The importance of foreign banks in financing the Spanish economy

Joaquín Maudos[1]

The role of foreign banks in financing the Spanish economy is critical. To prevent further capital flight, the Spanish and European authorities should act fast, drawing on the main lessons learned from the crisis.

Two major economic imbalances in Spain are the size of its negative financial position versus the rest of the world and its high level of external debt. A large part of Spain's financing comes from banks in third countries and the effects of the crisis have led to increased capital flight. Three main lessons can be drawn from this crisis. First, the stigma of a bailout causes increased capital flight by foreign banks. Second, increasing financial markets globalization and integration demand global responses. Third, European banks reduced more their capital exposure to other euro-area partners, undermining confidence and deviating from the path of financial integration. To prevent further deterioration of the current situation and capital flight, the Spanish authorities should push forward reforms to restore confidence and continue working with their European partners in constructing a more integrated European financial market.

One of the Spanish economy's most significant imbalances is the size of its net negative financial position vis-à-vis the rest of the world, in conjunction with its high level of external debt.

In the case of Spain's financial position, two indicators illustrate the country´s high dependence on international financing. The first being net financial assets, which are negative and represent 91% of GDP - a level only exceeded in the Euro area by countries that have received a bailout. The second being external debt, standing at 165% of GDP.

A large share of this external financing comes from banks in third countries. As a result, it is worth addressing the question of whether the crisis that is affecting the Spanish economy is also damaging the economy's borrowing from international banks. In Spain's current context of recession and the sovereign debt crisis, it is worth exploring two key issues to get a better understanding of the potential impact of the crisis on foreign banks' exposure to Spain.

- Has the composition of foreign banks' investments in Spain changed? And if yes, how has it varied?

- Have foreign banks reduced their exposure to the Spanish economy?

[1] Professor of Economics at the University of Valencia and Researcher at the Ivie. This article is related to the research projects SEC2010-03333 of Spanish Ministry of Science and Innovation and PROMETEO/2009/066 of the Valencian Government.

To explore these issues, we differentiate exposures to public debt and bank debt from exposures to non-bank private sector debt of the economy. The data we use in our analysis was published by the BIS. This data also allow us to perform an analysis of Spanish banks' exposure to countries that have seen the steepest increase in their risk premiums.

Finally, as the International Monetary Fund has recently warned in its latest report on the Spanish banking sector, some Spanish banks have significant exposures to the foreign banking and non-financial private sectors. In this article, we also take a closer look at the geographical distribution of Spanish banks' foreign exposures to identify areas of potential risks.

Which foreign countries' banking sectors are lending to Spain?

To analyse this issue, we use the BIS's statistics to quantify different banking sectors' exposure to a given country's debt, broken down by issuer: i.e. public sector, banks and the non-bank private sector. The BIS also provides useful information on indirect exposures through credit commitments, guarantees extended and derivative contracts.

Spain´s external debt held by foreign banks. At the end of 2011, the Spanish economy's external debt held by foreign banks stood at 720.4 billion euros[2], of which 63% was direct exposure, acquired by purchasing debt securities, and the remainder, indirect, in the form of other potential exposures (Exhibit 1). In the case of the former, the largest component (60% of total foreign claims) corresponds to debt issued by the non-bank private sector, followed in importance by debt issued by Spanish banks (27% of total direct exposure) and the public sector (13%).

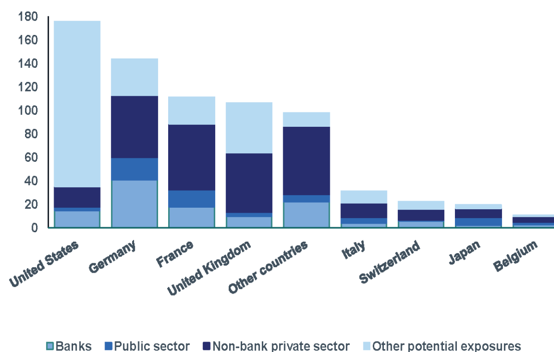
[2] Given that the BIS publishes its information in dollars, the dollar-euro exchange rate for the last day of the year has been used.

International banks' exposure to the Spanish economy. US banks were the most exposed, accounting for 24% (175.9 billion euros) of the Spanish external debt held by foreign banks. In Europe, banks in Germany (143.8 billion euros, 20%), France (111.4 billion euros, 15%), and the United Kingdom (106.3 billion euros, 15%), were the most exposed to Spain, to the extent that these three countries held half of Spanish debt on foreign banks' balance sheets.

