Building on easy money:

The political economy of housing bubbles in Ireland and Spain

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Abstract

This paper undertakes a structured, focused case-study comparison of housing bubbles in Ireland and Spain, based on the selection of two most-different cases that nonetheless share a common outcome of interest. Both countries were exposed to the same set of changes in their international policy environment in the late 1990s and early 2000s, in the form of a low interest rate regime associated with the creation of European Monetary Union (EMU). The two countries have very different economic structures, different political decision-making profiles, and different relationships between the political and banking systems. Yet these two countries had the most extreme experience of housing bubbles during the 200os, and both suffered a similar construction-related economic collapse that ruined their respective banking systems after 2008. The paper argues that the decision-making taking place within their very different domestic institutional frameworks was subordinated to the fact that they shared a similar form of international vulnerability. Both were extremely open to mobile international capital during the 2000s. Their vulnerability to financialization resulted in a common experience of very rapid asset price inflation, which left both countries particularly exposed when the international financial collapse took place. The shared experience of European 'peripherality' meant that two countries belonging to different 'varieties of capitalism' ended up with very similar kinds of economic collapse.

1. Introduction

The international financial crisis of 2008 had an uneven impact in different European economies. Among those particularly severely affected were Ireland and Spain. In both countries, a housing bubble had developed, backed by rapid expansion of the banking sector, during the years running up to the crisis. After the crash, the landscapes of the two countries were littered with ghost estates, half-finished construction projects, and households burdened with mortgage payments which, with a collapse in property values of over 50%, they were unlikely ever to be able to repay. In both countries, the financial system was ruined, and taxpayers were obliged to take on the burden of recapitalizating the banks. Indeed, the massive scale of bank rescue undertaken in Ireland tipped the country's capacity to deal with an already expanded fiscal deficit right over the brink, and Ireland was obliged to enter an EC-ECB-IMF loan programme in 2010. Spain, regarded as 'too big to fail', but also 'too big to bail', was at the centre of the Eurozone sovereign debt crisis of 2010 and 2011. In neither country can it yet be said that the troubled financial system is yet resolved. The biggest outstanding issue in both cases is the volume of private debt, particularly mortgage-related debt on residential property.

The scale of the disaster experienced by these two economies was more far-reaching than it needed to have been. Ireland and Spain shared a common experience of extreme openness to mobile international capital during the 2000s, which made possible the rapid escalation in asset price inflation. They were therefore highly vulnerable to the dangers of the liquidity crisis associated with the international banking crisis, and highly exposed to the fiscal hazards of a sudden stalling of economic activity. But other countries, similarly exposed, were not ruined by the experience. The challenge is to go beyond description of the crisis in the two countries, to try to provide an adequate explanation of why, given that many countries also experienced housing bubbles prior to the crisis, these two countries were so severely affected.

The structure of the paper is as follows: first we outline the strategy of comparative case study inquiry. We then identify the scale of the property boom

in Ireland and Spain in comparative perspective, profiling the shared pro-construction bias in capital utilization in these two late-industrializing economies, and the active role of the banking sector in channelling funding into construction in the two countries. The following section unpacks three causal mechanisms that biased decision-making in Spain and Ireland in a direction that led to crisis: policy legacies of owner-occupancy that underlay the property boom; fiscal incentives that super-sized the boom; and the political constellation of close links between politicians, banks, builders, and property interests that facilitated both corruption in property transactions and exceptionally lax regulatory standards. We find that on each of these explanatory variables, political and institutional arrangements in Ireland and Spain were differently constituted; but common incentive structures emanating from the international political economy gave rise to behaviour that converged on similar choices with similarly disastrous outcomes. International circumstances, mediated through contrasting domestic configurations, produced convergent outcomes. We have two conclusions. The first is that varieties of capitalism in this case did not function as a critical mediating influence on response to change in the international political economy. Rather, the shared structural location of Ireland and Spain as 'peripheral' economies in a Eurozone context left them particularly vulnerable to the destabilizing effects of cheap money and highly mobile international capital. The second conclusion is that the scale of the damage done was intensified by domestic policy errors – peripheral economies need to be especially vigilant in their institutional design; they should be highly suspicious of the functioning of their financial systems; and they need to implement precautionary policy controls long in advance of the advent of crisis, particularly if, as in the Spanish case, they are simultaneously trying to build up a social democratic politics of welfare provision.

2. Analytical approach: structured-focused comparison, most-different case selection

The theoretical approach adopted here involves systematic two-country case-study comparison. The case selection stems from their shared experience on the outcome of interest (Tarrow, 2010, Bennett and Elman, 2006). The experience of

a housing bubble left Ireland and Spain vulnerable in very comparable ways: their economies had become over-reliant on the role of finance in generating growth. Employment in the construction sector, both commercial and residential, had expanded rapidly. The ratio of house-prices to income had risen in ways that even at the time were held to be unsustainable. In both countries, the experience of growing European integration changed domestic incentives: both countries converged on low interest rates as required by the Maastricht Treaty, and both were able to avail of historically low interest rates in the national context once the Euro had been created. Both countries had been among those in the poorest tier of EU member states, and both experienced a relatively late transition from agriculture, compared with the rest of Europe.

But in many other respects, Ireland and Spain are very different. They are typically classified as belonging to different 'varieties of capitalism': the structure of the Irish economy aligns it with the Anglo-American model, and it is generally seen as a liberal market economy, while Spain's model of capitalism more closely resembles the state-led mixed market economy model of other southern European economies (Molina and Rhodes, 2007, Hall and Gingerich, 2009). Most crucially for the purposes of this paper, the experience of financialization, equally pronounced in the two countries, took a different structural form in each case. The functioning of the banking system, and the structural links between banks and property interests on the one hand, and banks and the political system on the other, were very differently configured institutionally. Alternative means of conceptualizing commonality based on varieties of housing tenure also prove problematic.

Schwartz and Seabrooke identify distinct 'varieties of residential capitalism', based on the distributions of home ownership and mortgage debt, and Ireland and Spain fall into the same 'Catholic' group, along with Italy and Belgium (Schwartz and Seabrooke, 2009, p.9). But this classification cannot explain the housing boom that took place in Ireland and in Spain, but not in Italy or in Belgium. This is because their conceptualization of varieties of housing structure and welfare state structure is not dynamic. To understand the evolution of a housing bubble, we need to take account of the policy responses to the new

phase of growth made available by the low interest rate regime associated with European Monetary Union.

Ireland and Spain stand out as having had the most pronounced experience of property bubble, as we shall see below. They are also cases with a great deal of intrinsic interest. Ireland's growth model is seen as a model for other periphery countries, with its strong FDI-led industrialization: quite explicitly, Portugal has been viewed 'in the Irish mirror' (Lains, 2008). Spain's economic structure has long had a stronger domestic industrial base than Ireland, and it is among the largest economies in Europe. Its growth trajectory exceeded Ireland's until the 1990s, when Ireland experienced a phase of super-normal growth. It is therefore all the more interesting to why Spain proved as vulnerable as Ireland to financialization in ways that disrupted and distorted their respective development and growth models.

The theoretical interest of this comparison stems from the selection of two cases that exhibit similar outcomes in response to similar causal conditions, but where the mediating conditions display a marked contrast: ours is a most-different case study research design (Tarrow, 2010, Seawright and Gerring, 2008). The puzzle is to explore what it is about the intervening variables that mediate common background causal conditions into common outcomes. The research design is summarized in Figure 1.

Figure 1. Most-different case study design: Ireland and Spain

The argument we wish to make is that Ireland and Spain had a shared experience of difficulty in absorbing new sources of finance effectively in productive areas of activity. In both cases, the availability of cheap credit was more quickly translated into high-yielding investments in the form of property rather than into manufacturing or traded services. The availability of new factors of production (whether in the form of human capital or financial capital) results in an expansion of economic activity, but is not easily translated into an upgrading of productivity. It is more likely to result in 'extensive' than 'intensive' growth in less developed economies (Eichengreen, 2006). It is easier, in other words, to gain returns on investment by channelling new funding into construction activity

than into manufacturing or high-tech software development or other traded services activities.

There are important variations of course: Ireland's high-tech sector, largely though not exclusively developed through incentivization of foreign direct investment, went through two phases of expansion, during the 1970s and again during the 1990s, in ways that resulted in an upgrading of the composition of economic activity. (It should also be noted that data on the productivity or the Irish foreign-owned sector are somewhat open to question, since the tax system may introduce incentives multi-national firms to over-state the profitability of the parts of their economic activity that are located in Ireland). But other sectors of the Irish economy, particularly the largely domestically-owned employment-intensive sectors, were less able to upgrade in this way. Similarly in Spain, there were pockets of innovation and skill upgrading, but these were not widespread across the economy.

International conditions provided the facilitating conditions for the construction boom during the 2000s (Dellepiane and Hardiman, 2010). Preparations for European Monetary Union meant that in Spain and Ireland, as elsewhere in the Eurozone candidate countries, domestic interest rates were brought down to what were for them historically low levels. The European Central Bank maintained low interest rates to facilitate growth in the larger economies. But the unanticipated consequence of this policy stance was that the peripheral countries of the Eurozone experienced very rapid growth: the confidence-enhancing effects of low interest rates encouraged very large inward flows of capital. This pushed up domestic demand and domestic inflation rates, resulting in de facto negative short term real interest rates for several years. This in turn greatly intensified the surge of international lending into these countries, and therefore onward lending by the national banking systems, the great bulk of which went into construction.

Thus we see convergent outcomes in countries that, while very different in economic structure, are similarly situated vis-à-vis the broader international political economy. International pressures were mediated through domestic

policy preferences. These were formed in contrasting institutional frameworks, but they converged in the content and consequences. In this paper, we isolate three aspects of domestic policy choice, which were played out in very different institutional frameworks, but which converged on the same outcome, that is, the facilitation of housing bubbles. Firstly, the propensity to channel new investment into non-productive outlets in construction activity in both countries was facilitated by a policy legacy involving a strong preference for and promotion of owner-occupancy, maintaining a steady demand for residential housing. Secondly, domestic political coalitions built up around this policy stance meant that governments in both countries had every incentive to provide fiscal incentives to continue the boom, in ways that proved highly pro-cyclical in both cases. Thirdly, the translation of these common vulnerabilities into a common outcome in the form of financial crisis is mediated through contrasting structures of finance. More specifically, the financial systems of the two countries are embedded in very different relationships with both productive activity on the one hand, and with the political system on the other. The Spanish experience is one in which the liberalization of the banking sector after the end of the Franco regime, and the commitment to deregulation undertaken in the context of joining the EU in1986, did not in fact result in much increase in competition. The banking sector continued to have close ties to the political system, and to benefit from its capacity to generate large profits through economic protection (Perez, 1999). Meanwhile, the smaller lending institutions became ever more closely entwined with the politics of regional separatism, and their lending practices were subject to variations in the partisan preferences of regional and local governments. In Ireland, on the other hand, the international deregulation of financial institutions and liberalization of capital controls opened new opportunities for the liberalization of the domestic banking sector. Like Spain's, it began to expand its international operations. Meanwhile, new competition in the form of the arrival of foreign-owned commercial banks generated more competition for business on the domestic front. The financial services regulatory framework was designed to be minimally intrusive on banks' activities, because since the late 1980s Ireland's FDI-led growth strategy had expanded into internationally traded services. Ireland's 'light touch' regulatory stance on

financial services mimicked that of Britain. In the case of the Irish commercial lending banks, this facilitated the emergence of ever-riskier lending practices. In both Spain and Ireland, we find that despite their different institutional and regulatory settings, close relationships between the banking sector and the political system enabled the banks to expand their lending to the construction sector to an extent that left both countries highly exposed when international liquidity came to a sudden halt in 2008.

3. Case selection: extreme property booms in late-industrializing countries

There is no unequivocal definition of a property bubble, and over-heating of asset prices is generally confirmed after and not before the event. One such definition would have it that 'a boom is defined… as a rise in the level of real per capita residential investment of at least 15% over a five-year period' (Rae and van den Noord, 2006, p.20). This is a useful indicator, and house price trends are one useful indicator of the presence of a property bubble. But in a context in which the economy is growing rapidly and real earnings are rising, what is of significance is not house prices themselves, but the 'affordability' of housing, that is, the ratio of house prices to earnings.

The corollary of this is that if the pace of increase in house prices exceeds changes in earnings, outstanding mortgage loans will increase, and the total volume of household debt will be driven up (Kelly, 2009). As Kindleberger notes, 'Speculative manias gather speed through expansion of credit. Most increases in the supply of credit do not lead to a mania – but nearly every mania has been associated with rapid growth in the supply of credit to a particular group of borrowers' (Kindleberger and Aliber, 2005, p.62). Alongside any trend in increasing house prices, we need to consider what is happening to the availability of credit.

Ireland and Spain stand out as distinctive in having experienced extreme property booms between the mid-1990s and about 2006 (because European property markets started to stall before the banking crisis finally broke). Figure 2 shows the ratio of house prices to income, taking the average of the period between 1990 and 2007 as the base-line.

Figure 2. House price to income ratio, Ireland and Spain

This shows that the sharp upward trend in Irish house prices relative to earnings started in 1995, and that although there was a drop in 2000 and 2001 (associated with the downturn resulting from the collapse of the dot-com bubble, to which Ireland was very exposed because of the rapid growth in the presence of high-tech foreign-owned firms in the preceding years), the trend continued sharply upward until 2006. Spain had experienced an upward surge in the relationship of house prices to incomes during the five years after 1986, when Spain joined the EU, committed itself to liberalizing measures relating to the creation of the Single European Market, and undertook a sudden process of bank deregulation. This phase of housing boom tapered off during the 1990s. The surge in the ratio of house prices to earnings took off again in Spain from 2001, when it took on more pronounced bubble-like features. Figure 3 shows that in Ireland and Spain, the overall ratio of year-on-year change in house prices to year-on-year change in manufacturing employees' compensation altered more than in any other European country.

