Building the Stairway to Heaven: Institutional Components of Industry Upgrading in Spain

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Between a Rock and a Hard Place

Under which conditions do middle-income FDI-dependent economies evolve towards increasingly more sophisticated industries in an open market context? What institutional components underpin such evolution?

Economic models sustained by low cost advantages are inherently weak because the emergence of a lower-cost competitor can quickly shift business away. FDI dependency exacerbates this risk because the competitive strategies of foreign investors are *not* critically dependent on conditions in any single country except their home base. However, the transformation of low-cost models into complex, advanced economies, a process called industry upgrading, is expected to be difficult. Industry upgrading involves the creation of new sources of comparative advantage to support complex, higher value added industrie. This requires adequate institutional under wiring. In the post-1980s context of open markets and rapid economic cycles, governments alone cannot undertake this task. History evidenced the risks and limitations of massive public intervention in economic activities. Moreover, the erosion of barriers to the movement of capitals, goods and services deprived national governments of traditional means to act as the sole agent of change. Governments in FDI-dependent economies are even weaker due to their need to accommodate the interests of foreign investors. Firms alone cannot undertake this process either because they lack the overarching capacities needed to reconfigure the national institutional design on which their survival depends. Firms lack normative power, they are only motivated by a narrow set of interests which are not shared across all firms, and they lack the ability to broker deals and compensate less benefited parties. The hurdle is even more acute in FDI-dependent economies where local firms are weak and dispresed relative to large foreign multinationals. The few more influential local firms may find it more effective to engage in highly clientelistic relationships with government -which may in fact hamper institutional change- than to invest their resources in advocating a broad set of

national reforms. Foreign multinationals on the other hand, are expected to be only mildly interested in institutional upgrading because they have an exit option.

As a result, middle-income economies find themselves trapped between a rock and a hard place. Lower barriers to the movements of goods, services and capital, and technological advances that facilitate the modularization of production mean that competition in the low-cost segment is fierce and foreign investors have a wide range of choices. On the other hand, the inherent weaknesses of local firms and national governments prevent these actors from becoming, on their own, the agents of change. Yet, unless they overcome this problem, middle-income economies risk losing the economic status they fought so hard to achieve.

Spain may have managed to solve this problem. Until the early 1990s, strong FDI inflows, in traditional sectors such as car manufacturing, chemicals and food products were key to support the country's fordist production model. Spain's largest firms in the banking and utility industries seemed poised for oblivion under the imminent threat of competition with larger, savvier European rivals. Spain's political economy (PE) institutions at the time were stiff, fostered inefficiencies and speculation, deprived the government from appropriate supervisory instruments and prevented firms from responding quickly to competitive demands or sudden shocks (Rivases 1991, Pellicer 1992). By the mid 2000s, the Spanish landscape had changed. The country was still an attractive investment location for foreign investors, albeit for very different sectors than those which drove and sustained the country's industrialization process. Spanish firms in the banking and utility sectors ranked among the world's largest and most competitive, and the nation's very recent institutional underdevelopment looked like documentary material from a distant past.

This situation contrasts with the evolution of other middle income economies. Italy, for example, remains mired in a vicious cycle of clientelistic business-government ties that clips the wings of potentially emerging sectors like telecommunications and discourages foreign firms form entering the market. Meanwhile, traditional industries succeed at the margins of the institutional framework by creating ad-hoc arrangements whose long-term sustainability is questionable (Rodriguez D'Acri)[1]. On the opposite end, Korean chaebol have progressed along a path of increasing quality and productivity under a system traditionally reliant on strong government support and limited local

[1] (Unpublished)

presence of foreign competition (Rodrik 1994). Among the sub-group of FDI-dependent middle-income countries, prospects for the development of complex locally-based industries look bleak among the emerging nations in the Eastern European periphery. Governments in these countries are weakened by the need to make concessions to foreign firms and local firms hardly stand a chance against such formidable competitors. (Nolke and Vliengenhart 2009). Meanwhile, economic successes like Ireland, have followed a different path along productivity upgrades in more traditional low-tech industries like food and drink or paper and publishing, and very strong FDI ties with a single country; the US (UNCTAD 2000, Barry et al 2003, ISEQ20, 2010).

This situation begs the following question: under what conditions do middle-income, FDI-dependent economies achieve industry upgrading? Using empirical evidence from Spain, this paper hypothesizes that industry upgrading will require a particular sort of coordinated institutional change in order to create the right environment to support a new set of comparative advantages. Such coordination requires an active collaborative alliance between local businesses and government. In addition, two additional conditions need to concur. First, a transformational event that puts under question the existing institutional arrangement and shifts the interests of business and government in the same direction. Second, the presence of an economic elite which can articulate a plan and gain political support to turn it into action.

Defining FDI-dependent Middle-Income Economies

Defining Middle-Income Economies

The term "middle-income" economy is ambiguous. Since the early 1990s, multilateral organizations have often appropriated the term to refer to a broad group of countries which include the BRICS, the Asian tigers, the post-communist bloc and more generally any country that stands between utter poverty extremes and the world's highest GDP per capita levels. Adding to the confusion, some of these " in-between" countries, especially those those in Western Europe (PIGS), have fought hard to be included in the first-world for aspirational and practical reasons.

To overcome this bottleneck, we need to define a category of comparable middle-income economies using specific criteria. According to Investment Development Theory, Dunning (1981, 1986, 1993), Narula (1996), Dunning and Narula (1996) and Duran and Ubeda (2001, 2005) a country's net outward direct investment position is systematically related to its level of economic development. This implies that the study of a nation's FDI position is a good indicator of its

position in the global division of labor, which in turn reflects the structural complexity of its economy. Based on this theory, Duran and Ubeda (2001, 2005), establish a classification of a sample of 54 nations, in five different "blocks". The classification may not be perfect, but it is systematic, it does take into consideration both economic structure and economic performance and it identifies at least two important features of middle-income nations; production of standard goods and government's role as a mix of market making and asset creator. I then clean up their original classification to eliminate city-states and regions (Singapore and Hong Kong). I then separate countries rich in natural resources (oil, gas, copper..) because it invalidates, or at least questions heavily the premise that the survival of the foreign multinationals is not dependent on its presence on the host country (Hymer 1976). I expand the original sample by including the Czech Republic, Poland, and the Slovak Republic per Nolke and Vliegenhart (2009). Finally I use UNCTAD's 2000 data on FDI as percentage of GDP and using a 20/80 criteria[2] to separate FDI-dependent countries from the rest. The result constitutes the comparative set of Middle-income, FDI-dependent economies. This group shares a number of characteristics: lack of significant natural assets, strong presence of foreign corporations and geographical periphery. In principle, any of these countries or a combination of them would be a good case study for industry upgrading. However, evidence for this paper is only drawn from the Spanish case. This is based on a final selection based on a combination of two criteria. The first one is success in industry upgrading (evaluated using national blue chip stock indexes as a source of information for national sectoral specialization, and international projection of these sectors). The second criteria is absence of distorting factors which may affect data quality (ie Ireland's role as an offshore financial center means that a substantial portion of funds labeled as FDI do not actually stay within the country).

Country	**Inward FDI Stock as % of GDP (year 2000)****
Ireland	131.9
Hungary	47.7
New Zealand	47.3
Czech Republic	38.2
Portugal	28.4
Latvia	26.6
Spain	26.2
Slovak Republic	23.3
Poland	20

[2] Countries that exhibit rates of FDI stock of 20% or more of their GDP are considered FDI-dependent, while the rest are not.

Israel	18.6
Slovenia	17
Greece	11.2
Italy	11
S Korea	7.1

Source: Countries: Duran and Ubeda 2001 + Nolke and Vliegenhart FDI, UNCTAD FDI database year 2000

Why FDI-dependent Economies are Different

Often, a country finds itself in a position where FDI accounts for a large portion of GDP out of a situation of need. Governments in middle-income economies are impelled to attract and welcome foreign investors to avert an economic and social disequilibrium which could spiral out of control destabilizing the social order. This was the case when Spain's francoist government faced serious balance of payments crises (1951 and 1958) and the option was to either impose an austerity package on a population already humiliated and deprived or open the country to foreign investors. It was also the case after the Berlin Wall fell, when post-communist countries could choose between social unrest or rapid integration with Western Europe. While FDI staves off the immediate risk, the trouble is that sets a low glass ceiling for the country's economic development.

Levitt (1972, 2002) states that foreign MNCs'massive resources and competitive capacity and the fact that they tend to set their strategies, retain the most productive, most skillful jobs and core technologies at home[3], inhibits the emergence and consolidation of a local capitalist class and atrophies local capacity for innovation. This implies that local firms will likely be weak relative to foreign multinationals, probably even depend on MNCs for survival. Although Levitt's argument is supported with data from Canada up to 1970s, most (if not all) of her ideas are echoed in Nolte and Vliegenhart (2009), for four post-comunist countries. These authors also highlight that governments in FDI-dependent nations will also find themselves in a less autonomous decision-making position due to the fact that increasing competition for FDI forces them to make concessions. These authors point out that FDI-dependent nations are likely to be characterized by lack of excellence in public education and weak vocational training, corporate governance systems in which managers respond to foreign owners, low investment in research and innovation, firm-based industrial relations systems (which they argue are the most accommodating to the interests of MNCs), relatively weak firing and hiring regulations and governments forced to balance extremely favorable fiscal incentives to foreign MNCs with increasing social inequalities between those that participate in the

[3] In this she coincides with Porter (1990).

