10. The real estate sector and the financial crisis: the Spanish experience

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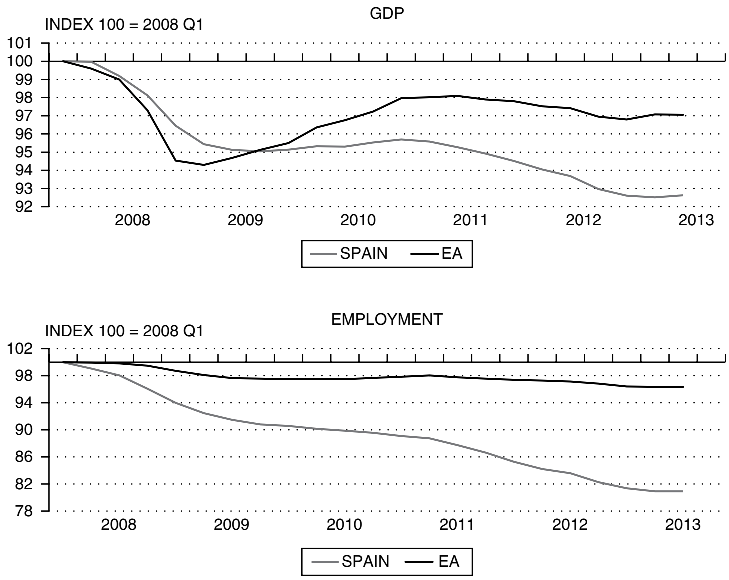
10.1 INTRODUCTION

The Spanish economy is going through a process of correcting the macroeconomic and financial imbalances which emerged in the years before the onset of the financial crisis in 2007. These imbalances affected the real estate sector, the level of private credit and the competitiveness position of the Spanish economy, all of which fall squarely within the scope of the issues addressed in this volume. Against this background, the focus of this chapter will be on the lessons to be drawn from the developments in these three areas since 1997.

Spain is emerging from an unusually deep economic crisis. This crisis has been more severe in Spain than on average in the European Union and it has had a sizeable cost in terms of employment destruction. With the perspective of the six years that have passed since the outbreak of the global financial crisis (Figure 10.1), the severity of the recession in Spain can now (2013) be seen to be the consequence of a combination of a number of causes. The starting position of the Spanish economy in 2007 was characterized by a number of macrofinancial imbalances that had built up over the expansionary phase of the cycle, which heightened its vulnerability to financial shocks. In addition, the macroeconomic crisis together with the superimposed sovereign debt crisis gave rise to a vicious circle of tightening financial conditions and deteriorating confidence, which led to a worsening in the macroeconomic environment. Finally, the growing complexity of the crisis, as the links between the macroeconomic and financial problems became stronger and the crisis of the single currency project emerged, made it difficult to diagnose its causes and to identify the necessary economic policy response.

The Spanish economy started to emerge from the second recession of this long crisis in mid-2013, when the first signs of positive growth



Note: EA = euro area, GDP = gross domestic product.

Sources: Eurostat, Instituto Nacional de Estadistica and Banco de España.

Figure 10.1 GDP and employment levels: Spain and the euro area

became visible. The projections available at the end of 2013 point to some positive growth in 2014. Nevertheless, transforming this as yet weak recovery into a path of robust growth remains challenging since it requires completion of the deleveraging of the public and private sectors and speeding up the reallocation of financial and productive resources across the economy.

In order to highlight the magnitude of these challenges this chapter will address four main points. Following this introduction, section 10.2 starts with a brief review of the nature of the accumulated imbalances that emerged after the long expansion (1998–2007). Section 10.3 provides a description of the main features of the process of adjustment and rebalancing of the Spanish economy, paying particular attention to three areas: the absorption of the imbalances in the residential sector, the deleveraging of the private sector and, finally, the internal devaluation and the reduction of the external deficit. Afterwards, in section 10.4 some lessons to be drawn from these developments will be put forward. Finally the chapter will conclude in section 10.5 with some comments on the issues that the

Spanish economy needs to address to ensure a sustained recovery and a healthier pattern of growth.

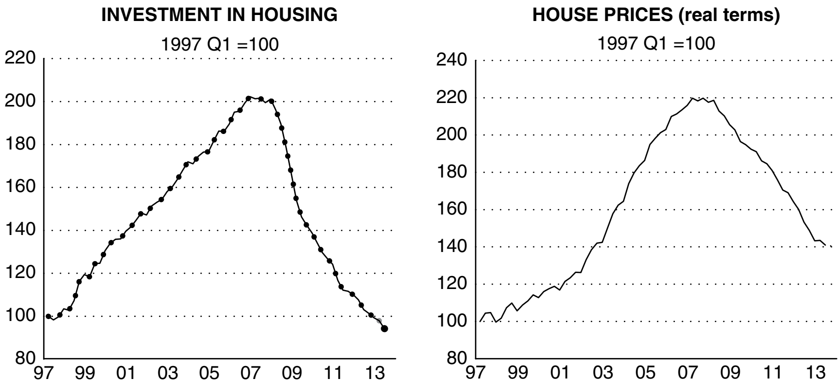
10.2 MACROECONOMIC IMBALANCES BEFORE THE OUTBREAK OF THE FINANCIAL CRISIS

After the creation of the euro, Spain enjoyed very high economic growth. Gross domestic product (GDP) growth averaged 3.6 per cent from 1999 to 2007, 1.4 percentage points above the euro area average. A key determinant of this long expansion was the predominance of rather expansionary macroeconomic and financial policies during the first ten years of the euro (Estrada et al., 2009). In this context, strong demand pressures emerged which were only partially offset by certain developments in the supply side of the economy driven by the sizeable increase in migration flows (the population increased by 6 million from 1999 to 2008 and the labour force was boosted by an increase in the participation rate of women, as well as by immigration).