Figure 3. Ratio of change in house prices to change in earnings, 1995-2006

Figure 3 also indicates that although the UK experienced a property boom, and an increase in the ratio of house prices to incomes over time, the overall scale of change in the relationship between change in house prices and change in earnings is a good deal less pronounced between 1995 and 2006 even than the EU15 average. By the end of this period, property-related lending in Ireland was estimated to be double that of the UK in absolute terms; and 'proportionate to population, house completions were six times higher in Ireland than in the UK' (Nyberg, 2011, p.60).

Figures 4 a-f detail how the four indicators summarized above have behaved, that is, trends in house prices on the one hand and employee compensation in industry on the other; and trends in outstanding mortgage loans, and in the overall ratio of household debt to GDP.

Figure 4. House prices, outstanding mortgage loans, household debt, and earnings: Spain, Ireland, Portugal, Greece, Netherlands, Germany, EU15

Ireland's experience is the most striking of the six profiles summarized here, if we consider the rapidity of the rise in house prices, and the scale of the increase in both mortgage lending and household debt relative to (an already very rapidly rising) GDP. House prices increased rapidly in Spain too, relative to the much slower increases in employee compensation, and this trend was therefore associated with a steady increase in both mortgage and total household debt. The significance of Spain's experience can be gauged by comparing it to the Portuguese trends, since the two economies have tended to move in tandem over time. Even though we see an increase in mortgage debt, there was no housing bubble in Portugal: house prices rose very much in line with the (relatively slow) rate of increase in earnings. The absolute levels of debt in Greece are much lower than in other countries, which made it more sustainable than in Ireland or Spain (as we know, the big debt problem in Greece was in the public finances and not in private or household debt). But the rate of growth of debt is exceptionally fast. Moreover, the ratio of change in house prices to change in employee earnings also grew exceptionally rapidly. (Note that all data reported in Figure 4 are in related to GDP, not disposable income, so the trend in relation to disposable income would be even more dramatic).

Considering the profile of the EU15 overall, we may note an overall trend whereby house prices departed from employee compensation over time. But not all of this amounts to a housing bubble. In the Netherlands, overall mortgage debt and also household debt rose considerably more than the EU15 average; but the trend in house prices is a only a little more marked than the EU15 average. Compare these graphs with that for Germany, where we see almost no change at all in either house prices or employee compensation. Indeed, Figure 3 showed that over time, industrial employees' wage growth rate grew more rapidly than growth in house prices in Germany, while Figure 4 shows that the take-up of mortgage debt actually falls over time, resulting in a slow decline in the total ratio of household debt to GDP from 2000 onward.

These graphs suggest a contrast between the experiences of the European 'core' and the 'periphery'. The UK and the Netherlands experienced a housing boom, but we would argue that this did not amount to a bubble on anything like as damaging a scale as in the periphery. But the periphery is not homogeneous either, since Portugal was on a slightly different growth cycle from the other periphery countries, and the effects of financialization were muted by depressed domestic demand and high real effective exchange rate after the creation of the euro. And Greece, starting from a much lower private debt level, did not suffer a crisis of 'affordability'.

One further aspect of the contrast is that owner-occupier residential housing is much more important in the less developed European economies, where long-term rental accommodation is not as well established, a trend we will explore further below. And in the more highly developed 'core' countries in which mortgage debt did indeed increase, such as the Netherlands, the importance of construction to overall economic performance is much less marked. A country such as the Netherlands can absorb something of a housing boom without it becoming a 'bubble' that endangers the overall composition of employment and output in the economy as a whole; a similar point may be made about the UK. But in the countries of the European 'periphery', a housing boom is reflected in the diversion of considerable proportion of economic resources into construction, and building assumes a much greater role in its contribution to overall GDP. This is illustrated in Figure 5.

Figure 5. Gross value added and employment in construction, 1995, 2005, and 2010

From this we can see that the gross value added in construction across Europe was highest in Spain, Ireland, and Portugal in 1995, and that while in most countries (including Portugal and Greece, as well as the UK) this went down between 1995 and 2005, construction actually increased in its importance to the economies of Spain and Ireland during this period. By 2010, the Irish construction sector had collapsed. Spain's still remained strong – the legacy of Zapatero's stimulus programme, which was only reversed in the wake of the

Greek sovereign debt crisis of May 2010. Figure 5 also shows that employment in construction in 2005 accounted for 13% of total employment in Spain, 12% in Ireland, and 11% in Portugal, but only half these levels in the more diversified and more 'mature' economies of the Netherlands, Germany, and the UK.

The problems of securing a good and continuous profile of productive capital investment in both Ireland and Spain have been well documented. Ireland's strategy of industrial developed has depended heavily on incentivizing foreign direct investment, particularly concentrated in areas such as communications and information technology and pharmaceuticals. With some exceptions (such as agri-food, banking in the 1990s and 2000s, and the small Irish software sector that emerged during the same period), the capital-intensive, exporting sector is foreign-owned – these firms account for about 90% of all Irish exports, but less than 50% of jobs in manufacturing. The indigenous sectors, where the bulk of employment is concentrated, are more low-tech and mostly oriented toward the domestic market (Barry et al., 1999, Ó Riain, 2009, Breznitz, 2007). But between 2000 and 2008, while capital stock increased by 157% in real terms, housing accounted for two-thirds of this increase (White, 2010). Furthermore, investment in 'core' productive capital stock was not driven by the private sector, but was mostly undertaken by the state.[1] This was mostly directed toward roads, schools and hospitals, energy supply, and other utilities infrastructure, rather than human capital, communications, and software, where there were ongoing significant deficits (White, 2010). What is of course also noteworthy here is that most of this activity also provided a major boost to the construction sector. At a time of already over-heating construction activity, and when land prices were being pushed ever higher, the costs of undertaking these investments at this time were certainly larger than they might have been otherwise (O'Toole, 2009, O'Toole, 2010).

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[1] Indeed, of the much smaller levels of venture capital investment in Ireland during the 2000s, the state presence was also significant: the share of the public agency Enterprise Ireland almost doubled from 12% to 23% between 2000 and 2005 Ó Riain, S. (2014) *The Rise and Fall of Irelan's Celtic Tiger,* Cambridge, Cambridge University Press.

This extraordinary expansion of Spain's construction sector in the 2000s was driven by the collusion between state elites and two powerful lobbies, one linked to housing and construction, the other linked to banking, the origins of both of which can be traced back to the Franco era. Naredo and Marquez argue, similar to the Irish case, that construction (not only housing, but also on infrastructure) became Spain's real national industry from the mid-1990s on, despite the fact that the country already had more houses and roads per capita than most European countries (Naredo and Marquez, 2011). The rise of the construction industry was instrumental for compensating for the challenges the traditional agrarian and industrial sectors had been suffering since accession to the EU in 1986 – not least because construction was particularly labour intensive, and Spain was facing huge unemployment issues.

Barnes and Wren have argued that 'liberal economies… pursued growth based on the expansion of domestic demand, enabled by the expansion of private credit', and that Ireland even more than Britain relied on 'private debt-based expansion in sheltered domestic sectors as the chief engine of employment expansion' (Barnes and Wren, 2012, pp.293, 299). But the same claim can be made in relation to the southern European 'mixed-market' economies. Ireland and Spain share a good deal in common, in opposition to the 'traditional' export-oriented growth model based on traded goods characteristic of 'coordinated' market economies.

The international context is central to understanding these dynamics. The process of preparing for European Monetary Union after 1992 was intended to bring the economic cycles of all Eurozone candidate member states into alignment with one another, particularly on the key indicators under the terms of the Maastricht Treaty of domestic interest rates, inflation, and fiscal deficit. The convergence on low domestic interest rates had two paradoxical effects which were the unintended consequences of seeking harmonization of economic performance. Firstly, the confidence generated in the peripheral economies made it easier for them to borrow money internationally, and lenders in large capital-rich countries proved more than willing to extend new credit lines to borrowers in the newly attractive periphery countries. But these new credit lines

were disproportionately used to fund new construction projects. Economic growth came to be more strongly dependent on construction than on other activities.

Figure 6. Housing investment and exports as a proportion of nominal GDP growth in Ireland, 1998-2006

Figure 6 shows that even in Ireland, where export performance had been very important for economic growth during the 1990s, construction activity became a much more important contributor to growth between 2000 and 2006.

Secondly, easy money helped to generate new domestic inflationary pressures within these countries. Interest rate policy was now set centrally by the European Central Bank, whose primary concern was with Eurozone-wide average inflation rates. With Germany and France experiencing a slump in the first half of the 2000s, low interest rates were indicated. But these were far too low to contain inflationary pressures in the Eurozone periphery. Figure 7 shows that real interest rates actually entered negative territory in Ireland in 1998, Spain in 2000, Portugal in 2001, and Greece in 2002, giving an enormous incentive to borrowers.

Figure 7. Short-term real interest rates

Over the whole period between 1999 and 2008, average inflation rates in the EU15 were relatively low, but this masks a great deal of variation. Meanwhile, gross fixed capital formation in the construction sector was much greater in the European periphery. Figure 8 shows a very strong correlation between the degree of deviation from average EU15 inflation rates on the one hand, and the deviation from the significance of construction in gross fixed capital formation in the EU15 overall. The inflow of borrowed capital to the periphery was mostly funnelled into construction; the ready availability of cheap money drove up domestic inflation; the two trends were mutually reinforcing.

Figure 8. Inflation and construction: deviation from EU15 average, 1999-2008

We see from this that the four 'periphery' countries of Ireland, Spain, Greece, and Portugal are outliers on this measure. But once again, Ireland and Spain are more extreme cases than Portugal and Greece. In all four cases, but especially in Ireland and Spain, domestic inflation is very strongly associated with an expansion in construction activity. Low or negative real interest rates incentivized new borrowing, and lenders sought high returns on their lending in the rapidly-growing periphery. It may also be noted here that there are divergences between the measurement of inflation in different countries' Consumer Price Index, and between these and the EU's Harmonized Consumer Price Index. Aggregate Eurozone consumer price inflation is subject to strict monitoring by the ECB. But sector-specific inflation is not captured by these measures. And house-price inflation is not normally included in national measures of consumer price inflation. As a result, inflation is not a focus of political vigilance. When ever-rising property values make voters feel wealthier, politicians' preferences may well be to let the inflationary surge continue untrammelled (Hay, 2009).[2]

On the other side of the story, we may take up Kindleberger's point that a property bubble can only develop where the supply of credit has increased to particular lenders. We can see that the availability of cheap credit resulted in an enormous take-up of borrowing opportunities in the periphery countries. Figure 9 shows the scale of exposure of European banks to loans in the Eurozone periphery. (Of course not all of these money inflows were used for construction. Further analysis is required to assess banks' exposure specifically to construction and related activities. But the trends are highly indicative).

Figure 9. Credit availability and exposure of 'core' European banks to banks in the Eurozone periphery

[2] There are some striking examples of politicians' unwillingness to face up to an over-heated property market, such as, for example, Taoiseach (or Prime Minster) Bertie Ahern's notorious 2004 dismissal of expert warnings of a potential hard landing: 'Sitting on the sidelines, cribbing and moaning is a lost opportunity. I don't know how people who engage in that don't commit suicide because frankly the only thing that motivates me is being able to actively change something'.

This shows that banks in Germany, France, the UK, the Netherlands, and the US are very exposed to bank loans they have made to Spain.[3] Germany is highly exposed to Irish bank debt. In fact the Irish data (especially in relation to Britain) over-state banks' external financial liabilities because they do not differentiate between loans to 'ordinary' banks and loans to institutions associated with the International Financial Services Centre. The latter companies include foreign-owned subsidiaries and other financial institutions apart from the six commercial banks that were covered by the Irish government's depositor 'blanket guarantee' introduced in September 2008. Nevertheless, as Figure 10 shows, the Irish domestic commercial banks' take-up of loans from foreign lending institutions increased very sharply between 2003 and 2008.

Figure 10. Stock of net borrowing of Irish resident credit institutions from abroad, 1991-2009

It must also be recognized, though, that the banks in Ireland and especially in Spain had greatly expanded their own overseas lending activities during the 1990s and 2000s. The Spanish banks are still major international players. Figure 11 shows the scale of their foreign lending activities.

Figure 11. External lending by banks in the Eurozone periphery

In summary, therefore, Figure 12 indicates the net implications of the banks' liabilities.

Figure 12. Net claims of the banks in the Eurozone periphery on the rest of the world, 1999-2012

This shows that the Irish banks were in a net positive position in the early 2000s, but that this declined after 2003 as they took on more and more foreign-sourced borrowing. While the Irish banks' share prices rose until 2006, they started to fall soon thereafter, and investors began to move money out of them steadily between 2006 and 2008. It was not clear at the time of the government's total

[3] Indeed, the scale of the German government's bail-out of the German banking system between 2008 and 2012 is vast, at about €646bn.

guarantee to the banks in September 2008 that the banks had in fact become insolvent, not just illiquid. But their net position had already plunged deep into negative territory by then and, notwithstanding massive injections of public money, did not recover. The Spanish banks' big expansion into foreign markets took place after 2004, and in fact their activities have diversified enormously since 2008, especially in Mexico and Brazil, which means that their overall profile is very different from Ireland's.

Readily available credit fuelled house construction and house purchases, and this drove up costs. The relaxation of supply conditions (such as, for example, deregulating planning, and the slackening of risk evaluation in the banking sector) did not result in an easing of the upward pressure on house prices. Rather, expectations of rising prices began to drive buyers into a phase of speculative 'mania', in which beliefs about endlessly increasing house prices drove some to buy in a panic before they were priced out of the market, and others to leverage up to buy more in the expectation that they would be able to reap profits through re-sale in the future.