Exhibit 1

Foreign banks' exposures to Spain. December 2011

(billions of euros)



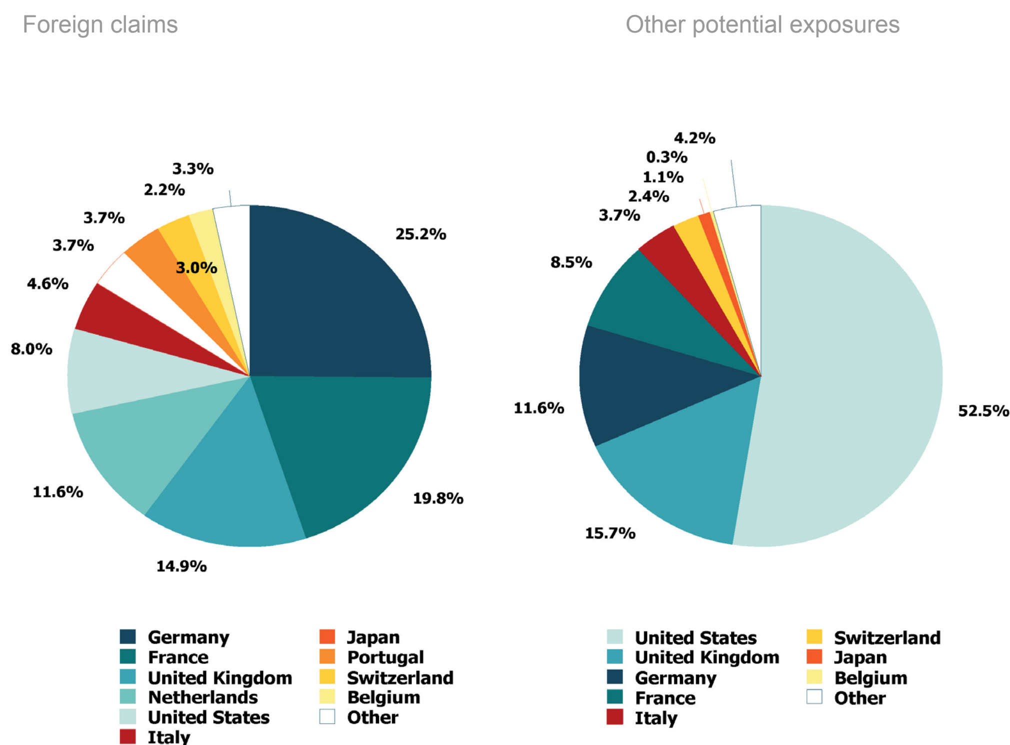
Source: BIS

Turning to *direct exposures resulting from the purchase of debt securities* (Exhibit 2), German (112.9 billion euros, 25%) and French banks (88.6 billion euros, 20%) were the most exposed to Spain, while US banks (35.4 billion euros) had drastically reduced their exposure, and their remaining exposure to Spain's risk was mainly in the form of guarantees extended. In particular, US banks are by far the most exposed to the Spanish economy when it comes to other potential exposures, as US banks hold more than half of the total (140.5 billion euros, 53%).

In the case of *non-financial sector private debt* (the bulk of Spanish external debt in the hands of foreign banks), the main holders of Spanish debt were the French (56.2 billion euros, 21%), German (52.7

Exhibit 2

Geographic distribution of foreign banks' exposures to Spain. December 2011
(percentage)



Source: BIS

billion euros, 20%) and UK (50.9 billion euros, 19%) banking sectors. Conversely, in the case of public debt, the United Kingdom's banks had only a minor exposure to Spain, with German banks being the most exposed, accounting for 32% of all the Spanish public debt held by foreign banks (19.1 billion euros).

Did foreign banks reduce their exposure to Spain in 2011?

The adverse macroeconomic context surrounding the Spanish economy has had a negative impact on net external financial investment. Over the course of 2011 there was a net outflow of capital, which became more intense in the first quarter of 2012. In 2011, capital outflows were 75 billion euros, whereas in the first quarter of 2012 capital outflows were 97 billion euros.

The BIS's information can be used to analyse the change in foreign banks' exposure to Spain in 2011. As Table 1 shows, between December 2010 and 2011 foreign banks reduced their exposure to Spain by 19.5 billion euros. Nevertheless, there is an important difference between direct and indirect exposures. In the case of direct exposures, the amount of Spanish debt held by foreign banks fell by 75.4 billion euros, while indirect exposure rose by 56.0 billion euros.

