ABSTRACT: This paper explains similarities and differences in the way in which two Southern European financial systems have been affected by the global financial crisis and have reacted to it. The concept of financialization and its specific features in the two countries examined (Italy and Greece) is used to explain why both countries were affected moderately at stage 1 (banking crisis) and stage 2 (credit crunch & recession), but affected severely by stage 3 of the crisis, i.e. crisis in the overcrowded global markets of public debt. Greece suffered an extreme sovereign debt crisis, and resorted to an EU/IMF bailout. Thus Greece and (potentially) Italy are cases of contagion spreading from the public debt sector to the national banking system.

Introduction

The economic and financial crisis that broke out full force in the autumn of 2008, though sharing some common features worldwide, affected various countries in different ways, even in a relatively homogenous regional block, such as the European Union (EU). Whereas some countries, such as the UK and Ireland, were badly hit by the first phase of the crisis (banking crisis) and the second stage (credit crunch and recession), others, such as Italy and Greece, were moderately affected by the banking crisis and the credit crunch, but were severely affected by the third stage of the crisis, which involved difficulties in financing sovereign debt.

What explains similarities and differences in the way in which national financial systems have been affected by the crisis and have reacted to it? This paper sets out to address this question by carrying out a structured comparison of two Southern European countries, Greece and Italy, focusing mainly on the first stage of the crisis, i.e. the banking crisis. We use this comparative case study to reflect on the question of the persistence and relevance of a ‘Southern’ financial system model, which the two countries are claimed to represent.

As Hardie and Howarth (2010) note, the literature on varieties of capitalism (for a comprehensive analysis, see Schmidt 2002; Hall and Soskice 2001; Hancké, Rhodes,
and Thatcher 2007) has paid limited attention to the financial system per se, and the few specific studies on it (Zysman 1983, Allen and Gale 2000) are somewhat outdated. Moreover, in the classical literature on varieties of capitalism, Italy and Greece, as well as other Southern European countries, are somewhat overlooked and do not fit neatly in either of the two main varieties identified by the various authors, namely coordinated market economies, such as Germany, and liberal market economies, such as the UK. Schmidt (2002) points out a third category, state-led capitalism, exemplified by France in the past decades, and locates Southern European countries, such as Italy and Greece, in this group.

We seek to examine how (and why) the crisis affected the two countries’ financial systems (the dependent variable), and to account for cross-national similarities and dissimilarities. The global financial crisis can be considered as the independent variable, which therefore takes two values: absence of the crisis, prior to late 2007, and the breaking out of the crisis and its aftermath from 2008 onwards. The crisis is taken as a given in that its origins are not investigated. In line with the other contributions to this special issue, the concept of financialization, defined as the trading of risk, is the main intervening variable, teasing out the main causal mechanism through which the global crisis played out in national economies.

This paper operationalizes financialization by looking at the business model adopted by banks (i.e. banks balance sheets), in particular their assets and liabilities. As for the latter, we look at the funding base of banks, in particular their reliance on retail deposits or on wholesale market for funding. As for the former, we look at the trading of securities (i.e size of the trading book), the presence of toxic assets and the use of SIVs. We also consider the expansion of Greek and Italian banks abroad through branches and subsidiaries, especially in Central and Eastern European countries, which was a channel through which the crisis hit the Italian and Greek banks. In turn, we argue that the degree of financialization in these Southern European countries very much depended on, or was mediated by the evolution of the financial system and the regulatory framework.

The two countries selected for the comparison, Italy and Greece, have been chosen for sharing important similarities: their national financial systems have evolved as bank-based systems, they were latecomers in liberalization, subject to regionalization rather than globalization, and had relatively limited ‘financialization’ if compared to the more advanced EU financial systems. This selection of case studies also allows us to examine whether there is a shared Southern dimension to the crisis, asking whether the upheaval has reinforced the distinction between the main varieties of financial capitalism or whether it has contributed to the convergence of national models.

Empirically, the paper proceeds as follows. Section 2 outlines the evolution of the national financial systems under scrutiny, their regulatory environment and their degree and type of financialisation. Section 3 examines how Italy and Greece have been affected by the financial crisis, why that was the case as well as the response of the national authorities. Section 4 analyses the macroeconomic dimension of the crisis, explaining how the sovereign debt crisis turned into a banking crisis in Greece. Finally, the paper draws some insights concerning national varieties of financial capitalism.
2. Tracing the Southern financial model: the financial systems of Italy and Greece

Until their liberalization in the late 1980s and 1990s, the Southern financial systems of Italy and Greece (like those of France and Spain) were typical credit-based Mediterranean systems, characterized by extensive state control over the banking system, underdeveloped capital markets, and pervasive financial interventionism. Under the post-war developmentalist economic orthodoxy, financial interventionism was deemed necessary to accelerate the process of economic development, which in the 1950s and 1960s was considered as almost synonymous with industrialization; the ‘later’ the industrialization (Italy was a ‘late’, Greece was a ‘late-late’ industrializer) the more active the state in engineering financial interventionism. Financial interventionism over the postwar period became a prerequisite both for autarkic development strategies based on import substitution industrialization (where heavy protectionism, capital controls, and subsidized credit to industry were main instruments) and for open trade strategies of export-led growth (employing favorable financial regulations for manufacturing and exports) (Shonfield 1965; Zysman, 1983; Loriaux 1997; Perez, 1997; Woo-Cumings 1999; Pagoulatos, 2003a). In all such cases, financial interventionism served as the institutional apparatus that directed national savings exclusively into the national banking system; and subsequently transformed bank deposits (trapped into national banking systems sheltered through capital controls and market protection) into low-interest credit for ‘productive’ sectors, industrial enterprises, and most notably, the government itself. Indeed, in Southern countries characterized by public sector and balance of payments deficits, largely resulting from weak tax bases, financial interventionism taxed the domestic banking system in order to secure cheap government finance, to penalize consumption and other ‘non-productive’ activities, and to bolster export-oriented sectors.