The only means of anticipating trouble that was available to European policy-makers was the extent of countries' compliance with the terms of the Stability and Growth Pact (SGP). This proved to be a very soft constraint, and one that the 'core' economies of Germany and France were the first to breach when it suited them – while Ireland and Spain remained formally compliant (Hallerberg and Bridwell, 2008). But fiscal discipline had very little bearing on the nature of the financial crisis that was brewing in Spain and Ireland. There was no central oversight of borrowing profiles or of prudential risk management, or of the capital adequacy and leveraging profiles of banks in member states, since regulatory responsibilities were devolved to national authorities.

But crucially, the balance of payments of the periphery economies was not subject to any scrutiny, and private sector indebtedness was not considered to be problematic because it was presumed not to have any bearing on government fiscal responsibility. The scale of investment in non-productive areas rather than in tradable and exportable goods and services signalled the future inability to

repay the large volume of borrowings incurred abroad. 'By the peak of the boom in 2006, housing investment in Ireland accounted for around 14% of GNP… total investment account for around 31% of GNP' instead of a more normal 20% or so of GDP (FitzGerald, 2012, p.1243).

Thus by 2000, the scene was already set for the dramatic take-off in financialization which was to be the big unintended consequences of the creation of European Monetary Union. Ireland and Spain proved to be particularly vulnerable to the consequences of the credit boom because they were less diversified economies with less mature ways of absorbing newly available capital: in these ways, we may identify them as 'peripheral' in the emerging Eurozone economic area.

However, these structural similarities are not enough to account for the political responses within each country to the new incentives and opportunities opening up on the international scene. After all, as we have seen, Portugal and Greece shared many structural features with Ireland and Spain in relation to the wider European economy. While they also experienced an increase in credit availability (both public and private), and an increase in activity in construction, they did not experience a speculative frenzy centred on activity in the construction sector as happened in Spain and Ireland.

We still need to account for why the housing bubble took a similar form in Spain and Ireland, although their economic and political systems were so different in many ways. The way this happened was mediated through domestic political institutions and policy choices. We must now unpack these in order to set out a systematic explanation of the way in which different institutional frameworks produced convergent policy responses and similarly disastrous policy outcomes.

4. Convergent policy outcomes in contrasting systems

Both Spain and Ireland developed property bubbles that resulted in their banking systems being ruined and their taxpayers put on the line for enormous sums of money. In the Irish case, the very capacity of the country to conduct an independent fiscal policy was forfeited in its entirety (with the need to enter an

EC-ECB-IMF loan programme in November 2010). Figure 1 noted that Ireland and Spain have very different economic profiles, summarized in terms of varieties of capitalism. It is now time to explore more systematically what the underlying political economy conditions were, and how policy responses were shaped, such that countries that were structurally very different nevertheless came to respond to intensified financialization in such similar ways.

Three explanatory variables are identified here: the legacy of past policy choices that shaped current policy responses; the use of fiscal incentives in a pro-cyclical manner; and close ties between politics and banks. Firstly, both Ireland and Spain display a strong path-dependent bias toward home ownership. This shaped the policy response to the availability of cheap money and the propensity to turn this into property development. But by itself, this is not enough to account for why this turned into a speculative mania during the 2000s.

Secondly, in both countries, fiscal incentives were commonly used to promote home ownership. These were used more actively to stimulate the construction sector during the 1990s and 2000s, while at the same time, the revenue system became more heavily reliant on flows from construction and less resilient in the face of a downturn in this sector. But the reasons why fiscal incentives to construction got so badly out of hand have to be pressed further.

The third element of our explanation points toward the way in which, in each of these two countries, particularly close relationships were permitted to grow up between politicians, property developers, builders, and bankers, such that in both countries, the banking sectors were permitted to exercise a particularly broad degree of discretion in their lending practices.

All three explanatory variables push us toward seeing Ireland and Spain as sharing deeper similarities in their structural relationship to the wider European economy than has previously been noted. Despite the fact that their economic structures and export intensity were very different, and despite the fact that their policy responses to EMU took place within very different political frameworks, there were deeper similarities at play that we summarize in terms of the political economy of peripheral status. But it is the third element of

explanation that sets Ireland and Spain apart from the other periphery countries: poor corporate governance practices, and poor regulatory oversight, were within the control of national authorities, if they had chosen to exercise these powers more forcefully. Policy responses in Spain and Ireland, worked out in very different institutional configurations, yet produced very similar outcomes.

a. Path-dependent bias toward home ownership

The significance of home ownership varies a good deal across European countries. It is striking that the relatively less-developed countries are the ones in which owner-occupier residential housing is most developed.

Figure 13. Home ownership in the EU, 1980 and 2010

Spain and Ireland lead the league table, with in excess of 80% owner-occupancy by the peak of the boom, comparable in scale to the countries of east-central Europe where very rapid privatization following the collapse of communism also gave rise to the dominance of the owner-occupier model of housing provision.

It has been argued that there is likely to be a policy trade-off between home ownership and welfare state development (Schwartz and Seabrooke, 2009). Home ownership has been understood as a hedge against income insecurity in old age, so in countries with less well-developed welfare state provision, home ownership is more likely to be favoured. But while it is true that in Ireland and Spain welfare state expansion preceded the development of a large owner-occupier residential sector, southern European countries including Italy and Greece, and also Spain, have now long combined extensive home ownership alongside relatively more generous social insurance schemes for old age (Castles and Ferrera, 1996).

A commitment to both home ownership and high pensions therefore does not necessarily always entail a trade-off. What southern European countries evince is a policy mix that tends to favour older people over younger, by favouring the income needs of older people while simultaneously making it relatively more difficult for younger people to get onto the property ladder (Allen et al., 2004). This helps to explain why the impetus in Spain is so marked for expanding

construction for housing – it helps to resolve pent-up demand for residential housing for rising generations, and it provides a ready source of new employment for young less-skilled labour market entrants who are otherwise hard to absorb. Indeed, Naredo has noted the importance in Spain of the construction of new houses, which also entails the actual destruction of the older urban housing stock, as well as the despoliation of the natural environment, including but not confined to large tracts of Spain's Mediterranean coastline. The promotion of new construction (*obra nueva*) is aimed at extracting extraordinary rents that are linked to the discretionary reclassification of land by local elites (Naredo and Marquez, 2011). Moreover, this also results in increased demand for cement, another important source of additional employment creation.

We are arguing here for strong policy path-dependence in favour of owner-occupied housing in both Spain and Ireland. But in both countries, the policy regime supporting home ownership has a history, and was the subject of deliberate though contrasting forms of policy innovation in the past.

In Spain, the demand for private housing was initiated under the dictatorship of Franco with the deliberate intention of social pacification. Indeed, a Minister of Housing in 1957 noted the objective of transforming Spain from a country of 'proletarios' to one of 'proprietarios'. In 1960, rented accommodation accounted for as much as 45.5% of the total number of main residences. The change of policy direction was accompanied by the rapid development of mortgage credit provision. The expansion of access to home ownership may well have helped defuse social discontent during the phase of rapid urbanization in the 1950s and 1960s. The opening up of the Spanish economy, particularly the development of the tourism sector in the 1960s, generated a high level of demand for new construction. These state-led initiatives laid the foundation for a new coalition of social interests that provided powerful subsequent support for policies supporting house-construction.

Social housing was always marginal in Spain, and it remained so. The stock of social rented housing was largely built in the 1950s and 1960s, often using cheap materials to low standards, in the context of large-scale schemes aimed at

facilitating slum- clearance programmes (McCrone and Stephens, 1996). This form of tenure was never the focus of sustained policy initiatives. In 1999, the distribution of the housing stock was as follows: home-ownership, 86% (the highest in EU); private-renting, 12% (the lowest in EU, after Ireland;) social housing, 2%. And yet, against this already near-saturated background, Spain constructed more houses every year between 2002 and 2006 than France and Germany taken together.

The bias toward home ownership was further reinforced by Franco's 1964 Law of Urban Leasing (Ley de Arrendamientos Urbanos). These regulations sought to protect low-income families and pensioners, but created perverse incentives. Owners avoided renting, which partly accounts for Spain's uniquely high level of empty houses. Owners had little incentive to invest in the maintenance of their properties, and institutional investors did not invest in this form of tenure. These patterns were set in place by the time of the transition to democracy, when political transformation generated widespread expectations of even better access to home ownership. During the democratic era, the Boyer Decree (1984), and the more comprehensive reform of the Ley de Arrendamientos (1994), were aimed at deregulating the market while still protecting most vulnerable groups (such as pensioners). Yet in the context of highly inconsistent incentives – for example, the government combined these measures with further fiscal incentives on homeownership – these reforms conspicuously failed to reactivate the already depressed renting market. In the late 1990s, the private rental sector collapsed to around 10%, one of the lowest in Europe (Alberdí and Levenfeld, 1996, McCrone and Stephens, 1996, Trilla, 2001).

Deregulation not only made property ownership more profitable than the rental sector, but it also changed the ratio of rents to mortgages, and thereby further incentivized home purchase. Underlying these developments was a more enduring set of cultural practices, shared between Spain, Portugal, Italy, and Greece, involving strong inter-generational links as the basis of income security in the context of weak welfare state development, deeply-rooted practices of patrimonialism in public life, and simultaneously, weak levels of trust in

government and a corresponding propensity to engage in building activity in the margins of official endorsement (Allen et al., 2004).

In Ireland, the policy dynamic is different but it had similar results. Irish patterns of housing after independence in 1922 departed from the British trend with which it had common origins. In Britain, social housing became a significant element of the total housing stock, especially in the post-World War Two reconstruction period. In Ireland though, the country was not only much poorer, and with a much higher proportion of slum-quality housing, but governments were ideologically much less well disposed toward direct public provision of housing. Owner occupancy grew rapidly during the 20th century, from 54% of households in 1951 to 78% in 1990 (McAllister, 1996, p. 155). Large-scale public housing initiatives were undertaken in the 1930s, the 1950s, and 1970s (and as in Spain, this laid the foundation for long-term alliances between government and construction). But these involved a continuing reliance on the provision of fiscal incentives, cheap public loans, and outright subsidies, to promote the maximum uptake of private house-purchase (O'Connell, 2005). The withdrawal of the state from direct funding from the 1980s onward was replaced by more indirect methods of incentivizing home ownership through tax-based schemes. Strong and continuing demand for private residential housing built up close ties between local governments and property developers, opening up the opportunity to engage in mutually beneficial links, up to and including corrupt financial transactions, over land rezoning, development permits, and construction contracts (Norris and Shields, 2007, Tribunal of Inquiry, 2012, McDonald and Sheridan, 2009, Ross, 2009, Byrne, 2012).

The policy consequences of these measures could be difficult to discern clearly, especially since demand for residential housing in Ireland displayed an upward surge in in the mid-1990s that coincided with the take-off of the economy. The rapidly increasing labour force masked the emergent signs of the boom, since the demand for housing was intensified by Ireland's first sustained experience of inward migration. Thus even OECD commentators stated, at the height of the boom, that 'most of the increase in Irish house prices is justified by the economic and demographic driving forces' (Rae and van den Noord, 2006, p.5).

The bias toward home ownership is ideologically very strongly rooted in both Ireland and Spain, as evidenced by the high proportion of people owning more than one property. Both countries have experienced great difficulty in finding acceptable policy responses to the growth of non-performing mortgage loans in the two countries in the aftermath of the crash. In both countries, massive volumes of public money were poured into the banks to save them from their imprudent lending. While the institutional investors were saved, individual household debtors were afforded no such fiscal privileges. The Spanish banks undertook large-scale measures to recover debts more quickly than in Ireland, and failing this, to repossess houses, including 30,000 family homes in 2012 alone (De Barró, 2013). But this has encountered very widespread social resistance, in the form of social movements such as PAH (Plataforma de Afectados por la Hipoteca). In Ireland, the government imposed a two-year moratorium on the failed banks' repossession of houses early in the crisis. Both the Troika and the Irish Central Bank then began to push the banks to seek to recover more of their outstanding loans. Some 400,000 households were estimated to be in negative equity following a crash of over 50% in house prices by mid-2013. The 'bad loans' ratio was estimated at 25% in Ireland (also 25% in Greece and 11% in Spain in mid-2013). This excludes the large volume of toxic loans that had been removed from the Irish banks into NAMA. About half the loans to the small and medium enterprises sector were estimated to be in arrears in spring 2013, 27% of buy-to-let properties, and 16% of family homes (Hennigan, 2013). But home repossessions in Ireland were extremely politically sensitive, and viewed as something to be avoided, and resorted to only as an extreme measure and as an absolute last resort (Honohan, 2013).

b. Fiscal incentives

The only effective means of managing a housing bubble in the context of monetary union is through strong control over domestic costs. From the early 2000s, in already overheating economies, Ireland and Spain would have had to run very tight fiscal policies in order to counteract the lax monetary policy that was so unsuited to their circumstances (Conefrey and FitzGerald, 2010). But to manage this, they would also have needed to ensure compliance on the part of

the main labour market actors. The nature of industrial relations and the linkages between state and labour market institutions was different in the two countries. Ireland had maintained national-level 'social partnership' framework pay agreements since 1987, while Spain's capacity to develop social pacts was capable of being mobilized in the context of the recurring need for democratic stabilization, but proved to be more sporadic and more ideologically contested (Molina and Rhodes, 2011, O'Donnell et al., 2011). However, the scale of the restraint that would have been required to counter the extraordinarily strong inflationary surges attendant upon cheap money was way beyond the organizational capabilities of the industrial relations systems of the peripheral countries (Regan, 2012, Scharpf, 2011, Armingeon and Baccaro, 2012).