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By countries, all Europe's banking sectors for which the BIS publishes information have reduced their exposures to Spain, with Germany's banks cutting their exposure by the largest amount (23.9 billion euros), followed by the French banks (19.9 billion euros). On the other hand, US banks increased their exposure to Spain by 44.3 billion euros, a fact that is almost entirely explained by their indirect exposure. In particular, the guarantees extended by US banks to protect investors holding Spanish debt rose in value by 50 billion euros in 2011.

In percentage terms, foreign banks cut their total exposure by 2.6%. However, this average masks important differences both between debt types and between countries. In the former case, whereas holdings of debt securities shrank by 14.3%, indirect exposure through derivative contracts, guarantees extended and credit commitments grew by 26.5% – mainly concentrated in the hands of US and (albeit to a lesser extent) UK banks. In terms of countries, whereas Belgian banks reduced their exposure by 34.8%, US banks increased theirs by 33.6%. German and French banks cut their exposure to Spain by around 15%, while the exposure of UK banks remained virtually unchanged.

The breakdown by debt type shows that Spanish bank debt is where other countries' banking sectors have most reduced their exposures to Spain, with a decrease of 27% (45.2 billion euros). The reduction in public debt holdings was also substantial, however, with foreign banks'

Table 1

Change in foreign banks' exposure to Spain 2010-2011

	Total	Belgium	France	Germany	Italy	Japan	United Kingdom	United States	Other countries
				Billions of euros					
Total	**-19.5**	**-5.8**	**-19.9**	**-23.9**	**-0.5**	**-0.7**	**-0.2**	**44.3**	**-12.7**
Foreign claims	**-75.4**	**-6.0**	**-16.6**	**-23.2**	**-0.8**	**-0.8**	**-15.9**	**1.9**	**-14.1**
Banks	-45.2	-4.9	-11.0	-15.4	-2.0	-1.1	-5.8	2.2	-7.3
Public sector	-16.0	-0.4	-8.3	-2.3	0.8	-0.2	-3.7	0.0	-1.9
Non-bank public sector	-14.2	-0.7	2.7	-5.6	0.6	0.5	-6.4	-0.2	-5.1
Other potential exposures	**56.0**	**0.1**	**-3.3**	**-0.6**	**0.3**	**0.1**	**15.7**	**42.4**	**1..4**
				Variation (%)					
Total	**-2.6**	**-34.8**	**-15.2**	**-14.2**	**--**	**-3.3**	**-0.2**	**33.6**	**-9.5**
Foreign claims	**-14.3**	**-37.0**	**-15.8**	**-17.1**	**-3.5**	**-4.5**	**-19.9**	**5.8**	**-12.0**
Banks	-27.0	-61.7	-37.8	-27.2	-31.4	-29.8	-36.9	16.9	-20.6
Public sector	-20.9	-14.6	-36.5	-10.6	19.2	-3.2	-52.2	-0.2	-20.3
Non-bank public sector	-5.0	-12.9	5.0	-9.6	5.1	6.6	-11.1	-1.2	-7.0
Other potential exposures	**26.5**	**16.5**	**-12.8**	**-2.0**	**2.8**	**4.1**	**59.8**	**43.2**	**8.4**

Source: BIS

Spanish public debt portfolios shrinking by 16.0 billion euros (20.9%). This latter result is in line with the decrease in the amount of Spanish public debt held by non-residents (banks, investment funds, pension funds, insurance companies, etc.) which fell by 16% (37.1 billion euros) between December 2010 and December 2011.

Sovereign debt crisis and foreign banks' exposures

Against the backdrop of the sovereign debt crisis it is worth analysing banks' exposures to those countries whose risk premiums have risen the most.

Since we have already analysed the exposure to Spain previously in this article, the countries examined below are Greece, Ireland, Portugal and Italy. The IMF's September 2011 financial stability report devoted a section to the increase in credit risk (based on the change in risk premiums and CDSs) in banking sectors since late 2008, as a consequence of the debt exposure (public and private) of these countries plus Belgium.

Greece

In the case of Greece (Exhibit 3), the information for December 2011 showed foreign banks' exposure to the country's external debt to total 132.7 billion euros, of which 56% was direct exposure. In the case of exposures arising from debt security purchases, the French banks are by far the most exposed to the Greek economy, in the order of 34.3 billion euros, equal to 46% of foreign banks' total direct exposures. German banks (10.3 billion euros) and British banks (8.1 billion euros) are much less exposed, although together these three countries account for as much as 71% of all the direct exposure to Greece. The Spanish banking sector's exposure is limited, at just 749 million euros.

In the case of public debt, which is the greatest cause for concern due to the high level of Greek public sector debt (despite the agreed 53.5% write-off in nominal bond values), foreign banks' exposures stood at 17.6 billion euros, of which 10.5 billion euros were shared equally by France and Germany. Although its direct exposure was more limited (just 560 million euros of Greek debt), the United States accounted for a larger share of foreign banks' indirect exposure, with a total of 35.7 billion euros in the form of guarantees.