FDI dominated sectors and those who do not, or who bear the brunt of the benefits bestowed on the foreign MNCs.The result is a vicious circle in which the national government's capacity for independent action is diminished and there is not enough demand for the type of structural transformations that would result in more sophisticated comparative advantages. Some authors (Smith 1998) graphically call this environment "maquiladora syndrome" highlighting the dependency that comes with foreign MNC development.

If the national government and firms in FDI-dependent nations are weak, and these countries are mired in their dependency, how can such a country generate a new set of comparative advantages to support the development of local complex industries?

Creating Conditions for Industry Upgrading: Industry and Institutional Upgrading

Firms, not countries compete and they do so the basis of their competitive advantages. Most firms develop their competitive advantages in their home countries, and there is a tendency of producers of specific sectors to concentrate on a small number of nations (Porter 1989). This suggests that some nations are more suited than other for certain types of activities. More specifically, the concentration of more sophisticated industries in certain countries indicates that certain national systems are more apt than others to support them. Thus, there is a connection between the national environment and its pattern of industry specialization. What matters about a nation is its institutions; the regularized sets of practices between economic actors. These practices lay out a set of sanctioned potential paths of action for a given set of problems (Hall and Thelen 2009). In doing so, they determine the potential actions firms may take, and in doing so, the types of advantages they may develop.

However, if the given institutional setup of a middle-income, FDI-dependent economy is determining the existing industry specialization, this implies that the institutional setup will need to evolve in order to support a new set of more sophisticated industries. Thus, the question about industry upgrading becomes a question about institutional change, and about the actors and the circumstances under which institutional change will lead to industry upgrading. Evidence from the Spanish case suggests that three circumstances need to concur for such change to drive industry upgrading: a realignment of the business-government relationship, a crisis and a plan.

Crisis

A crisis, in the sense used in this thesis is a window of opportunity, a moment where existing rules of action and established behaviors are questioned. A crisis thus creates room for change. Authors like Kingdon (2003) call them “policy windows”, and define them as “an opportunity for advocates of proposals to push their pet solutions, or to push attention to their special problems”. They are calls to action, momentum builders. Institutional change is a process and institutions are constantly transforming themselves. However, the qualitative change required to create new comparative advantages requires careful deliberation planning and execution. It will happen gradually and take many forms, but it will not start spontaneously because it requires the sort of agreement that PE actors do not feel impelled to take unless there is immediate need for it. This type of institutional change will be a negotiated process among political actors who pursue the advancement of their interests. This suggests that for institutional change to take place, it will need to be *on top of agendas* of government and business. A crisis is precisely the type of event that alters the regular set of priorities of PE actors, and sets institutional change at the top of the list.

This is not to say that a crisis will necessarily be an unexpected, fortuitous, uncontrolled or even exogenous event. Crises of the type that call for institutional change can be calculated and premeditated, or at least foreseen. This makes the crisis a secondary element of this process; it is necessary because without momentum there is no push for action, yet it is not crucial per se because given the need for such immediacy, PE actors can to a certain extent “build”, look for, and plan out the opportunity. Viewed from another angle, a crisis is not a sufficient condition for the type of institutional change that generates industry upgrading (henceforth institutional upgrading); the moment will be spoilt if there is no proposal, or of that proposal does not have enough political visibility and support.

Plan

Institutional upgrading will not take place unless a coordinated, well versed elite group can articulate and manage implementation of a plan of action. Institutional upgrading is a form of coordinated institutional change. Firms’ activity involves simultaneously several types of institutions; it is unlikely that institutional upgrading will spontaneously take place in the required sequence, at the right time, targeting exactly those institutions that are required in the same direction. Clearly defined objectives, parameters, lines of action and principles are needed. The need for structure, makes the plan a necessary condition, yet, the presence of a plan per se is not

sufficient to achieve institutional upgrading. Analysis and planning capabilities are often removed from the political, decision-making realm. Even the best plan will be nothing more than mere theory unless its authors can find political support to translate it into action.

Business-Government Realignment

To achieve institutional upgrading, the business-government relationship needs to become an alliance of specialized partners. Acting independently neither one of these actors has enough capabilities and resources to achieve institutional upgrading; government may have normative and leadership powers, but without a direct connection to business to access information about business competitive needs government will fail to act where it is necessary. Furthermore, in the post-1980s world of lower barriers, governments have lost the ability to direct the economy in the same way that post-world *dirigist* governments did; they require business support to implement their measures. Firms, on the other hand, cannot not achieve institutional upgrading on their own; first, individual firms are concerned only with a narrow set of interests: those directly related to their line of activities; they do not necessarily have the vision to structure institutional upgrading. Second, firms lack normative capacities. Finally, they also lack the ability to bestow goods to different national constituencies to achieve long-term national compromise and balance the long, and short term consequences of the institutional and industry upgrading processes. Such balance is necessary, because in choosing to support a particular core of comparative advantages (usually by supporting a core of industries), governments will need devote to this goal a great portion of their assets to the detriment of other industries, constituencies and goals. This risk upsetting the existing pay off equilibria of the nation and requires careful balancing. Institutional upgrading is a sustained, long-term effort, it will not occur unless someone can juggle the benefits and hardships across different interest groups it requires. Government's overarching position makes it the only actor that can successfully achieve this balancing act.

However, middle-income, FDI-dependent economy face a fundamental hurdle. The business-government relationship is unlikely to have, ex-ante the form of a working alliance that can achieve institutional upgrading. As mentioned earlier, both local firms and the national government are likely to be weak. Evidence suggests that they will need to overcome this weakeness, partly by relying on each other to bring about the process of institutional upgrading that fosters complex industry specialization.

Evidence from the Spanish Case

1. Becoming a Fordist, FDI-dependent economy: Motivations, Structure and Implications

Origin and characteristics of the Spanish FDI-dependent Model

Spain's modern industrialization has a clear start date: 1959. The launch date of the Stabilization Plan (*Plan de Estabilización*) that put an end to two decades of autarky and international isolation. Two sets of reasons motivated the country's opening; political and economical. Despite exerting a ferrous dictatorial control at home, Franco's regime sought long-term consolidation through international approval. The regime did so by appealing to the US, with whom Spain signed a collaboration agreement in 1953. In the following years, and with US backing, Spain became a member of the Bretton Woods institutions and the UN. European nations quickly followed suit, thus ending Spain's diplomatic isolation and legitimating (to an extent) the regime. Spain paid a political price for its recognition; the most visible item was the establishment of US military bases in Spanish soil. Also, unlike other European countries that benefited from the Marshall plan, most of the funds that Spain received were in the form of loans which had to be returned, not grants (Barciela Lopez, 2000)

The second set of reasons was economic: The prevailing ISI regime failed to raise Spain's output; for instance, wages remained below their peak in 1929 until 1956 and so did iron and steel production (Chilcote 1983), which were subject to quota allocations. Spain's dependency on foreign inputs and technology made the situation unsustainable and led to a first balance of payments crisis in 1951. A second and deeper crisis in 1958 forced the government to choose between imposing further austerity measures on a population already living quite frugally (with the consequent risk of social upraising) or opening the country. In essence, what led to Spain's acceptance of foreign presence were the weakness of its government and the inability of its entrepreneurial class to operate in a closed economy context.

The industrialization model that ensued in the 1960s and early 1970s was based on a mix of economic models such as Hirshman's theory of unbalanced growth and Perroux's growth poles (Hirshman 1958, Perroux 1950), World Bank recommendations of neoclassical inspiration (*Informe*

sobre la economia Espanola 1962) and Spanish government limitations to competition and free market development[4] (Sanchez Dominguez 2001, Barbera 1998).

These economic models built on the idea that underdeveloped nations should channel economic means to the development of a few "lead" sectors. Growth would expand from the lead sectors to those linked upstream and downstream. The World Bank recommended financing operations with private investment to stimulate competition and minimize misallocation of funds. Finally the Spanish government set limits to free market development out of political considerations; its goal was to prevent labor demands that could lead to social unrest. These ideas were reflected in the first Spanish development plan (Law 164/1963 of December 28*: I Plan de Desarrollo Economico y social 1964-1967*) which made industrial development its priority[5]. The first plan was followed by two others that lasted until 1975[6].