What remains, then, is strong fiscal policy. The nature and composition of the fiscal incentives took a different form in the two countries, which may be understood once again in terms of the path-dependent evolution of tax policy formation.

The budgetary stance of the Irish government during the 2000s was, on the whole, expansionary rather than contractionary, as would have been indicated by a counter-cyclical strategy (FitzGerald, 2012, Bénétrix and Lane, 2012, Kearney, 2012). Large fiscal incentives to home-ownership were left in place for electoral reasons, and only began to be tapered off very late in the boom. Attempts to quell the already over-heating housing market in the late 1990s were reversed soon thereafter. Tax incentives to target investments into particular regions or kinds of activity, such as urban regeneration, or housing in tourism-related seaside resorts, or less-populated regions such as the Upper Shannon, proved very blunt instruments of policy, succeeding only in channelling activity even more strongly into areas with little or no social or economic return (Menelaos and Norris, 2011, Norris and Menelaos, 2011).

Ireland stands out among OECD countries in that it both permits tax relief on mortgage interest and, until 2013, lacked any systematic approach to taxation of residential property. Tax expenditures were available for a wide range of activities, and property reliefs were particularly important (Collins and Walsh,

2010, TASC, 2009, Callan et al., 2005). Spain, along with Portugal and Finland, has similar tax privileges for property at national level, but in each of these cases, municipal taxes are levied on residential property (Rae and van den Noord, 2006, p.8).

A turn toward the simplification of tax policy design in the late 1980s, consistent with the international tax reform movement, was only partially adopted by the policy-making establishment. Politicians continued to use tax measures to incentivize, stimulate, and target particular activities, often in poorly-designed ways and with poorly-understood consequences (Christensen, 2012, Collins and Walsh, 2010). Governments of both centre-left and centre-right pursued somewhat different priorities within the tax system, but the basic approach was quite consistent across governments.

However, it was the dominance in government of the large populist centre-right Fianna Fáil party between 1997 and 2011 that tilted the taxation system in a direction that intensified the property boom. During a period of exceptional growth, it proved possible to take in strong revenues, while also engaging in populist tax-cutting measures. The rates of taxation were reduced and simplified over time; capital gains tax was halved in 2002; and tax reliefs to low-paid earners were delivered in the form of removing them from tax liability altogether. This was pursue to the extent that, when the bubble burst in 2008, about 40% of employees were paying no income tax whatsoever. The progressive erosion of the tax base was masked by the extraordinary revue flow coming from construction activity, a short-term advantage on which long-term spending commitments were undertaken (Hardiman, 2004, Honohan, 2010). Once the bubble burst, revenues plummeted, further revealing the extent to which economic activity in general and revenue flows in particular had become over-reliant on construction activity. Meanwhile, the trajectory of spending commitments continued upward, further boosted by the new welfare demands for transfer payments. And yet, while the cost of rescuing the banking sector in Ireland has been enormous, the size of the fiscal deficit that opened up during the crisis is only partially accounted for by burdening the state with private debts. Some two-thirds of the deficit is accounted for by the shortfall in the

state's capacity to fund itself, as trends in revenues and expenditures diverged sharply. By November 2010, Ireland's capacity to fund itself had reached crisis point, and it was obliged to enter the EC-ECB-IMF loan programme.

In Spain, strong fiscal incentives underpinned the rapid evolution of owner-occupied housing, and these were sustained throughout the democratic era. Often, policy decisions were at odds with one another. For example, in the mid-1990s, while the right-wing PP government was trying to liberalize the private rental market, it also eliminated the subsidies for renting and increased the fiscal incentives for the purchase of houses (Alberdí and Levenfeld, 1996, McCrone and Stephens, 1996). The effective subsidy on house purchase ranged from 20% to 50% of the total price during the 1990s, with a fiscal cost of around 2% of GDP, which was the highest in Europe. Moreover, the distributional pattern of this policy was perverse, and resulted in a U-shaped curve whereby groups on low and high incomes benefited disproportionately. We may note that this further helped governments build a broad-based populist coalition behind home ownership. Successive fiscal reforms in the late 1990s sought to reduce effective subsidies, but the system remained strongly biased towards the development and purchase of new residences. In any case, the easing of borrowing constraints due to declining interest rates and financial innovations more than compensated the effects of the fiscal reforms (Montalvo, 2002). Well into the boom, in 2004, most of the key economic advisors to left-wing (PSOE) prime minister Zapatero suggested the removal or at least a reduction in the notably generous tax reliefs on the purchase of houses. He was very unwilling to do this, as it would have been electorally very unpopular (Montalvo, 2007). Some were indeed later withdrawn, but at the worst moment, after the bubble had already burst.

In Spain, as in Ireland, we note a highly pro-cyclical trend in the use of fiscal stimulus, and a similarly marked unwillingness to withdraw them until it is, in effect, too late to take the heat out of the situation. In both countries, the pro-cyclical bias in the fiscal incentives for home ownership further contributed to building up close relationships between governments, bankers, builders noted above. Boosting construction is an easy way to stimulate an ailing domestic economy. The scale of the fiscal incentives provided to construction activity is

striking in both Spain and Ireland. In both cases, the incentives were both poorly targeted and mis-timed in relation to the scale of construction activity. In both countries too, the incentives to construction were explicitly meant to encourage speculative investment in housing, in the name of stimulating the private rental sector. This boosted the already well developed tendency in Spain for households to purchase a second property, often a holiday home in a tourism region; and it promoted a whole new class of Irish purchasers to enter the market, often with the explicit intention of investing in property as a means of boosting pension income through the anticipated flow of rental income. 'New buy-to-let mortgages constituted 20% of all mortgage transactions in 2004 while 30% of second-hand dwellings sold during the first half of 2004 were previously held as investment properties… (I)n 2005, around 15% of homeowners aged 35-54 owned a second home (Rae and van den Noord, 2006, pp.18-19).

In Spain, as in Ireland, a growing proportion of tax revenues came from housing transactions, which had a similarly paradoxical effect. Buoyant revenues from the booming construction sector – through income taxes, taxes on development activity, and sales and other taxes associated with the sale and transfer of property – postponed the need to examine the underlying robustness of the apparently stable public finances. The PSOE maintained a strong commitment to spending on the welfare state. But over-reliance on the performance of construction gave rise to growing fiscal vulnerability.

In both countries, the politics of right and left alike converged on a preference for satisfying the broad social coalition of support for owner-occupancy. But the problems were not fundamentally fiscal – and therefore are unlikely to be resolved by adherence to stricter fiscal rules – but rather follow from the extraordinary 'demand shock' in their national economies the followed from the ready availability of cheap money (Gaulier et al., 2012).

c. The banks that got out of control

In both Ireland and Spain, the proximate cause of the disaster that befell the financial system was the development of extremely risky lending practices on

the part of the banks, and the utter inadequacy of the regulatory oversight system to identify what was happening or to intervene to put a halt to it.

Here again we find that Ireland and Spain reached the same point, but through different institutional and political channels. In the Irish case, the issue was a naïve and uncritical acceptance of the efficient market hypothesis, and excessive trust on the part of the policy-makers in government, the Central Bank, and the Financial Regulator's office, that the banks knew best how to run their own business. They explicitly sought to emulate the British practice of light-touch, principles-based regulation, the better to be able to entice inward investment on the part of foreign and especially British-based branches of firms in the traded financial services industry. But in effect, light regulation meant no regulation (Lewis, 2011, Clarke, 2009, Clarke and Hardiman, 2012). Evidently, earlier experiences of banks that had got out of control did not provide enough of a warning – for example, Allied Irish Bank had needed public funding to rescue it in 1985, when its wholly-owned subsidiary, the Insurance Corporation of Ireland, collapsed in the wake of poor management decisions and failure to maintain adequate reserves. Moreover, in 2001 the major banks had been found to be colluding to assist depositors to avoid tax liabilities in Ireland (Public Accounts Committee, 2001).[4]

This time round, the Irish banks behaved no better. Faced with strong incentives to compromise on prudential lending and cautious risk assessment, they capitulated with relatively little resistance. As one of the recent official reports on the banking crisis noted: 'Overwhelmingly the most important issues to investigate are those that seem to have involved very serious specific breaches of corporate governance… (The second set of issues) concern breakdowns in risk management approaches and in some cases the unwarranted or excessive overriding of internal guidelines' (Regling and Watson, 2010, p.45).

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[4] But many senior politicians had been similarly engaged in illegal offshore concealment of bank deposits through the 'Ansbacher' scheme, discovered by the Moriarty Tribunal on corrupt payments to politicians. Moriarty, M. (2011) Report of the Tribunal of Inquiry into Payments to Politicians and Related Matters. Dublin.

In Ireland, two big commercial banks had long engaged in a form of duopoly. Until the mid-1980s, there was a range of mortgage providers: lending was dominated by mutual building societies, and by public sector lending to low-income households. From 1987 onward though, banks moved more vigorously into the lending market. The direct role of the public sector in mortgage lending all but disappeared. New entrants to the Irish market (especially the Royal Bank of Scotland) raised the stakes. For the first time, 100% loans were extended to first-time purchasers.

Meanwhile, two institutions – Anglo Irish Bank, and the Irish Nationwide Building Society – began to engage in much more aggressive property lending to developers. As it turned out, these loan decisions were very poorly monitored and not well secured against identifiable assets, or even secured at all. But in a boom economy, the practice was highly profitable, on paper at least. The other banks came under mounting pressure from their own shareholders to emulate these practices. The feedback circle was closed by the personal as well as political links between Fianna Fáil politicians, developers, builders, and key bankers (Clarke and Hardiman, 2012).[5]

In Spain, in contrast, the banking system involved close networks of highly embedded banks. Liberalization and deregulation did not result in keener competition in the market (Perez, 1999). Moreover, much of the credit allocation for private housing took place through local cajas, which were highly politicized. Unlike Ireland, it was not unregulated market competition and the drive for profit that drove the surge in risky lending practices. But like Ireland, the whole

[5] It should also be noted that the political control of banking, and corrupt links between banks and politicians, are not solely the preserve of the Eurozone 'periphery'. Just as Spain's cajas are politically controlled, about 45% of Germany's banking industry is in public hands, quite apart from the stake taken by the government in major banks in the course of their bail-out. The state banks or Landesbanken are typically owned by state governments and local institutions, and about 400 Sparkassen or local savings banks are controlled by state and municipal politicians. Both banking sectors have 'a long history of corruption and mismanagement' – Ewing, J. (2013) In Germany, Little Appetite to Change Troubled Banks. *New York Times.* New York., 9 August.

financial system had very close ties with the political system. And like in Ireland, it was the unusually high levels of credit availability that tipped the system over the brink. Cheap and easy access to credit altered the incentives to lenders and borrowers alike. Financial deregulation, consolidated by EU accession and then the creation of the euro, not only led to lower and more stable interest rates, but also facilitated mortgage market sophistication and financial innovations (André, 2010, pp.19-20). This significantly eased borrowing constraints on borrowers. As in Ireland, new lending practices involved products never before seen, such as the emergence of 50-year loans. Combined with generous tax incentives, the 'wealth effect' was enormous, and borrowers were willing to take on hitherto unconscionably large debt burdens, just as lenders were willing to extend them, in the expectation that the value of assets would increase indefinitely. Except, of course, that they did not (Palma, 2009).

5. Conclusion and implications

The consequences of the collapse of the housing bubble, and the wreckage of the banking system, have been devastating right across the developed world, but they have been particularly severe in Ireland and Spain. The Irish bank rescue has been exceptionally onerous for the Irish state. The total volume of public funding that has been channelled into the banking sector in Ireland amounts to about €65bn, or about 45% of GDP. Spain avoided having to enter a loan agreement, but has required bank recapitalization through the European Stability Mechanism. In both countries, the banking system was only kept afloat through the availability of long-term liquidity from the European Central Bank, and in both countries, there are still major undisclosed losses that may result in the banks' requiring further recapitalization.

This paper set out to examine how, in two countries that have very different political and financial systems, but which are similarly situated in a broader European context, both Spain and Ireland came to exhibit very similar responses to the shared incentive structure, and produced very similar kinds of policy outcomes. We tracked the comparative dimension of their shared experience,

and sought to set out the underlying politics through which, in different contexts, the same end-point was reached.

The inadequate institutional architecture of EMU meant that lenders were no more constrained than committing to unsustainable credit extension than were borrowers from taking this up. The dynamics of growth in the 2000s, stemming from the wider European political economy context, 'trumped' national capacity to resist. The structural situation of countries that are 'peripheral' to the well-developed and well-diversified richer countries in Europe – late industrializers, with a poor capacity to absorb new sources of investment – shared an unexpected common vulnerability to the new circumstances of financialization. While speculative bubbles have always been a feature of capitalism, the most recent phase of asset price inflation centred on housing has two additional features. Firstly, it must be understood the context of the liberalization of capital that started in the mid-1980s and the surge of financialization that took place across Europe since the mid-1990s. Secondly, it can plausibly be understood not as an exceptional experience, but as a phenomenon that is itself the consequence of growing national vulnerabilities as a result of the 'unholy marriage of unlimited liquidity and limited asset classes' in the world economy since the 1980s (Blyth, 2008, p.388).

The scale of the crisis that engulfed Ireland and Spain also had deep domestic roots: things did not have to be quite this bad. The national policy weaknesses that predisposed both Ireland and Spain to crisis were embedded in a deeper domestic political economy context. If risk management was the key, it was not something domestic political institutions were well equipped for.