Then, from the second half of the 1980s, Southern financial systems were liberalized, in a process that was crucially driven by the European single market program. Financial liberalization was, to a significant extent, a necessary prerequisite for the central banks’ programmatic effort to achieve effective disinflation. For the South, at a subsequent stage, a stabilization strategy based on monetary austerity entailed the significant political advantage of allowing governments to eschew a more radical pace of fiscal adjustment (Pagoulatos, 2003b). As a result, fiscal consolidation in the European South during the 1990s, especially Greece and far less so Italy, was mainly revenue-based rather than structural, and was relaxed following EMU accession (Blavoukos and Pagoulatos, 2008). This is an important observation, because it helps understand the background of the 2010 sovereign debt crisis. But we before we go to that lets take a look at the two countries’ financial systems.

Until the 1990s, the Italian financial system was mainly ‘bank-oriented’, in that it was characterised by an extensive activity of financial intermediation performed by banks (Allen & Gale 2000). With the reform of banking, finance and corporate legislation in Italy in the 1990s, the financial system became more market-oriented, even though it remained bank-centred in a different way, in that the decline in the use of traditional bank instruments did not coincide with the
reduction of the role of the banks, which engaged extensively in securities trading and were important market shareholders (Ciocca 2005).

In the same decade, segmentation in the banking sector came to an end: the formal change took place with the transposition in 1992 of the Second Banking Directive issued in 1988, which introduced the all-purpose universal bank in Italy. At the same time, the banking system was privatised, modernised and consolidated (Panetta 2004; Giordano 2007). The pace of consolidation fasted after the establishment of EMU in 1999 and the Financial Services Action Plan (FSAP) issued by the European Commission and endorsed by the member states in 2000. Nowadays, the five biggest banks, Unicredito, Banca Intesa, San Paolo IMI, Capitalia and Monte dei Paschi di Siena, hold over 50% of total assets (Bank of Italy 2008a). Two big banks, namely Unicredit and Intesa – San Paolo account for more than 35% of total assets (Bank of Italy 2008a), ranking them among the top European banks. Foreign operations represent about a third of total assets for the top 5 banking groups (OECD 2009). Other banking groups operate mostly in the domestic markets, where a large number of small banks, including co-operative banks specialized in local financing, are also active.

Until the early 2000s there was a relatively limited penetration of foreign banks and financial institutions for a variety of reasons, amongst which were the complex national regulatory environment; the preferences of Italian consumers for national brand names, i.e. Italian banks, often local banks; the role of Mediobanca; and the lukewarm (if not overtly hostile) attitudes of the public authorities, with first and foremost the Bank of Italy during the governorship of Antonio Fazio (1993–2005) (Quaglia 2008a).

Increasingly into the 2000s, pressure from other EU member states, EU bodies and financial markets, coupled with sharp domestic criticisms led to an opening up of the Italian banking system, after the resignation of Governor Fazio (Quaglia 2008b). The opening of the Italian banking system to foreign operators is nowadays as high as in other EU countries, and foreign banks have acquired major Italian banks (e.g. the Banca Nazionale del Lavoro was acquired by BNP Paribas). In 2007 the market share of foreign banks in Italy approached 19 per cent. In Germany, France and Spain in 2006 the market share of foreign banks averaged 10.5 per cent (Saccomanni 2008). The activity of foreign banks has also gradually moved from the wholesale market to credit intermediation in the retail sector. Last but not least, there was the merger of the Borsa Italiana (Italian Stock Exchange) and London Stock Exchange, which contributed to the internationalisation of securities trading in Italy. At the same time Italian banks began expanding abroad, mainly through subsidiaries. Especially relevant for the topic of this paper is their activity in CEECs, which as explained in the following section, was one channel of exposure of Italian banks to the crisis. Such exposure topped 148 billion euros in December 2008, 5% of total assets of the Italian banking system (OECD 2009). In absolute terms, Italian banks were mostly exposed to Poland, Croatia, Hungary and Russia.
Despite the privatization, modernization, consolidation and opening up of the Italian banking system, the degree of financialization in Italy remained rather low. By looking at the bank balance sheets, as far as assets are concerned, the Italian banking system had a low exposure, either direct or indirect, to US subprime mortgages, and its operations in the structured finance market were relatively limited, as compared with other main European banks (Banca d’Italia 2008). At the end of 2007, the exposure of Italian banks to structured products amounted to € 4.9 billion, only about 2% of supervisory capital. Consequently, write-offs and losses were limited for top banking groups, totaling € 4.5 billion by the end of 2008 (OECD 2009). Securitizations of assets located in Italy were about 7% of total gross emissions in Europe in 2007. The reliance of Italian banks on traditional lending activity to firms and households is suggested by the relatively high share of loans to customers (as opposed to securities and other assets). Net interest income represented over half of total income in Italian banks. Among non-interest revenues, those from trading activities are an especially low fraction of total revenues (6%), while revenue from services accounts for a large share. Moreover, Italian banks had little exposure to directly sponsored Structured Investment Vehicles because of the rule and practices of the national supervisory authorities (OECD 2009).

