
Good banks and bad banks, centralised banks and local banks and economic growth

La interminable crisis bancaria ha puesto de manifiesto la importancia de la banca para el crecimiento económico. Mientras que el banco como creador de dinero es indispensable para el funcionamiento de la economía, el banco como prestamista de la empresa productiva es necesario para la actividad económica. Un pilar del debate político internacional es la necesidad de una reforma estructural bancaria que permita a los bancos desarrollar esas dos funciones más eficientemente. Por una parte, está la propuesta de separación de funciones entre la banca tradicional (depósitos y créditos) y las de aquella otra (banca de inversión) que ha expuesto al sistema mundial a un excesivo riesgo, esto es, distinguir entre una banca «buena» y otra «mala». A la vez, se da otro debate sobre los diferentes logros de la banca a gran escala concentrada en centros financieros y los de la banca a escala local o regional.

Bankuen krisialdi amaigabeak nabarmendu du zer garrantzitsuak diren bankuak hazkunde ekonomikoan. Batetik, ezinbestekoa da bankuek dirua sortzea, ekonomiak funtzionatzeko, eta, bestetik, beharrezkoa da maileguak ematea ekoizpen-enpresei, jarduera ekonomikoari eusteko. Ildo horretan, nazioarteko eztabaida politikoaren ardatz bat da bankuen egitura erreformatu beharra, bankuek eraginkortasun handiagoaz bete ahal izan ditzaten bi funtzio horiek. Proposamen bat da bankuen funtzioak bereiztea: banku tradizionalak (gordailuak eta kredituak) eta inbertsio-bankuak bereiztea, inbertsio-bankuek gehiegizko arriskuan jarri baitute munduko sistema; alegia, banku «onak» eta banku «txarrak» bereiztea. Era berean, bada beste eztabaida bat, finantza-zentroetan metatutako banku handien eta tokiko edo eskualdeko bankuen lorpenei buruzkoa.

The on-going banking crisis has demonstrated the significance of banking for economic growth. While banks as creators of money are important for the functioning of the economy, bank lending to productive enterprises is necessary for economic activity. Much of the international policy discussion supports the notion of reform of banking structure to allow banks to perform these two functions more effectively. On the one hand there is a discussion of separating traditional banking functions from those which exposed the system to excessive risk, i.e. separating 'good' banking from 'bad' banking. At the same time there has been discussion of the relative merits of large-scale banking concentrated in financial centres and smaller-scale local banking.

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1. INTRODUCTION

The future of banking is a critical matter for debate in Spain and in Europe more generally. The current fiscal crisis stemmed from the banking crisis which first became apparent in 2007 and which evolved into a financial crisis, a fiscal crisis and an economic crisis. The problems with banking were decades in the making (Chick, 2008) but the focus provided by the crisis gives us an unusual opportunity to address these problems. More important it gives us an opportunity to go back to first principles in order to consider what it is we want banks to do – what makes for a good bank? Only then do we consider below what went wrong and therefore what should now be done differently. This approach is a conscious attempt to counter the current tendency to design policy with a focus on minimising problems rather than considering in a constructive way the contribution we want banks to make to economic growth. Given the historical importance of a regionally-diverse banking structure in Spain, the discussion will focus particularly on the relative role of centralised and local banks in contributing to economic growth. We start the discussion at the general level before analysing the particular experience of Spanish banking.

2. BANKS AND ECONOMIC GROWTH

2.1. What makes for a good bank?

The function of a traditional retail bank which contributes to economic activity more generally and to economic growth in particular are the provision of a safe money asset and the creation of credit to finance capital investment. We can characterise banks as being functional if they perform these functions (Stuart 1995). While these two functions support each other, we consider each in turn. The discussion is based on Chick's (1986) stages of banking development framework which sets out the logic of a successful process of banking development (see further Dow, 2012).

Capitalist societies could not function without money – the most safe, liquid asset. While money makes retail transactions logistically easier, its importance lies more in providing a way of denominating contracts, particularly debt and labour contracts. Further, it is necessary to have a safe asset to hold in times of particularly high uncertainty. By far the bulk of money in modern societies (as a means of payment as well as a safe asset) consists of bank deposits.

The confidence in these deposits which make them suitable as money assets was built up over a long time. This confidence is necessary given that banks operate a fractional reserve system, such that there is never enough liquidity were there to be a bank run. Confidence was encouraged by banks handling their assets prudently. But individual banks may still face a liquidity problem if there was a system-wide loss of reserves (as with a balance of payments deficit). Central banks therefore took on the role of supplying banks with liquidity in such situations to prevent a crisis of confidence. As time went on, central banks took preventative action against crises by undertaking to supply liquidity as required – the lender-of-last-resort facility. In practice this has been the counterpart to the authorities supporting the official rate on the wholesale market, supplying liquidity when banks needed more. But as a *quid pro quo* for providing this facility, central banks have required retail banks to conform to regulations designed to ensure prudent behaviour and thus a reduced risk of crisis. Overall then the historical experience of retail banking was a mutual support relationship between the central banks and the retail banks whereby the latter would provide society's money with liquidity support from the central bank in exchange for restrictive regulation.