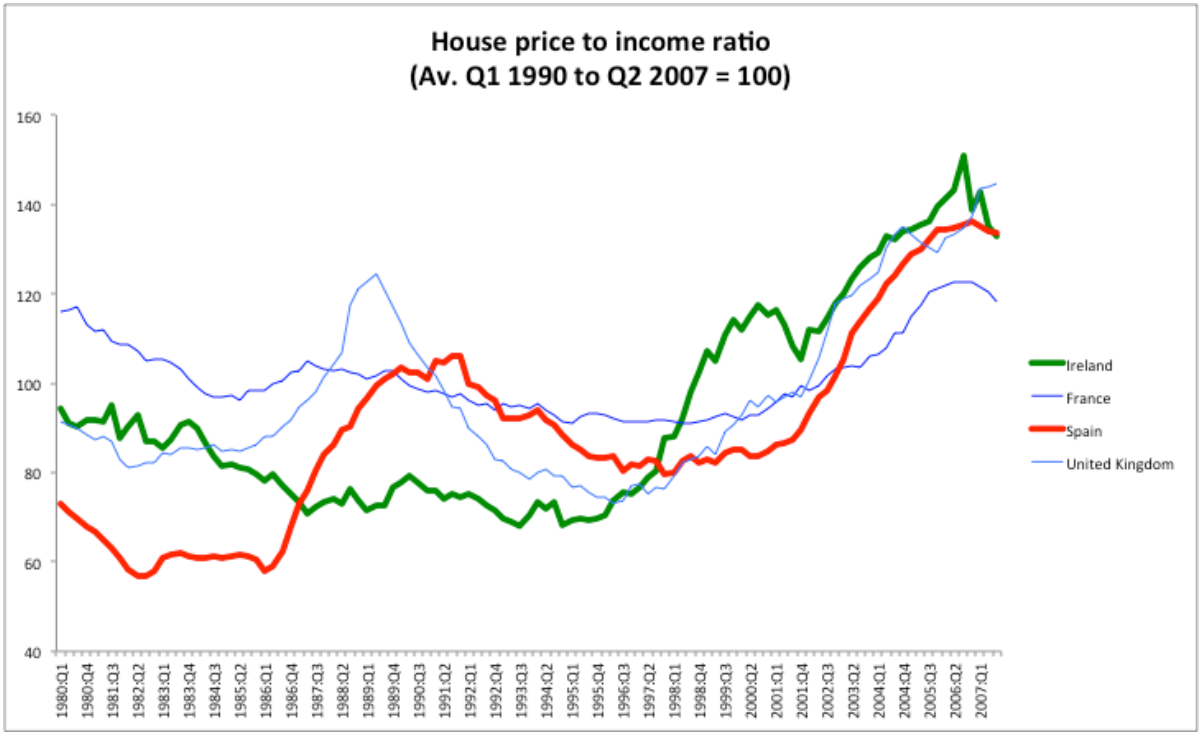
In conclusion, we are perhaps used now to think in terms of the vulnerability of small economies in the teeth of financialization (Darvas, 2011, Schwartz, 2011), but it should also be clear that the issue is not just one of small size, nor even of the extent of financial leveraging. It is also a matter of the relative size of the financial sector in the overall economy (Moghadam and Vinals, 2010), a problem to which we argue late-industrializing economies with poorly diversified economic activity are particularly prone. Peripheral economies in a monetary

union, it is now clear, are advised to be extremely vigilant about the hazards emanating from the international environment.

Figure 1. Most-different case study design: Ireland and Spain

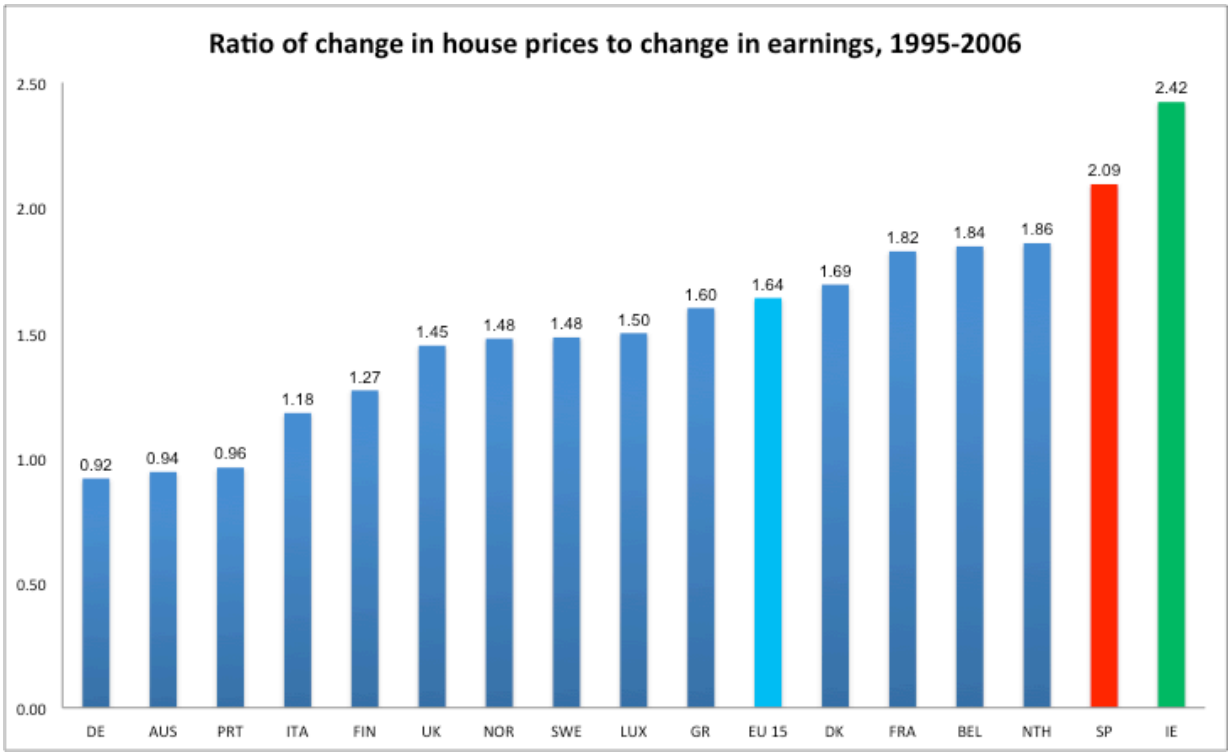
	Similar causal factors	Different mediating conditions: growth models and underlying politics	Same outcomes
Ireland	Late industrialization; low interest rates in the context of European integration	Liberal market economy	Asset price inflation, housing bubble
Spain	Late industrialization; low interest rates in the context of European integration	Mixed market economy	Asset price inflation, housing bubble

Figure 2. House price to income ratio, Ireland and Spain



Source: OECD Economic Outlook database, sourced from (OECD, 2008, p.43, Figure 2.1)

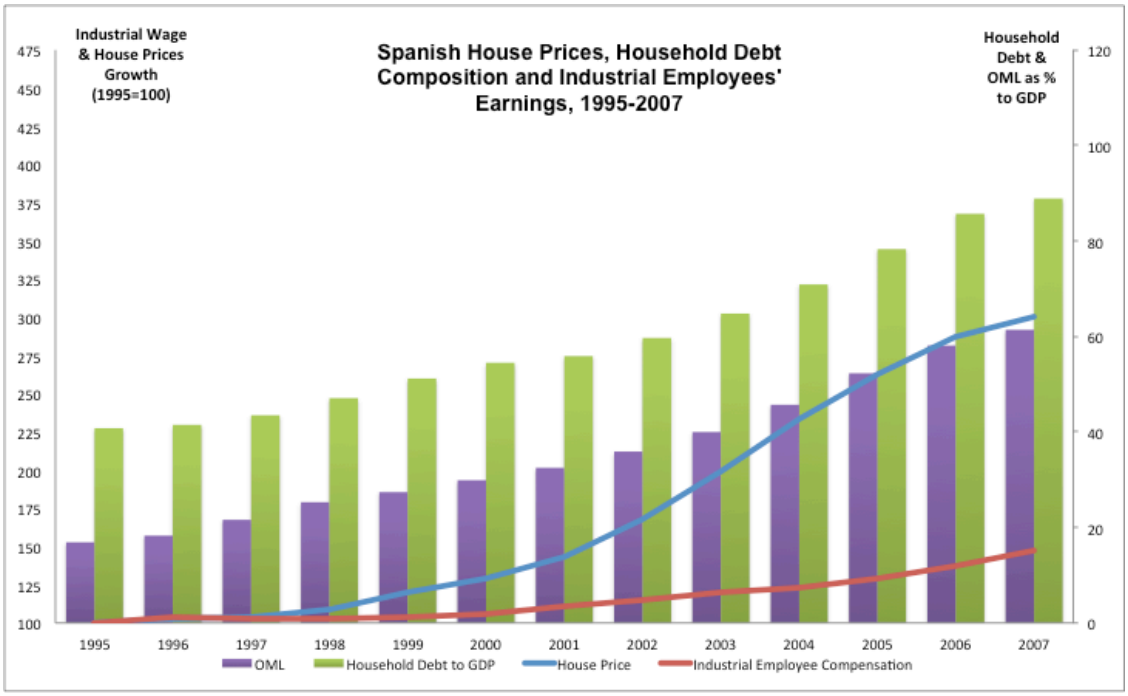
Figure 3. Ratio of change in house prices to change in earnings, 1995-2006



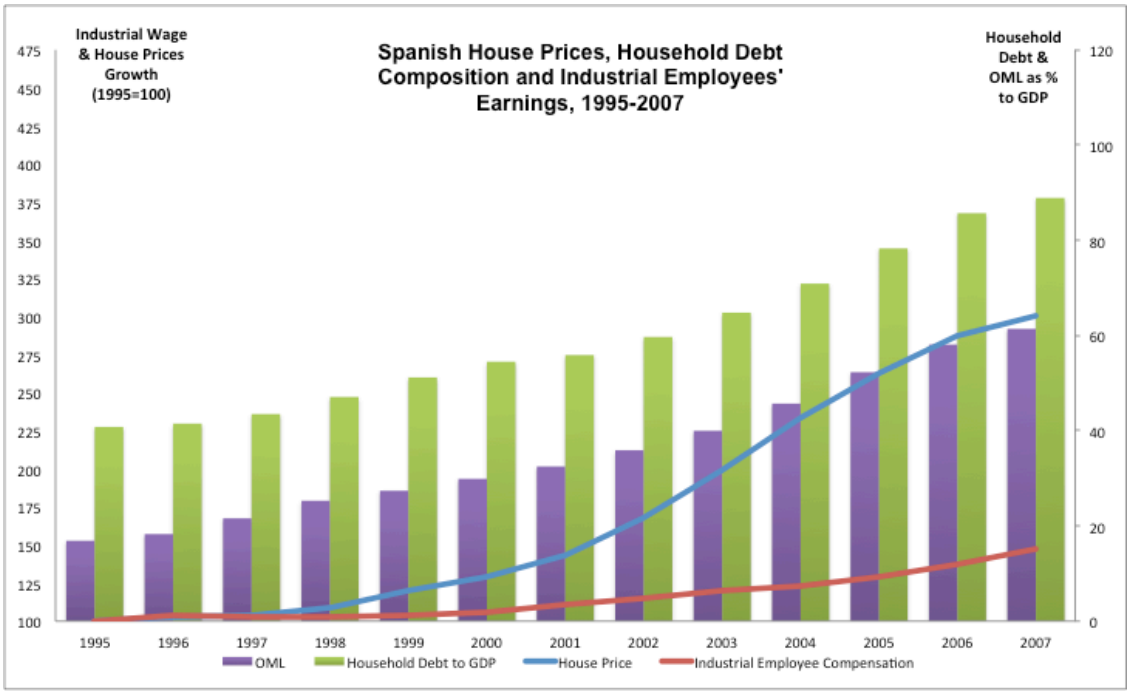
Source: European Mortgage Foundation, EU AMECO

Figure 4. House prices, outstanding mortgage loans, household debt, and earnings: Spain, Ireland, Portugal, Netherlands, Germany, EU15

