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Financial resource curse in the Eurozone periphery

Sebastian Dellepiane-Avellaneda[a], Niamh Hardiman[b] and Jon Las Heras[c]

[a]School of Government and Public Policy, University of Strathclyde, Glasgow, UK; [b]School of Politics and International Relations, University College Dublin (UCD), Belfield, Dublin, Ireland; [c]University of the Basque Country (EHU), Bilbao, Spain

ABSTRACT

The housing booms and busts in Ireland and Spain were among the most striking episodes of the Eurozone crisis. While asset price inflation and financialization of housing was gathering pace across the developed world, these two 'most different' cases converged on the same outcome as the most extreme forms of construction-based bubbles. The key contributions of this paper are threefold. Firstly, we show how cheap credit can be understood as analogous to a natural resource such as oil: resource abundance generates a 'paradox of plenty' whereby an asset becomes a liability. Secondly, we open the black box of political pathways through which this happens, expanding our understanding of how perverse outcomes are produced. Thirdly, we account for why Spain and Ireland were more susceptible to extreme outcomes than other European countries, thereby extending our understanding of asymmetries in the political economy of the Eurozone.

KEYWORDS

Financial resource curse; pathways from the periphery; housing bubbles; growth models; Spain; Ireland; Eurozone crisis

1. Introduction

The legacy of the policy failures of the Eurozone crisis and the huge politico-economic dislocations it generated are still very much with us ten years on. In spring 2020 Covid-19, the largest and most severe pandemic in a century, swept across countries in which economic recovery was still fragile. Social cohesion and the channels of political representation in many European countries were already under huge stress. In these circumstances it is really remarkable that European leaders were able to coordinate agreement on economic assistance packages far more rapidly than during the Eurozone crisis. But many problems persisted, and post-crisis policy tightening may yet prove once again to be the engine of variation in countries' growth potential (Johnston & Regan, 2018).

CONTACT Niamh Hardiman Niamh.Hardiman@ucd.ie School of Government and Public Policy, University of Strathclyde, Glasgow, UK.

The interface between national policy choices and the incentive structures of the international political economy remains a topic of enduring importance for the discipline. This paper contributes to debates on the European political economy by revisiting a key episode, the politics of housing booms in Ireland and Spain in the run-up to the global financial crisis in 2008. Our research asks why Ireland and Spain experienced such a pronounced housing bubble. The aim is to look more closely at pathways through which international developments are mediated by national institutions. We believe that debates about the future of European Monetary Union (EMU) and indeed of the EU itself need to engage more deeply with the continuing relevance of core and periphery in countries' adaptive responses to new challenges. The policy lessons for our current situation, we believe, are surprisingly timely.

Housing bubbles were a common experience in the early twenty first century as the glut of accumulated reserves in wealthy countries – a 'wall of money' (Aalbers, 2016) – sought out investment opportunities with good returns and found them through the newly liberalized and deregulated outlet of residential financialization. Spain and Ireland had very different political economy frameworks and had followed divergent development trajectories, yet they ended up with outcomes that make them European outliers. A fresh look at these experiences can teach us important lessons not only about how to buffer against shocks that have their roots in the good times, the better to withstand the bad times when they come, but also about some deeper structural features of peripheries in a world of financialized globalization.

It is by now widely acknowledged that the smoothing of countries' international credit risk profiles after they'd signed the Maastricht Treaty in 1992 was the ultimate source of divergent experiences for core and periphery states. States in the Eurozone periphery gained in international credibility and, therefore, borrowing capacity. Interest rates were set for larger countries with low inflation propensity. This facilitated a flood of cheap credit to the periphery that led to the build-up of unsustainable booms. But then these periphery states were fatally exposed to the devastating effects of a 'sudden stop' (Baldwin & Giavazzi, 2015; De Grauwe, 2020; Dellepiane-Avellaneda et al., 2018). Scholars of comparative capitalism have shown that crisis could push countries featuring different 'varieties of capitalism' – where Spain is a Mixed Market Economy and Ireland a Liberal Market Economy – into the same debtor-country boat (Dellepiane-Avellaneda & Hardiman, 2015; Frieden & Walter, 2017; Nölke, 2016).

And yet there has been 'little honest reflection with the European Commission' about what happened and why, and many policy lessons may still be learned (Tooze, 2020). Our question is about the policy and political dynamics connecting the enabling conditions ('easy money') and the outcome of interest (extreme housing booms and busts). Relatively little attention has been accorded to the institutional and political channels that link them. Our aim is to open this 'black box' to show how the connections work, to show why they played out in Spain and Ireland more extremely than elsewhere, and to draw out some important strands of policy learning.

We argue that the sudden access to cheap credit, or easy money, is analogous to the experience of the 'paradox of plenty' generated by natural resources such as oil or gas (Auty, 1993; Karl, 1997; Ross, 1999). This is not quite the same thing as the phenomenon of financialization understood as the accumulation of financial asset value in preference to wealth creation through production of goods and services (Fernandez & Aalbers, 2020, p. 680). Financialization has been defined as 'the increasing dominance of financial actors, markets, practices, measurements, and narratives at various scales, resulting in a structural transformation of economies, firms (including financial institutions), states, and households' (Aalbers, 2016, p. 2), which is rather precisely what Shaxson calls a 'finance curse' (Shaxson, 2019). But by conceptualizing finance as a 'resource curse', we can develop analytical tools to investigate the disruptions following from the paradox of plenty that we normally associated with natural resource wealth, particularly in oil states. Hence 'financial resource curse': the counterintuitive observation that resource abundance may lead to economic and eventually governance problems, and function as a curse rather than the expected blessing.

Oil curse scholarship tells us there are three mechanisms through which a resource curse disrupts and even corrupts development (Benigno et al., 2015; García Santana et al., 2016): economic (policy priorities change), political (the quality of governance declines as a result of shifts in decision-making practices, supported by shifts in electoral coalitions), ideas (a shift in shared cognitive frameworks distorts perceptions). This approach offers surprisingly rich insights when applied to the financial resource curse.

We demonstrate that Spain and Ireland self-select as outliers in the scale and significance of their respective housing bubbles. We then engage in a within-case comparison of the two countries: this comparative paired case study research design delivers insights into the wider phenomenon and gives additional analytical leverage in explicating the processes underlying the observed outcomes of interest (Gerring, 2017; Goertz & Mahoney, 2012; Seawright & Gerring, 2008).

The rest of the paper proceeds as follows. Section 2 makes the case that the Irish and Spanish housing booms converge as extreme cases in Europe. Section 3 draws analytical insights from the resource curse literature. Section 4 applies the three explanatory variables to the two case studies. Section 5 broadens the comparative frame and asks why Spain and Ireland stand out from other major housing bubbles (in the Netherlands, Denmark, the UK); and why other periphery states (Portugal, Greece) did not experience boom and bust on this scale. A final discussion reflects on the broader implications for policy learning arising from this crucial episode in the international political economy.

2. The Irish and Spanish housing bubbles

A housing bubble is identified when residential property prices rise in relation to long-term average values, followed by a short-term sudden disruption resulting in a sharp downturn. The bubble phase generates 'a demand shock that cannot be counteracted by an increasing supply' (Joebges et al., 2015, p. 20). The easy availability of credit is one of the conditions for identifying housing bubbles:[1] loose monetary policy that lowers interest rates is a necessary condition. In addition, there needs to be a loosening in credit controls and the conditions for lending, such that more capacity is available in the system to increase personal or household debt.