As far as liabilities are concerned, Italian banks had a broad and stable funding base, low leverage ratio and low dependence on wholesale interbank funding (IMF 2008). Funding from retail customers, more stable than wholesale funding, constituted a large share of the total. In June 2006, deposits from retail customers represented 37.4% of total funding, more than in Germany, France and the Euro Area average, although less than in Spain. Bonds sold to retail customers contributed to 17% of total banks’ funding, more than in the aforementioned countries and in the Euro Area on average, so that, overall, funding from retail customers represented 54.4% of total funding, a high value in international comparisons (OECD 2009).\footnote{Moreover, Italy had a strong household balance sheet with a net positive financial position.}

Why has the degree of financialisation of Italian banks remained rather low? One explanation is the slow evolution of the national financial system and has to do with the fact that domestic political economy institutions are rather sticky, hence banks were reluctant to change their business model. The second explanation is the national regulatory context. Both explicit regulation and supervisory practices seem to have played an important role in ensuring the Italian banking system did not increase its risk exposure or leverage excessively (OECD 2009). World Bank indicators give Italy high scores (10) in measures of ‘capital stringency’ and of ‘restrictions’ imposed on banks’ activities; Greece is also given a high score (9) (Laeven et al. 2008).

The Bank of Italy, which is a highly respected institution in Italy and abroad, has wide supervisory power in that it is responsible for the systemic stability of the financial sector, including all financial intermediaries; the prudential supervision of banks and securities market intermediaries; the oversight of relevant markets for monetary policy; and the oversight of the payments system.\footnote{Until 2005 the Bank was responsible for safeguarding competition in the banking sector, which was subsequently transferred to the Competition authority.} It should also be mentioned that since 2006, the governor of the Bank of Italy, Mario Draghi, has
also been the chairman of the Financial Stability Forum (later renamed and transformed into the Financial Stability Board), the main international forum in which issues related to financial stability have been discussed, and the response to the financial turmoil has been coordinated internationally. In the annual report of the Bank of Italy, Governor Draghi was one of the first to warn about the risk posed by complex financial activities.

In Greece, financial liberalization over the 1990s changed the structure of a traditionally state-controlled, heavily regulated and bank-based financial system. Deregulation, followed by EU-driven reregulation (such as the implementation of the capital adequacy and other EC directives from the early 1990s onwards) subjected the financial and banking system to a common, less interventionist, European regulatory framework. The state retreated from the ownership of banks, either completely privatizing banks in a market that was soon to be dominated by private credit institutions or limiting itself to indirect government control occasionally through minority equity ownership of the banks. The financial system was transformed towards a more market-based structure, but one in which new financial market instruments and institutions were colonized by existing banks and their subsidiaries.

Over the 1990s the Greek financial system was transformed momentously. Annual credit expansion led economic growth from the late 1990s through the 2000s. Following the trajectory of other emerging markets of the 1990s, the Athens capital market boomed after 1998. Total volume of capital drawn from the stock market as percentage of bank credit to businesses went from 1.6% in 1996 to 5.6% in 1997, to 27.7% in 1999, shrinking back again to nearly 1% levels during 2001-04 and peaking again at 11% in 2007. In addition, from the 1990s and especially into the 2000s, the Greek banking market opened up to foreign institutions. The market share of foreign branches and subsidiaries over total Greek banking system assets was 37% in 2006, down to 22% in 2008 (European Central Bank, 2010).

At the initial stage, Greek banks confronted the global banking crisis from a sound footing, being relatively sheltered. Well grounded on a traditional banking model and a large deposit base, Greek banks were retail oriented and had no legacy toxic assets or special investment vehicles (IMF, 2009). Greek banks were not involved in toxic products, their investment and assets being mostly directed to traditional areas such as corporates, mortgage and consumer credit. Despite however the high credit growth rates of the 2000s, Greek corporate and household leverage was moderate. A significant part of bank assets involved Greek government securities; in the pre-2008 world, euro-denominated government securities were considered among the safest possible asset categories. Thus 'financialization’ of the Greek banking system at the outset of the crisis was very low.

The liability side of Greek bank balance sheets was among the best in the Eurozone. Greek banks have had a strong tradition, dating back to the times of financial “repression”, of financing their loans largely through deposits. Thus dependence on the interbank market, and the associated liquidity shocks, was limited if compared to credit institutions of more advanced EU financial systems.
In 2008 the interbank market dependence ratio of Greek banks (deposits from credit institutions to total assets) was 13%, equal to the Eurozone average; in the same year the funding base stability ratio (deposits other than from credit institutions to the sum of total deposits and total debt certificates) was 70%, better if compared to a Eurozone average 52% (European Central Bank, 2009: 37).

Greek banks were thus relatively sheltered from the most intense forces of global financial contagion. Moreover, the internationalization of Greek banks was mostly regionalization, in terms of ownership of subsidiaries and participation in banking groups in Southeastern Europe to which Greek banks expanded in the 2000s seeking to benefit from the higher profit margins. Turkey, Bulgaria and Romania represented the lion’s share of Greek banking group foreign assets in emerging Eastern Europe, followed by Poland, Serbia, Albania, the FYR of Macedonia, and Ukraine. Total assets of foreign subsidiaries and branches of Greek banking groups in 2008 amounted to € 118 billion, an equivalent 28% of total banking system assets and 49% of Greece’s GDP; of that, the banking system assets in the emerging Eastern European economies amounted to € 51 billion. Thus the Greek banking system’s global risk was mainly emerging market risk. When the financial crisis spread to the emerging markets of Southeastern Europe as well, Greek bank balance sheets were affected through the deterioration of local economies. They were also tempted to channel part of the government finance they received to bolster their Balkan subsidiaries, which created repeated tensions with the Bank of Greece, as it also happened with Austrian banks and their national supervisor.