Given Spain's capital and technology deficiencies, FDI was key to achieve industrial development in capital intensive sectors (Campa and Guillen 1996, Varela Panache et al 1974, Munoz et al 1978, Duran Herrera 2005). FDI was encouraged but subjected to an ownership cap (initially 25% then rose to 50%). Investors were attracted by Spain's combination of qualified but cheap and docile labor, presence of ancillary industries, a potentially large internal market, a good geographical position to serve the surrounding markets and institutional facilities for foreign investment. However, due to heavy tariffs on imports and exports, the original configurations of these industries catered mostly to Spanish demand[7] (Maravall 1987, Lopez Claros 1988). Low income levels and lack of buyer sophistication favored production of mid-quality, relatively undifferentiated products of moderate price. As a consequence, production plants in Spain did not incorporate state of the art machinery, or undertake operations of high value-added content. Instead, production relied on older

[4] There were typically introduced to avoid a high increase in income inequalities and dampen demands that contradicted the regime's principles. For instance, full labor market liberalization would have led to demands for free union representation and the right to organize strikes, which were contrary to the regime's principles. (Sanchez Dominguez (2001).
[5] The main industrial sectors were chemicals, metal, machinery and transport equipment and energy (Sanchez Dominguez 2001).
[6] This plan was followed by the II Plan de desarrollo economico y social 1969-1971, which paid closer attention to equity and redistribution matters as well as to better resource allocation, and the III Plan de desarrollo economico y social 1972-1975, whose main goals were "primacy of the social element, selective investment, competitiveness, better resource allocation, market strengthening, elimination of interferences due to political price setting and integration with Europe" (Sanchez Dominguez 2001)
[7] By the mid-1970's Spain was still the closest country in Western Europe; the ratio of exports to GDP stood at 7.5% and that of imports to GDP at 14.5%) Augusto Lopez-Claros, The Search for Efficiency in the Adjustment process, IMF papers, 1988

equipment and use of abundant labor. Components were imported for assembly rather than being manufactured in Spain (Smith 1998, Guillen 2005). It could be argued that the recipient country can impose demands for a certain % of home-produced parts, but Spain lacked such leverage. Smith calls this the "maquiladora" tendency. This had two important consequences; first, FDI in these conditions did not necessarily contribute to "trickling down" knowledge or innovation. Second, since most (or all) of the most complex components were imported, there was little incentive to develop a network of sophisticated Spanish suppliers.

The automotive sector embodies this situation: it is a capital intensive industry with high potential for spillover effects to local industry (Pallares-Barbera 1998), the type that would have ideally fulfilled the Spanish government's development plans. Furthermore, it requires large contingents of semi-skilled labor and does not require advanced technology. In fact, components can be easily imported and simply assembled in a given nation. Several automakers setup production plants during the 1950s, but their presence and production only expanded in the 1960s and 1970s (3,000 cars in 1950, 58,000 in 1960 and 455,000 in 1970, Pallares-Barbera 1988). Assemblers specialized in compact car models, often using production machinery that had already been discarded in the manufacturer's home countries (Guillen 2005). Other sectors that developed rapidly during this period were electronics components, machine-tools and chemicals (Duran Herrera 2005). All of these relied in a "Smithsonian" assembly structure that benefited from economies of scale and scope (Duran Herrera 2005).

The national government attempted to achieve targeted industrialization through multi-annual development plans inspired on the French tradition (Smith 1988, Royo 2000, S Perez 1997). These plans established a list of **preferential industries** and geographic areas. To support the plans, the government established two instruments of privileged financing: a special rediscount rate for commercial banks that extended credit to state-specified users, and a credit line channelled through the INI. These two sources of finance accounted for 49% of private investment by 1970 (Perez 1997). Unlike their French counterparts, these plans failed to achieve their objectives (Sanchez Dominguez 2001, Brana, Bueso and Molero 1984). In the best cases, they led to very fragile industries (Maravall 1987). Severe weaknesses stemmed from reliance on cheap inputs (labor, energy, capital), a complex protectionist structure that lowered the cost of maintaining

inefficiencies, and imposed public control (through *acciones concertadas*[8], price controls, import barriers). In addition, regulatory and systemic hurdles trammelled entrepreneurial activity (obstacles to international trade, a complex and inefficient fiscal system, underdeveloped capital markets, an opaque and often arbitrary public credit allocation system). Firms also suffered from simple internal deficiencies (high costs of foreign patents, lack of expertise managing large complex industries, skill deficiencies among the labor force).

Under these conditions, it is no surprise that most of the large-firm industrial tissue that developed through these plans had public or semi-public character, important competitive deficiencies and very limited international projection (Maravall 1987, Sanchez Dominguez 2001, Brana and Molero 1994, Guillen 1994). In fact, by the mid-1970's Spain's ratio of exports to GDP stood at 7.5%[9] (Lopez-Claros 1988). In short, Spain's firms operated in restricted markets, in which they did not need to face competition from foreign rivals, otherwise, they would have easily failed.

The position of **banks and utilities** stands out when compared to manufacturing industry during this period. By 1974, 8 out of the 20th largest Spanish firms by asset value were utilities and 6 more were private banks (Carreras and Tafunell 1993, 1994) vs. only three manufacturing firms. Utilities and banks shared some of the inefficiencies outlined above including a bureaucratic culture -Telefonica, was the paradigm of this feature (Claver, Gasco, et al 2000), seniority based systems -rather than performance based- (Estevez-Abe 2005, Rivases 1988) and lack of qualified labor (in banks like Hispano Americano and Central it was traditional to start as a bellboy at 16 and raise up the ranks; consequently the vast majority of these banks' employees lacked college degrees- Rivases 1988). Despite these weaknesses, utilities and banks were much better positioned than industrial firms. As in most other countries at the time, utilities and banks were considered "strategic" industries and as such remained fully closed to foreigners[10], hence they designed their own strategies. In addition, they enjoyed legal privileges. Some of these firms operated as

[8] These were agreements and often fully fledged plans for particular industries that established the terms of the relationship between the state and the firms. These plans established obligations for the firms(including sharing information with government, cross financing government projects in other industries). In return, these sectors obtained fiscal deductions and other financial benefits. According to some authors, these plans were equivalent to nationalizations (Tamames 1964). The legal doctrine has problems classifying them and they generally fall under the term of "state contracts" (Entrerria 1973)

[9] Augusto Lopez-Claros, The Search for Efficiency in the Adjustment process, IMF papers, 1988

[10] The 1962 Banking Law allowed a measure of foreign presence, albeit very limited, and that portion of the law would not be implemented until the 1980s in any case- Perez 1997). The energy and telecommunications' markets remained fully closed until the late 1990s.

monopolies in the nation (Telefonica, REE) or in their regions. Banks were protected by legislation that forbade the incorporation of new banks. Furthermore, they developed close connections to power. This was partly due to the character of their services; as necessary industrial inputs, demand for banking, communications and energy grew rapidly with the industrial boom, increasing the leverage of the firms providing these factors.

Banks were a force of their own. They were the only strong privately run sector in the nation, and in addition to the logical influence that financiers have in any economy, they exercised heavy influence in government decision-making. Unlike firms in other sectors (ie: Telefonica- formerly AT&T) which had a private past but were nationalized in the 40s, Franco resisted demands to nationalize the banking sector because they supported him during the war (Tortella and Garcia Ruiz 2003). This independent and leveraged position was further consolidated early on through three legal measures. The first one was a 1941 decree that limited dividends (which contributed to reinforce the capital base of the banks and hence their resilience). The second was the 1946 Banking Law, which allowed large banks to self-regulate, prohibited the establishment of new banks and allowed banks to establish minimum interest rates for loans and maximum interest rates for deposits. This asserted the power of the "big 7" cartel by limiting competition and leaving ample margin for profit (Guillen 2005, Perez 1997). Finally, the mechanism of *pignoracion automatica*, which had been created in 1921, was rediscovered and widely used. The *pignoracion* allowed banks to monetize their debt and expand credit operations rapidly and without risk as the economy boomed (Perez 1997, Guillen 2005). The bank's strong economic position was further acknowledged and strengthened by the 1962 Banking Law, which established special rediscount rates from the Bank of Spain for credits extended to state-specified users.

As a result, the "Big 7" became angular pieces of the industrialization plans their share of private financing climbed from 57 to 60% over the 1960s (Perez 1997). They also benefited disproportionately: their profits increased by six fold (Torrero 1989).
The Spanish public credit institution, INI[11], played a much smaller role than its French and UK counterparts (Anderson 1970). Furthermore, the four stock markets were too shallow to challenge the bank's pre-eminence (Perez 1997).

[11] Instituto Nacional de Industria, a public institution modeled after the Italian IRI

Banks acquired important industrial participations over this period in a variety of sectors (Fernandez-Otheo 2003). Not all banks participated in industry to the same degree; of the large banks, Hispano, Central and Banesto were the most involved, while Santander was the least and Bilbao and Vizcaya had selected industry interests in metals and energy (Fernandez-Otheo, 2003, Rivases 1991, 1988, Guillen 2005). Information about board positions of bankers in industry provides some measure of these relationships. At the end of the 1960s, Santander's board members occupied 179 board positions in other firms. Banco Bilbao occupied 478, Vizcaya 463, Central 390, Banesto 378, Hispano Americano 201 and Popular 228 (Guillen 2005) . As was the case with the composition of large conglomerates elsewhere, there was not a strong product or industry alignment in these investments, which in fact spanned very diverse industries[12]. As a result there was little potential for synergies.

Influence in the political and economic spheres were self reinforcing for the "Big 7"; favourable legislation asserted their oligopoly position, high profit margins and fundamental role as the economy's financiers. During the "economic miracle" of the 1960s this led to substantial material benefits, but also, to greater importance in the process of economic growth, since they provided the credit that fuelled new business creation. Furthermore, given the technical complexity of banking and macroeconomics and the increasing complexity that came with economic development, bankers' expertise was sought after by the government. Such requests were well aligned with a significant shift in government focus, from a military dominated focus to reliance on the so called "technocrats" (several of which shared a common "Chicago School" background- Perez 1997). This is reflected in the number of key government positions occupied by top bankers. Between 1939 and 1945 only 11 large bank board members occupied positions in the executive, legislative or regulatory bodies such as the bank of Spain. Between then and 1975, that number reached 213 (Tortella and Garcia Ruiz 2003, Guillen 2005). Bankers, in turn, used their policy-making positions to the advantage of their sector, thus increasing their power. It is thus understandable that Franco, in 1962 decided to veto the proposed merger between the two largest Spanish banks, Central and Hispano, out of fear that their combined resources would overrun his government's position (Rivases 1991, Guillen and Tschoel 2008).