Ireland

Foreign banks' exposure to Ireland totalled 475.7 billion euros, of which 313.7 billion euros was direct exposure in the form of debt securities. The United Kingdom's banks were the most heavily exposed, with an exposure of 148.5 billion euros, representing 31% of the worldwide bank total. German banks (98.3 billion euros) and US banks (74.1 billion euros) were also highly exposed to the Irish economy. In the case of the Spanish banking sector, the exposure to Ireland was 9.1 billion euros, of which slightly more than half was Irish non-financial private sector debt.

Portugal

Foreign banks' exposures to Portugal came to 211.0 billion euros, of which 133.5 billion euros are in the form of debt securities, particularly those issued by the non-financial private sector. Spanish banks are by far the most exposed to the Portuguese economy, holding 34% of foreign banks' total exposure. Spain's biggest exposure is in the non-financial private sector, while its exposure to Portuguese public debt is similar to that of Germany (around 5.5 billion euros).

Italy

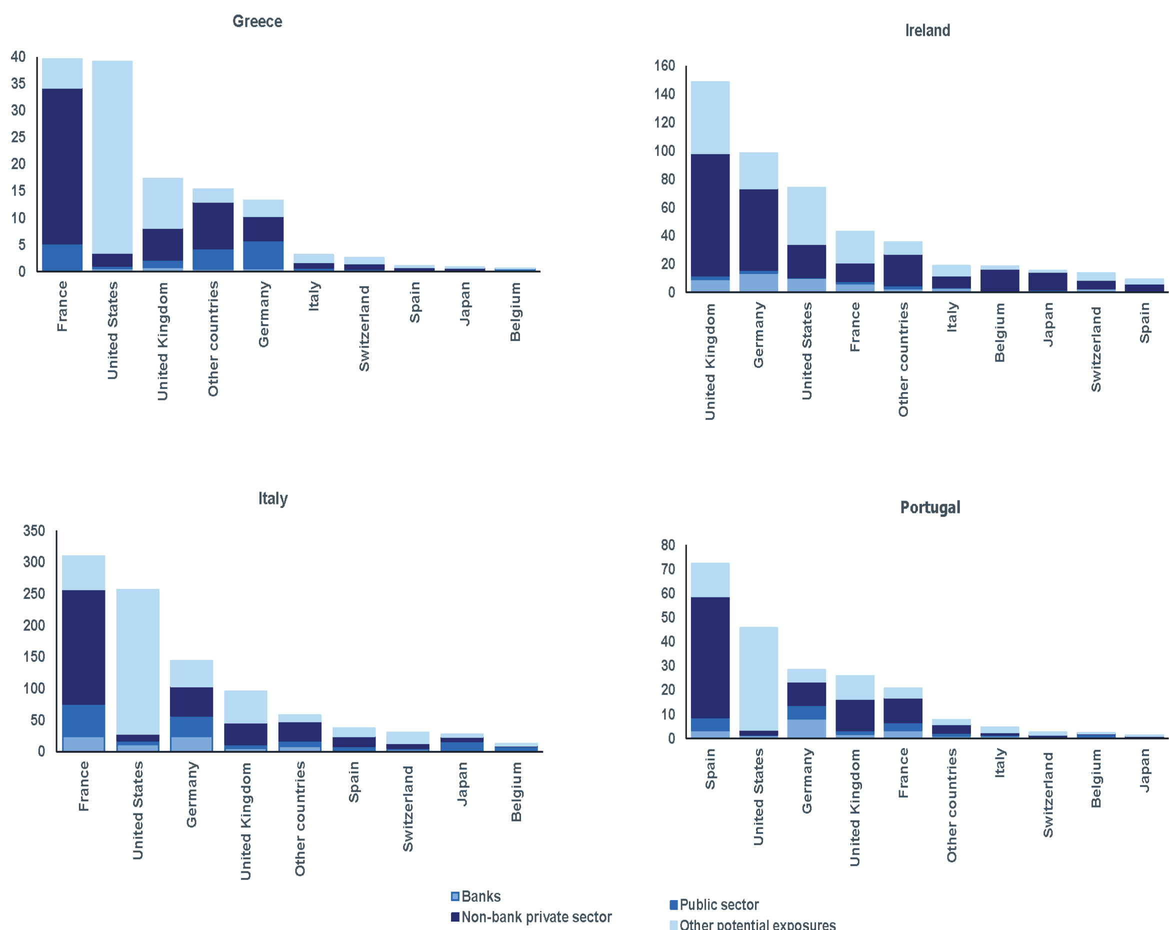
Given the larger size of the Italian economy, the risks assumed by foreign banks are much greater