It was the emergence of the habit of treating bank deposits as money which allowed banks to create credit, ushering in the fractional reserve system. Confidence in the safety of bank deposits therefore allows banks to perform their other major function, which is to finance productive investment. Confidence in bank deposits in turn was reinforced by prudent lending practices, as well as central bank supervision. Banks built up their expertise in risk assessment, which further encouraged confidence. Once the lender-of-last-resort facility was introduced, bank

lending was no longer constrained by reserves; banks decided first on loan applications then borrowed more reserves as required. As a result both the volume of credit and the money supply became endogenous. Central banks could not control credit or money, only exert influence on them.

2.2. The emergence of bad banking

The retail banks began to chafe under the restrictions of their regulation compared to other types of financial institution, forgetting the privilege they enjoyed in being able to create credit. They successfully lobbied for deregulation from the 1970s to allow them to compete in a wider range of markets. Already freed from reserve constraints they were able to expand credit dramatically in the 1970s, much of it to finance speculation rather than productive investment as they fought over market share, and beginning to rely increasingly on wholesale funding. This process was accelerated in the EU by the pursuit of a single financial market in the name of increased efficiency (Cecchini, 1988). When the authorities tried to rein the ensuing credit explosion in by introducing capital adequacy requirements from the 1980s, the banks responded by securitising debt and seeking profit opportunities in international derivatives markets rather than in loan contracts with their traditional customers. The excessive leveraging and wilful ignorance of risk led to the banking crisis which began in 2007 (see further Chick, 2008).

The banking system had moved a long way from the functionality expected of 'good' banks. The confidence which underpins a successful banking system has been severely threatened; the safety of bank deposits themselves has come into question. The authorities' commitment to the lender-of-last-resort facility was uncertain at the onset of crisis, causing bank runs. Although the liquidity was ultimately forthcoming, the on-going policy discussion around making banks small enough to fail has continued to raise questions about the safety of bank assets. The initial proposal for all bank deposits in Cyprus to be taxed 10% added fuel to the fire. At the same time the continuing fiscal crisis in the Eurozone has meant that sovereign debt, which conventionally is treated as a safe liquid asset for banks to hold in addition to reserves, is itself no longer so safe. At least however there is now public awareness of deposit insurance which was largely absent before the crisis.

The banks are currently focussed on repairing their balance sheets; not only were they holding opaque structured products of uncertain value, but they were also holding bad debt they had issued themselves, particularly against overvalued real estate. Efforts to encourage growth by monetary policy have so far been largely ineffective since banks are wary about resuming lending. This has hit small and medium-sized firms particularly hard, since large firms typically are hoarding money balances until investment prospects improve. While banks can expect to back any increased lending with borrowed reserves in the normal way, some

authorities have been actively feeding liquidity into their economies through quantitative easing programmes, further adding to the pools of idle liquidity. The banks are not contributing to the economic recovery.

While recovery requires fiscal stimulus, monetary policy being relatively powerless in a recession, the question remains what kind of banking system we want for the longer run. Some smaller banks in different countries have been more functional than others in the crisis, but will face strong competition from the big banks once recovery gets underway. We consider now the question of whether efforts should be made to support local banks in order to improve the on-going contribution of banking to economic growth.

2.3. Does centralisation of banking contribute to good banking?

The conventional judgement up to the 1970s was that the optimal size of banks was medium-sized (see e.g. Guttentag, 1976). There were technical economies of scale such that efficiency rose with bank size, but this advantage tailed off at medium size. While banks until that time were predominantly retail banks, distinct from investment banks, their changing character from the 1970s increased the scope for economies of scale such that efficiency gains peaked at a much larger size. On the one hand, the increasing importance of IT systems required a substantial investment; particular spurs were the increasing incidence of online banking and the increasingly complex nature of bank assets. In addition, as banks increasingly sought funding from wholesale markets to support their growth aspirations, large banks enjoyed scale advantages in the cost and availability of such funding. It became increasingly hard for smaller banks to compete other than in niche markets (including localised markets).

The 1970s deregulation experience in Europe was given a particular impetus in the EU with the Single Banking License, which opened up competition, not only between markets in different products, but also between geographical markets. The initial flurry of competition however settled into a process of consolidation as mergers and acquisitions gathered pace. The EU was optimistic that the increase in efficiency resulting from banking consolidation would be in the general EU interest, although there was an unsubstantiated expectation that small local banks would eventually re-emerge (Commission of the European Communities 1990).