[12] For instance, Santander was involved in the following sectors: automotive, cements, beer, milk products, shipbuilding, appliances, electricity, petrol, railways, construction, banking, hotels and water (Guillen 2005).

In short, the Spanish industrial model that emerged during this period had several important characteristics: 1) it was build over the weakness of both the government and the local industry 2) it relied heavily on FDI, attracted by government concessions and favourable labor conditions 3) despite public support, planned industrialization efforts failed to create a strong local industry. 4) While the national government lacked economic leverage and entrepreneurship was squalid, a few local sectors, and especially one: banking, managed to carve out a fiefdom of power supported by protective sectoral regulation and the government's need of its technical skills.

2. Crisis and Opportunity (1975-1985)

Building the bases for change: The Business-Government Alliance

Two features of the Spanish landscape made it extremely vulnerable to the oil crisis; dependence on cheap energy and capital, and heavy inflows of foreign investment. The crisis hit Spain on both fronts with devastating effects: it tipped the nation's chronic balance of payments disequilibrium, brought to the surface the inefficiencies of local firms, created payments problems for most firms, and dried flows of foreign investment.

Initially, the magnitude of the crisis was misinterpreted. Moreover, the 1973 and 1979 crises occurred at a delicate time during the country's political transition, when social discontent derived from the crisis could have derailed the political transformation process. As a consequence, initial measures tried to offset an economic meltdown rather than deal with structural weaknesses. According to an IMF study (1988), during the 1973-1979 period, energy consumption rose unabated (the cumulative percentage increase of oil imports during 1973-1980 for the EEC was 595%, for Spain 1229%) and external debt rose from US$ 8.5 billion to US$19.5 billion. By 1982 the public budget deficit hit 5.6% of GDP. The INI played safety valve for social discontent by acquiring 25 ailing firms in the shipbuilding, steel, automobile, chemical and other industries. Predictably, INIs annual deficit rose; by 1982 it was receiving 15% of the state's budget to cover loses (Smith 1998).

By the time the second oil crisis hit in 1979 the need to make deep reforms was evident. From 1980 to 1982, the government concluded agreements with employer representatives in 11 sectors and 5 individual firms (Smith 1998, Real Decreto 9/1981 of June 5th) These agreements stipulated that the state would provide monetary concessions (including tax breaks, special-rate financing, and payments to laid-off workers) to facilitate investment and reduction of unprofitable capacity and labor. However, these measures had limited scope because the UCD centrist government was in a

weak position to undertake profound transformation. Indeed, dissent within government was on the rise, and significant sectors of society were getting restless. This dissent led prime minister Suarez to resign his position in January 1981; a military attempted coup followed only a month later. In-depth industrial reform would have to wait until democracy was firmly established by the newly elected, more cohesive government that took office in late 1982.

Despite these limitations, the late 1970s were crucial years and established the basis of future economic direction. By 1977, the crisis had also extended from the productive to the banking sector. 51 banks out of the existing 110, and accounting for 20% of deposits were rescued between 1978 and 1985. Estimated losses amounted to 16.8% of GNP (Caprio and Klingebiel 1996). The 1973 shock precipitated the crisis, but in essence this was a systemic failure caused by rapid expansion of credit in a context of inappropriate early warning, reporting, control and supervision mechanisms (Sheng 1996, Caprio and Klingebiel 1996, Rivases 1991, OECD 2009). This obscured the true situation of many small and medium banks, which often extended credit to shaky borrowers or engaged in very dubious banking practices (Sheng 1996, Rivases 1991, Guillen and Tschoelg 2005). The banking crisis was adeptly dealt with by the Bank of Spain, by way of combining private and public intervention (through a newly created instrument, the *Fondo de Garantia de Depositos)* to separate the bank's regular monetary and supervisory duties from the rescue mission. This, and public-private cost-sharing[13] of the crisis served to control the fiscal outlay.

The banking crisis highlights the inadequacy of Spain's economic institutions, showcases another failed aspect of the planning system and points out the urgent need for systemic reform. More importantly, the efficient treatment of the banking crisis under leadership of the Bank of Spain, and the protracted delay of the central government in addressing the industrial is a good reflection of the forces at play during those crucial years. The government position was increasingly weak as the conglomerate of factions that composed UCD pulled in different directions and the credibility of indicative plans plummeted with the crisis. Yet, judging by their ability to handle the banking crisis, something was stirring within the Bank of Spain.
The crisis, in the context of a changing political and economic context, provided an opportunity for a new network of reformers to gain credibility and establish their position.

[13] "Rehabilitation followed a sequence the authorities dubbed "accordion" recapitalization. First, existing bad debts were written off against remaining capital. Then, the FGD acquired a controlling interest in the bank, and later injected cash for additional equity stakes, finally selling the bank to new shareholders. Since the old owners lost their equity, incentives were strong for improved corporate management" (Dziobek and Pazarbasioglu, IMF 1998)

New Economic Intelligentsia

Mariano Navarro Rubio, governor of the Bank of Spain between 1965 and 1970, brought to his post closed connections with economic academics[14] and technical staff , which he had established in his effort to support the IMF-backed 1959 Stabilization Plan (Perez 1997). During his tenure, he undertook the development of the Research Service department, delegating the task to Mariano Rubio (future governor of the Bank) and Angel Madroñero. They did so by recruiting young graduates, mostly from the Faculty of Economics at the Universidad Complutense (Rivases 1991). Luis Angel Rojo, director of the Research Service between 1971 and 1988, continued the task initiated by Rubio and Madroñero and intensified recruitment of academic brainpower during the early 1970s (Perez 1997, Guillen 2005, Rivases 1991).

Experience at the Research service, which often included graduate study in leading American universities, produced an affinity of economic ideas within this group of economists[15].They shared Navarro Rubio's opposition to the planned industrialization process. Their disagreement stemmed from resistance to the inflationary finance pursued throughout the period and from the *developmentalism* (*desarrollismo*) of the planners. This is evident from the Bank of Spain's annual reports during this period (Bank of Spain Annual Report 1967, 1968 and 1969). Instead, they argued for market-oriented reform and a strengthening of the Bank of Spain's ability to control liquidity in the system. They were the economic elite of the country. According to Sanchez Quintana[16] "Nobody, absolutely nobody, was able to articulate a valid alternative to the reform criteria that the Bank of Spain developed". The efficiency with which the Bankers attacked the banking crisis in the late 1970s was already revealing of the technical strengths of this group and stands in stark contrast with the failure of indicative plans and the weakness of government action.

Despite the promise it held, this emerging leadership group needed two sources of support to consolidate its reforming agenda; political support and banking support. Despite its specific

[14] These included Luis Angel Rojo, Juan Velarde Fuertes, Enrique Fuentes Quintana, Julio Segura, Jose Luis Garcia Delgado, Gonzalo Anes, Gonzalo Arnaiz and Angel Alcaide Inchausti (Jose Luis Malo de Molina, acceptance speech of the Infanta Cristina Economics Price 1998). All of these were economics professors at the Universidad Complutense during the 1969-1974 period.

[15] Miguel Boyer (Minister of Economics 1982-1985)Carlos Solchaga (Minister of Industry and of later of Economics 1982-1993) Mariano Rubio (Subgovernor and Governor of the Bank of Spain 1977-1992) Angel Madronero, Antonio Sanchez Pedreno, Jose Luis Malo de Molina (current director of Research Services at the Bank), Raimundo Poveda, Pedro Schwartz, Raimundo Ortega, Luis Garcia de Blas, Guillermo de la Dehesa, Andres Garcia de la Riva, Antonion\ Sanchez-Pedreno, Jose Perez, Gonzalo Gil, Juan Jose Toribio.

[16] Prologue to Rafael Termes Desde la Banca (Madrid, Rialp 1991)

attributions, the Bank of Spain was a department of the Ministry of Economics until 1994 (Ley 13/1994 of Bank of Spain autonomy). Thus, any strengthening of the powers of the Bank of Spain required government approval. Furthermore, the type of reforms that the Bank of Spain advocated was hardly possible to achieve without consent and support of the ruling government. Such support was unlikely during the late 1970s, first, because the first democratic governments lacked the political capital to support decisive transformation and second, because some of the technocrats that had built the development plans still held decision-making posts. In addition, the Bank of Spain needed to establish a working relationship with the “banking cartel”. To control liquidity in the market, the Central Bank needed to create a real money market. This came in direct conflict with the interest of the big 7, who opposed regulatory alternations that might undermine their privileged position. Considering the position of power of the bankers, and the fact that they were the largest capitalist group in the country, this would require negotiation.