3. Global financial crisis unfolds: the initial effects of the crisis and response of authorities in Italy and Greece

The peak of stage 1 of the global crisis (as banking crisis) was reached on 15 September 2008, when the investment bank Lehman Brothers filed for bankruptcy in the US and was not rescued by the US authorities. This suggested that not all systemically important financial institutions would be rescued by the public authorities. Moreover, many other financial institutions had positions open with Lehman brothers. Lehman’s failure was followed by a contraction in trading on the interbank market, a widening of the spreads between interbank rates and the reference rates set by the monetary authorities, and an expansion in overnight deposits with the European Central Bank. Banks funding maturity mismatches began to arise as banks relied on relatively short-term ECB refinancing and retail bond issues (Banca d’Italia 2008). Thus financial contagion spread to Europe via channels of global financial interdependencies.

Amongst the various European countries, neither Italy nor Greece were hard hit by the first stage of the financial crisis: no Italian or Greek bank (or foreign bank operating in these countries) failed nor rescued through direct public intervention. The main concern for the two main Italian banks was their exposure in Central and Eastern Europe, especially through acquisitions, mostly establishing subsidiaries, even though such exposure was limited. Similarly, Greek
banks were exposed to emerging market risk through their Eastern European subsidiaries, but the risks were relatively moderate.

The reason for the relative resilience of the Italian banking system to the financial turmoil is twofold: the configuration of the Italian financial system and the activities undertaken by Italian banks; and the regulatory framework and prudential supervision carried out by the Bank of Italy, as explained in section 2. The response of the supervisory authorities to the crisis was ‘prudent’ and ‘systematic’ (IMF 2008). The Bank of Italy intensified prudential oversight of risk management, liquidity management and disclosure enforcement. This, together with the measures adopted by the Government, in consultation with the Bank in early October, reduced systemic risk and liquidity and funding strains (IMF 2008).

In phases 1 and 2 of the global financial crisis, the response of the Italian authorities was based on two pieces of legislation (law decrees of 9 October 2008 and 13 October 2008) issued by the Government in the autumn of 2008 in consultation with the Bank of Italy. These law decrees, particularly the second, mirrored the responses articulated elsewhere in Europe and were in line with the coordination effort taking place in the Eurogroup and at the EU level (see Quaglia 2009). The response of the Italian authorities was articulated into three main actions: the recapitalisation of Italian banks through public funds; support for operations designed to cope with the severe liquidity shortage; and a state guarantee for depositors. The Ministry for the Economy and Finance was empowered to subscribe or guarantee capital increases decided by Italian banks whose capital the Bank of Italy judged to be inadequate. In addition, in the event of severe liquidity crises, the Ministry for the Economy and Finance was authorized to guarantee the loans granted by the Bank of Italy to Italian banks and the branches of foreign banks. As regards depositor protection, the Ministry was empowered to issue a state guarantee to back up the Italian interbank deposit insurance scheme, which provides for coverage up to €103,000, considerably higher than the EU minimum, raised to €50,000 in the midst of the financial turmoil.

Subsequently, a third law decree of 29 November 2008, created the so-called ‘Tremonti bonds’, named after the Italian Treasury Minister who sponsored them. These bonds were hybrid instruments to be subscribed by the state, aimed at increasing the core tier of banks capital and to foster credit to SMEs (one of the conditions to be fulfilled by the banks to subscribe to these bonds). This special facility was designed with a view to avoiding direct equity injections which could lead to effective public ownership, given past experiences with state ownership of banks in the past. While no Italian bank was subject to compulsory measures of recapitalization, five Italian banks took part in the government-sponsored bond purchase scheme to boost banks' capital, namely: Banco Popolare, Monte dei Paschi di Siena, Banca Popolare di Milano, UniCredit and Banca Intesa. The total volume of financial help to Italian banks exceeded 10 bn EUR.

In the second stage of the crisis, when Italy entered into a fully fledged recession, Italian banks began to reduce lending to industry. Since the financial system is
bank based, i.e. businesses rely on bank financing rather than equity or bond markets to raise money, this was detrimental to the activity of the small and medium enterprises that constitute the backbone of the Italian economy. Reportedly, this is one of the factors that triggered government intervention through a bank support scheme (Betts 2008), the above mentioned Tremonti bonds. In the second stage of the crisis, despite their limited room for maneuver, the authorities introduced a number of anti-crisis measures, which were limited in macroeconomic terms and were are designed to be fiscally neutral overall (OECD 2009).

Greek authorities reacted to stage 1 of the crisis in the typical proactive fashion exhibited by other EU governments and within the framework agreed at Eurozone level. Initial stress tests conducted in early 2009 under the Bank of Greece suggested a significant exposure of Greek banks to credit risk (non-performing loans that were bound to increase under recession), cross-border risk (from a large total exposure to Southeastern Europe amounting to €53 billion (203% of equity), market risk despite the relatively small trading books (resulting from high volatility on equity, bond, and foreign exchange markets), and liquidity risk (mainly associated with bank inability to rollover 50% of wholesale funding and 10% of time deposits) (IMF, 2009: 16-17).

In view of these sector risks, and from the first months of 2009, the Greek government raised the deposit insurance limit from €20,000 to €100,000, made available capital injections up to €5 billion in preferred shares that increased banking system high-quality Tier-1 capital, provided liquidity assistance up to €8 billion in special-issue zero-coupon government bonds eligible for ECB discounts against collateral, and extended funding guarantees up to €15 billion (IMF, 2009: 16). A further banking support package for €15 billion in additional guarantees was extended in May 2010. Following Greece’s resort to the EU/ECB/IMF emergency financing mechanism, a €10 billion strong Financial Stability Fund was set up in summer 2010 to provide capital support if necessary to banks under stress.