The creation of EMU was the initial condition for this resource curse in the Eurozone. The elimination of exchange rate risk in countries with historically high interest rates created unanticipated perverse incentives. Converging interest rates after 1992 reduced market perception of risk in the periphery countries

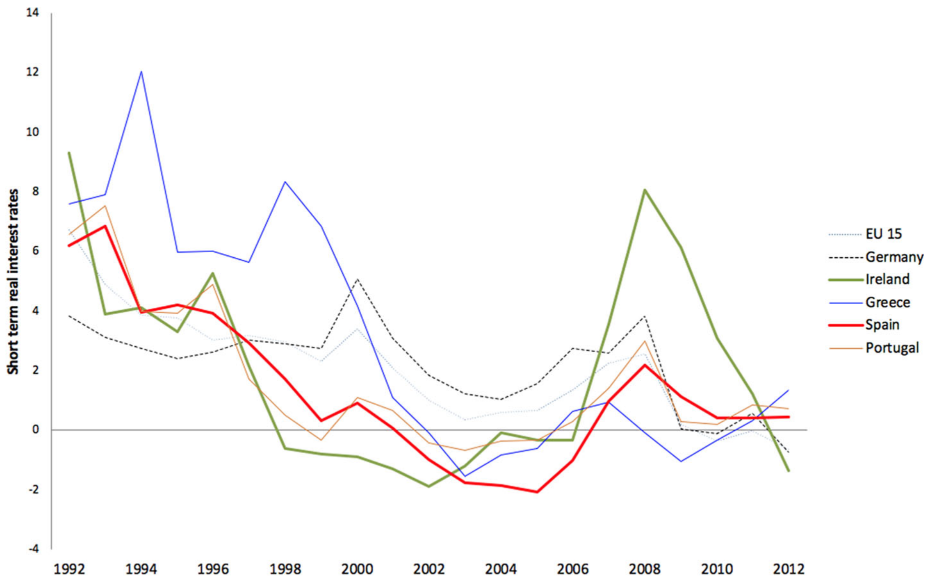

Figure 1. Short term real interest rates, 1992–2012.
Source: EU AMECO Database.

(Fernández-Villaverde et al., 2013). Real interest rates were even lower, since ECB rates were set for the slower-growth core. As Figure 1 shows, Ireland and Spain both experienced negative real interest rates for most of the years from the late 1990s until the onset of the crisis. The incentives for large-scale borrowing were considerable.

Surplus savings in the slow-growing European core surged into periphery countries that were engaging in catch-up growth. Expanded domestic credit was readily channeled into consumption and investment in the periphery, which in turn further pushed up the domestic cost base. The degree to which credit in the periphery was dependent on borrowing from the international wholesale market is evident from Figure 2 below.

The surge of credit moving into Spain and Ireland was vast, as was the rate of increase in the expansion of domestic credit. This combination of negative real interest rates and the availability of greatly increased volumes of credit amount to what we term a financial resource curse. Figure 3 shows the scale of banking sector credit made available in the run-up to the crisis, and indeed beyond.

Easy money – cheap credit – reinforced the inflationary surge in the periphery economies. Collective bargaining and social concertation sought to link nominal wages with inflation rates, though real wages did not keep pace with labor productivity. The sustainability of domestic demand was progressively eroded while the economy grew, putting increased pressure on all those struggling to keep up (Las Heras & Ribera-Almandoz, 2017).

Nominal wage increases did not damage the export capacity of the economy as it has been conventionally understood. Markets targeted by the high-tech export sectors were often relatively insulated from conditions in the domestic economy (Brazys & Regan, 2017; Naredo et al., 2007; Villanueva et al., 2020). The erosion of

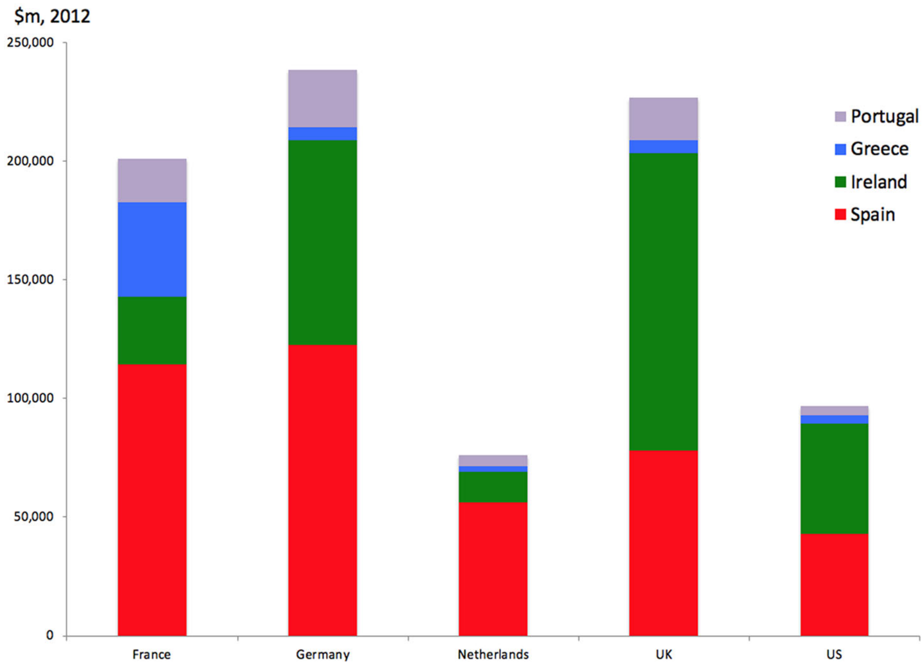

Figure 2. Indebtedness of banks in the Eurozone periphery to core country banks, 2012.
Source: Bank of International Settlements.

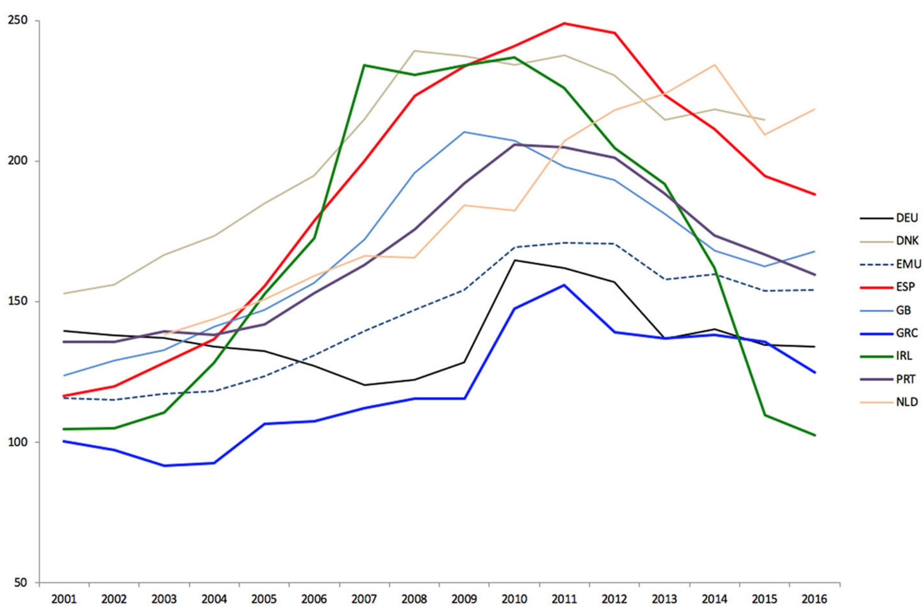

Figure 3. Domestic credit provided by banking sector, % GDP, 2001–2016.
Source: World Bank, Domestic credit provided by financial sector (% of GDP).

domestic competitiveness followed from the inflationary effects of housing bubbles, fueling employee efforts to maintain real purchasing power, although with relatively little success in large manufacturing plants (Las Heras, 2018a, 2018b). Figure 4