But the regional finance literature indicates concerns that this kind of centralisation of banking leads to economic centralisation (see e.g. Dow, 1993 and Dow and Rodríguez Fuentes, 2000).¹ Against the argument that large banks enjoy

¹ For further reading, see Dow (1987a, 1987b, 1992 and 1998), Faini *et al.* (1993), Greenwald *et al.* (1993), Samolyk (1994), Rodríguez Fuentes (1998), Rodríguez Fuentes and Dow (2003) and Usai and Vannini (2005).

economies of scale in risk assessment was set the argument that risk assessment remote from the local context suffers from knowledge shortfall to the detriment of potential borrowers. Even where large national banks have a wide branch network, the increasing use of credit-scoring techniques as a cost-saving measure further reduced the knowledge base. Just as the financial crisis arose from unrealistic confidence in financial markets' capacity to measure risk, so banks moved away from risk assessment by judgement to risk assessment by crude calculation. Further these calculations reflected the expectation of continuing stability in asset prices, such that mortgage lending for example did not take account of the possibility of a housing market collapse. The large banks felt confident in their ability to securitise assets in order to sell on undue risks, while at the same time taking on opaque risks packaged together in internationally-issued structured products.

Small, local 'good' banks on the other hand have a comparative advantage in assessing local risks. But even there, such assessment is vulnerable to systemic risk within the economy as a whole – even if it did not arise from the practices of these banks. Local banks are more vulnerable than large banks given their exposure to the real local economy and their higher costs in accessing funding above the deposit base. Some 'bad' local banks, particularly following the kind of demutualisation which occurred in the UK, attempted to compete with the big banks in increasing short-term profits and therefore engaged in similarly high-risk increases in leveraging. Either way, small banks were highly vulnerable to the crisis.

Where those banks which followed conservative strategies, maintaining relationships with the local community, managed to survive, they have attracted increased business due to the loss of confidence in the large banks. Traditionally it is the large banks which have been most effective in inspiring confidence, implying economies of scale in attracting and retaining deposits. The fact that large banks have survived for long periods and continued to grow inspired confidence in a self-reinforcing way. But in addition the expectation which emerged that such banks were too big to fail further reinforced that confidence. The failings of the big banks and the apparent determination of the authorities to change the structure of banking to facilitate bank failure has seriously undermined this confidence. The question now is what structure of banking will allow banks to be 'good' in the sense outlined above, of providing a safe money asset and financing productive capital investment.

3. THE SPANISH EXPERIENCE

Each economy's banking system has its own character and so has responded differently to the competitive and regulatory forces at work over the last few decades. We focus now on the experience of the Spanish banking system which has been coloured by the way in which its regional character changed over this period. We will

see that this experience is particularly relevant for discussing the functionality of banking and the relative merits of centralised and decentralised systems.

The extraordinary expansion of financial and banking activity in Spain from the mid eighties was for a long time identified as one of the underlying factors in the intense growth and development process of the Spanish economy. Higher levels of financial efficiency, banking development and financial and monetary stability were understood to have fuelled economic growth through the intense reduction in financial costs, interest rates, inflation and the increase in the amount of funds available to lend.

The financial development of the Spanish economy was driven by the deregulation process initiated in the late 1970s; a process that continued through the 1980s until its completion in the early 1990s. The liberalisation process radically changed the prevailing banking market structure of the 1960s and early 1970s. The so-called «banking status quo» of that period had been characterised by the complete absence of competition among banks, both from an internal and external point of view, and a strict control both of interest rates and the allocation of the financial resources (credit) channeled by the banking institutions². The first step in this gradual but irreversible process took place in 1974, when private banks were allowed to open new branches to compete with each other for deposits. The number of bank offices doubled between 1974 and 1984, from 15.311 to 31.876 offices respectively. But the expansion of bank offices continued, at a lower rate, in the 1980s and 1990s, for the number of offices increased by 26% between 1984 and 2004. However, the liberalisation in the opening of banks offices only increased competition between national banking institutions (private banks and savings banks), since external competition would not be a force until the mid nineties. The construction at that time of the financial counterpart of the European Single Market in the EU forced Spanish financial regulation³ to incorporate the principles of the Second Banking Directive.

The liberalisation of bank office opening was extended to savings banks in 1989, hence removing the legal and institutional restriction that had confined savings banks' financial activities to their home region (or province) to preserve their «local character». The expansion of savings banks nationwide from 1989 had twofold effects. On the one hand, it allowed savings banks to increase their deposit and credit market shares and so catch up with private banks. On the other hand it also meant the starting point in the weakening of the local/regional character that had

² See Martín Aceña (2005), Torrero Mañas (1982) and Malo de Molina and Martín Aceña (2011) for further details on the historical conformation of the Spanish financial system.