Building Political Support: Economic Intelligentsia met Politics

The 1982 elections were crucial to the consolidation of the Bank’s political influence. Unlike the first democratic governments, the newly elected cabinet arrived with a substantial dose of political capital. The elected socialist government had shed historical leaders from its ranks to become free from the francoist legacy[17]. This was a smart move; such legacy crippled the first democratic UCD governments and hurt historical leftish leaders (ie the Communist Party), who obtained only 4% of the vote and 4 seats in parliament as well as right leaders (AP obtained 107 seats and only 26% of the vote). The PSOE thus won by a landslide (48% of the vote and 202 seats) [18]. In addition, the new government was led by a charismatic leader who not only garnered popular support, but abandoned ideological banners[19] to project a left-of-center image that galvanized political support towards “modernization” and European integration; two goals that held very broad appeal because they reflected the desires and aspirations of the Spanish broad middle-class. These goals offered the additional bonus of providing useful umbrellas for difficult institutional reforms. In short, unlike the UCD government, the PSOE government had the power to act. The question was, in which

[17] The PSOE historical leadership in Toulouse, headed by Llopis was abandoned in favor of a “local”, younger leadership. The running team was thus not taunted by historical leftish positions or by its relationship with the francoist regime. Because it came from inside the country and was younger, it was also more much in touch with the current Spanish reality and the aspirations of the middle class that the party leadership in exile (Smith 1998).

[18] http://www.elecciones.mir.es/MIR/jsp/resultados/comunes/detalleResultado.jsp?tipoAmbito=1&tipoEleccion=0&cdEleccion=2&anio=1982&mes=10&numVuelta=1&nombreEleccion=Congreso+de+los+Diputados&horaCierre=20:00&horaAvance1=15:00&horaAvance2=18:00&cdCCAA=99&cdProvincia=0&descripcion=total (Congress, accessed April 21 2010).

[19] The PSOE abandoned Marxism in 1979 (Wikipedia).

direction? The type of talent chosen by the new government would be decisive in answering this question.

The PSOE government recruited talent from the Bank of Spain Research Service to fill top economic positions. The Ministers of economics and industry (Miguel Boyer and Carlos Solchaga) both came from the Bank. This consolidated the relationship between the executive and the pragmatic economic ideas developed within the Bank. The relationship was further strengthened by the appointment of Mariano Rubio, personal friend of Boyer, as governor of the bank in 1984[20][21] (Rivases 1991).

This choice of talent had other important implications for the executive. First, this choice signed the demise of planned development (planners were now removed from their posts) opening instead the door to the economic liberalization and the strengthening/development of economic institutions that the Bank of Spain advocated. Second, by using an alternative source of talent (different from using bankers from private banks as was common in the past), the government put some distance between the public decision-making arena and private banking. Finally, by choosing to ally with a group of economist of neoliberal tendencies, the government opted to separate itself from an important socialist faction that advocated industry nationalization and fiscal deficit (Rivases 1991, Perez 1997, Smith 1998).

This choice also had important consequences for the Bank of Spain. First, the cohesive group that had its origins in the Research Service obtained the political support it needed to put its ideas into action. In fact, the prestige of the Research Service itself grew. During the 1980s the annual reports of the Bank became the document of reference to understand the economic situation of the country. Experience within the department became a springboard not only for ministerial positions, but for high ranking positions at the bank and other prestigious national and international institutions. In 2010 many of those young economists still hold key positions. Second, the appointment of Mariano Rubio was a significant change from the status quo; until then, the position of governor of the bank had been held by prominent regime politicians rather than economic experts (Perez 1997, Rivases 1991). Thus the choice of governor served to strengthen the value of Bank's recommendations and letters, which although devoid of executive power, were rarely ignored by those who received them.

[20] Until then and since 1977 he was sub-governor
[21] Mariano Rubio remained in his post until 1992, and Solchaga as Minister until 1993, ensuring continuation of this top level bond between the executive and the Bank.

The new government's decision-making strength and its liberal penchant is reflected in its first actions: First, the government tackled the industrial crisis. To this effect it enacted the Real Decreto Ley 8/1983 of November 30, which established the legal framework for the restructuration program that privatized and let fail unviable firms in 11 large sectors[22]. Most of these were preferential sectors under the development plans. Thus, the restructuration plan highlighted the failure of planned economy and brought to an end the epoch of state directed development. The government also demonstrated its willingness to end with unprofessional banking practices. The most impactful measure in this regard was the expropriation of Rumasa, the largest banking/industrial holding in the country (Decreto Ley 2/1983). At the time of expropriation Rumasa comprised 700 firms, including 20 banks, 65,000 employees and generated annual revenues of 350,000 million pesetas (Cinco Dias 2010[23]). Finally, the shift towards pragmatism and integration in the world economy is manifest in the PSOE's impulse for EU accession.

Negotiating a Working Alliance with Private Banks

While political support was important, to achieve their reformist agenda, the Bank of Spain also needed to build a working relationship with the private banks. Banks and savings banks accounted for 90% of the financial system in the late 1970s and early 1980s (Perez 1997). Thus, without support from the banks, especially the Big 7, economic reforms, no matter how appropriate, were unlikely to succeed: the banks would simply find a way around them (Culpepper 2005, 2008). The banks essentially needed to agree to the principle of economic liberalization and accept a more powerful Bank of Spain. In principle, the situation of privilege and the cartelistic nature of the Big 7 played against these goals since each of these measures involved a loss of power for the large banks. Traditional bankers who supported the cartel and those that were opposed to any modifications of the system of credit regulation were likely to oppose. Further opposition could come from the firms that had benefited from the existing circuits of privileged finance as well as from certain politicians.

[22] Albentosa 1985 cites them: home appliances, special steels, integrated steel production, textiles, electric equipment for automotion, shipbuilding, copper semi-transformed products, electronic components, regular steel, shoe manufacturing and heavy iron.

[23] http://www.cincodias.com/articulo/empresas/Rumasa-colea-lustros-despues/20030222cdscdiemp_9/cdsemp/ (Cinco dias accessed April 21 2010)

In addition, there were communication issues. The heads of the Big 7 had acquired the custom of meeting once a month for lunch. This was a well known, well documented tradition during which the bankers discussed policy and banking issues (Rivases 1988, 1991, Perez 1997). However, there existed no official representative body that could form the banking sector's policy position and act as the voice of the sector in public. The only existing communication typically took place through the Consejo Superior Bancario, a public deliberation organ attached to the ministry of economics through which the Big 7 exercised public powers behind closed doors (Perez 1997). To implement the Bank of Spain's liberalization and increasing transparency plans, there was a need for a body that would act as a communication platform to "define the image, thinking and voice of the banks as private enterprises, relate to the government in matters that affect the banking sector and to the unions to be its interlocutor in the industrial relations process, as well as (interact with) public opinion so that its positions would be well known and understood" (Rafael Termes 1991). This issue was resolved by the creation of the AEB (*Asociacion Espanola de Banca*), the Spanish banking sector association in 1977. Rafael Termes, one of the top characters at Banco Popular himself became its first president.

The first issue, opposition by traditional bankers, industries that benefited from existing circuits of preferential finance and a certain politicians would be harder to solve. Opposition by politicians, especially those that supported planned industrialization fell relatively easily; the impact of the 1973 crisis evidenced the failure of their strategy and the PSOE government use of Bank of Spain talent pushed them out of the political limelight. The 1983 industrial reconversion Royal Decree was the last nail in the coffin.

The struggle with traditional bankers, which made up the majority of the Big 7 group, was the most difficult hurdle, considering the power they held. However, the debility of the Spanish economic model was rendering the bank's strategy obsolete, helping create common ground for the Bank of Spain to negotiate with the bankers.

Throughout the industrialization process of the 1960s, the banks followed a strategy of making handsome profits through the rapid expansion of cheap credit an through investment in the same strategic industries that the government backed with its plans. However, by 1967 this model was showing signs of exhaustion. (Guillen 2005, Guillen and Tschoegl 2008, Perez 1997). Preferential industries had invested little to boost productivity and as a result, they were obsolete and unable to

produce efficiently, let alone compete independently. This was already becoming apparent by the middle of the decade: first the steel industry collapsed in 1963, then followed the coal industry in 1966 and finally the shipbuilding industry in 1969 (Perez 1997). The inefficiencies and corruption of preferential lines of credit became even more apparent in 1969 when the Matesa scandal exploded[24]. Furthermore, by the end of the 1960s, Spain had fundamentally achieved a structural transformation from eminently rural to industrial economy[25]. Thus, "easy" increases in productivity resulting from a structural shift from agriculture to industry were not forthcoming, and agriculture itself, having suffered from rural exodus and emigration abroad, was also underinvested and unproductive. The consequences of this situation for the banks were clear: a business strategy based on rapidly expanding credit was shaky because the economic model that it generated was unable to generate value. If productive sectors did not generate income, then the bank would hardly make a profit, and could risk not seeing its credit returned. In a non productive economy, expanding the monetary base would simply generate inflation, rather than profit as it indeed did (OECD Economic Surveys 1969, 1971). Despite their sheltered position and the high margins they were able to reap, the banks stood to benefit more from a healthy, productive economy than from the ailing model. Thus, they had selfish reasons to support a set of economic reforms that would allow the Bank of Spain to reign in monetary policy.