4. The macroeconomic dimension: from global financial crisis to sovereign debt crisis to banking crisis

4.1. Financial crisis as sovereign debt crisis: Greece but not Italy

As we saw, financial liberalization after the 1990s radically altered the features of traditional Mediterranean, interventionist, credit-based financial systems. But some of the structural underpinnings that had led to financial interventionism in the first place persisted. Government deficits remained a problem, as witnessed in the large public debt levels; and from the moment finance was liberalized, the current account deficits shot up. This was especially so in countries with weak exports, such as Greece and Spain, but not Italy, whose economic growth has been export-led to a significant degree. For every single year since its accession to the euro, Greece exhibited higher than Eurozone average inflation, which was also attributed to the demand boom created by credit liberalization and the low interest rates. As a cumulative result, over the 2000s, Greece suffered an estimated real exchange rate appreciation of 25-30%, leading to declining competitiveness and a 14% current account deficit in 2008. The pattern behind Spain’s current account deficit was similar.
At the time of break out of the crisis, in 2008, both Italy and Greece had similar public debt levels close to the 110% GDP area. In Greece and Italy the large public debt levels were not a matter of huge private debt (as in Spain or Ireland) turning into public debt, but public debt to begin with. Both the Italian and the Greek private sectors remained significantly underleveraged, as compared to the Eurozone standard, despite the higher annual growth rates of private debt in the 2000s. Relatively lower private debt levels reduced the risks of transferring private debt to public debt, as it happened with Spain, Portugal and Ireland following the 2008-9 crisis. In 2009, Italy’s total debt was 224% GDP and Greece’s 219% GDP, compared to a Eurozone average 249%, Spain 268%, Ireland 273%, and Portugal 314% GDP.

However, the external debt of both countries did converge to Eurozone and EU-15 average levels, and financial liberalization had a lot to do with it. A factor for the consumption boom that followed EMU accession was undoubtedly the lower interest rates of the 2000s, as opposed to the high interest rates during much of the 1990s. Interest rates had been low during the ‘financial repression’ era as well (1960s to 1980s) but there was no one else apart from the government sector and subsidized production sectors to take advantage of them as consumption and mortgage credit were heavily restricted. In the 2000s, however, low interest rates followed the high-interest rate period of the 1990s, under which the debt servicing burden for high-public debt countries had risen. Between 2001 and the beginning of 2008, the Greek government bond spread from the German Bund usually ranged in the low 20-40 basis points area, or even lower. To take a random example, in 1 April 2004, the German bond yield was 3.95% and the Greek one was 4.12%, just 17 basis points higher. Combined with the boundless opportunities for public debt management (and window-dressing) created by securitization and financial accounting innovation, this ended up operating as a soft budget constraint that postponed hard fiscal consolidation decisions. Unlike Italy, Greek government budget primary surpluses (i.e. excluding interest payments on the debt) were short-lived, generated only in the end 1990s and sustained for just half of the 2000s. However, both Italy and Greece were unable to take advantage of the low interest rates and high growth rates of the 2000s to reduce their public debt/ GDP ratio (as countries like Belgium had done in the 1990s).

The Greek economy expanded from the late 1990s through the 2000s with an average annual real GDP growth rate above 3.5%. Economic growth was driven by domestic demand, consumption and constructions, financed by an annual credit growth rate that was among the highest in the Eurozone. Between 2001 and 2009, Greek annual credit growth ranged between 15% and 27%, compared to 4-11% annual average credit growth rates for the Eurozone. Despite the higher credit growth rates, the Greek household leverage ratio (household debt as percentage of gross disposable household income) remained consistently below the Eurozone average (rising from 35% to 70% in 2003-2009, compared to 80-95% average Eurozone levels during the same period). In Italy, the ratio of debt to disposable income was about 50% (OECD 2009). In the same way that credit expansion spearheaded demand-driven GDP growth until 2008, the collapse of domestic demand at negative growth rates in 2009-2010 dragged the economy deep into recession (-2% GDP growth in 2009, projected -4% in 2010). From a 30% annual growth rate in 2005, household credit growth reached just above 1% in 2010.
On the contrary, the Italian economy exhibited a low average annual GDP growth rate in the 2000s (0.54% annual average real GDP growth between 2000 and 2010 versus 1.37% for the Eurozone), but posted a primary budget surplus from 1995 to 2008. Far more export-led than all other Southerners, Italy also had a very low current account deficit, 3.2% in 2009, which paled compared to Greece’s staggering 11.2% in the same year. Thus Italy entered the 2008 crisis with far healthier economic fundamentals as compared to Greece.

In stage 2 of the global financial crisis, namely the credit crunch and economic recession, Italian banks, heavily involved in lending to small & medium enterprises, the backbone of the Southern model of capitalism, began to cut the credit available to enterprises. Credit crunch was the typical channel through which the financial crisis hit the real economy, from the US and the UK to Eurozone countries, Italy and Greece. With the recession, credit quality worsened, especially for small and medium enterprises (IMF 2008). Moreover, the Italian economy was negatively affected by the slowdown of global demand and trade, and the fact that the Eurozone entered into recession because the Italian economy is largely export-led. On the contrary, Greece's relatively lower economic openness was the principal factor that cushioned the initial recessionary impact of the crisis. As already mentioned, over the 2000s, Italy has suffered from persistently low economic growth rates exacerbated by the lack of structural reforms—a trend that the financial crisis turned into outright recession in late 2008 (IMF 2008).