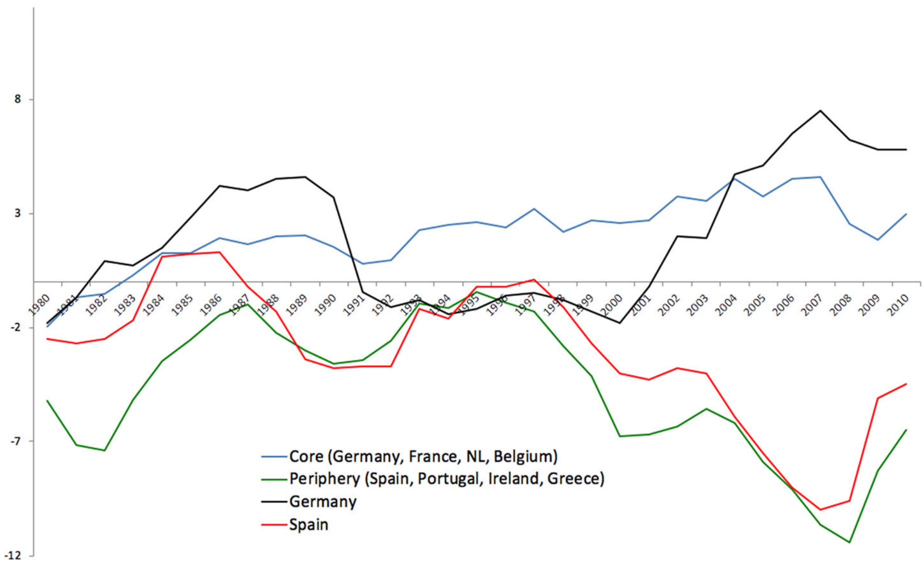

Figure 4. Current account imbalances between core and periphery, % GDP, 1980–2010.
Source: EU AMECO Database.

illustrates the macroeconomic imbalances that followed, particularly in the form of a growing polarization in trade performance and a newly exposed differentiation between core and periphery under EMU.

Continuing financial inflows and deteriorating real effective exchange rates combined to build up a huge exposure of net foreign debt in both public and private sector (Gros, 2011; Hope & Soskice, 2016). This is, in essence, the background to the worsening macroeconomic imbalances in the Eurozone periphery during the 2000s (Jones, 2016), to which 'internal devaluation' would later be held to be the remedy (Dellepiane-Avellaneda & Hardiman, 2015; Villanueva et al., 2020). Figure 5 illustrates the trend in the net indebtedness of the peripheral economies.

Coming back to the domestic side of the story, easy money is a necessary but not a sufficient condition for housing bubbles. Identifying a housing bubble also requires information about house prices, earnings, mortgage debt and interest rates. Combining this information leads us to isolate Spain and Ireland as particularly extreme cases. Across the EU15, the price of housing rose by an average of 66% between 1999 and 2006, but by more than 100% in Spain and Ireland. Mortgage loans rose rapidly during this period too. Figure 6 shows that Ireland and Spain had the most significant increases in house prices in the EU15 between 1999 and 2006, and also the highest proportion of the growth in mortgage debt relative to GDP.

The rate of increase in house prices relative to the rate of increase in earnings is another key indicator of a bubble. Denmark's house prices rose rapidly during this period, as did the scale of its mortgages, but Figure 7 shows that its house prices did not rise significantly faster than earnings (calculated here in relation to nominal wage growth in manufacturing). As in the UK, the overall scale of change in Denmark in the relationship between change in house prices and change in earnings is a good deal less pronounced between 1995 and 2006 than even the EU15

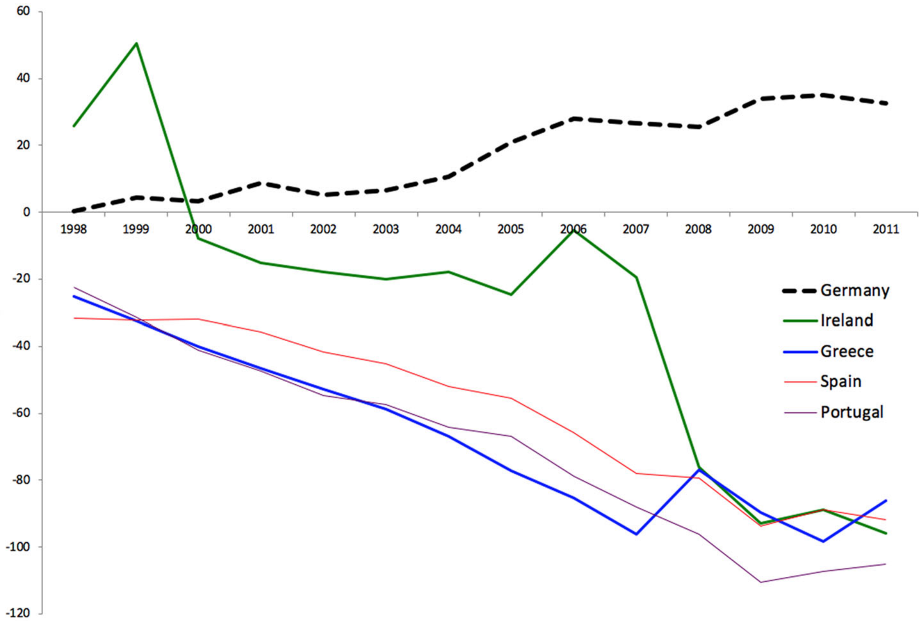

Figure 5. Net international investment position, % GDP, 1998–2011.
Source: EU AMECO Database.

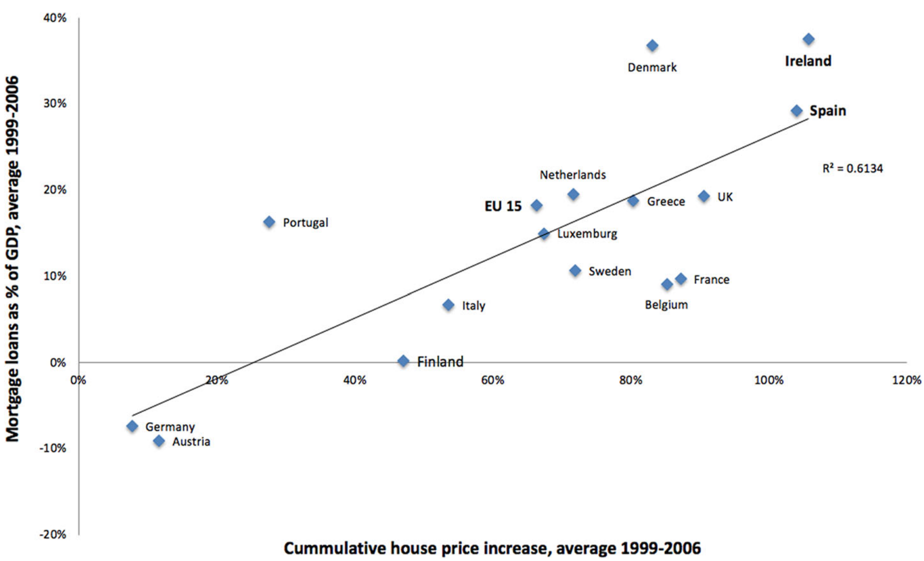

Figure 6. House price increases and mortgage loans – cumulative growth as % GDP, 1999–2006.
Source: European Mortgage Foundation, EU AMECO Database.

average. Spain and Ireland had the most dramatic increase in the ratio between these two trends. Figure 7 shows that the rate of growth of labor costs was far outstripped by the rate of money inflow: employee earnings failed miserably to keep pace with rising costs.