³ The formal or legal opening-up of the national market to foreign banks took place in 1978, but the conditions imposed on foreign banks were so restrictive that they could not compete with national banks for the domestic retail market until the 1990s, when the principles of the European Single Market for Financial Services were inevitably incorporated into Spanish banking regulation.

distinguished savings banks so far. Hence the percentage of these institutions that concentrated their activity in at least two regions went down from 97,4% in 1985 to 67,4% in 2001⁴. This was particularly true for the larger savings banks, which opted to expand nationwide, while medium-sized institutions mostly remained local or extended their activity only to the regions surrounding their market of origin.

Table 1. **SPANISH BANKING SECTOR: SOME BASIC FACTS**

	1985	2005	2012
Number of Institutions	364	269	258
Number of Branches	32.503	41.599	37.903
Concentration (C5)	30,1%	39,5%	n/a
Private Banks	40,1%	71,1%	71,4% *
Savings Banks	31,3%	42,0%	43,3% *
Loans per Branch (thousands euros)	2.838	27.590	40.546
Interest Margin	4,04%	1,29%	0,89%

* Year 2007.

Source: Maraval *et al.* (2009) and Bank of Spain Statistical Bulletin.

If we completely excluded from our analysis what has happened in the Spanish economy and financial sector from 2007 onwards, we might conclude that the financial deregulation and liberalisation process in Spain contributed positively to economic growth, since it helped the achievement of higher levels of competition and *financial efficiency* within the banking system, allowing banks to supply more and cheaper finance. Hence, the credit-per-office ratio increased by a factor of 15 between December 1994 and 2008, from 2,6 million euros in 1984 to 39,3 in 2008, and the same happened to the ratio of credit-per-employee, which increased by a factor of 19 during the same period (see table 1).

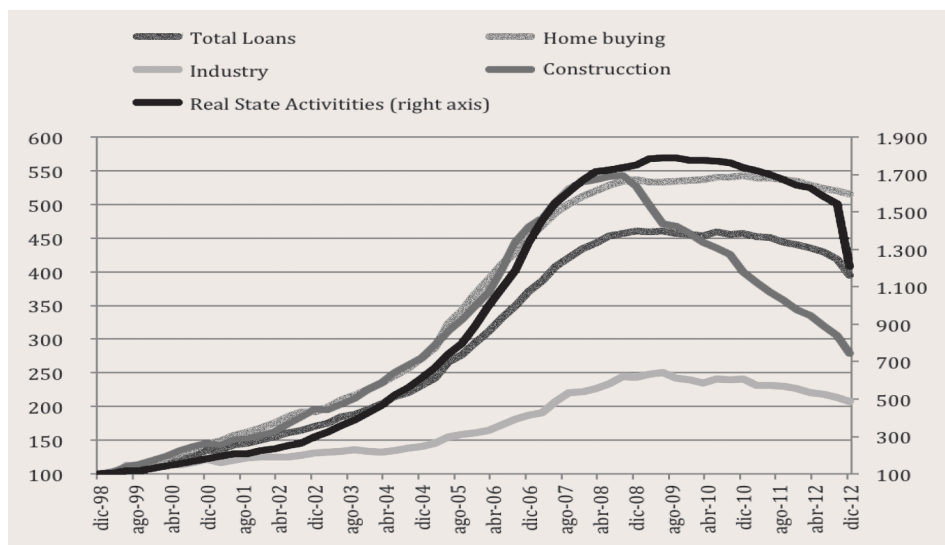
However, this positive assessment misses the point that financial deregulation also produced a strong increase in the degree of concentration within the Spanish banking system⁵, as well as an extraordinarily dense (in terms of bank offices) and costly banking infrastructure (compared to other European countries). The banking expansion

⁴ The percentage for those concentrated in one region went down from 90,8% in 1985 to 50,0% in 2001. For private banks the figures were 28,2% and 12,8%, respectively (Rodríguez Fuentes *et al.* 2004: 52-53).

⁵ When analyzing the evolution of concentration in the banking system, Maraval *et al.* (2009: 85-86) conclude that concentration decreased from early 1960s to mid 1980s, whereas from 1985 onwards this trend it is reverted and started to increase constantly, particularly.

almost doubled the average number of offices per bank between 1984 and 2008, from 86 offices to 160. The higher costs associated with a more dense bank network were probably offset by efficiency gains, but also by the existence of higher interest margins in the 1980s and early 1990s, which were four times those prevailing in 2012. But when margins started to go down in the nineties,⁶ bank profitability started to rely increasingly on two factors: the success of each financial institution in permanently increasing its market share, by expanding lending or exploring new products-markets, as well as the access to unlimited and cheaper funding resources in international markets. These two conditions did not last for ever, as the financial crisis clearly revealed for Spain. Hence, from 2008 there is a strong contraction in bank loans (graph 1) as well as a sharp decline in the funding that Spanish banks had been getting from the rest of the world, producing a quick deterioration in banks' performance ratios.⁷

Graph 1. **BANK' LOANS EXPANSION IN SPAIN (Index, 1998:IV = 100)**



Source: Bank of Spain Statistical Bulletin. Own calculations.