in comparison to those with the other countries analysed. Specifically, in late 2011, foreign banks' exposure to Italy stood at 969.3 billion euros, with France (32% of total exposure) and the US (26%) being the most exposed countries. Almost a quarter of the total direct exposure of 552.9 billion euros was in the form of debt issued by the public sector, to which the French and German banking sectors had the biggest exposures. In particular, these two countries alone owned almost two thirds of the Italian public debt held by foreign banks. Spanish banks' exposure to Italy came to 36.7 billion euros, with exposures to the non-financial private sector accounting for the lion's share.

Exhibit 3

Foreign banks' exposures to Greece, Ireland, Portugal and Italy. December 2011

(billions of euros)



Source: BIS

How do foreign banks react to a country being bailed out?

The sovereign debt crisis, which stemmed from high government deficits and levels of debt in certain European countries, ultimately made bailouts necessary for Greece, Ireland and Portugal. The crisis first broke out in the spring of 2010 with the bail-out of Greece. Later in that same year, Ireland also needed outside help to tackle its banking crisis and the consequent need to recapitalise its banks, which had caused its public debt and deficit to skyrocket. And in May 2011, Portugal was rescued.

One of the concerns with a bailout is the possible reaction by the country's bondholders. In the specific case of bank creditors, this reaction can be quantified using BIS statistics by analysing changes in foreign banks' exposures to these countries. To this end, Table 2 quantifies the changes in the exposures of banking sectors for which the BIS reports information on the debt of the three bailed out countries, together with Spain and Italy, which are also suffering the consequences of the sovereign debt crisis, with sharp rises in their risk premiums. In 2011, the risk premium against the German ten-year bond rose to 433 basis points in Spain and 519 in Italy in November (monthly average).

Of the three bailed out countries, Greece saw the biggest reduction in foreign banks' exposure in 2011, with a drop of 11.7% (17.5 billion euros). Belgian banks reduced their exposure to Greece most (a reduction of 59.5%), followed by those of Germany (44.7%) and Japan (41%), although in absolute terms Japan's reduction was small (525 million euros). US and British banks increased their exposures sharply (by 25.6% and 8.2%, respectively), although through other potential exposures rather than directly. Spanish banks increased their exposure, but by a smaller percentage (2.7%).

Focusing on direct exposures, the drop in exposure to Greece was very sharp (27.8%), particularly in the case of bank debt (61.3%) and public debt (49.3%). The size of the percentage increase in Spanish banks' exposure to Greek debt stands out, although the amount is small (just 20 million euros).

Foreign banks also reduced their exposures to Ireland and Portugal, although to a lesser extent than in the case of Greece. In particular, whereas the reduction in the exposure to Greece was 11.7%, in that of Ireland and Portugal the drop was 6.3% and 5%, respectively. There was also a difference between the two countries in that in the case of Ireland, foreign banks reduced their exposure to public sector debt more than to bank debt, whereas in the case of Portugal the reverse was true. The reduction in Spanish banks' exposure to these countries was biggest in relation to Portugal, with a drop in debt holdings of 3.7 billion euros.

If we compare the changes in foreign banks' exposures to the three bailed-out countries with the changes in their exposures to Italy and Spain, the drop in exposures to the former was clearly greater, with the decrease in exposures to Italy and Spain being 2.6% and 2.4%, respectively. There was also a difference in how exposures to Italy and Spain changed, in that the largest reduction in foreign banks' holdings affected government debt in the case of Italy, and bank debt in the case of Spain.

Spanish banks' foreign exposures

Analysis of Spanish banks' investments abroad (Exhibit 4) reveals that a large percentage of this exposure is concentrated in the United Kingdom and the United States, and to a lesser extent, Brazil. Total foreign exposure comes to 1.5 trillion euros, 71% of which is in the form of directly purchased foreign debt and the remainder, other potential exposures. In the former case, the countries mentioned account for 56% of Spanish banks' foreign investments, with investments in the United Kingdom standing out (28% of the total).