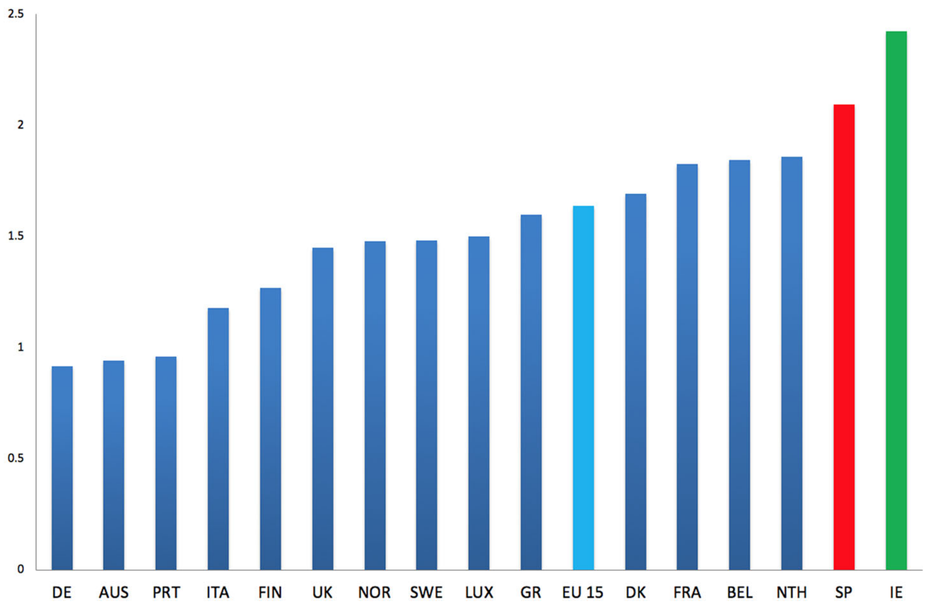

Figure 7. Ratio of change in house prices to change in earnings, 1995–2006.
Source: European Mortgage Foundation, EU AMECO Database.

3. From financial resource curse to housing bubble: Key mechanisms

We have profiled the convergence of Spain and Ireland on the outcome of interest: these two cases stand out as the most extreme instances of a housing bubble in Europe. But how did cheap money generate what in hindsight is clearly such a toxic housing bubble? We draw on the established literature about natural resource curses to isolate these three mechanisms (Fernández-Villaverde et al., 2013; Ross, 1999, pp. 308–312):

a. Economic: incentives are distorted, hence longer-term policy priorities are derailed.
b. Political: governance standards are compromised through new interest lobbies and the mobilization of new electoral coalitions.
c. Ideational: new narratives reduce the perception of risk, prolonging the cycle.

Firstly, a resource curse incentivizes the reallocation of resources toward non-productive investments that have fast profit yields but low social returns, as well as into consumption. The observable implications are a derailing of the existing growth model and its policy underpinnings. Infrastructure turns into a liquid investment; housing shifts from use-value to a store of value and an investment (Fernandez & Aalbers, 2020, pp. 685, 687). Domestic production cannot now absorb new capital quickly or effectively enough, resulting in a rise in the importation of tradable goods that further worsen the balance of payments. Stronger demand for non-tradables with lower productivity pushes up production in this sector. The positive shock generates a boost to growth through consumption (Benigno et al., 2015).

With the second mechanism we see a deterioration in standards of governance. The eruption of the resource curse changes the incentives available to the business classes in general, weakening the previously dominant business coalitions and enabling the emergence of a new cluster of interests. The new business factions gain the ear of political decision-makers as the avatars of a different and (for now) more successful approach to growth. The wider institutional framework is thus affected. The political class (or a key section of it) is co-opted into support for the new policy mix, opening the way for rent-seeking deals and the politics of patronage, including slacker regulatory standards (Torvik, 2009, pp. 252–253). The new alignments feed back into electoral politics as coalitions of voters are assembled who have a growing interest in sustaining the new growth strategy. With so much money at stake, 'crony capitalism' reinforces the inefficient allocation of resources. It is important to note that even countries with ostensibly high standards of good governance on conventional measures may be affected in this way. It is not just that a resource curse takes hold in already corrupt polities –a resource curse can introduce corrupting features into what are *ab initio* quite well-functioning polities.

The third mechanism involves the emergence of a new cognitive framework about what is going on, observable in the form of new narratives generated by the emerging dominant factions. We can identify a 'cluster concept' of interests and ideas at work here (Blyth, 2003; Rodrik, 2018). A shift occurs in the shared ideational or cognitive framework such that the policy elite misperceives risk, and this fuels over-confidence among policymakers and voters alike. Moving beyond Shiller's concept of narratives in economics simply as observed or given phenomena (Shiller, 2019), we understand these narratives as essentially political constructs. Mental models or cognitive maps complement the interests that have high stakes in the status quo, however, dysfunctional these may be, and these in turn undergirds the policy regime (North, 2005). Narratives are instrumental for legitimizing policy decisions, accommodating mounting anomalies and preventing adjustments. Ultimately, narratives contributed to the stickiness of unsustainable growth models.

Narrative discourses in turn have their own power to shape social expectations that 'this time is different' (Fikse & Aalbers, 2020; Palma, 2009; Reinhart & Rogoff, 2009; Shiller, 2019). The result is a deterioration in the capacity of policymakers to distinguish between the signals coming to them about appropriate policy responses. At worst, the quality of institutional performance declines in both public and private sectors, subverting the capacity to maintain commitment to long-term planning and rational economic development objectives (Fernández-Villaverde et al., 2013; Ross, 1999, p. 298).

4. Housing booms in Ireland and Spain as a resource curse

This understanding of how a natural resource curse works is unexpectedly applicable to bubble economics. In this section we examine how the mechanisms worked out in Spain in Ireland. Despite their different initial conditions in the form of institutional frameworks and economic attributes, these two cases arrived at the same endpoint.

4.1. Economic: distorted incentives disrupt the policy underpinnings of national growth models

Cheap credit shifted Spain and Ireland off the growth pathways they had embarked upon in between the 1960s and 1990s, which had involved a diversification of economic activity and support for sectors with exporting capacity. The resource curse literature predicts that cheap money will be channeled into non-productive activities and especially construction, and this is exactly what we see (Gaulier et al., 2012).

The surge in the scale of construction and especially housing construction was little short of astonishing. '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). Similarly, in Spain, 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 & van den Noord, 2006, pp. 18–19).

The average rate of house starts in the EU between 1999 and 2006 was 633 per 100,000 population; but in Spain it was 1479 and in Ireland 1640. In 2007, while Spain was building at a rate of 1440 and Ireland 1111 per 100,000, France's housing starts were 766 and Germany's 222 (European Mortgage Federation, various years). Indeed by 2007, 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).

The decay in the quality of lending on the part of the banks and other financial institutions, facilitated by slack regulation, is a key part of this story. In Ireland, light regulation meant little or no regulation (Casey, 2018a, p. 73; Clarke & Hardiman, 2012; Ó Riain, 2014). This resulted in untenable compromises on prudential risk assessment and provision of quality collateral (Regling & Watson, 2010, p. 45). In Spain, much of the credit allocation for private housing took place through the expanding scope of the *cajas* lending institutions during the 1990s and 2000s (Fernández-Villaverde et al., 2013, pp. 153–154). The *cajas* also grew increasingly politicized following the transfer of their management to the regions.[2] But as in Ireland, while the whole financial system had close ties with the political system, it was the unusually high levels of credit availability that tipped the system over the brink. The quality of lending decisions deteriorated under conditions of perverse incentives (Véron, 2017). Liberalization and deregulation had not resulted in keener market competition in either country (Perez, 1999). Regulation of bank lending practices was insufficiently rigorous (Argimón et al., 2018; Ó Riain, 2014). Mortgage market innovations such as 50-year loans in Spain and 110% loans in Ireland became commonplace (André, 2010, pp. 19–20).