Italy's membership of the Eurozone helped stabilize the situation during the financial turmoil because it effectively eliminated the risk of currency crisis, that is, a run of the lira and inability of the Italian government to pay short-term foreign debts for lack of access to 'hard currency'. Such was even more so the case of Greece, another notoriously weak-currency country prior to its euro accession. However, there remained some risk of a solvency crisis, not so much of the Italian banks, as pointed out earlier, but of the Italian state, given the high levels of Italian public debt and deficit. Gross public debt was around 106% of GDP in 2008 and in 2010 it reached over 115% of GDP, with an annual deficit of 6% of GDP. About one sixth of existing public debt has to be refinanced every year and around half of Italian government debt is held abroad (OECD 2009).

Signs of declining fiscal creditworthiness in Italy as well as in other Eurozone member states were evidenced by the fact that the spreads between the ten-year treasury yields of Italy and those of Germany rose from 35 basis points in 2007 to 140-150 basis points in late 2009—the highest since the launch of the single currency in 1999 (Dimmore 2008; OECD 2009). However, Italy, unlike Greece, did not suffer a fully fledged sovereign debt crisis and did not have to turn to the EU and IMF for financial assistance, as we shall further see.
That the Italian public debt was never quite perceived at an imminent threat of default risk is evinced in the credit default swap (CDS) rates. Sovereign (5-year) CDS rates for Greece went from 120 basis points in September 2009 to 900 basis points in September 2010, while for Italy they ranged from 67 in September 2009 to 190 one year later, lower than Spain, Portugal and Ireland (335, the second highest after Greece). Even in the post-crisis year 2009, Italy’s budget deficit was a modest 5.3% and declining. As a result of its good fundamentals, Italy in autumn 2010 was estimated at the lowest risk of debt restructuring among all peripheral countries (Greece, Ireland, Portugal, and Spain), as was demonstrated in the CDS rates. Thus, at the time when the financial crisis was evolving into a Greek sovereign debt crisis, the Italian authorities were not forced to take special measures, like those adopted in Greece. For all such reasons Italy, despite its large public debt/GDP ratio, eschewed the sovereign debt crisis faced by Greece.

The main reason for Greece becoming the first Eurozone country to be bailed out, and the largest bailout in history, was a nasty combination of an unsustainable level of public debt (115% in 2009), 80% of which was external, combined with a staggering public deficit of 12.7% GDP revealed after the October 2009 elections, against a 6% level officially estimated by the previous conservative government. In addition, the government’s 2009 borrowing requirement to be funded by open market placements was €50 billion (21% GDP) and €41 billion (16.5% GDP) for 2010 (IMF 2009). The revelation of a public deficit in the 13% area shocked both Brussels and the extremely nervous markets, which were already scrutinizing sovereign debt numbers following the November 2009 Dubai debt crisis. The revelation of the actual Greek public deficit levels by the new socialist government prompted an unprecedented market speculation against the Greek bond, with the spread and CDSs reaching record levels. Borrowing spreads on 10-year Bunds jumped to 300 basis points in early 2009 (the highest in the euro area) then receded temporarily before shooting up to prohibitive levels (See Diagram 2). Greece was downgraded by S&P to two notches from minimum ECB collateral standards in early 2009, and finally downgraded to junk

\footnote{Later revised to 13.6% GDP by Eurostat.}
bond status by two credit rating agencies in spring 2010, after which the bond spread settled in the 700 basis points area or above.

In the first months of 2010 an overwhelming majority of market analysts were predicting a Greek default, a prediction markets were doing the best to turn into a self-fulfilling prophecy. As market prices became completely prohibitive, the Greek government was forced, in May 2010, to resort to an EU/ECB/IMF Emergency Financing Mechanism, followed by a rigorous 3-year conditionality program. Thus Greece initiated the domino of sovereign debt crisis in the Eurozone, that culminated in the April 2010 EU/IMF €110bn bailout mechanism for Greece. This was followed by a May 2010 EU/IMF €750bn notional European Financial Stability Fund, set up as a special purpose vehicle to avert a sovereign debt crisis in other vulnerable economies of the Eurozone periphery (in particular Spain, Portugal and Ireland).

![Greece Spread 1/1/2000 - 27/4/2010](image)

Thus, the 2008-9 financial crisis found Italy in a relatively sound and Greece in an extremely precarious fiscal standing. The preconditions were there for the financial crisis to develop into a sovereign debt crisis for Greece but not for Italy, despite their almost similar public debt/ GDP levels. The explanation for why Italy eschewed a debt crisis has emerged from their comparison: though at equal levels of public debt, Italy depended on the markets for refinancing only 1/6 of its debt, as compared to Greece having to refinance more than 1/5; Italy had a far lower public deficit in the sensitive year 2009, and a consistent track record of fiscal discipline and credibility over the 2000s; and, more importantly, Italy only had 50% of its public debt held abroad, contrary to 80% of Greece. The latter relates to the financialization of the 2000s.