⁶ On average, interest margins for the deposit institution were at 4% during the period 1984-1992, then went down to 2% for the period 1993-2005, until they finally reached the 1%, which is proximately its current level (1,17% for the period 2006:3 to 2014:12).

⁷ According to the Financial Accounts published by the Bank of Spain, the Spanish financial institutions obtained almost 5.000 million of Euros in loans from the Rest of the World between 2005 and 2007 (approximately 1.700 million euros per year, which represented 25% of the outstanding amount of loans provided by the Rest of the World and 0,5% of Spanish GDP), whereas for the period 2008- 2012 there is a negative flow of 6.000 million euros (a reduction of around 1,2 million euros per year, equivalent to 30% of the stock of loans from the Rest of the world and 0,6% of Spanish GDP).

Table 2. BANK LOANS EXPANSION (1998-2008) AND CONTRACTION (2009-2012)

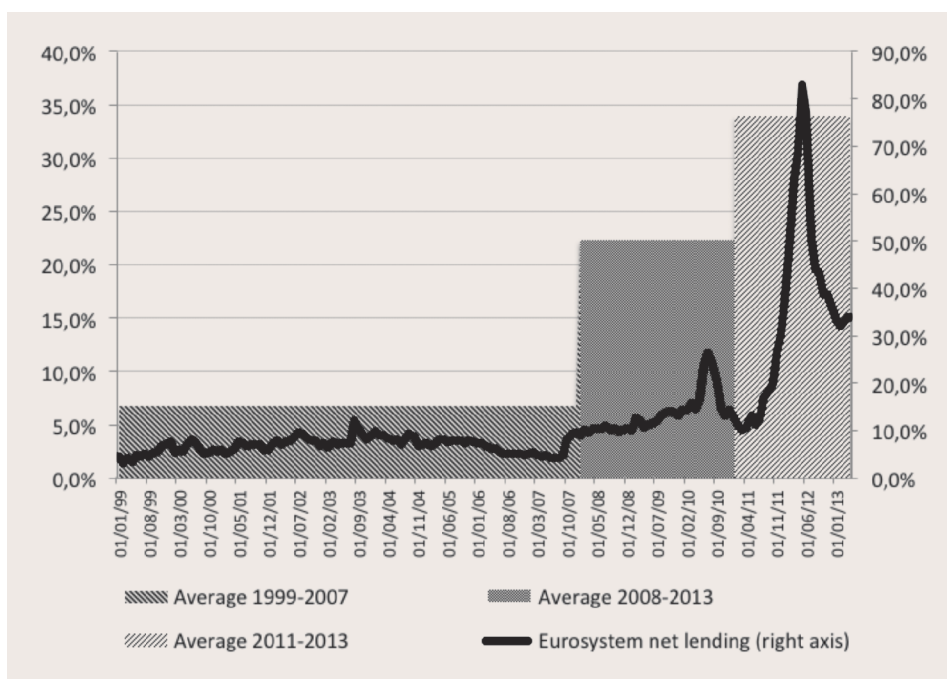
	Total Loans	Home purchase	Agriculture	Industry	Construction	Real state
Average annual rate of growth (%)						
1998-2008	16,49%	18,29%	9,84%	9,27%	18,07%	33,16%
1998-2004	14,96%	18,19%	9,88%	5,75%	18,13%	35,38%
2004-2008	18,83%	18,45%	9,79%	14,78%	17,99%	29,91%
2008-2012	-3,81%	-1,02%	-6,21%	-3,92%	-14,67%	-8,84%
Increase 2004-2008	1.404.963	526.173	15.765	85.105	118.261	295.377
Increase 2009-2012	-253.943	-22.221	-3.997	-24.478	-60.851	-102.543
		8,8%	1,6%	9,6%	24,0%	40,4%
Share (%)						
1998		30,9%	2,6%	15,3%	7,1%	4,6%
2004		35,8%	2,1%	10,0%	8,2%	10,6%
2012		40,4%	1,3%	8,0%	5,0%	14,1%

Source: Bank of Spain Statistical Bulletin. Own calculations.