The residential finance systems of Spain and Ireland were quite different (Regling & Watson, 2010, p. 6; H. Schwartz & Seabrooke, 2008, p. 249; Segoviano et al., 2013, p. 58). But in Schwartz and Seabrooke's typology of the political economy of residential capitalism, Ireland and Spain cluster together with other peripheral Eurozone countries in the 'familial' model of housing finance. Both had high

Table 1. Components of average annual growth rates in Spain, Ireland, Germany and EU15, 1994–2000, 2001–2007, 2007–2011, 2012–2019.

1994–2000	GDP	Export (A)	Household expenditure (B)	A / B
EU 15	2.8%	8.3%	5.7%	1.45
Germany	1.9%	8.5%	2.5%	3.42
Ireland	8.0%	17.8%	12.9%	1.38
Spain	3.7%	11.0%	6.2%	1.79
2001–2007	**GDP**	**Export (A)**	**Household expenditure (B)**	**A / B**
EU 15	2.1%	4.9%	3.5%	1.40
Germany	1.4%	7.3%	1.9%	3.95
Ireland	5.2%	6.5%	8.4%	0.78
Spain	3.4%	3.9%	7.0%	0.56
2008–2011	**GDP**	**Export (A)**	**Household expenditure (B)**	**A / B**
EU 15	−0.1%	1.5%	0.5%	2.82
Germany	0.8%	2.6%	2.1%	1.25
Ireland	−3.4%	2.5%	−2.9%	−0.86
Spain	−0.9%	1.4%	0.1%	10.27
2012–2019	**GDP**	**Export (A)**	**Household expenditure (B)**	**A / B**
EU 15	1.4%	3.5%	2.2%	1.58
Germany	1.4%	3.1%	2.6%	1.19
Ireland	6.8%	11.3%	3.7%	3.09
Spain	1.4%	3.7%	1.8%	2.05

Source: EU AMECO Database. Based on Baccaro and Pontusson (2016).

levels of owner occupation but relatively low levels of household mortgage lending, and 'dual' not 'unitary' housing markets (Norris & Byrne, 2017, p. 7; H. M. Schwartz & Seabrooke, 2009, pp. 9, 10).[3] Funding came from wholesale financial markets rather than the direct penetration of foreign financial institutions seen in East Central Europe (Bohle, 2018). The connecting links between domestic political economy and transnational finance had very similar effects in the two countries. Their different institutional set-ups nonetheless resulted in convergence on the same outcomes.

The effect of the shift in Spain was that younger generations were diverted away from acquiring higher-level skills and indeed often out of education altogether (Felgueroso et al., 2016; Mascherini & Ledermaier, 2016). In Ireland, the effect was to intensify already fluid migration patterns (Conefrey & McIndoe-Calder, 2018, pp. 44–45).

A growth-model approach may provide a better insight than the conventional 'varieties of capitalism' model as it distinguishes between export-led and demand-led components of growth (Baccaro & Pontusson, 2016, p. 187). Either option can be generated sustainably, depending on the pattern of insertion into the international political economy and the constraining conditions to which they are subject.[4] The indicative data profiled in Table 1 below gives us a flavor of the dynamics at work.

What we see is that the relative contribution of exports and of household expenditure (a proxy for consumption) varies over time, in parallel with the general European experience and indeed also with Germany, Europe's export-led powerhouse. But the scale of the changes between the first phase (1994–2000) and the second (2001–2007), which we attribute to the financial resource curse, is particularly marked in Spain and Ireland.

In the 1990s both Ireland and Spain exhibit strong growth in household spending but even stronger growth in exports. But between 2001 and 2007, the boom and bubble years, the growth of household consumption overtakes the share of exports in GDP growth. Spain saw household consumption growth of over 3% per annum in the ten years prior to the crash (Revista de fomento social editorial board, 2007). The ratio falls dramatically, in sharp contrast with Germany.

During the years of the crash (the third panel 2008–2011), Ireland and Spain appear to diverge if we look only at the column A/B, the contribution of exports to GDP growth relative to household consumption. But what the two countries share is a precipitous collapse in domestic purchasing power (i.e. household consumption), worsened by household debt and mortgage payment burdens, coinciding with the continued slump in exporting capacity. (We consider the fourth panel, 2012–2019, in section 6.)

4.2. Politics: the quality of governance declines, institutional quality weakens, new social and electoral coalitions of interest are enabled

How did the inflection in the trajectory of the growth models come about so quickly and so markedly? The answer may be found in the second mechanism anticipated by the resource curse literature. The construction-related business sectors gained prominence as agents of growth in new networks of influence. Policymakers afforded them more traction over policy priorities, with growing corruption and worsening governance performance. What Blyth and Matthijs refer to as the main 'target variable' for economic policy shifted, and the states' institutional choices followed, generating a new 'macroeconomic regime' (Blyth & Matthijs, 2017, p. 208). New electoral coalitions of interest were strengthened and provided a feedback loop to government to sustain these measures. Construction provided an opportunity for lenders, investors, developers and builders to get quick returns from cheap credit; governments found a way to generate new jobs quickly; large sectors of the electorate experienced a wealth effect from rising property values, or experienced new pressures to enter the property market in the expectation that the price trajectory was upward only. In sum, the quality of governance deteriorated in the public as well as they private sector.

Baccaro and Pontusson define social blocs as 'enduring constellations of sectoral and class interests that are organized in hierarchical manner, with certain components of the social bloc being privileged relative to others' (Baccaro & Pontusson, 2019). But we should also note that the relative economic and political dominance of different busines sectors can change. The rise of the new construction-related bloc of business interests in Spain and Ireland is well documented (Jiménez, 2009; O'Toole, 2010). The coalition of builders, developers and bankers formed an unholy trinity in both Spain and Ireland with very little political resistance or countervailing pressures. The result was, as the model predicts, that corruption flourished as governing parties and leading politicians opened their doors to the newly empowered influencers, who were also potentially generous party donors – for example 39% of disclosed donations to Fianna Fáil between 1997 and 2011 came from property and construction interests (E. Byrne, 2015). The scale of the corruption turned out to be systemic, even epic, though none of this was as yet in the public domain (E. Byrne, 2012; Charron et al., 2014; García Santana et al., 2016; Jiménez, 2009; O'Toole, 2010; Torres, 2018). The 'concrete economy' was now in full flow.

'Asset-price Keynesianism' appealed to governments in both countries as a means of short-circuiting persistent problems of regional development: housing was a powerful generator of jobs. Growth-priming through construction activity was popular among a broad spread of voters, especially in areas where there was little other economic activity (Norris & Byrne, 2015). But building up private owner-occupancy had been a long-standing policy commitment in both countries anyway (Alberdí & Levenfeld, 1996; Dol & Haffner, 2010, p. 66; McCrone & Stephens, 1996; Norris, 2016a). Franco's Minister for Housing in 1957 had noted that housing would be the means of social pacification by turning a country of 'proletarios' to one of 'proprietarios' (López & Rodríguez, 2011, p. 6). Spanish mortgage credit provision had long been tightly controlled through close links between state and the banking sector (Perez, 1999). State-led intervention in the Irish property market provided preferential mortgage terms through local authorities for much of the twentieth century. This was different from the typical Southern European patrimonial practice of intergenerational support for housing as a means of ensuring income security (Allen et al., 2004). But it had the same effect in that the incentives to acquire property were associated with traditionally weak old-age income support (Norris, 2016a, 2016b). The effective subsidy on house purchase in both countries ranged from 20% to 50% of the total price during the 1990s. In Ireland, this resulted in a growing segmentation of the housing market between property-owners, a very small private rental sector and an increasingly residual public housing sector (Norris, 2016a). The distributional pattern in Spain was perverse as it resulted in a U-shaped curve whereby groups on lower and on higher incomes benefited disproportionately. This further helped governments build a broad-based populist coalition behind home ownership. Even well into the boom, in 2004, left-wing (PSOE) prime minister Zapatero was unwilling to risk electoral unpopularity by scaling back on fiscal incentives for house purchase (Montalvo, 2002, 2007).