Table 2

Change in foreign banks' exposures to Greece, Ireland, Portugal, Italy and Spain 2010-2011

a) Absolute values (billions of euros)

	Total	Belgium	France	Germany	Italy	Japan	Spain	United Kingdom	United States	Other countries
GREECE										
Total	**-17.5**	**-0.9**	**-9.1**	**-10.7**	**-1.3**	**-0.5**	**0.0**	**1.3**	**8.0**	**-4.4**
Foreign claims	**-28.7**	**-0.9**	**-8.2**	**-9.2**	**-1.4**	**-0.5**	**0.0**	**-2.4**	**-2.0**	**-4.2**
Banks	-5.0	-0.1	-1.4	-1.1	0.0	-0.2	0.0	-1.2	-0.6	-0.5
Public sector	-17.1	-0.8	-6.2	-5.8	-1.2	-0.3	-0.2	-1.2	-0.6	-0.9
Non-bank public sector	-6.6	0.0	-0.6	-2.3	-0.2	0.0	0.2	0.0	-0.9	-2.8
Other potential exposures	**11.2**	**0.0**	**-0.9**	**-1.5**	**0.1**	**0.0**	**0.0**	**3.7**	**10.0**	**-0.2**
IRELAND										
Total	**-32.2**	**-1.8**	**1.1**	**-20.4**	**0.6**	**-1.1**	**-1.0**	**2.3**	**-5.4**	**-6.6**
Foreign claims	**-29.4**	**-2.1**	**-0.9**	**-14.7**	**1.8**	**-1.1**	**-1.4**	**-2.8**	**-3.2**	**-5.0**
Banks	-12.2	-0.3	0.1	-7.5	1.4	-0.2	-0.3	-4.5	1.5	-2.3
Public sector	-3.8	-0.3	-1.3	-0.3	-0.2	-0.3	0.0	-0.5	-0.9	-0.1
Non-bank public sector	-13.3	-1.6	0.3	-6.9	0.8	-0.6	-1.1	2.2	-3.8	-2.7
Other potential exposures	**-2.8**	**0.3**	**2.0**	**-5.6**	**-1.2**	**0.0**	**0.4**	**5.1**	**-2.2**	**-1.6**
PORTUGAL										
Total	**-11.2**	**-0.5**	**-3.5**	**-9.2**	**-1.0**	**-0.7**	**-5.6**	**2.2**	**10.6**	**-3.5**
Foreign claims	**-19.0**	**-0.5**	**-3.3**	**-3.9**	**-0.6**	**-0.7**	**-3.7**	**-2.0**	**-0.4**	**-3.8**
Banks	-10.1	-0.1	-1.1	-3.6	-0.4	-0.1	-1.3	-1.6	-0.5	-1.5
Public sector	-6.4	-0.4	-2.9	-0.3	-0.1	-0.5	-0.9	-0.1	-0.5	-0.6
Non-bank public sector	-2.5	0.0	0.6	0.0	-0.1	0.0	-1.6	-0.4	0.6	-1.7
Other potential exposures	**7.7**	**0.0**	**-0.1**	**-5.3**	**-0.5**	**0.0**	**-1.9**	**4.2**	**11.0**	**0.4**
ITALY										
Total	**-24.0**	**-9.1**	**-44.5**	**-17.5**	**-**	**-7.3**	**1.3**	**15.7**	**55.3**	**-17.9**
Foreign claims	**-95.2**	**-9.7**	**-36.9**	**-17.9**	**-**	**-6.7**	**0.6**	**-3.8**	**2.0**	**-22.7**
Banks	-25.5	-2.1	-7.1	-13.0	-	-1.8	0.1	-1.2	3.4	-3.8
Public sector	-61.6	-7.3	-21.9	-5.9	-	-6.3	-0.5	-2.1	-1.6	-16.0
Non-bank public sector	-8.1	-0.3	-8.0	1.0	-	1.4	1.0	-0.6	0.2	-2.8
Other potential exposures	**71.2**	**0.7**	**-7.5**	**0.4**	**-**	**-0.6**	**0.7**	**19.5**	**53.3**	**4.7**
SPAIN										
Total	**-19.5**	**-5.8**	**-19.9**	**-23.9**	**-0.5**	**-0.7**	**-**	**-0.2**	**44.3**	**-12.7**
Foreign claims	**-75.4**	**-6.0**	**-16.6**	**-23.2**	**-0.8**	**-0.8**	**-**	**-15.9**	**1.9**	**-14.1**
Banks	-45.2	-4.9	-11.0	-15.4	-2.0	-1.1	-	-5.8	2.2	-7.3
Public sector	-16.0	-0.4	-8.3	-2.3	0.8	-0.2	-	-3.7	0.0	-1.9
Non-bank public sector	-14.2	-0.7	2.7	-5.6	0.6	0.5	-	-6.4	-0.2	-5.1
Other potential exposures	**56.0**	**0.1**	**-3.3**	**-0.6**	**0.3**	**0.1**	**-**	**15.7**	**42.4**	**1.4**