The case for liberalization was harder. Although the Big 7 were large relative to the size of the Spanish economy, they were dwarfs form an international perspective (Guillen and Tschoegl 2008). Furthermore, neither the underlying conditions of cheap credit expansion and preferential industry treatment nor the "old boys club" practices followed by the Big 7 fostered a culture of highly developed competitive advantages. Thus, if liberalization of industry could eventually help regenerate the productive tissue of the country and create business opportunities for the banks, liberalization of the banking sector itself, would be a fatal blow for Spanish banks. Consequently, the banks, who were in a position to negotiate with the reformers, agreed to the reforms, but on condition that foreign presence in their sector would be limited. This did not happen overnight, but by 1977, when the AEB was set as an instrument for dialogue between the banking industry and government, a rudimentary foundation for agreement had been found.

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[24] Matesa, Spain's largest export firm at the time was the recipient of more than 50% of the privileged export credit granted by the Banco de Credito Industrial, one of the official credit instituties. Matesa defaulted on its credit leaving the Treasury with heavy losses (Perez 1997).

[25] Between 1959 and 1974, the contribution of industry to Spain's GDP rises from 24 to 42%, while that of agriculture falls from 20 to 11% (IMF 1988)

Immediate Economic Consequences of the Government-Banking Re-alignment

The agreement between the banks and the reformers brings to light the leverage of bankers and public institutions, the mutually beneficial nature of their relationship, the weakness of private local firms and the hands off approach of foreign firms.

The Bank of Spain reinforced its power and influence, as did the government. Tighter monetary policy and liberalization were necessary to bring the economy under control after a decade and a half of unbridled credit expansion. The plans articulated by the reformers suited the government's goal of integrating Spain in the EU because they reinforced Spain's credibility abroad. EU integration also suited the reformers because it ensured that the government would stay the course. Monetary reforms suited the needs of the private bankers. An inefficient productive model held no long-term exciting business opportunities for well run banks. The strategy of realizing handsome profits based on ever-expanding credit was no longer feasible. The balance of payments crises of 1967-1969, and rising rates of inflation had already demonstrated this. As long as their home turf remained protected, banks were for market liberalization. Of course, the latter point would change, as circumstances evolved.

Consequences for Spanish Industry

Spanish industry, and more generally Spanish society, disproportionately bore the brunt of the new adjustment between the government and the banks. In the aftermath of the 1979 crisis, banks quickly divested their investments to cut losses (Perez 1997, Guillen 2001, 2005, 2008, Torrero, 1991; Blanch 1991), the INI originally absorbed the costs, but the restructuration decree of 1983 greatly diminished public intervention. Furthermore, the INI had mostly intervened in the case of the largest, formerly preferential industries, leaving medium and small local enterprises to their own devices.

As in any demand crisis, access to funds became the most urgent problem. However, interest rates rose sharply between 1976 and 1979. According to one survey, investment credit was averaging 21% in 1980 and the head of the AEB admitted to 20%[26] in the context of an acute recession. The result was a steep rise in firm's indebtedness as they struggled to pay higher labor and energy costs and reposition themselves. However, most sources of funds for firms were limited. As mentioned

[26] Antonio Torrero "Banca y crisis economica" Informacion Comercial Espanola n 570, 1981 and Tendencias pp 36-37, 108

above, Spanish banks quickly divested from industry in the wake of the crisis. Furthermore, although a 1978 decree allowed foreign banks to have presence in the Spanish markets the Bank of Spain rarely extended operation licences and even when it did, activities were severely limited (Guillen 2008, Perez 1997).Access to the capital markets was also restricted. According to a study of the Bank of Spain (1992), stock markets until the 1988 reform (Ley 24/1988) were fragmented, "narrow, lacked fluidity, had strong speculative component and were very illiquid". It was mandatory to operate through state-licensed agents who charged a commission, and lack of transparency distorted price formation. The situation was even more dire for smaller firms, which by their characteristics could not even access capital markets. Guillen's work on the relevance of family firms in Spain possibly points out to the only source many of these firms could tap into: private funds.

Aside from family funds, which would likely be insufficient to support large firms and possibly handicap growth for medium firms, there was only one alternative for Spanish firms: foreign investors. However, transitional conditions in Spain were uncertain enough to shake investor confidence, and in the aftermath of the crisis, most large foreign firms were regrouping at home. This would dramatically change after Spain's EU accession.

And What Happened to the Foreign Multinationals?

The total absence of foreign multinationals in this set up is striking, considering the role they had played in Spain's industrialization. None of the accounts addressing the transition do as much as to even mention them. Although this will require more careful analysis, this leads to two preliminary conclusions. First, it highlights the idea that realignments of the type Spain was going through at the time are fundamentally endogenous processes, born and carried out by negotiation among insiders. Second, the absence of foreign multinationals supports the argument that these firms tend to disengage from the internal processes of a recipient nation, possibly because conditions in that nation are not determinant for their competitive advantages.

Acting out the Opportunity

Thus, in the aftermath of the 1982 election, the new economic leadership who originated in the Bank of Spain had public momentum through ministerial presence and a personal working alliance with Mariano Rubio (who was first sub-governor and from 1984 onwards governor of the Bank of

Spain). Furthermore, provided liberalization did not affect the banking industry, the new leadership also had support from the banks, the most powerful private sector elite in the nation.

The major political goal of the new government was European integration. To achieve this, Spain needed to showcase itself as economically stable. To do so, and under the reformist agenda, the government embarked on an austerity program to control inflation. By 1985 the annual rate was reduced to 8.8% (down from 14.4% in 1982)[27] .Three main measures were used for this. Wage restraint, tight monetary policy and reduction of the fiscal deficit.

EU integration was politically motivated; EU membership, was expected to consolidate the Spanish young democracy (Perez Diaz 1993, El Pais 11 April 1985[28]). As it would later be the case in post-communist nations, EU membership also played the aspirations of the Spanish middle-class. Tellingly, "*Ya somos europeos*" or we are finally European was the slogan of the 1986 EU membership referendum, a consultation that was as much a celebration of the newly recovered right to vote, as a vote of confidence for the government.

EU membership, would also had deep economic implications. The EU signed the Single European Act (SEA) in 1986. The core element of the SEA was to inaugurate the European Single Market by January 1 1993. Spanish negotiators were well aware of this and of the implications for Spanish firms, including Spanish banks. The Spanish inefficient and badly starved for cash industry would face a choice between shaping up, being acquired or simply disappearing. Spanish banks would also face competitive intense threats that could endangered its new alliance with the government. Well aware of the weakness of Spanish banks, and the situation that had led them to accept reform, the Spanish negotiators to the EU, made sure to negotiate the longest possible transitional period for this industry: until January 1993 (Perez 1997). A third group of industries would remained yet temporarily sheltered; public utilities.

[27] Source: Consejo economic y social: Memoria and MTSS Boletin de estadisticas laborales (various years).

[28] Interrogantes sobre el ingreso de España en la CEE, in El País. 11.04.1985. http://www.ena.lu/

3. The Aftermath of the Bank/Government Compact (1986-1993)

3.1 The Strategic Transformation of the Big 7

Spanish banks went through significant transformation between 1986 and 1993. This transformation reflects a strategic shift that responded to new terms of competition. The times of accommodation and stability were over: to survive and remain in local hands banks needed to become larger, more agile and more competitive.

Erecting Protective Barriers

Spanish banks faced the threat of unwanted acquisition. This was a more immediate threat than the Spanish government's protective stance and the negotiated six year delay in EU consolidation would lead to think. Already in 1986, KIO, the Kuwait Investment Office, acquired 4% of Banco Central. KIO would develop a strong reputation for speculative investments in the 1980s (Guardian January 10 1993)[29]. Minister Solchaga faced the situation head on by inquiring about their intentions and asserting that the Spanish government would not permit Spanish banks to fall into foreign hands, least of all be the object of speculative investment (Rivases 1988). Despite the warning, KIO repeated its attempt against BancoVizcaya a year later. This time the bank reacted quickly by expanding its capital base to dilute the strategic value of the purchase. Alerted by these events, both the banks and the government became convinced that creating barriers to acquisition was a priority[30] . Essentially, if takeover occurred, the government could no longer count on the banks to support its reform. By virtue of being under foreign control, the strategic direction and the competitive advantage of the banks would no longer rely in domestic conditions, but on those of the country that succeeded in conducting the purchase. This would make them less sensitive to government efforts to undertake reforms that would render the Spanish economy more productive. Furthermore, the Spanish government at that point was still looking to assert Spain's position in the world (and especially in the EU). Foreign takeover would showcase Spain's debilities, blow off the country's prospect for credibility and curtail prospects of becoming anything than second fiddle in

[29] http://www.independent.co.uk/news/business/kios-spanish-inquisition-the-growing-scandal-of-kuwaits-massive-losses-in-spain-is-exposing-the-dirty-linen-of-one-of-the-worlds-most-secretive-investment-agencies-and-ringing-government-alarm-bells-as-the-feud-spills-into-the-courts-justin-webster-looks-at-what-lies-behind-the-grupo-torras-disaster-1477729.html

[30] The exception would be Banco Popular, which, as this is written in 2010, still remains the smallest of the Spanish large banks, yet it heads rankings of profitability and is considered one of the most efficiently run (Rivases 1988, Guillen and Tschoegl 2008)

the EU. This in fact, would materialize the worst fears of countries like France, which had long opposed Spain's EU membership. For the banks, acquisition meant that they would lose their strategic independence, an outcome that they rejected energetically because they had their own plans in mind and these required strategic control. In addition, none of the top bankers was eager to relinquish their post. Within this context, failure to counter speculators like KIO was a worst case scenario, since Spanish banks would not only lose their independence but likely become puppets.