The prior policy bias toward home ownership underscores why political parties had strong incentives to support the social forces behind property development in both countries. In Ireland, Fianna Fáil (the dominant government party from 1997 to 2010) had a cross-class support base and a policy profile that was pro-business and center-right yet also familiar with populist methods of vote-gaining. Spain's party-political system featured more marked bipolar partisan competition. But both the conservative People's Party (PP, in power 1996 to 2004) and the Socialist Party (PSOE, in power 2004 to 2011) were committed to supporting the construction-based economic growth strategy. In Spain and Ireland during the 2000s we see the electoral construction of new cross-class alignments built around construction-fueled domestic demand. The politics of right and left, therefore, converged on a preference for satisfying a broad social and electoral coalition of support by sustaining and prolonging the bubble economy.

4.3. Perceptions were distorted: new narratives generated cognitive shifts

This was enabled by the third mechanism linking a resource curse to a perverse outcome, that is, a shift in the mental maps guiding decision-making. Without effective policy and political brakes, 'frothy' markets contributed to a familiar kind of speculative mania (Kindleberger & Aliber, 2005, p. 62). The political system did not generate reliable information about the quality of investment and savings decisions. But newly dominant narratives in both Spain and Ireland supported a distorted understanding of the bubble and further diminished the ability of policy and political actors to assess the risks associated with letting it continue. We see the power of narratives in two areas: the perception of housing inflation, and the expectation of a soft landing. Both were nested in the broader narrative associated with the turn toward liberalization and deregulation since the 1980s to the effect that 'markets know best'.

The narrative of endless risk-free growth was led from the top. Economy Minister Rodrigo Rato (in Aznar's PP government, to 2004) consistently ignored the evidence that a housing bubble had developed. He argued that the solution to any emerging 'issues' was to double down on market interventions including further deregulation of lending, land controls and so on (El País, 2003). Irish Taoiseach (Prime Minister) Bertie Ahern, when asked about rising inflation that was driven by soaring house prices, stated in 2006 that higher inflation should be seen as a sign of a strengthening economy: 'In actual fact the reason it's on the rise is because probably the boom times are getting even boomier' (Coleman, 2006). Many cautionary voices expressed concern about house price inflation in both countries, but typically this was too restrained to make a difference, too cautious to make a dent in the dominant narratives. In 2003, for example, the Bank of Spain pointed to the dangers of overvaluation in the housing market of around 20%, to no political avail (Bank of Spain, 2003). The same is true in Ireland in relation to both domestic and external advisers (Breen, 2012; Casey, 2018b; O'Leary, 2010).

The dramatic fall in the Irish banks' share prices in spring 2007 signaled grave market doubts (Lane, 2015). But government and policy officials' access to accurate information about the scale of exposure was lacking even after the notorious blanket bank guarantee in September 2008 (Ó Riain, 2014; Woll, 2014). The Bank of Spain's assurances about measures intended to guarantee the solvency of the banking system led to a misplaced sense of complacency (De Sousa Santos, 2008). The Spanish financial system, with its large overseas business activities, especially in South America, was perhaps better placed to withstand the shock of the collapse of the construction sector than was its Irish counterpart. But as in Ireland, neither the politicians nor the banks anticipated the disastrous consequences of road they were on (Royo, 2013; Santos, 2014).

A second key policy narrative is that the boom would end in a 'soft landing' and that overvaluation would be correctly smoothly. In Spain, PSOE leaders were just susceptible to this mind-set as the PP (Solbes, 2013; Zapatero, 2013). *The Economist* newspaper validated this: a 2006 story reported 4% inflation (1.5 points above the Euro area), an overvaluation of house prices of around 25–35%, a distorted growth model in which construction accounted for 16% of GDP and 12% of employment and a shocking current account deficit of 9% of GDP. Yet the message was that there was nothing of any great concern in all this. The reassuring punchline came from a Goldman Sachs expert: 'we expect the slowdown to be quite mild' (The Economist, 2006). A very similar narrative prevailed in Ireland. The IMF (in 2000) and the OECD (in 2006) published studies of the residential property market in which they explicitly cautioned that a soft landing had never been documented empirically. But these voices did not prevail over Department of

Finance complacency that peak-boom house prices were 'in line with fundamentals' (Casey, 2018b, p. 57).

Voters were not unaware of the cautionary voices, but the dominant narrative shaped popular perception. The reliability of property as investment was taken as a given, fueled by media stories in which dominant economic interests prevailed (Casey, 2018a; Mercille, 2014, 2017; Vallès Codine, 2014). In a 2005 survey in Ireland as the boom was peaking, 'only one in 500 people expected major house price falls in the coming year' (Casey, 2018a, p. 150).

We might note here that the framing of these narratives was further validated by the macro-European level of political discourse: 'the problem lies at the level of the system' (Blyth & Matthijs, 2017, p. 214). The low-inflation, market-friendly international political economy regime shaped incentives for national decision-makers. The scale of the inflation differential that had developed between Spain and Ireland and the rest of the Eurozone was obscured from the Commission's view since official measures of inflation did not include mortgage interest repayments (Hay, 2009). But the issue here is not just whether or not external net credit balances were being monitored effectively across the Eurozone, but that the legitimating narrative was embedded in the neoliberal European macroeconomic regime itself.

5. Why Spain and Ireland?

Why then did this massive policy and political failure take root, and why were these two countries so much more severely affected than elsewhere? National macroeconomic regimes cannot be understood in isolation from the international conditions supporting open capital markets. What emerges here is long-standing vulnerabilities that were embedded in these countries' development pathways, which had not been systematically addressed during the years of steady growth. It was the inability of the peripheral countries to manage the good times effectively that exposed their hidden weaknesses. The scale of the crash was the logical outcome of these very vulnerabilities. Here lies the poignancy of the trap in which Spain and Ireland found themselves: they were viewed as favored members of the periphery, yet they were not quite fully-fledged members of the club of rich countries. The degree to which they had really graduated from the periphery, notwithstanding the estimation of the markets, was incomplete. A comparative perspective helps us isolate the reasons why the resource curse affected these two countries as profoundly as it did.

A first observation is that Spain and Ireland had a distinctive status during the 1990s and 2000s. Investors' expectations are shaped by the countries' reputations, where ideas and narratives matter, and Spain and Ireland appeared to be the prize pupils of successful adaptation. They had convincingly met the Maastricht convergence targets by the late 1990s. Spain's general government debt fell from 66% of GDP in 1995 to 36% in 2007, and Ireland's from 79% to as low as 24% (European Commission, 2017, table 78, p. 164). Both scored very well on international ratings of institutional performance such as Transparency International. During the 2000s, Spain and Ireland stood out as 'poster children' for the EMU experiment. Their demographic profiles (with large young populations) seemed to legitimate expansion in housing supply in a way that was not relevant elsewhere (Fernández-

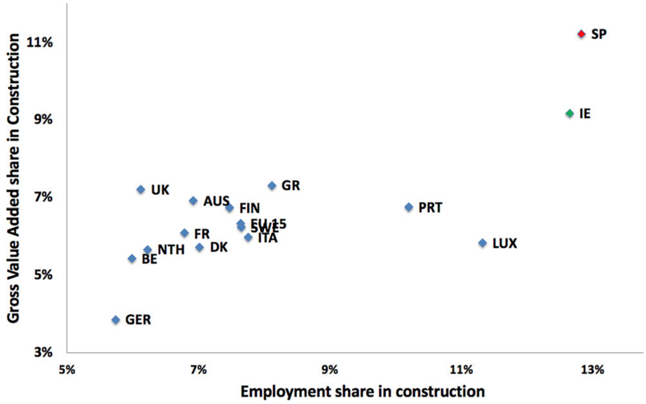

Figure 8. Employment and Gross Value Added in construction, 2007.
Source: EU AMECO Database.