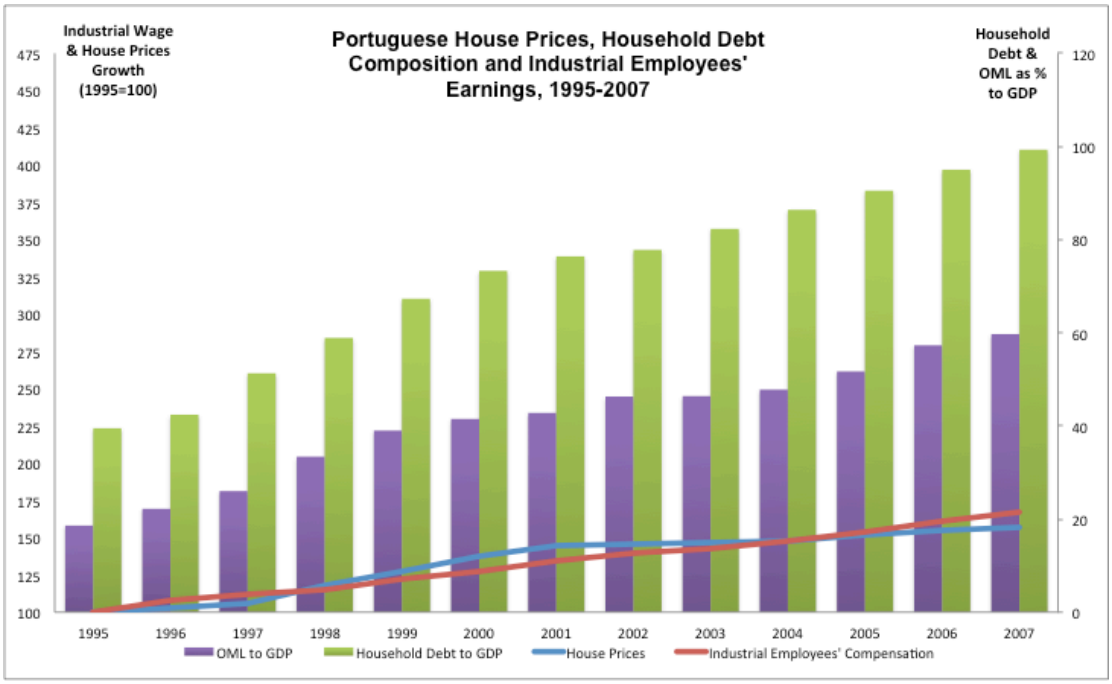
a. Spain



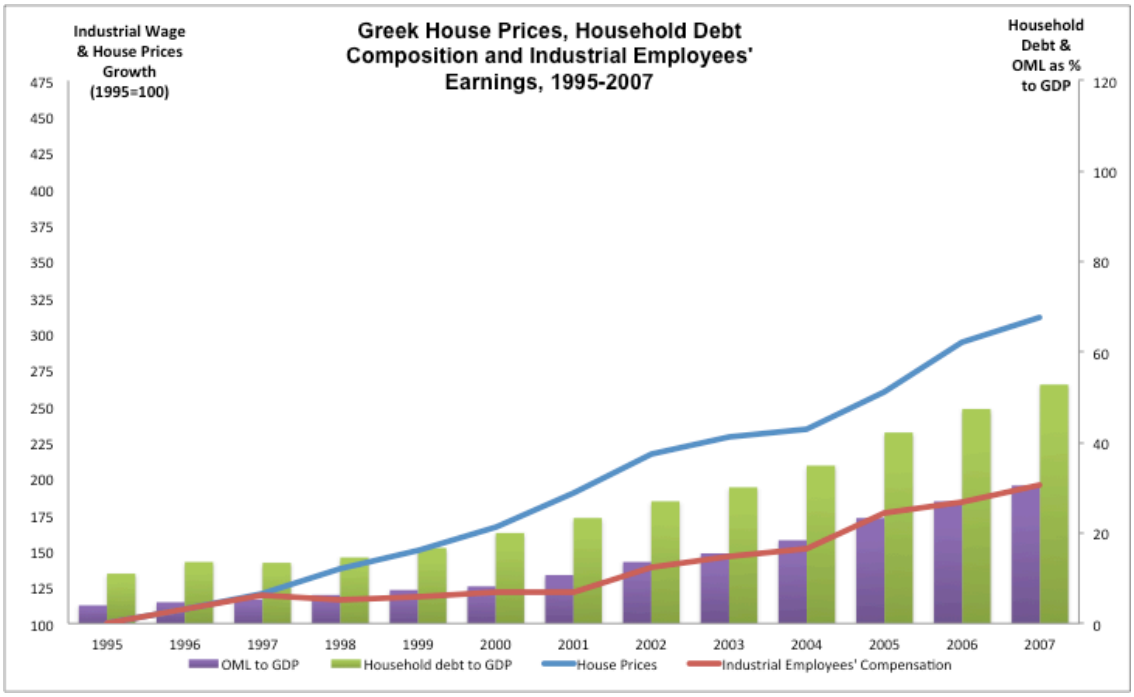
b. Ireland



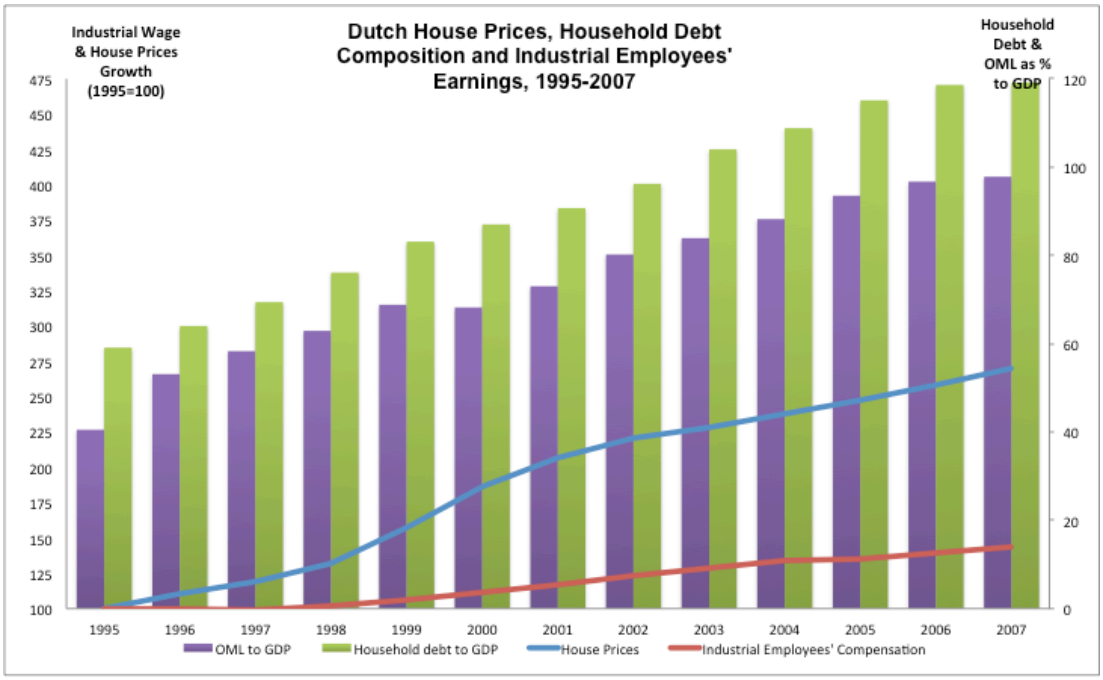
c. Portugal



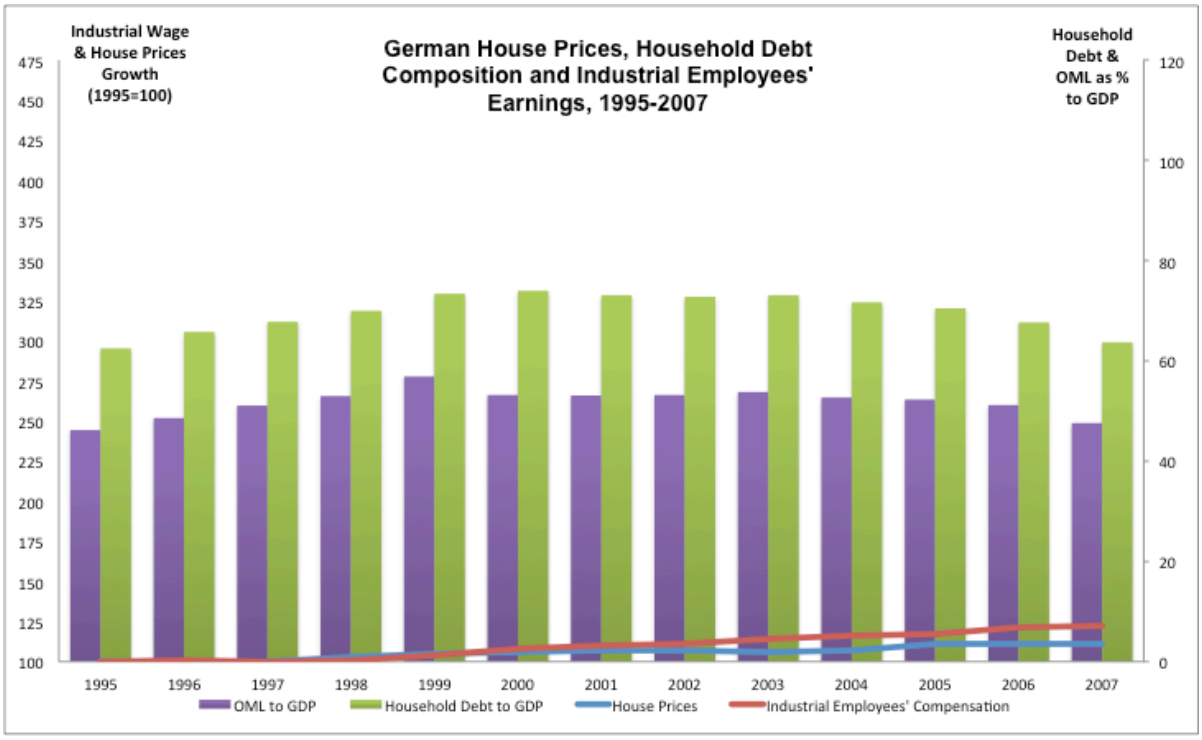
d. Greece



e. Netherlands



f. Germany



g. EU15

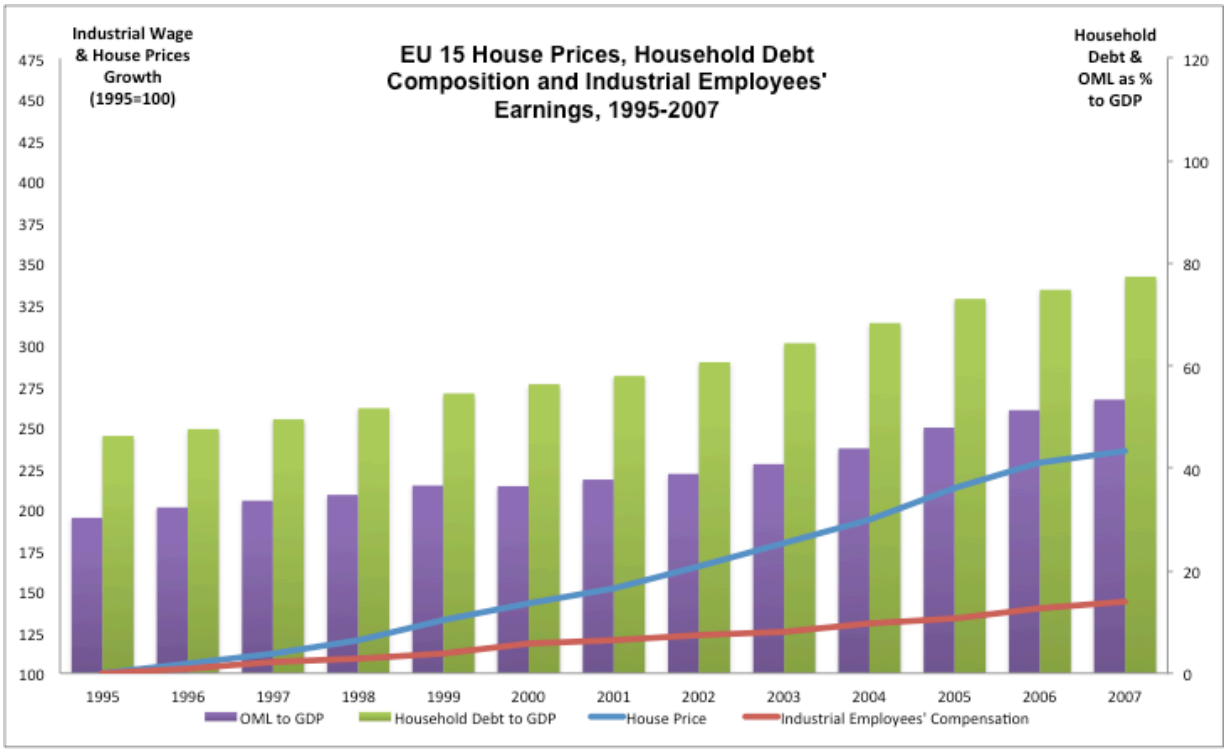
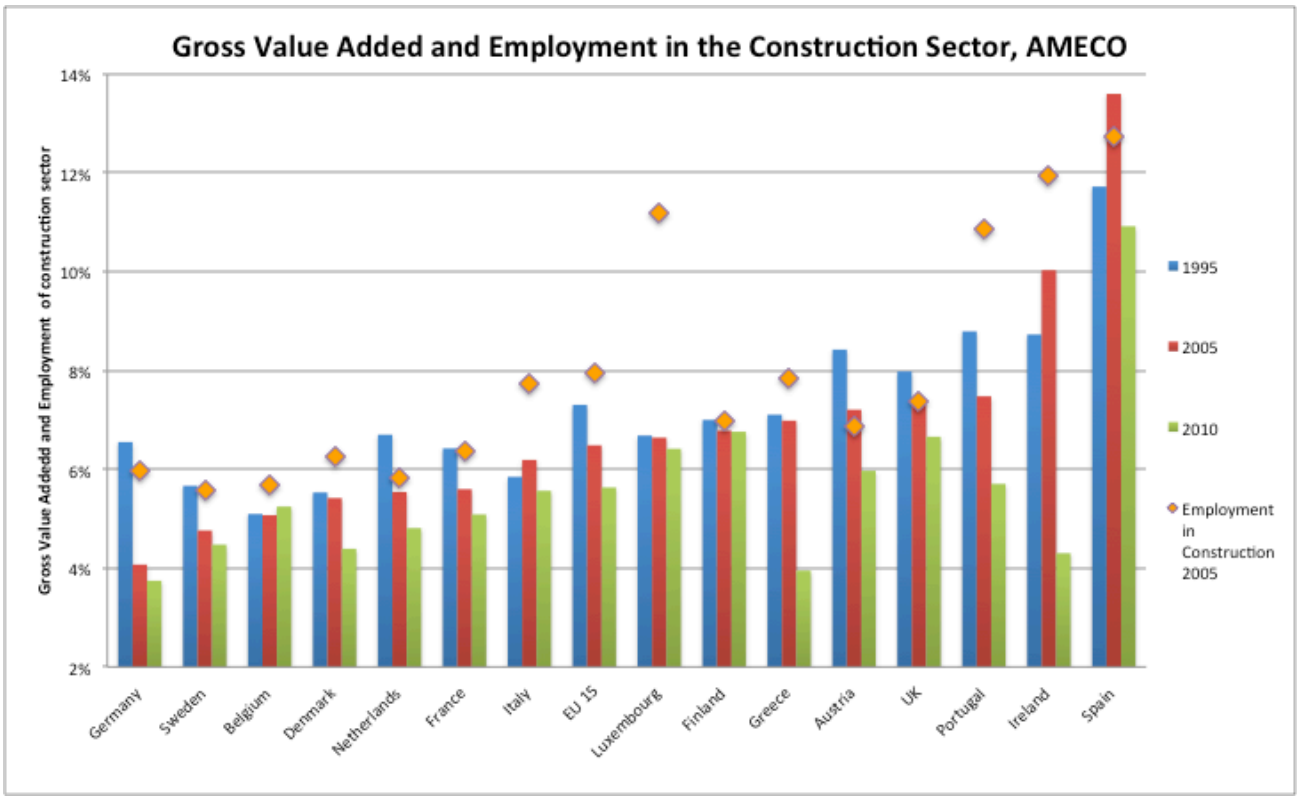
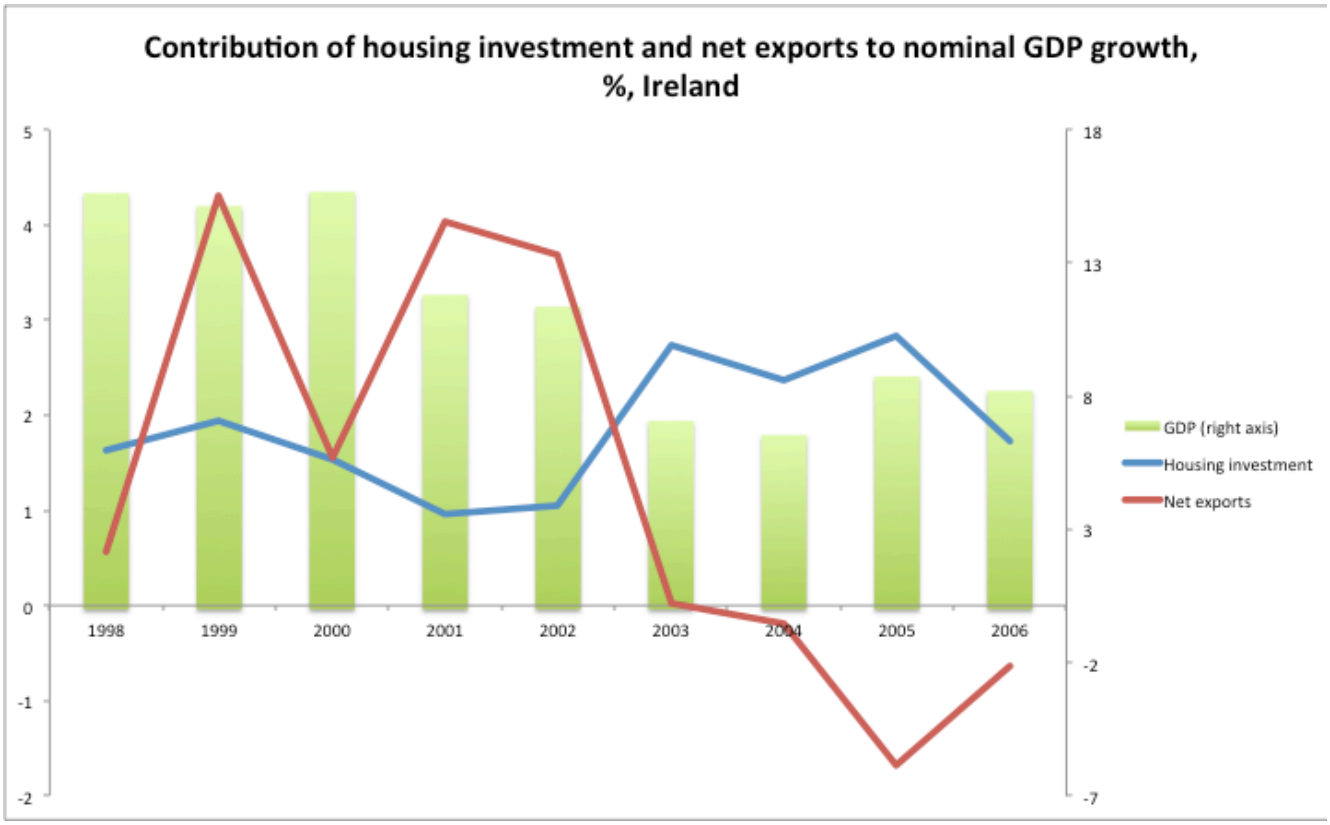