The expansion of demand was underpinned by residential investment, fostered by a large reduction in interest rates and an improvement in the affordability of housing. Moreover, certain fundamentals (such as population dynamism and improved income expectations) also contributed to this expansion of demand. Some indicators, mainly in the financial domain, failed to signal overheating in this period. Interest rate differentials vis-à-vis the core euro area countries moved within a narrow range, well below 100 percentage points, until the very beginning of 2009, and large-scale inflow of capitals during the initial years of Stage Three of European Economic and Monetary Union (EMU) enabled the deficit to be funded, mainly through the banking system. This development was wrongly interpreted by some to mean that external deficits were always sustainable within EMU. However, subsequent events would show that the external constraint remained fully operative in EMU.

Indeed, this pattern of growth gave rise to a set of macroeconomic and financial imbalances, which took the form of a rapid expansion of credit and leverage in the private sector and persistent cost and inflation differentials with the euro area. These imbalances emerged simultaneously and were mutually reinforcing: the growth in private sector indebtedness was closely connected to the housing boom and demand pressures fostered cost and price differentials and sizeable competitiveness losses. Overall, the imbalances led to a high dependence on external finance, with a current account deficit of about 10 per cent of GDP in 2007.

Between 1995 and 2006, the weight of residential investment in GDP

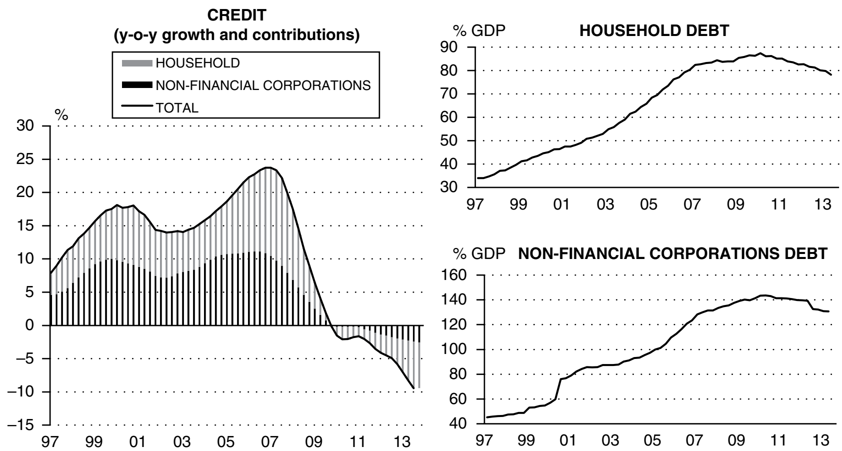


Source: Ministerio de Fomento, Instituto Nacional de Estadística and Banco de España.

Figure 10.2 Housing developments in Spain

almost doubled, to reach a peak of 12.5 per cent. Housing supply was able to respond flexibly thanks to the strong inflow of immigrant workers, among other factors. However, both housing prices and the number of housing units produced overreacted. In fact, residential prices more than doubled in real terms between 1997 and 2007 (see Figure 10.2). Additionally, due to the long lags involved in the production of dwellings, the fall in residential demand, once financial conditions and expectations changed after 2007 as a result of the financial crisis, generated a sizable overhang of unsold homes.

As a result of this overshooting in the residential market, both productive factors and financial resources were overly concentrated in the real-estate sector. On the financial side, private sector indebtedness expanded forcefully (see Figure 10.3). In the mid-1990s, the debt of Spanish households and firms amounted to only 77 per cent of GDP, 28 percentage points below the euro area level. From this relatively low starting level, after the beginning of Stage Three of EMU, private sector indebtedness grew rapidly. Between 1999 and 2007, credit to firms and households grew at an annual average rate of almost 19 per cent, while nominal GDP grew at an average rate of just below 8 per cent. As a result, private sector indebtedness reached 199 per cent of GDP in 2007, well above the euro area average of 153 per cent. In the case of households, the bulk of the expansion of credit demand was linked to the mortgage market. Lending to households for house purchases doubled as a percentage of GDP, from 30 per cent to over 60 per cent. In the case of firms, the bulk of the expan-



Note: y-o-y growth = year-on-year growth.

Source: Instituto Nacional de Estadística and Banco de España.

Figure 10.3 Credit and debt growth in Spain

sion related to financing for construction and real-estate development activities, which rose from somewhat over 10 per cent of GDP in 2000 to above 40 per cent in 2007. It was financing flows to these sectors that saw the most risky operations. However, significant flows of financing also went into productive investment during this phase, helping to enhance the solidity of certain segments of the Spanish productive system.