Consequently, to some extent the financial deregulation and liberalisation process in Spain also contributed to the increasing vulnerability of the whole financial and banking system as well as to the progressive deterioration of its «functionality», for it pushed banks to allocate «too much» funds and loans to the development of activities with very limited effects on potential economic growth and global competitiveness. In this sense, it is remarkable that from 1998 to 2008 bank credit grew at an annual average rate of 15%, whereas credit for real state activities grew at a rate of 35,4%. In the same line of reasoning, during the same period credit to the construction sector and households' loans for house-purchase or rehabilitation grew at an annual rate of 18,1 and 18,2 respectively. Almost 60% of the increase in bank loans between 2004 and 2008 is attributed to home purchase and real estate activities loans increase. However, these two activities also concentrate the contraction in bank credit since 2009 (9% for home purchase and 40% in real state). Despite the contraction from 2009 onwards, the outstanding amount of bank loans for home purchase and real estate activities in 2012 accounted for the 54% of total bank loans, and this explains a great deal in the deterioration of banks' performance ratios since these two activities (construction and real estate) more than double the global default rate for loans (see graph 2).

But it would be misleading to conclude, as has been asserted many times, that the extraordinary expansion of credit in Spain was caused by a regulatory failure which allowed «bad banks» to grow well beyond their limits. The credit boom was the result of an extraordinary low level of bank liquidity preference combined with a strong demand for credit, in a context where international markets providing liquidity on very favourable terms. So the credit boom was not really a market failure but, as Minsky (1982) pointed out, the result of the market interplay between supply (the motivation of financial intermediaries to increase their market share) and demand (economic agents that asked for finance to increase activity in speculative markets). The boom increased the financial vulnerability of the system, since the «continuity» of the expansion of credit depended on the fulfilment of the borrowers' expectations on investment returns and the ability of banks to keep credit expansion going. But the credit boom also deteriorated the functionality of the banking system, since it did not contribute to improving the potential growth of the Spanish economy.

Graph 2. EUROSYSTEM NET LENDING TO SPAIN (in %)

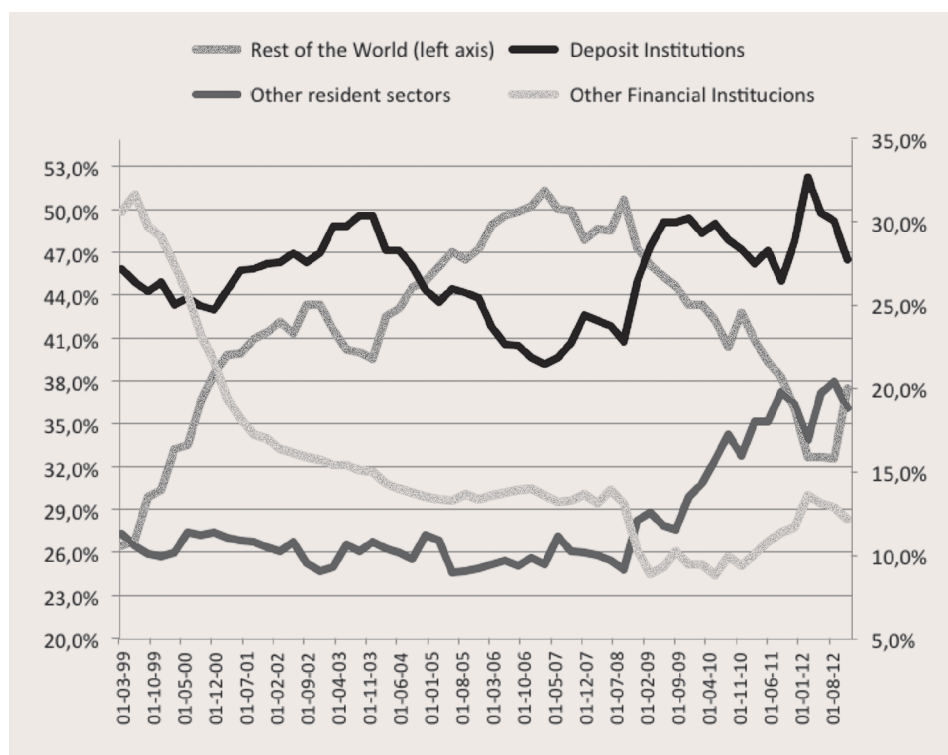


Source: Bank of Spain Statistical Bulletin.

The credit boom came to its end when the international scenario changed radically in 2008, and the international financial crisis originated a «liquidity problem» for the Spanish banking system (due to the sudden and unexpected interruption of the financial inflows coming from the international markets). This problem caused

the functionality of the banking system to deteriorate in an even more serious way for the overall functioning of the economy. It raised the possibility of bank failure, threatening confidence in bank deposits as the main form of money. The Spanish banks managed to address the liquidity problem thanks to the funds provided through the eurosystem. During the period 1999-2007 the amount of net loans granted by the eurosystem to the Spanish banks accounted for the 6,7% of the funds provided to the whole system. Since 2008 this percentage has increased constantly (see Graph 2), and reached the 34% on average for the period 2011-2013 (29% for 2010-13, and 22% for 2008-2013).