Mergers came to be seen as the most immediate way to erect barriers against unwanted acquisitions. This option had in its favor the support of the Spanish government and the Central Bank, the liquidation of the banking cartel, the experience in merger and turnaround of Spanish banks, the presence of relevant options for acquisition following the 1975-1985 banking crisis, and the lack of better immediate options. Later, mergers as protective mechanisms would be supplemented by two additional protection measures: investment in Spain's still protected industries and international expansion to Latin America.

The merger among Spanish banks was the option favored by the government (Perez 1997, Guillen and Tschoelg 2008, Rivases 1991). It is important to know that government and the minister of Economy and Finance had a major influence on the viability of the mergers because they could approve or deny fiscal credits to account for capital gains and update the book value of assets (Guillen and Tschoelg 2008, Rivases 1988). Thus, willingness to concede these credits was a strong signal of support. Furthermore, public figures like minister Solchaga delivered unambiguous messages. Reuters cites Minister Solchaga saying that if Spanish banks were to remain in local hands they would have to merge before the foreign banks arrived (Reuters News 11 December 1987).

The Bank of Spain, like the government, was wary of unwanted takeovers. In fact, the Law of Discipline and Intervention of Credit Entities (Ley 26/1988), elaborated by two former general directors of the Bank of Spain[31] mandated that anyone taking control of 5% or more of the social capital of the bank needed to inform the Bank of Spain. Participations over 15% of social capital were subject to authorization by the Bank. This seems to indicate that the Bank of Spain wanted to have a saying in any significant foreign incursion. The Bank of Spain favorable approach to

[31] Aristobulo de Juan and Miguel Martin

mergers was also visible in the manner in which it dealt with the crisis; it often issued recommendations that the Big 7 absorb ailing banks. The government publicly supported these recommendations (See for instance Miguel Boyer's address to Congress in March 30th 1983 defending Banco Hispano's takeover of Banco Urquijo)[32]. The cleaning process of Rumasa's twenty banks in 1983 had also taken place by allocating their assets to different banks (Perez 1997). This policy gave Spanish banks ample experience in merger operations. For instance, between 1980 and 1986, one bank alone, Vizcaya, acquired 11 banks[33]. This was not an isolated case, and all the Big 7 controlled several additional banking institutions as of 1987 (see Rivases 1988 for specific details).

If merger was the favored option, one possible obstacle was the existence of the banking cartel. However, the cartel by this period had fully lost its utility. By 1987 all interest rates and commission had already been liberalized. There were the last aspects in a long list of formerly restricted variables that the cartel had agreed upon (Canals 1993). Once the restrictions were over, there was no point to the bank's negotiations. Some bankers recognized this publicly. In 1987, Sanchez Asiain, president of Banco Bilbao, said that "one way of operating banks, the conventional banking way, has died and it is necessary to resist all temptation to seek refuge in the old ways, or to think that the old ways provide secure shelter from the gathering storm"[34]. Thus, there were no "moral" barrier to the acquisition of other large banks. The old "gentlemanly" rules died (Economist 1988[35]).

Finally, from the viewpoint of 1986, alternative options to national mergers were limited. The alternative of expanding abroad was limited by the size of Spanish banks, their lack of international experience and the shallowness of the capital markets. The limited scope for alternatives is supported by theory. According to IDP theory (Dunning 1997, 2005) the relatively inferior level of sophistication of Spanish banks relative to their European peers limited their chances of success at European expansion. European markets were more developed than Spain and more competitive, so

[32] Congreso de los Diputados Library, session transcripts
[33] Banco de Credito Comercial, Banco Meridional, Ahorrobank, Bnaco Occidental, Banco Comercial Occidental, Banca Catalana, Banco de Barcelona, banco Industrial del Mediterraneo y Banco Industrial de Cataluna, Bankisur y Credito Canario (Rivases 1988).
[34] Jose Angel Sanchez Asiain "Reflexiones sobre la banca. Los nuevos espacios del negocio bancario" Real Academia de Ciencias Morales y Politicas, discurso de reception del academico de numero Excmo. D. Jose Angel Sanchez Asiain, Madrid, 1987.
[35] Economist, "After the banker's siesta" , May 21 1988

there was no reason to think that Spanish banks would be better than local banks at handing traditional retail business (Hymer 1976, Tschoelg 1987, Dufey and Yeung (1993). Furthermore, in a sector like banking, credibility is key, and Spain's turbulent and still recent democratic transition was not viewed as fully credible yet. German or Brittish banks would have fought Spanish acquisition with all weapons at their disposal. Alternatively, Spanish banks had the option to expand to less sophisticated markets, where they could in theory have an advantage relative to native, possibly well less run banks. Yet, in the second half of the 1980s and with protectionist barriers still firmly in place, there were few options available. Once these were lift, and again as the theory predicted, Spanish banks would pursue them in earnest, most notably in Latin America.

Another possible option for Spanish banks was to erect higher barriers by investing in "friendly" firms. However, this was not seen at the moment as the most attractive option. In fact, lessons from the 1975-1985 crisis led banks to turn away from industry and consolidate their positions as traditional banks (Perez 1997, Canals 1993, Guillen 2005, Fernandez 2003, Zoido 1998). With the crisis still in its final stages, banks would have understandingly regarded investment in industry with much caution. However, this option would gain traction in the late 1990s. By then the major industrial restructuration was behind, and surviving firms were on firmer bases. Furthermore, the opportunity would present itself when the PP government, partly as a result of a political stance, and partly as a way to meet EMU criteria, swiftly privatized public firms. Banks would then pick up the invitation to invest in these firms, and they would do so following much more selective criteria than in the past.

Thus, mergers among Spanish banks were not only the option supported by the Bank of Spain and the government, but also a strategy consistent with the experience of the banks and the most likely to meet their goals in the immediate term. And so the Big 7 merged. Five operations[36] including two failed ones took place within the 1987- 1994 period (Guillen and Tschoelg 2008). Of the Big 7, only two banks, the smallest two: Santander and Popular, stayed on the sidelines.

[36] 1987: Bilbao-Banesto (unsuccessful), 1988: Central and Banesto (unsuccessful), 1988: Bilbao and Vizcaya (successful), 1991 Central and Hispano Americano (successful), 1991: Banco Exterior, Caja Potal, Banco de Credito Local, Banco de Credito Industrial, and other state owned banks (to become Argentaria) (successful).

Becoming Competitive: New Products and Lower Operating Costs

In addition to protect their outer flanks, banks needed to protect their core by becoming competitive. Internal conditions called for greater competitiveness, especially the reform of savings banks. The LORCA (Law 31/1985 of August 2) removed restrictions to the expansion of savings banks beyond their autonomous region. The LORCA unchained a process of consolidation in the savings banks sectors that paralleled the one experienced by the banks and unleashed the so-called deposit wars o “*guerras del pasivo*” with the banks. Savings banks were indeed stealing market share from the banks. By 2003, they matched the banks and from then on surpass them (Maravall, Glavan et al 2009)[37]. Banks counterattacked by launching a number of innovative products. These include Santander’s *Supercuenta* (1989), a high-interest checking account, with which Santander increased its market share of deposits by 7% points and BBV’s *Libreton* (1990) a lottery-linked checking account that targeted the low-income segment (Guillen and Tschoelg 2008, El Pais April 29, 2010, Guemawat, Ballarin and Campa 2006). Thus, internal competition encouraged sectoral competition through innovation.

Bank competitiveness increased through a combination of two other factors: cost control and better human capital. As a result of the industrial crisis, banks’ debt levels increased and operation costs and provisions for bad debt rose. This caused a significant deterioration in return on assets and before tax profits. Gross margins went from 4.34% of total average assets in 1975-1979 to 4.28% in 1980-1984. Before taxes profits dropped from 0.94% to 0.67% (Canals 1993). This was compounded in 1989 by a new reserve ration imposed by the bank of Spain. The banks knew that they could not afford to post no profits. The experience of Banco Hispano in 1984 was significant. Laden by its own debt and by the ones it acquired with the absorption of Banco Urquijo in 1983, the bank was forced to use all of its profits and to announce early in 1984 that it would not share dividends. Shares of the bank lost 1/3 of its stock value almost immediately (Rivases 1988, 1991, Guillen and Tschoegl 2008). Thus, banks embarked on a number of measures to reduce their cost structure. Personnel costs was perhaps the most significant of these.