Source: BIS

Table 2 (continued)

Change in foreign banks' exposures to Greece, Ireland, Portugal, Italy and Spain 2010-2011

b) Percentage

	Total	Belgium	France	Germany	Italy	Japan	Spain	United Kingdom	United States	Other countries
GREECE										
Total	**-11.7**	**-59.5**	**-18.6**	**-44.7**	**-28.9**	**-41.0**	**2.7**	**8.2**	**25.6**	**-19.7**
Foreign claims	**-27.8**	**-60.9**	**-19.3**	**-47.1**	**-44.7**	**-40.8**	**2.7**	**-22.6**	**-37.1**	**-22.5**
Banks	-61.3	-86.5	-89.3	-65.0	-21.9	-55.2	571.2	-59.9	-53.7	-36.5
Public sector	-49.3	-59.7	-55.1	-52.7	-66.0	-79.8	-42.2	-46.7	-50.3	-19.2
Non-bank public sector	-11.0	-41.4	-1.9	-33.5	-15.5	-8.9	51.3	-0.5	-26.8	-22.5
Other potential exposures	**23.7**	**-32.9**	**-14.2**	**-34.4**	**9.2**	**-45.8**	**2.5**	**67.8**	**39.0**	**-5.3**
IRELAND										
Total	**-6.3**	**-8.8**	**2.6**	**-17.2**	**3.2**	**-6.4**	**-10.0**	**1.6**	**-6.7**	**-11.8**
Foreign claims	**-8.6**	**-11.2**	**-4.3**	**-16.7**	**18.1**	**-7.0**	**-19.2**	**-2.7**	**-8.5**	**-11.9**
Banks	-19.6	-30.8	1.6	-35.3	77.1	-15.1	-40.4	-33.2	17.9	-29.5
Public sector	-26.1	-46.6	-44.6	-12.8	-31.0	-35.7	49.3	-13.3	-57.2	-2.9
Non-bank public sector	-5.0	-9.0	2.2	-10.7	10.7	-4.2	-17.3	2.7	-13.8	-8.6
Other potential exposures	**-1.7**	**20.4**	**10.2**	**-18.6**	**-15.4**	**2.0**	**16.2**	**11.4**	**-5.2**	**-11.3**
PORTUGAL										
Total	**-5.0**	**-19.4**	**-14.4**	**-24.6**	**-**	**-34.4**	**-7.1**	**9.2**	**30.2**	**-25.1**
Foreign claims	**-12.6**	**-19.4**	**-16.5**	**-14.3**	**-18.9**	**-42.3**	**-5.9**	**-11.2**	**-10.3**	**-33.9**
Banks	-32.2	-16.8	-23.9	-30.7	-25.4	-73.7	-28.2	-45.4	-25.0	-49.6
Public sector	-24.5	-21.5	-47.1	-5.8	-25.5	-64.2	-13.6	-4.9	-62.7	-30.1
Non-bank public sector	-2.6	-12.2	6.8	0.4	-7.5	0.1	-3.0	-2.8	44.9	-27.3
Other potential exposures	**10.8**	**-19.3**	**-3.2**	**-51.7**	**-18.1**	**-4.2**	**-12.1**	**78.0**	**35.2**	**14.2**
ITALY										
Total	**-2.4**	**-41.7**	**-12.6**	**-10.8**	**-**	**-21.3**	**3.6**	**19,6**	**27.5**	**-16.9**
Foreign claims	**-14.7**	**-50.4**	**-12.6**	**-14.8**	**-**	**-22.2**	**2.4**	**-7,7**	**7.7**	**-27.0**
Banks	-23.2	-43.0	-22.5	-34.7	-	-50.5	3.6	-18,1	43.1	-23.5
Public sector	-31.4	-56.9	-30.0	-15.5	-	-29.5	-6.8	-24,1	-19.8	-59.3
Non-bank public sector	-2.4	-22.0	-4.2	2.3	-	25.3	6.8	-1,6	2.5	-6.9
Other potential exposures	**20.6**	**27.3**	**-12.6**	**1.0**	**-**	**-13.9**	**5.9**	**64,8**	**30.5**	**21.6**
SPAIN										
Total	**-2.6**	**-34.8**	**-15.2**	**-14.2**	**-**	**-3.3**	**-**	**-0,2**	**33.6**	**-9.5**
Foreign claims	**-14.3**	**-37.0**	**-15.8**	**-17.1**	**-3.5**	**-4.5**	**-**	**-19,9**	**5.8**	**-12.0**
Banks	-27.0	-61.7	-37.8	-27.2	-31.4	-29.8	-	-36,9	16.9	-20.6
Public sector	-20.9	-14.6	-36.5	-10.6	19.2	-3.2	-	-52,2	-0.2	-20.3
Non-bank public sector	-5.0	-12.9	5.0	-9.6	5.1	6.6	-	-11,1	-1.2	-7.0
Other potential exposures	**26.5**	**16.5**	**-12.8**	**-2.0**	**2.8**	**4.1**	**-**	**59,8**	**43.2**	**8.4**