Graph 3. **SPAIN DEBT (ACCORDING TO THE EXCESSIVE DEFICIT PROCEDURE)**

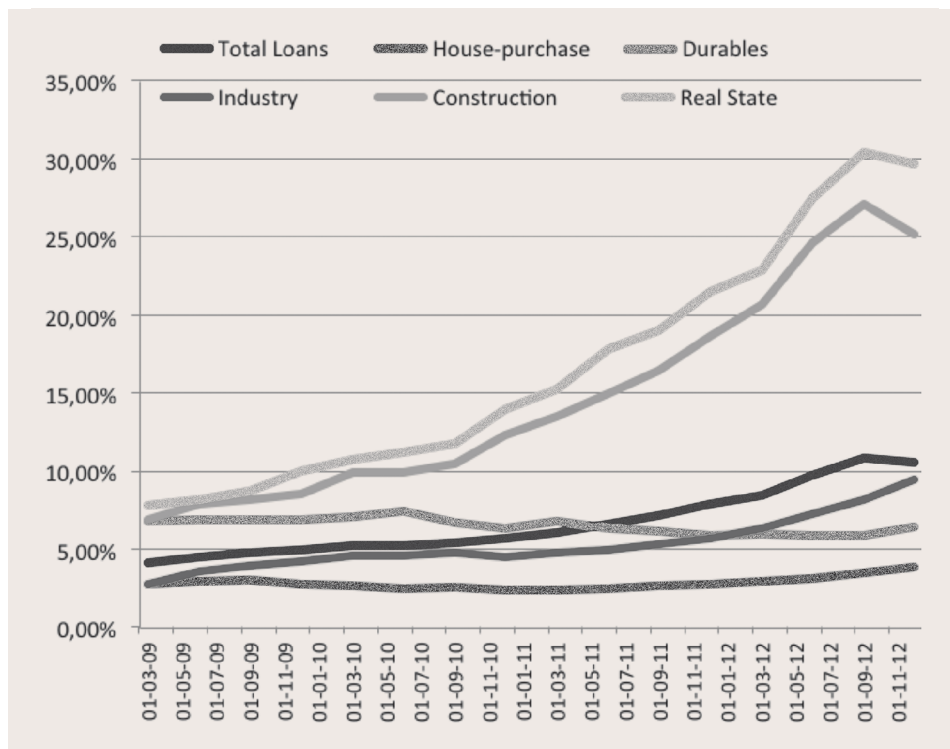


Source: Bank of Spain Statistical Bulletin. Own calculations.

The liquidity problem was later aggravated by a «solvency problem» caused by the intense deterioration of economic activity in Spain and the rise in loan default rates, particularly in the real estate and construction sectors whose default rates reached 25,2 and 29,7%, respectively, in 2012, whereas the global default rate for loans was 9,1% (see Graph 4). The resulting concern over the safety of bank deposits re-

duced the functionality of banking as the provider of society's money, since banks have displayed a sort of «defensive financial behaviour» (see Dow, 1992) by reducing the supply of credit for productive purposes and diverted their funds towards public assets from 2008 onwards (contrary to what foreign investors and other financial institutions have been doing since then).

Graph 4. **LOAN DEFAULT RATES (%) IN SPAIN**



Source: Bank of Spain Statistical Bulletin. Own calculations.

The extraordinary deterioration of Spanish banking solvency, finally, forced the government to intervene by conducting a complete restructuring of the sector with the aim of restoring its solvency and the flow of credit. But although the recession deteriorated bank solvency globally, it is interesting to point out that it also affected each group of institutions differently (Maraval *et al.*, 2009: 241-253). Whereas the recession had in principle a stronger effect on savings banks' performance, the deterioration was stronger particularly within the bigger-size group of savings banks, which corresponds with the group that adopted a more expansionary strategy during the upturn (to emulate bigger private commercial banks). Interestingly, the private bank group experienced just the reverse effect: the recession affected smaller

commercial banks more strongly. So for the Spanish case it seems difficult to extract a sharp conclusion on the relationship between size and banking robustness ... since the relationship is pretty much influenced by the commercial strategy followed by every institution. So it might be misleading to think that further consolidation within the banking system will automatically lead to higher banking robustness in the future, for the Spanish experience shows that *being big* is important, but *behaving well* (and reasonably) also matters in banking.

The restructuring process of the Spanish banking sector has been justified by the urgent need to get a better banking system to contribute to economic recovery. But the process seems to be exclusively focussed on restoring bank solvency; actually there has been very little discussion of which kind of financial and banking structure might serve best the economic restructuring and development in Spain. It seems that everything is being left to the expectation (or wishful thinking) that once the international financial turmoil and the consolidation in banking in Spain is completed, the flow of credit will be restored automatically and so also the path to economic growth. However, we should question whether the reversal of the priorities would have *better* and more valuable economic and social outcomes, that is to say, whether we should *first* drive policy action to pursue the objective of functional efficiency in the first place and leave the financial efficiency goal on a secondary level from a temporal point of view. Our recent financial experience shows that an apparently sound banking system is a necessary but not sufficient condition to guarantee sound and sustained economic growth, since we now know that the sound Spanish banking of the nineties played an important role in the distortion of the Spanish growth model from 1995 to 2007 and to the increase in the financial fragility of the financial system. Our recent experience has shown that the relevant issue is not an «either/or» choice between efficient and functional banking, but to find out the best combination between both elements (efficiency and functionality) according to the economic and institutional circumstances.