In the past, e.g. through the 1980s and much of the 1990s, excessive public deficit and debt levels in Greece were prevented from turning into a sovereign debt crisis by the

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6 consisting of €440bn Eurozone funds, €60bn EC budget funds, and €250bn IMF funds
fact that the vast majority of that debt was domestic, held by the Greek banking system, most of which was also state-controlled. This was no more the case in the 2000s. The public debt management over the 2000s was modernized, making use of advanced financial instruments such as extensive securitization, special investment vehicles, and financial accounting innovation techniques, which allowed easy access to global money markets during the halcyon days of the global savings glut. Also using advanced financial technology instruments, like a 2002 $15 billion bond sale and currency swap organized by Goldman Sachs, through which Greece raised $1 billion of off-balance-sheet funding. The public debt conversion from domestic to foreign was accelerated into the 2000s. Through such reliance on market internationalization and ‘financialization’, Greece pushed its debt servicing burden to the future while becoming highly exposed to global debt market fluctuations. However, this global financial market exposure turned into a huge source of risk as soon as global liquidity dried out and markets became jittery about sovereign debt following the Dubai public debt crisis. When the Greek GDP growth rate turned negative and bond yields shot up, the public debt outlook became unsustainable, prompting the devastating sovereign debt crisis from which Greece could only be rescued by an organized bailout.

4.2. Sovereign debt crisis as banking crisis

We have seen so far that the banking systems of both Italy and Greece withstood the initial effects of the 2008 global financial crisis as a result of their “traditional” banking orientation, sound capitalization and limited financialization. However, these Southern European banking systems carried a heavy toll as a result of the sovereign debt crisis, being critically affected by their respective country risk. Thus the Greek sovereign debt crisis also turned into a Greek banking system crisis; this was far less so the case with the Italian banking system.

A strong starting position allowed considerable resilience of the Greek banking system in the face of the crisis: at 11.2% in 2007, regulatory capital to risk-weighted assets briefly fell to 9.4% in 2008, to rise to 11.7% in 2009, well above the 8% regulatory minimum (IMF, 2010). The strong capital standing of Greek banks if compared to many advanced European banking systems was demonstrated in the relatively low leverage ratios. The leverage ratio of Greek banking groups (total assets / shareholder equity) was 13 in 2007, 17 in 2008, down to 14 in 2009, following the significant increase of own funds. These levels are significantly lower compared to the leverage ratios of large Eurozone banking groups (Eurozone average 28 in December 2009), reflecting the strong capitalization of Greek banking groups (Bank of Greece, 2010). Indicatively, in 2008, Credit Agricole had an estimated leverage ratio of 40, Deutsche Bank around 50 (its total liabilities exceeding 80% of Germany’s GDP), Barclays a leverage ratio of 61 (its total liabilities larger than Britain’s GDP), and Fortis 33 (total liabilities several times larger than Belgium’s GDP) (Gros and Micossi, 2008). Gros and Micossi (2008) attribute the large gap between leverage ratios and official regulatory ratios mainly to the massive in-house investment banking operations performed by large European banking groups that are

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7 The domestic control of the public debt also explains why countries like Japan, whose public debt well exceeds 200% its GDP, are not under threat of a sovereign debt financial crisis.
not subject to any regulatory capital requirement. Being less susceptible to ‘financialization’, Greek banks, as well as Italian banks, did not engage in such scale of investment banking operations, and thus created relatively lower systemic risks of a ‘too big to fail and too big to be saved’ type.

Very soon after the financial crisis erupted in the advanced financial systems on both sides of the Atlantic, contagion spread to the Eurozone including the South. Bank funding costs rose, and asset quality in Greece and Southeastern Europe declined. Greek bank profitability declined rapidly in 2009 and 2010, and bank share prices fell steeply. By 2010 Greek bank equity prices had collapsed to 20-30% of their 2007 levels. Though operating income remained stable at elevated levels, the need for larger provisions against non-performing loans drove the Greek banking system as a whole into a loss after including provisioning and taxes in 2010. Since 2009 the Greek banks have been supported by purchasing Greek government bonds and depositing them as collateral for lower-interest rate ECB finance, benefiting from the spread. However, the depreciation of their government securities portfolio in 2010 developed into a major burden of the Greek banking sector, affecting particularly the banks with the largest government debt holdings. From spring 2010 the Greek banks followed the government in successive downgradings by the credit rating agencies.

The effects of the crisis became visible in the liability structure of the Greek commercial banking system. Bank bond issues declined from 10% in 2005 to 6% in 2009; client (non credit-institutions) deposits declined slightly from 63% to 60% (and decreased further in 2010, following a flight of mainly large depositors); and Eurosystem financing multiplied from 1% to 11% (Bank of Greece, 2010). Far better was the standing of Italian banks, corresponding to the lower perceived sovereign risk. In 2009-2010, the funding structure of Italian banks was deemed among the best in Europe, facing very low refinancing risk. Contrary to Greek banks, which relied extensively on the ECB, Italian banks in 2010 made little use of ECB funding, and their Net Stable Funding ratio in 2010 was estimated at 90% (above the 86% EU sector average).

During the first semester of 2010 an estimated € 20 billion worth of deposits (representing around 9% of total banking system deposits) flew out of the Greek banking system. Though much of that was due to tax reasons, the threat of a run on the banks and consequent bank collapse was a crucial factor. The deposit flight was forestalled only when the EU/IMF emergency financing mechanism was set up, providing explicit additional guarantees for the banking system and

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9 Total ECB funding to Greek banks was estimated at an equivalent of 35% of Greece’s GDP, as opposed to 2% GDP for Italian banks –Ireland received the equivalent of 45% of its GDP in ECB funding, and Portugal 13% (April 2010) (Credit Suisse, “Equity Research”, Europe/Italy, June 2010 – source: ECB, national CBs).
10 The Net Stable Funding (NSF) ratio, the new ratio included in Basle III, measures the amount of longer-term, stable sources of funding employed by an institution relative to the liquidity profiles of the assets funded and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations. The standard requires a minimum amount of funding that is expected to be stable over a one year time horizon based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures.
establishing, in the summer 2010, a Financial Stability Fund for bank recapitalizations.