EU 15 House Prices, Household Debt Composition and Industrial Employees' Earnings, 1995-2007
Industrial Wage & House Prices Growth (1995=100)
Household Debt & OML as % to GDP
475
450
425
400
375
350
325
300
275
250
225
200
175
150
125
100
120
100
80
60
40
20
0
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
OML to GDP
Household Debt to GDP
House Price
Industrial Employees' Compensation

Figure 5. Gross value added and employment in construction, 1995, 2005, and 2010



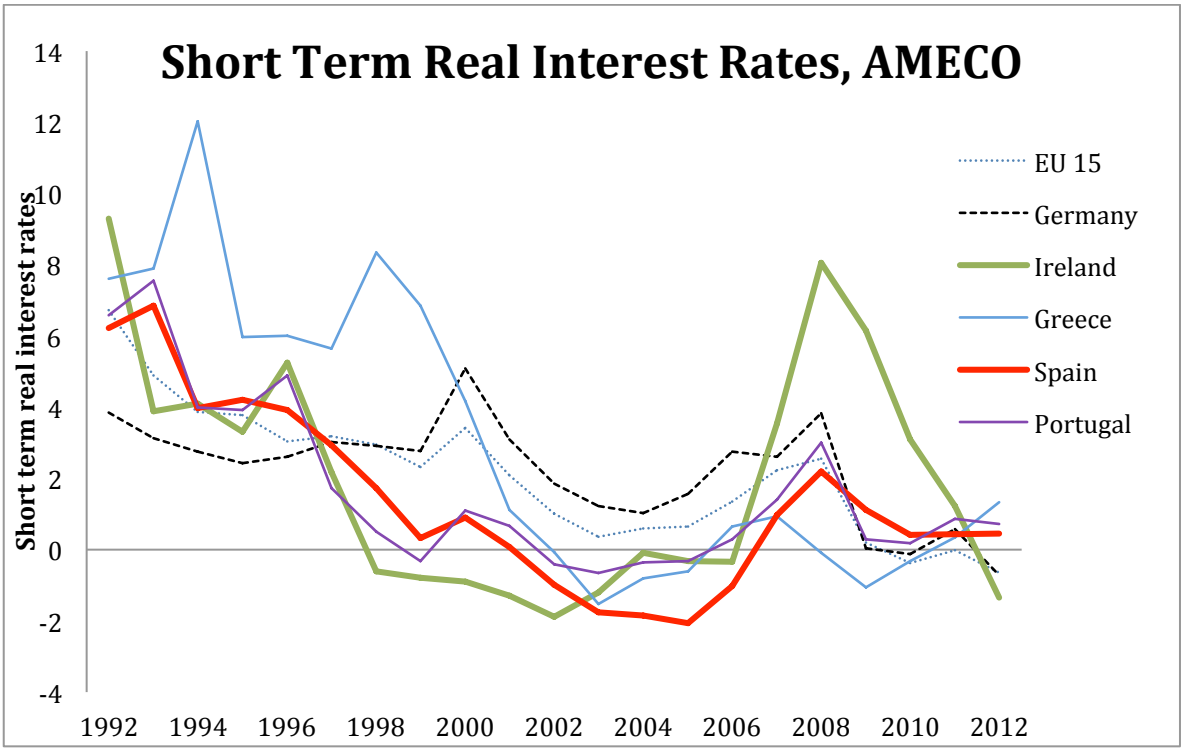
Source: EU AMECO

Figure 6. Housing investment and exports as a proportion of nominal GDP growth in Ireland, 1998-2006



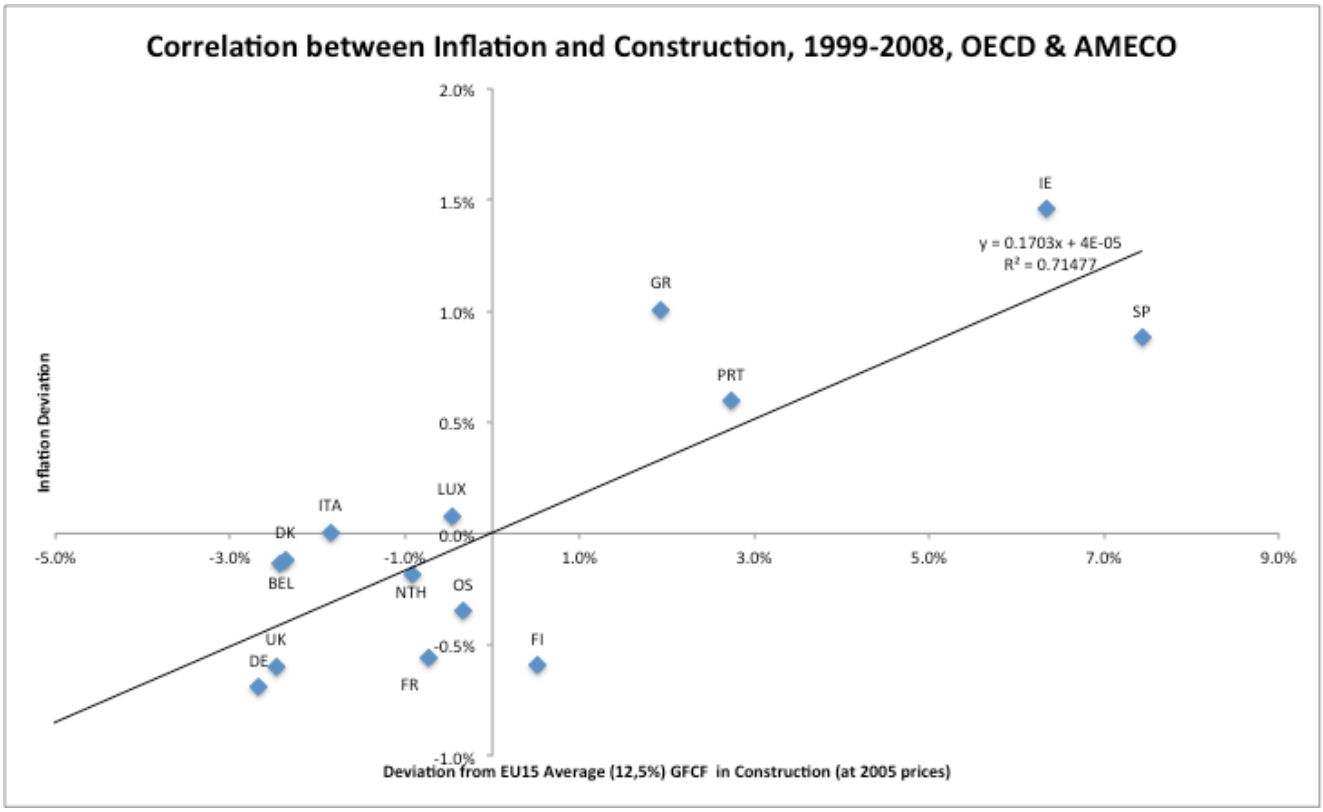
Source: (OECD, 2008)