But the fact is that, although the ongoing restructuring process has already changed radically the prevailing structure of the banking sector,⁸ it has been completely ineffective in restoring the flow of credit for economic activity. Whereas bank credit grew at an annual rate of 4% during 1998-2008, from 2008 it has gone down at an annual rate of 1% from 2008 to 2012.⁹ Some economists suggest that this credit crunch will not necessarily impede growth, since credit-less recoveries are not rare events at all (Bijsterbosch and Dahhaus, 2011; Abiad *et al.*, 2011; and Coricelli and Roland, 2011). However, the critical issue here is to ask whether it is a fea-

⁸ The restructuring process has meant, so far, an important reduction in the number of institutions (30 deposit institutions). See IMF (2013) for further details on this issue.

⁹ The credit contraction has been much more intense in some particular sectors, such as the construction and real estate sectors, with an annual rate of growth of -3,9 and -2,3%, respectively.

sible assumption to expect economic recovery to take place without activating the flow of credit, particularly in Spain, where credit is not only the main funding source but there is a majority of small and medium enterprises. Maybe the «credit-less recovery» is simply a new misleading term whose meaning needs some explanation; or maybe it is simply another slogan to avoid explicitly acknowledging that the policy priority is to restore banks' solvency first ("financial efficiency") with the expectation that this will lead us to the recovery of the economy as well, but later and subject to this temporal ordering.

Another crucial missing point in the current discussion on banking restructuring in Spain concerns the consequences of centralisation and increased banking concentration for regional growth and social cohesion. And this is an important issue because current bank restructuring in Spain has meant the complete removal of the regional segment within the banking sector, and there is evidence supporting the argument that regional banks have contributed to the availability of credit in the less developed regions (Rodríguez Fuentes, 1997 and 1998; Romero Sánchez, 1997; and García Ruiz, 2007) and that spatial segmentation in financial systems does not necessarily produce inefficiency (Williams and Gardener, 2003). Obviously, some authors might conventionally argue that what *really matters* now is to have *efficient banks* and that, once such an objective is achieved, stronger financial efficiency will automatically guarantee the provision of credit everywhere it is needed. But this argument does not explicitly address the question of what (or how) the banking system could (should) do to promote, not only economic growth, but also higher economic and social cohesion; these should be the priorities for the economic policy in Spain considering the huge regional differences in terms of potential growth and unemployment rates. The conventional argument does not address the critical question of whether higher levels of concentration and centralisation in the banking sector may exacerbate credit cycles in remoter areas,¹⁰ reinforcing the cyclical inherent instability of the market system.

4. CONCLUSION

We have put the emphasis of our discussion on the two general positive roles we want banks to perform: providing a safe money asset and creating credit to promote growth.

We saw how changes in competition in European banking and the liberalisation of bank regulation threatened that functionality in Spain, as elsewhere. This has be-

¹⁰ During economic booms, centralisation in banking might facilitate credit and funding in remoter areas, but this can be abruptly reversed in periods of recessions, when uncertainty and high liquidity preference increases. So it might well happen that higher centralization and consolidation in banking end by intensifying the «pro-cyclicality» of credit in remoter economies.

come particularly apparent as a result of the crisis. Banks faced liquidity and then solvency problems which were resolved by emergency central bank action which, together with increased public understanding of deposit insurance, restored confidence in banks for the time being. But, having diverted credit creation to the financial and housing sectors during the boom, banks remain reluctant to expand lending to non-financial business.

We saw that the crisis was preceded by a process of concentration in Spanish banking, with a particular effect of reducing the regional character of the banking system. But there is a substantial literature which supports the view that small regional banks are well suited to providing credit to small and medium-sized local enterprise. Their knowledge of the local economy and local borrowers in particular is generally stronger than large centralised banks. The policy emphasis on bank efficiency as being the best indicator of capacity to promote growth therefore misses the important dimension of the regional distribution of credit. The more centralised the banking system, the weaker and more volatile the supply of credit to regions away from the financial sector due to the relatively weak knowledge base. Not only does the resulting regional distortion of economic activity damage the whole economy's growth prospects, but it also threatens social cohesion. In other words it threatens the functionality of the banking system. The efficiency criterion should therefore be understood in terms of efficient functionality. This requires attention to the regional composition of the banking system.

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