Workforce was one of the banks’ largest outlay of funds, and banks took advantage of the period of mergers and the broader climate of reorganization that was taking place in the country to pre-retire

[37] From a stable share of deposits of 28% in 1985 (70% for the banks), saving banks reached approximately 49% of the market in 2003. From then and until the latest data published in 2009, the percentage of deposits at savings banks *exceeds* that of the banks.

most of their older, less qualified and most expensive workers. These policies were often very aggressive and included workers starting at 50 years old. Union sources estimate that annual outlays for the sector were in the vicinity of 1,000 to 4,000 employees. According to a study by the Bank of Spain, Santander, Central and Hispano alone eliminated 60,000 positions. In 2006, Santander, which merged with Central Hispano in 1999, had 50,000 employees in Spain[38]. The reduction in operating costs was significant, since according to the banking collective agreements in vigor[39] Spanish bank employees had the right to perceive pay complements for every three years they were at the company and many of those who pre-retired had been with their firms between 30 and 40 years. By contrast, all new hires were given basic salaries. Although they too had the right to accumulate pay complements and other privileges, they started from lower levels and it would take time before their costs reached levels comparable to those of the employees that pre-retired. In addition, a number of positions had simply been eliminated as merged banks had duplicated offices.

The other benefit of this measure was to increase employee efficiency. Because of the lower educational levels predominant in Spain in previous decades, and because of the traditional practices of some of the largest banks like Hispano and Central, which hired candidates at around age 16 and favored internal promotion (Rivases 1988), a great portion of those pre-retired had no university education. In 1973, a new counselor of Banco Hispano reported that he found scarcely 50 employees that held a university degree among Hispano's 18,000-strong workforce. (Rivases 1988). According to several former employees of Hispano, a point was made to selectively pre-retire employees without higher education during this period. This had an impact on the bank's operations since new technologies were taking the banking sector by storm, increasing the complexity of operations and requiring more flexibility and adaptability of employees.

In short, this was an intense period for the Spanish banking industry during which the banks underwent considerable external and internal restructuration to increase competitiveness and to protect themselves from takeover. However, despite these efforts, the future of Spanish banks, and with them, that of the Spanish economy was still highly uncertain. Despite the frenzy of mergers, Spanish banks were still dwarfed by their EU competitors (Guillen and Tschoegl 2008, Guillen 2005). They were thus, still very vulnerable to acquisition. This suggests that the process of

[38] Santander annual report 2006
[39] This was still the case in the collective agreement in vigor in 2006 by the way.

industry and institutional upgrading had not yet achieved its objectives, although evidence suggests that it had at least given the banks a competing chance the formerly did not have.

3.2 FDI and the Difficult Choices of Spanish Firms

While the banking sector was immersed in a transformational process that would set the basis for competition in a fully liberalized market, the rest of Spanish industry seemed poised to follow a continuity strategy based on FDI reliance and production of undifferentiated mid-quality products. A continuation strategy looked attractive from the Spanish perspective because the country lagged behind in measures of innovation (it still does in 2009 with R&D investments about 40% below the OECD average- OECD Statistics) and productivity. FDI provided a quick way to improve industry standards without incurring astronomical costs. In addition, shallowness and fragmentation of stock markets, the credit restriction imposed by the Bank of Spain in 1989 to fight inflation, the high interest rates charged by Spanish banks, and the virtual absence of foreign banks until 1993 left local firms with few options to meet their debts. Finally, given the high social costs of the restructuration effort of the previous years and the strained relationship with social partners (Royo 2008, Smith 1998), Spanish decision-makers may have found it politically and socially intolerable to pursue deeper reform in too many fronts at once. Many firms have thus, little choice than to hang the “for sale” banner.

A strategy that consolidated Spain as the EU’s low-cost assembler of certain products of Europe looked feasible from the vantage point of 1986. European recuperation was already underway which means capital was available. EU membership made Spain an attractive location: it helped generate confidence among European investors and brought about the end of FDI caps, which allowed investors to truly control their investments. The recession had put firms with reasonable market shares and solid products under financial stress, lowering their market price and creating real bargains. Despite double digit inflation, Finally, Spain is strategically located to serve West European markets by sea or by road/rail and offered relatively attractive labor costs (and a large workforce) (Pallares-Barbera 1989) plus a sizeable domestic market to help balance investment risks. Alternative locations in Western Europe (Portugal, Greece, Ireland) could not offer the same combination of elements. With the iron curtain still down, there was at the time, little additional choice.

Data from the period seems to corroborate this logic. Between 1986 and 1991 Spain attracted more FDI than any of the other "poor" EU economies. In the first 10 months of 1987 alone, FDI inflows exceeded US$8.7 billion. At the peak in 1991, inflows were equivalent to 4.2% of GDP (Guillen 2005, Chislett 2008)[40]. Many viable Spanish firms, especially in the food, beverages, chemicals and pharmaceutical industries were acquired by European investors during this period (Guillen 2005, Duran Herrera 1992). In fact between 1985 and 1990 the percentage of firms in foreign hands rose from 17% to 31.5% (Perez 1997). The automotive sector, one of the largest industries, quickly became 100% foreign owned. Furthermore, two additional assembly plants were established: GM (Figueruelas) and Mercedes (Vitoria). This data seems to indicate that investment from the EU was flowing primarily into the same sectors that had fuelled Spain's industrialization thus reinforcing its low-cost specialization. This pattern was reinforced by local demand whose income remained 25% lower on average than that of the average Western European nation (Banco de Espana 2002).

The continuity strategy would prove to be a short-lived success. Three developments threatened Spain's competitive niche as a low-cost offshore producer for Europe. The fall of the Berlin Wall in 1989 and the political decision to integrate Central and Eastern Europe to the EU increased direct competition on the low-cost segment. Threats would become compounded in the following years. In addition, the 1996 customs union with Turkey made the Spanish position even more precarious. As market liberalization and deregulation gained traction within the EU and outside of it, with the creation of the WTO, Spain's FDI-dominated industry, which included the largest employers in the nations (the car industry) had much to fear. Once again, a new economic crisis between 1992-1994 would ring the alarm bell. By 1992 the country was once again in the midst of a major crisis and unemployment in 1993 hit a high of 24% (INE 1993).

The situation of FDI-dominated (and generally FDI-attractive) sectors stands in stark contrast with that of the banks. The Spanish government, which had so fiercely protected its allies from unwanted foreign acquisition had little qualms letting firms in other sectors be acquired. These were after all, not immediately crucial at a point where much was still left to achieve, and the "core" industry, the banks, were still in danger. The government having only limited resources could not spread itself too thin. As with the banking system, events in the following years would thus be crucial to

[40] FDI data for Spain prior to 1993 reflects projected investment rather than actual investment , according to the methodology that the Spanish government used at the time.

understand the evolution of the Spanish industry and the role FDI would come to play. However, the initial strategy followed in this period suggests that Spain was not ready to do away with FDI in traditional sectors altogether.

Utilities (Energy and Telecommunications)

During this period, utility firms sit oddly in the middle. As sheltered, publicly owned sectors, energy and telecommunication were not subject to the same competitive pressures as the banks. Their immediate future was not threatened although developments in the UK and US telecommunications markets (1982 US Department of Justice decision to force AT&T to break up operations into seven regional firms and UK 1984 Telecommunications act liberalizing the telecom market) led to think that similar liberalization processes would take place at some point in the future, at least in the telecom market.

Like the rest of large Spanish public firms, utilities, underwent considerable restructuration during this period. As the banks, they resorted to pre-retirement schemes to eliminate excess or inefficient personnel. Telefonica's plan for instance, included a 62% staff reduction or 180,000 jobs (Aguilera 2004). Minority stocks of these firms were sold through public offerings .The purpose of the sale was not to relinquish public control, since the state maintained a golden share (32% in Telefonica's case). Day to day operations including chairman appointment also remained under government control. Instead, this movement was expected to help in the rationalization process of these formerly very bureaucratic companies by introducing external supervision of company management, and to raise funds to finance firm expansion without affecting the public budget (Claver, Gasco, et al 2000, Bell and Trillas 2005).

The situation of utilities during this period thus takes second place to that of banks, which faced imminent threat, and those of industry, which resourced to FDI in order to refloat. In the following years, as they too faced the treat of liberalization, telecom and energy firms would however come to play a much more prominent role.

Summary and Conclusion

Between 1959 and 1993 the Spanish landscape underwent considerable change. In 1959, the government's desire to assert its position set the basis for a fordist, FDI intensive development model that fuelled Spain's transformation from eminently rural and backward to fully

industrialized. The end of political isolation may have consolidated Franco's political leadership, but it weakened its economic capacities by forcing concessions on foreign investors. Spanish industry grew, but originally weak, it had little chance to flourish in this environment. Rather than foment the process of increasing development that theorists hoped, foreign investor relegated Spanish industry to a marginal role. Planned support for large heavy industry firms did not counterbalance this situation. The intricacies of the planned system stained these firms with "original weakness". Spanish bankers were an exception to this landscape of weak industry. Protected by sectoral regulation and by their influence on government, they flourished.

The combination of two economic shocks in 1973 and 1979, and the demise of the Francoist era put in question the system and created a window of opportunity for something new. A group of economists sharing a common background at the Bank of Spain led the way, gaining political clout through the newly elected socialist government and consent from the banking elite. The alliance thus forged between the banks and the reformist government was to endure major tests in the years following EU accession. The alliance seemed to emerge mostly unscathed, but it came at a price, paid mostly by those sectors that fell outside the alliance and by Spanish society. In 1993, the evolution of the Spanish economy still looked uncertain. Yet, the combination of three elements, business-government realignment, a new economic elite allied with the PSOE government and a decisive critical period, helped provide a core of Spanish industry with a competing chance in the open context of the 1990s. Spain did not yet have its Stairway to industry upgrading, but it had bought itself a chance, which is much more than it had before.

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