Figure 7. Short-term real interest rates



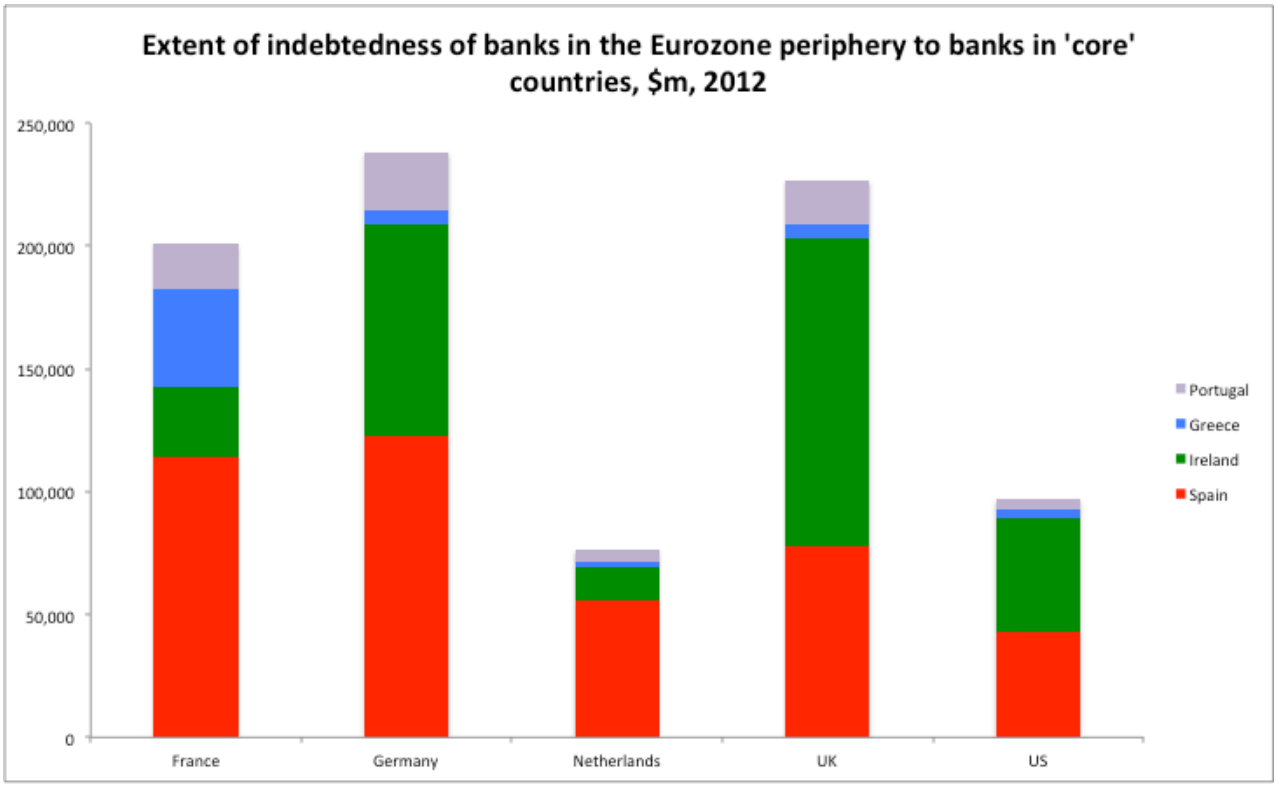
Source: EU AMECO

Figure 8. Inflation and construction: deviation from EU15 average, 1999-2008



Source: AMECO and OECD

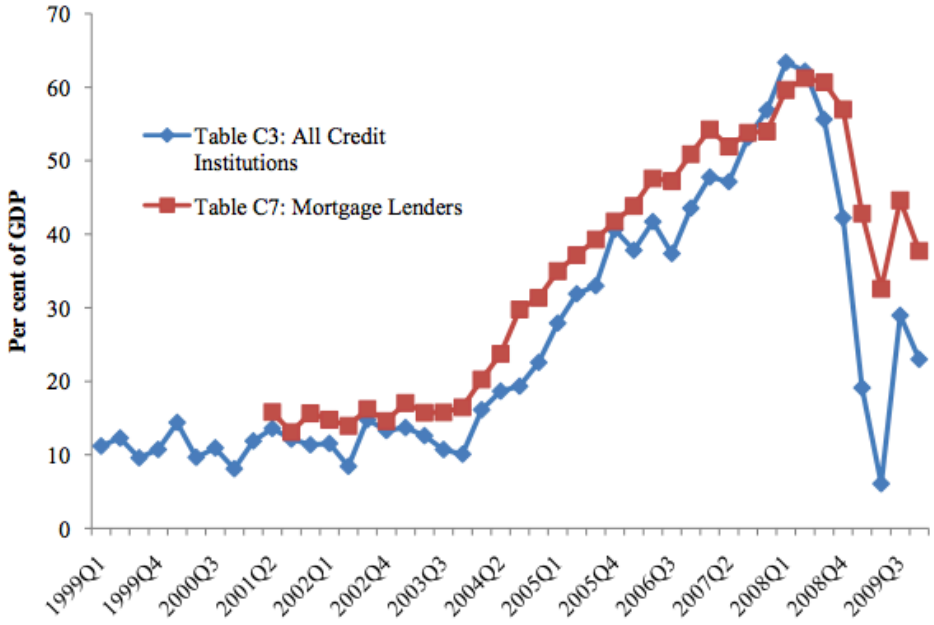
Figure 9. Credit availability and exposure of 'core' European banks to banks in the Eurozone periphery



Source: Bank of International Settlements

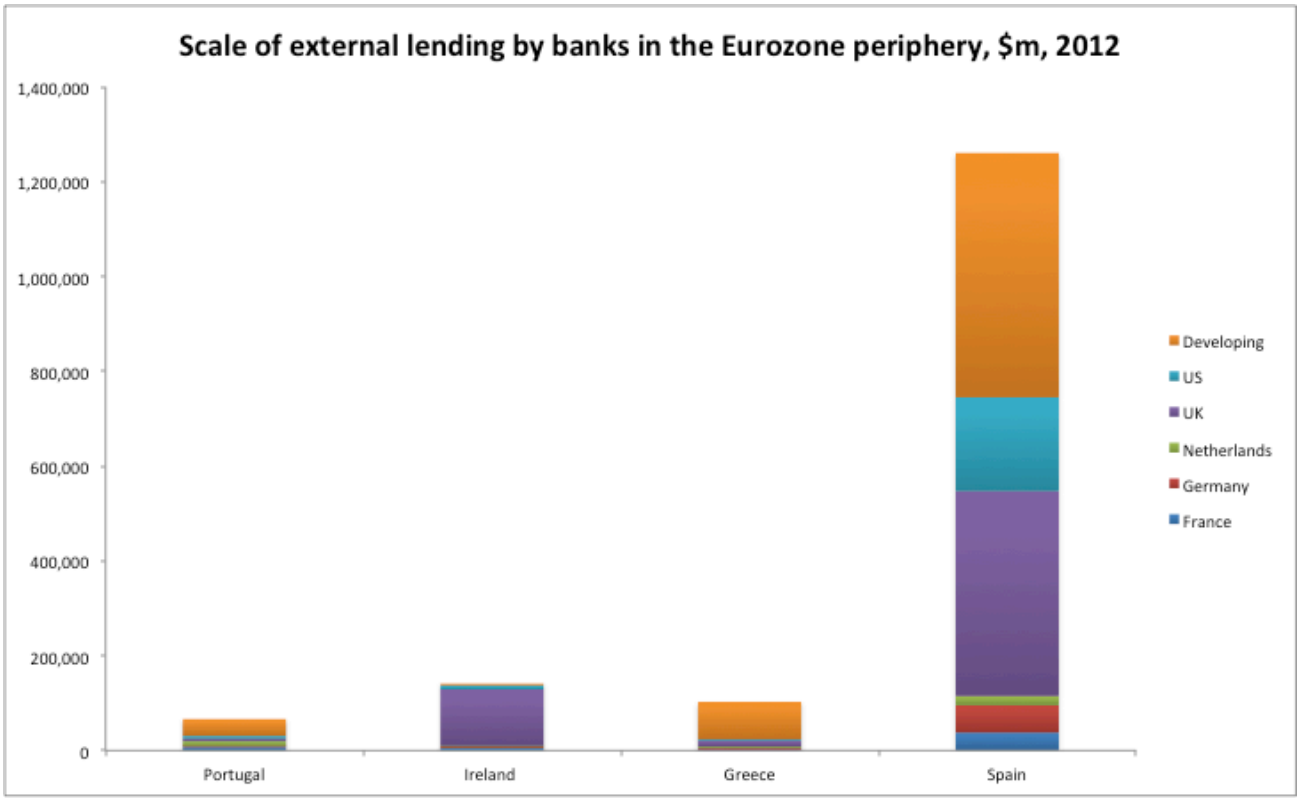
Note: Irish data over-state banks' external financial liabilities because they include data from the International Financial Services Centre, which includes subsidiaries of foreign-owned banks, and financial institutions other than the six commercial banks that were covered by the 'blanket guarantee' introduced in September 2008.

Figure 10. Stock of net borrowing of Irish resident credit institutions from abroad, 1991-2009



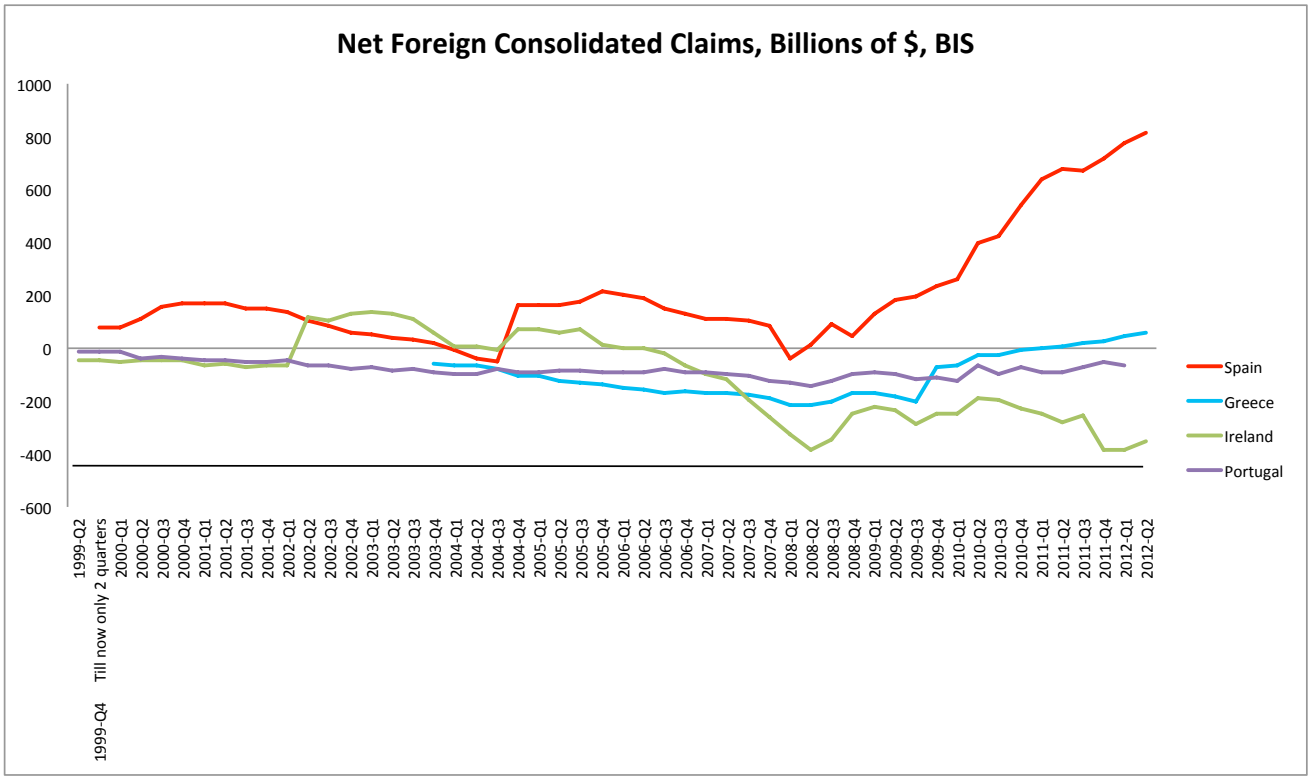
Source: (Honohan, 2010, p.27).

Figure 11. External lending by banks in the Eurozone periphery



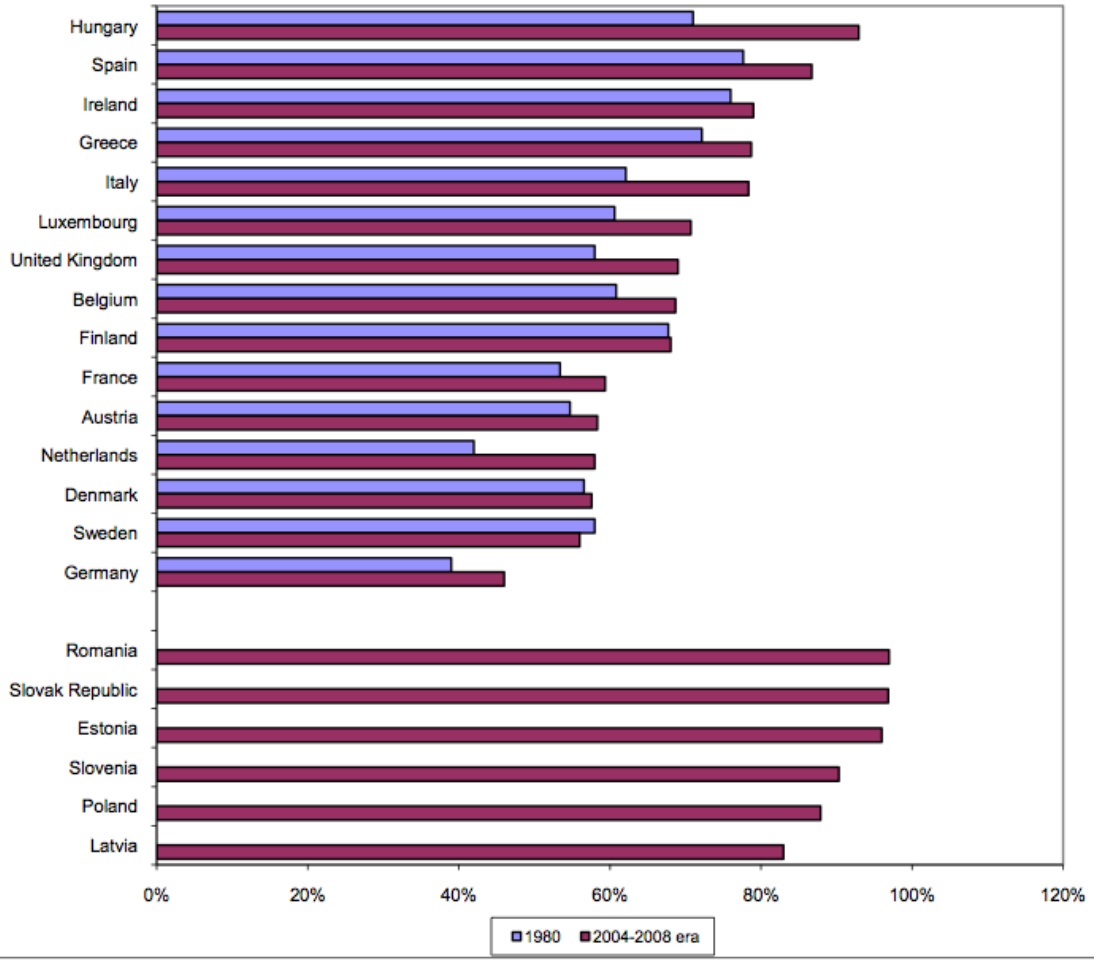
Source: Bank of International Settlements

Figure 12. Net claims of the banks in the Eurozone periphery on the rest of the world, 1999-2012



Source: Bank of International Settlements

Figure 13. Home ownership in the EU, 1980 and 2010



Source: (European Commission, 2010, p.66)

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