Source: BIS

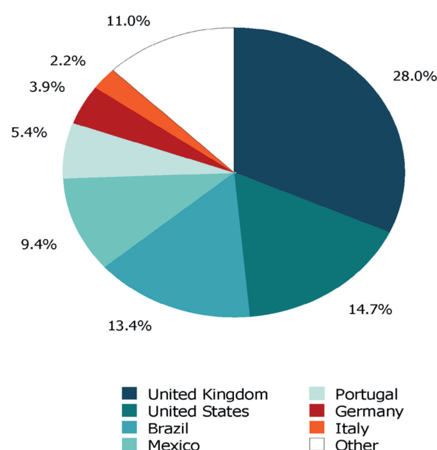
The geographical diversification of the exposure has contributed to alleviating the effects of the crisis on the larger banking institutions, which have the strongest presence abroad.

since 2011 has had an impact in terms of capital flight, although in the specific case of foreign banks, the reduction in their exposure has been limited. Focusing on direct exposure - i.e. that resulting from purchases of debt securities- the reduction in exposure has been greater, although similar to that affecting Italy.

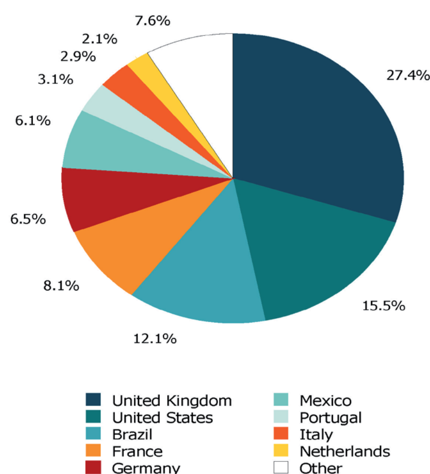
Exhibit 4

Spanish banks' foreign exposures. December 2011
(percentages)

Foreign claims



Other potential exposures



Source: BIS

Lessons from the crisis

Lesson #1: The stigma of a bailout causes foreign bank capital flight

One of the lessons of the sovereign debt crisis is the way in which foreign banks have reacted to their exposures to bailed-out countries. Events in 2011 clearly reveal that the stigma of a bail out causes capital flight by foreign banks, with a general reduction in their debt holdings, which have fallen by as much as 27.8% in the case of Greece.

In Spain's case, the complicated macroeconomic context in which the economy has found itself

Loss of confidence has been greatest in the case of bank debt, as the closure of the wholesale finance markets has prevented Spanish banks from issuing debt. This has been reflected in the sharp drop in debt held by foreign banks.

The Spanish treasury has also suffered the consequences of the crisis with a reduction in public debt holdings in the hands of banks abroad, but the drop was less significant than that suffered by the Italian treasury.

Against this background, the priority now is to push forward the structural reforms that have been embarked upon to restore foreign investors' confidence. In the specific case of the banking sector, the requirement for bank provisions as high as those set in the last two Royal Decrees concerning exposures to the real estate sector, and the recapitalisation of vulnerable banks with external aid from European Funds, are a necessary step to restore confidence and access to international finance.

Lesson #2: Increasing financial markets globalisation and integration demand global responses

Another lesson to be drawn is that the process of globalisation and increasing integration of the financial markets in the period leading up to the outbreak of the crisis also created the need for global responses. The high level of exposure of certain countries' banking sectors to the debt issued by those economies being buffeted by the European sovereign debt crisis have turned these problems into global ones. In the case of Italy and Spain their size is such that the global banking system is heavily exposed (in the order of 1.8 trillion euros), particularly banks in Germany, France and the United States. These three countries alone hold more than three quarters of the total exposure to the Spanish and Italian economies (1.1 trillion euros), giving them a crucial role in any solution to the European Union's problems.

Lesson #3: European banks reduced more their exposure to other euro-area partners, undermining confidence and deviating from the path of financial integration

Finally, it is the European banks that have reduced their exposure to the debt of the euro-area partners most, which represents a clear step backward on the road to financial integration.

With the crisis, the markets have fragmented, and the importance of the home bias has increased. This demands coordinated measures to recover lost ground and resume progress towards the construction of a single financial market.