. With regard to the globalisation *versus* state autonomy debate, it provides evidence in favour of frameworks that seek to highlight the persistence of a significant degree of economic discretion for states. As far as the alternative CPE frameworks is concerned, the dissertation provides evidence from which to argue in favour of a more integrated approach that gives causal force to each of institutional, material interest, partisanship and ideational factors, even while recognising that these approaches are insufficient, as they do not give sufficient credence to other important domestic factors such as the personal characteristics and judgement of decision-makers. While it is of course impossible to generalise these conclusions to other cases, if domestic factors have a key role in shaping economic outcomes, as this dissertation has shown to be the case in Spain, it is analytically impoverishing, if not flawed, to pretend that international economic dynamics, such as the euro crisis, can be understood without reference to domestic political factors. As Ravenhill (2010: 165) has argued:

> The significance of the interaction between the domestic and the international (…), between work in comparative and international political economy, has been reemphasised by the recession.

6.4. Limitations of the research

As is the case with all research, this dissertation has limitations. Firstly, it is limited to Spain, so its findings cannot be of general application. It may be that its conclusion regarding the salience of domestic political factors applies to the case of other states that have faced similar circumstances in the current crisis, but such a claim cannot be predicated on the basis of this research. In other words, it has neither probabilistic value nor capacity to explain what happened in EMU´s periphery, but rather illustrative value and analytical pertinence only for the Spanish context.

Secondly, the time period specified has left out some important episodes, such as the bailout of the financial sector that took place in the summer of 2012. The reasons for limiting the research to the period of the PSOE administration were explained in Chapter 1. Yet an extension of the investigation to the years of the PP administration would make it possible to explore whether the conclusions of the dissertation also apply during this period, especially in relation to the interaction between the Spanish government on the one hand and the ECB and Germany on the other.

Thirdly, the dissertation´s empirical conclusions are derived from qualitative in-depth interviews with senior policy-makers and are thus subject to the limitations that qualitative research of this type may suffer. The findings are the result of the observation of causal processes rather than observations of data. Furthermore, it is inevitable that the views of the actors interviewed are subjective and, the crisis being a particularly difficult period for most of them, it is to be expected that they would be biased. Nevertheless, significant effort has been made to control for such problems by cross checking against other sources particularly contentious or generic claims.

Finally, as with any research of this type, the conclusions cannot be final. The relationship between endogenous and exogenous factors in the management of the crisis was complex and does not lend itself to simple conclusions. The aim has been not so much to claim that external constraints were of no importance, which was certainly not the case, or to offer probabilistic certainty of the salience of domestic political factors in the management of the crisis, but rather to describe the general process of what was going in the *black box* of the decision-making process and to provide evidence to show that domestic political factors were crucial, offering some insight into how they were so.

6.5. Recommendations for future research

The limitations described above suggest areas where future research would be useful to complement the findings of this dissertation. Extending the research period to the first term of the Partido Popular (PP) conservative government, or at least until the financial sector bailout in June 2012, would allow us to test whether the same conclusions still applied. Similar studies of the management of the crisis in other EMU periphery states could help assess whether the claim to the salience of domestic political factors is generalisable in the context of the euro crisis. This would also make a useful contribution to debates on the globalisation *versus* state discretion and the sustainability of EMU. On the first topic the findings of the dissertation would be useful to test theoretical models on the tension between economic integration, democracy and sovereignty, such as Dani Rodrik´s globalisation *trilemma* (Rodrik, 2012). In relation to discussions on EMU´s sustainability, further corroboration in other EMU periphery states of the dissertation´s findings would be particularly useful, since the difficulties facing the monetary union have been predicated to some extent on the social and political discontent in EMU´s periphery with what is seen as external imposition of unpopular policies. This dissertation may assist comparative studies to identify mechanisms through which domestic political factors might have been more important than previously considered.

Finally, the results of the dissertation may be of interest to advance the research agenda in the field of political country risk analysis. Established country risk frameworks tend to be static but this research has shown that domestic political factors build risks over time, such as that of postponing structural reforms that can imperil the future growth prospects of a nation or delays in fiscal consolidation that make a country vulnerable to the doubts of sovereign bond investors. The results of the dissertation could help define risk analysis frameworks that go beyond narrow time frames, looking into how the different components of risk accumulate and help integrate different component blocks of national risk.

6.6. Conclusion

If there is one overall judgement that this research project has drawn it is that blaming external constraints for the predicament that Spain has found itself in must be treated with scepticism. Even in the most pressing circumstances, the Spanish government retained a degree of autonomy, if not on the timing or discretion to act, certainly on the content and shape of the response. External constraints mattered, but so did domestic political factors, and the most important contribution of the dissertation to the scholarly debate has been to provide evidence to this effect.

In the sombre era that the crisis has inaugurated in Europe and beyond, such a result may be a source of optimism. Fears that economic integration neutralises the autonomy of states are fuelling an increasingly pervasive dissatisfaction with the current socioeconomic system in developed economies, and certainly in Europe. If such a claim can be shown to be exaggerated, if states can be said still to hold significant leeway in defining their own political and economic destiny and addressing their citizens´ problems, then it is conceivable that a more gradual and effective ceding of sovereignty, this time through more democratic means and with states perceived by their citizens as voluntarily surrendering this autonomy through democratic processes rather than being forced to do so, could pave the way to a more sustainable age of economic integration, prosperity and socio-political contentment.

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