Sovereign risk was taking a heavy toll on Greek banks, which in the second half of 2010 faced the same CDS rate levels as the Greek government. Greek banks were able to deposit Greek government bonds as collateral for receiving ECB finance after the Eurosystem decided to accept as collateral government bonds from all Eurozone member states regardless of credit rating. While Greek sovereign paper remained eligible with the ECB, its rating as non-investment grade meant that it was subject to a 5% higher haircut, which put renewed pressure on the banks’ liquidity positions (IMF, 2010).

Thus, in Greece, the sovereign debt crisis was transformed into a banking crisis, despite the sound starting position of Greek banks. Greek banks were affected by the country risk and collapsed sovereign creditworthiness, leading to inability to raise funds from the interbank market, almost complete dependence on the ECB, depreciation of large asset portfolios of Greek government bonds, collapse of bank equity prices that rendered them vulnerable to a hostile takeover, and deposit flight that was only contained by the ‘imported’ safety guarantees under the EU/IMF financing mechanism. Italy being on a sounder fiscal footing, eschewed both the sovereign debt crisis and the ensuing banking system crisis; the same forces that generated and amounted to the Greek crisis played out in the case of Italy as well, but their intensity was far less severe.

Conclusion

Contrary to the advanced financial systems of the Anglo-American variety and other Eurozone countries, the financial crisis in Italy and Greece did not originate from their domestic financial systems, which were sound and well capitalized. On the contrary, in Greece (and far less so in Italy), the global financial crisis was mainly internalized as a sovereign debt crisis, which thereafter turned into a banking crisis. The state of the two countries public finances at the time of the crisis, and especially the structure of their public debt, was a crucial factor that defined public debt sustainability or the lack thereof.

Low ‘financialization’ sheltered the two economies from the stage 1 of the crisis (global banking crisis) which affected mainly globalized banking institutions exposed to ‘toxic’ financial products. Then stage 2 of the global crisis ensued (credit crunch and recessionary impact on the real economy). In that stage, crucial features of the ‘Mediterranean’ model of capitalism (extensive public sector, relatively closed economy—more for Greece than for Italy—extensive small-business and family-based enterprise sector flexible in adjusting to external economic shocks, widespread informal economy and tax evasion suggesting a cushioning of the effects of the crisis on real income) collaborated in somehow cushioning the intensity of the crisis. Italy, a more open and export-led economy was hit relatively earlier than Greece. The ‘Southern’ or ‘Mediterranean’ Italian and Greek banking systems, less ‘financialized’, regionalized rather than globalized, relatively ‘traditional’, retail oriented, low leveraged, able to rely on wide domestic deposits (result of a long tradition of underdevelopment of alternative investment channels), soundly capitalized, withstood
the effects of the crisis. The relatively low leverage of the private sector in both countries prevented private debt from turning into public debt. Thus, the features of the ‘Southern’ financial model cushioned the initial effects of the global financial crisis.

However, as the global financial crisis deepened, high public debt levels (another ‘Southern’ characteristic) became the crucial destabilizing factor. Italy eschewed a true sovereign debt crisis thanks to its moderate deficit levels and relatively favorable public debt structure. Lacking these mitigating circumstances, Greece took the full blow of a sovereign debt crisis, which subsequently affected its otherwise healthy banking sector. The internationalization and ‘financialization’ of the Greek public debt over the 2000s was a crucial factor that rendered Greece extremely susceptible to global market pressures, turning the financial crisis—as soon as debt servicing ability was seriously doubted—into a public debt crisis. The extensive exposure of Greek public debt management to market internationalization and ‘financialization’ encouraged policy complacency that helped Greek governments over the 2000s eschew the necessary fiscal consolidation. When the surrounding circumstances changed, the GDP growth rate turned negative and interest rates shot up, the public debt that Greece had failed to curb in good times became unsustainable, under those same forces of internationalization that had until then facilitated government borrowing.

Both countries were marginally affected by the banking crisis per se (ie stage 1) because of the low degree of financialisation of their banks, which in turn had been mediated by domestic political economy institutions, in particular the evolution of the national financial system, and the national regulatory environment. However, one way through which Italian and Greek banks were hit during the stage 1 of the crisis were their operations abroad. Both countries were hit by the recession that followed the credit crunch but in stage 3 of the crisis the market never really challenged Italy’s ability to pay its public debt, despite its staggering amount. One of the main findings that might perhaps be applied to other countries in a comparative perspective is that the concept of ‘financialization’ seems to have a significant explanatory power in accounting for the way in which the financial crisis per se played out in different countries, which, in turn, contributes to explaining the response of the national authorities.

What does all this tell us about varieties of financial capitalism; in particular is there a Southern or Mediterranean model? There are two main conclusions to be reached. First, financial capitalisms have radically converged under the forces of single market integration and globalization, as also witnessed in the speed and scope of financial contagion following the 2008-9 global crisis. Market liberalization and EU-level reregulation have rendered the ‘Mediterranean’ or ‘Southern’ financial capitalism model far less distinct from other European financial models than it used to be until the 1980s. Second, such convergence notwithstanding, the variety of financial ‘capitalisms” persists in the face of financial ‘homogenization’, and can play a definitive role on how a group of countries reacts to global-level financial crises. Along with capitalist diversity, cross-national diversity persists as well, highly sensitive to national institutional pathways and dependencies resulting from crucial past choices, of a political, market or regulatory nature.
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