Villaverde et al., 2013, p. 2; Rae & van den Noord, 2006, p. 5). Consequently, both countries benefited from high levels of credibility with international lenders. These conditions seemed to justify the 'crowding in' of capital, which permitted private consumption to displace public investment.

These conditions mark off Spain and Ireland from Portugal and Greece. Indeed, many a blind European (and Goldman Sachs) eye was turned to Greek fiscal data between its admission to EMU in 2001 and Prime Minister Papandreou's admission of the true scale of the public deficit in 2010. Moreover Portugal (like Italy) was struggling with low productivity and export market challenges at this time (Dooley, 2018; Lains, 2019). A reputation for good governance benefited the market standing of Spain and Ireland, considerations that depressed the risk assessment of Greece and Portugal (Vilariño Sanz et al., 2015).

However, behind the ostensibly successful growth performance and fiscal stability, dangerous weaknesses in institutional capacity persisted. The Irish model was premised on an unstable fiscal system that thrived on cyclical revenues, especially construction, even as ultra-rapid growth had given voters a taste for both more public spending and recurring tax cuts. The Spanish spending trajectory was similarly premised on late catch-up spending, particularly its as-yet incomplete welfare state build-up. Both were out of tune with the mood music of fiscal restraint in the Commission. Neither country had seriously their habitual mechanisms for accommodating conflicting interests into a more durable order that was capable of internalizing the disciplines of monetary union (Blavoukos & Pagoulatos, 2008; Dellepiane-Avellaneda & Hardiman, 2015).

The European authorities were untroubled by the dark pools of vulnerability that lurked behind official data. The significance of overt (let alone covert) inflation differentials was played down, the fragility of the ostensibly good fiscal performance was not challenged, and the scale of external deficits was thought not to matter. Yet credibility is volatile because it can be based as much on non-rational heuristics as on any evidence-based evaluation (Fourcade, 2013). Ireland and Spain were all too easily pulled back into the force field of periphery status and viewed not as star performers but much less appealingly as 'PIGS', that is, Portugal, Ireland, Greece, Spain (Brazys & Hardiman, 2015).

A second observation is that the sophistication and diversification of national economies matters. Their location in the international division of labor and their role in global supply chains make a difference to the impact of investment capital on the overall national economy. The economies of Spain and Ireland, although more diversified and with higher skill profile than Portugal or Greece, were less developed than those of most other advanced economies of western Europe (Charnock et al., 2014). They were, therefore, more susceptible to the financial resource curse that channeled the tidal wave of investment capital into construction rather than into competitive products for domestic, European and global markets (Buendía, 2020; Buendía & Molero-Simarro, 2018). To illustrate this, Figure 8 shows that in 2007 and at the peak of the bubble, a much larger share of the workforce was engaged in construction in Spain and Ireland than was the case elsewhere. And in both cases, a much greater share of Gross Value Added was attributable to construction. The employment share of construction at this time in Denmark, the UK and the Netherlands did not exceed 7%. It was about 8% in Greece and 10% in Portugal, but over 13% in Ireland and Spain.

We can now see more clearly how these two countries were particularly vulnerable to experiencing the full effects of the resource curse of easy money: they were more developed than the other periphery countries, but continued to be enduringly marked by their deep histories as periphery economies. We can see these features persisting in their experiences since 2012. The fourth panel of Table 1 seems to suggest that, just as a successful growth model can be perverted, a crash is not necessarily fatal but can provide a salutary re-set to a more sustainable growth trajectory. But a deeper dive into the countries' experiences would not support quite such a sanguine inference. The economic model of exposure to global finance that had given rise to the disasters in the first place had not fundamentally changed in either country (Kohler & Stockhammer, 2020; Stockhammer & Kohler, 2019). In Ireland, the national growth model doubled down on tax-incentivized foreign direct investment after 2012, and as before, new investment and not changes in price competitiveness was key to this. But in a world now made safer than ever for global capital, Ireland thereby joined Europe's top enablers of corporate tax avoidance[5] (Regan & Brazys, 2018; Saez & Zucman, 2019; Zucman, 2015). Ireland increasingly specialized in providing support services for investment finance and fund management, and services exports grew rapidly as a share of total exports (FitzGerald, 2015; Frank & Setser, 2018). Meanwhile and paradoxically, the collapse of the construction sector left Ireland with the worst housing crisis in a century, as the domestic market became ever more deeply embedded in internationally financialized housing (M. Byrne & Norris, 2018).

In Spain, a different but also well-established growth model similarly reasserted itself. The global reach of Spain's highly internationalized domestic banking sector contributed to export-led growth, as did the export-shift capability of large domestic manufacturers. But the main generator of foreign earnings after 2012 (or at least until 2020 Covid travel restrictions) was now once again tourism. Domestic demand continued to be severely constrained, impeding any convincing recovery. Indeed, internal devaluation 'explains 33% of total external sector readjustment over the 2010–2018 period, 98% of which is driven by the demand effect, with the remaining 2% resulting from price effects' (Villanueva et al., 2020, p. 292). Labor market liberalization and other nostrums of reform, driven by the one-size-fits-all

EU worldview, have achieved little of economic value yet caused much social damage (Buendía, 2020; Las Heras & Ribera-Almandoz, 2017; Perez & Matsaganis, 2019). Neither country's experience seems to suggest that they had definitively graduated from the periphery.

6. Conclusions

Our analysis demonstrates the urgent need to understand better the deep political structuring processes underlying economic outcomes (Buendía, 2020; Ebenau et al., 2015; Jessop, 2011). Our argument illustrates some fundamental political economy dilemmas facing countries in their pathways from the periphery. Spain and Ireland were viewed for years as most-likely cases for successful catch-up and even as role models of European integration (in contrast with Portugal and Greece). And yet it was precisely here that things went spectacularly wrong.

The key insight of the resource curse literature is that an apparent blessing such as the abundance of a certain resource or a positive economic shock may end up generating bad policy choices and bad governance outcomes. Shifting the focus backward from the turbulent crisis years to the political economy of good times allows us to uncover some of the policy, institutional and cognitive underpinnings of the perverse economic cycle, showing that these mechanisms operated in a highly interdependent and self-reinforcing way. Among our key findings is that while comparative literature suggests that the effects of the resource curse are conditional on the quality of standards of governance (Torvik, 2009), we show that the resource curse can actually overwhelm good governance in otherwise considered stable, consolidated democracies.[6]

Three further implications emerge from our analysis. Firstly, our cases demonstrate that perverse credibility cycles are not confined to emerging markets in the global periphery. EU experts and policymakers accepted, rather reluctantly and with evident delay (and no doubt motivated at least in part by how closely they skirted the cliff-edge of Eurozone break-up in 2012), that 'sudden stops' are an issue even under monetary unification. But the political mechanisms of sudden stops and credibility cycles are still under-studied. Marzinotto argues that a major implication of full capital-account liberalization is to enable the credibility channel (Marzinotto, 2016). But it is often forgotten that this is a two-way game. During the boom years, the credibility gamble seemed only to have an upside: the European periphery offered extremely attractive returns with few if any of the risks commonly associated with emerging markets. The irony is that a perverse cycle developed in the European periphery. The positive shock was followed by disastrous outcomes through exactly the same mechanisms observed in the outer peripheries (e.g. Turkey, Argentina). The abundance of easy money induced bad policy decisions, derailed the growth model, polluted the political system, undermined good governance and distorted mentalities. Late-developing European periphery countries turned out to be rather more 'emerging' than previously assumed. While EMU had provided the conditions for these outcomes in Spain and Ireland, it is just one of a range of circumstances that can generate a 'credibility shock'. The vista of a finance-led shortcut to prosperity may be too strong a temptation to resist even in otherwise quite well-run countries. Calamitous outcomes are all too likely if they have not already developed a full buffering set of institutional, political and ideological capacities to properly absorb and contain a huge positive shock. We might think here, for example, of Iceland, which is European but outside both EU and EMU (Moses, 2016; Wade & Sigurgeirsdottir, 2012).

A second observation is that there is nothing deterministic about falling victim to the perverse mechanisms of a positive shock. Empirical evidence on the economics of the resource curse is in fact quite mixed. Detailed case study analysis reveals the importance of government policy as the key intervening variable. So 'the failure of states to take measures that could change resource abundance from a liability to an asset has become the most puzzling part of the resource curse' (Ross, 1999, p. 307).

This moves us beyond a narrow understanding of state capacity understood in terms of institutional attributes or good governance indicators: we need to see the challenges in a broader political economy perspective (Bardhan, 2016; Besley & Persson, 2009; Lindvall & Teorell, 2016). Both Spain and Ireland had stable governments, solid majorities, decisive decision-making capabilities and broad social consensus. What was missing was institutional and policy competences to manage the productive absorption of positive economic shocks. The problem is not only one of institutional resilience and policy resources for the bad times – the often-neglected issue is the political management of good times. We have seen that a government's capacity to make good policy decisions has to be seen not as an exogenous variable as economists might view it, but as endogenously shaped and constructed.

But a third emergent implication of our argument is that the scope of a government's agency is shaped as much by international as by domestic path dependencies. We need to pay more attention to the interface between a national configuration and the international political economy. Institutional buffers in EMU prior to the crash concentrated on the downside risks but ignored upside risks. National-level politics must of course be understood as a field of discretionary choice, but it cannot necessarily withstand system-level perverse incentives.[7]

In these respects, what happened to Spain and Ireland may be seen as a kind of canary in the coalmine of an increasingly financialized and interdependent world. A consistently rules-based fiscal regime in Europe has had ongoing consequences for the unevenness of economic recovery since the global financial crisis. Stalled growth and choked-off aspirations for a better life have poisoned the hopes of a generation in country after country, and the political risks have mounted steadily across Europe (Baccaro & D'Antoni, 2020; Cram & Jones, 2019; Hopkin, 2020; Storm, 2019). EU policy responses have strengthened rather than attenuated a North-South differentiation in identities and interests (Matthijs & Merler, 2020). Even as the EU was working toward a shared fiscal rescue package in spring 2020, Covid-19 exposed a renewed tendency to look for national solutions in the face of uneven transnational coordination (V. Schmidt, 2020a). Yet debates about the future of EU governance are still too often framed in terms of 'more' or 'less' Europe. The dominant economic growth paradigm still centers on fiscal discipline and structural reform, with variation only in the nuances of rule-making and implementation: 'governing by rules and ruling by numbers' (V. Schmidt, 2020b).

Our analysis implies the need for more wide-ranging international cooperation, while also enabling greater flexibility in rule implementation to suit different national conditions across the Eurozone. But it also goes beyond many recent analyses of policy blind spots in EMU (Epstein, 2017; Gabor, 2019; Jones et al., 2016;

Schelkle, 2017; Walter et al., 2020). We have shown that perverse politico-economic cycles can still occur under rule-based, credibility-oriented policymaking; indeed, this model can induce and even amplify this phenomenon. More attention to state capacity and to building developmental capabilities may be needed – at both national and EU levels – to ensure the productive and socially sustainable absorption of positive shocks.

Perhaps the most important policy lesson that emerges from our study is not primarily about technocratic fixes, counter-cyclical measures, or institutional buffers – the question is more profoundly political. As the Eurozone crisis was unfolding, financial stability expert Andrew Haldane, commenting on sudden stops, said that 'the underlying problem may be as much the start as the stop. The seeds of emerging market crises are sown in the build-up phase' (Haldane, 2011). The pace of capital market liberalization has only intensified since then, even though the intellectual case for rethinking the dominance of markets has long been made (Rodrik, 2007; V. A. Schmidt & Thatcher, 2013). As Mazzucato and others remind us, state powers should not be understood solely as the means of correcting market failures and facilitating market actors. They are essential for the successful coordination of investment and for enabling the conditions for equitably shared growth. The implications of state actions for distributive outcomes and social well-being are irreducibly political (Jacobs & Mazzucato, 2016). We believe our analysis can contribute to further reflection on how we might build more sustainable growth models within more inclusive societies – essential conditions, we would argue, for building stable pathways from the periphery.

Notes

1. This is to distinguish credit-driven rising house prices from supply-side constraints, which is the source of the current drastic housing crisis in Ireland and indeed in the UK (Coelho et al., 2017; Kitchin, 2017).
2. It should also be noted that the political control of banking, and the potential for corrupt links between banks and politicians, are not solely the preserve of the Eurozone periphery. 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 bailout. The state banks or Landesbanken are typically owned by state governments and local institutions, and about 400 Sparkassen (local savings banks) are controlled by state and municipal politicians. Both banking sectors have 'a long history of corruption and mismanagement' (Ewing, 2013).
3. The others are the 'liberal market' regime (the other main English-speaking countries), featuring high owner-occupancy and high levels of mortgage debt; 'corporatist market' (Germany, Netherlands, Denmark), with lower owner-occupancy but relatively high mortgage-to-GDP ratios; and 'statist-developmentalist' (France, Austria, Japan, Sweden, Finland), with low owner occupancy and lower mortgage debt levels.
4. In the context of EMU, the difficulties of sustaining demand-led growth model are by now well known: a fixed exchange rate and a corset on debt and deficit performance incentivizes either strong export performance or tight constraints on domestic consumption (internal devaluation).
5. 'Foreign direct investment and equity investment now form a bigger share of flows than bank lending. But that may have more to do with multinationals chasing low tax rates than investment in factories' (Lund et al., 2017).
6. Information lag is also a factor, and investors typically made decisions on the basis of distorted institutional maps. Corruption was endemic during the boom but only fully

exposed after the crash, when it belatedly entered the perceptions-based international indicators of corruption (E. Byrne, 2015; Vallès Codine, 2014).

7. For example, capital surges and the associated inflationary tendencies of the early 2000s could not be managed at domestic level through unilateral interest rate increases. Yet the scale of fiscal repression that would have been required to deal effectively with a super-charged inflationary surge would have been particularly challenging to democratic legitimacy itself (Dellepiane-Avellaneda & Hardiman, 2015).

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Notes on contributors

Sebastian Dellepiane-Avellaneda (PhD Essex) is a senior lecturer in the School of Government and Public Policy at the University of Strathclyde. He studied economics and political science in Buenos Aires, Argentina. He has held research positions in several European universities including Essex, Antwerp and UCD. His research interests center on comparative political economy, institutional design, governance and development, and the politics of economic crises.

Niamh Hardiman (DPhil Oxon) is a professor of Political Science and Public Policy at the School of Politics and International Relations at University College Dublin (UCD), and a Fellow of UCD Geary Institute for Public Policy. She was formerly Fellow and Tutor in Politics at Somerville College, Oxford. Her research interests center on state structures and policy formation, state capacity, fiscal politics, European political economy and political development.

Jon Las Heras (PhD Manchester) is a lecturer at the University of the Basque Country in Bilbao. He studied economics and political economy in Madrid, Athens and in Manchester, he has held a research position in UCD, and has been a visiting researcher in several universities including Cádiz and Naples. His research interests center on European political economy, the politics of industrial relations and critical thinking.

ORCID

Sebastian Dellepiane-Avellaneda http://orcid.org/0000-0003-0318-8611
Niamh Hardiman http://orcid.org/0000-0002-3233-0181
Jon Las Heras http://orcid.org/0000-0001-9148-2516

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