As a result of these developments, when the international financial crisis changed the attitude to risk and flows of cross-border financing dried up, the risk accumulated in bank balance sheets, especially risks linked to property market excesses, and the high level of dependence on external wholesale financing turned into factors of fragility for a segment of the financial system. This compounded the adjustment phase which started in 2008.

10.3 ADJUSTMENT AND REBALANCING AFTER 2007

From 2008 to 2013, Spanish real GDP decreased by 7.5 per cent as the result of a sharp fall in domestic demand (–16 per cent), which was partly offset by a rise in net external demand. However, perhaps the measure that best illustrates the seriousness of the crisis is employment, which declined by 19 per cent in this period, and the rate of unemployment, which stood at slightly below 26 per cent of the labour force in 2013. During this period, some of the imbalances that built up during the upturn have been corrected and a substantial readjustment of the main Spanish macroeconomic aggregates has taken place (Ortega and Peñalosa, 2013).

First of all, there has been a rapid downsizing of the residential construction sector. The share of residential investment in GDP fell from 12 per cent in 2007 to 4.4 per cent in the second quarter of 2013, its lowest level for the last three decades. The decrease in the number of housing starts was even sharper, since in the 12 months to June 2013 the construction of 40 000 houses was started, around 5 per cent of the number commenced in 2006. With respect to prices, the real-estate bust affected house prices, which by the second quarter of 2013 had fallen in nominal terms by nearly 30 per cent from their peak. In real terms the size of the adjustment is 36 per cent, a sharper correction than in previous cycles and similar in magnitude to the largest adjustments experienced in other countries. This means that the gap which opened up between house prices in Spain and in the euro area in the boom period has closed considerably.

Non-residential construction also declined substantially, since on top of the downturn in residential construction there was a sharp fall in government investment, which has been one of the main drivers of fiscal consolidation in Spain.

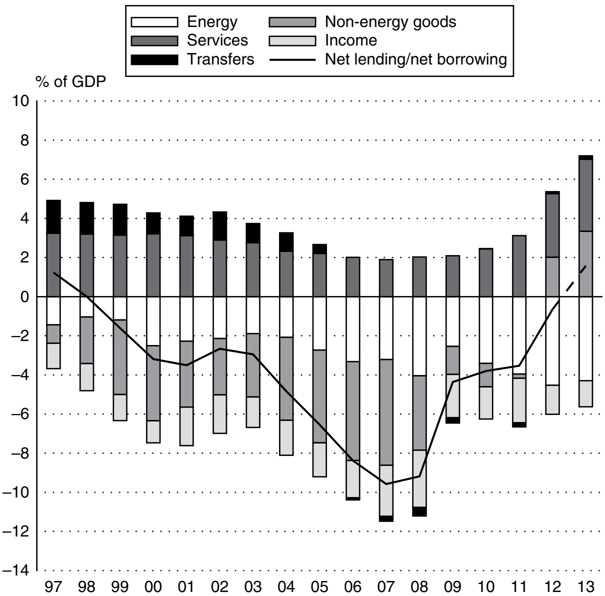
Despite the magnitude of the downsizing of the sector, the large stock of unsold houses and the prevalence of weak demand conditions (subdued income, tight financial conditions and low demographic dynamism) suggest that the Spanish housing market correction could continue for some additional quarters. However, regional disparity in terms of price and stock adjustments, consistent with the diversity of local housing markets, indicates that housing investment recovery will take place at a different pace across regions. The sharp halt in the construction sector had a considerable effect on employment because construction is very labour-intensive. Construction sector employment came to account for nearly 14 per cent of total employment in 2007, twice as high as in the euro area. In the second quarter of 2013 the persons employed in this sector accounted for 6 per cent of total employment, similar to the level in other European countries.

Secondly, with the onset of the crisis, the outstanding amount of credit to Spanish firms and households began to decline, with rates of growth falling from around 20 per cent in 2007 to reductions of around 6 per cent in mid-2013. The decline is proving steeper for non-financial corporations, but lending to households is also diminishing.

The strong fall in credit has not been so visible in terms of debt ratios, which are also diminishing, but at a slower rate. In mid-2013, the indebtedness of households was around 80 per cent of GDP, almost eight percentage points down from the peak observed in mid-2010. In the case of non-financial corporations, the corresponding ratio as at end-2012 was around 110 per cent of GDP, 17 percentage points down from its peak in mid-2010. To appropriately assess the magnitude of the effort made so far by the private sector in this respect, it is important to take into account the particular background in which deleveraging is taking place. First of all, real GDP has faced an exceptional contractionary cycle with an unprecedented double-dip recession, which started in the second quarter of 2008 and continued until the second quarter of 2013.[1] Moreover, the economy cannot rely on inflation to deflate the real value of debts since there is also the need to recover competitiveness. Finally, the banking sector has undergone a deep restructuring, which in some initial stages could have limited the use of write-offs. Therefore, deleveraging has mainly advanced through the contraction of debts, something that inevitably limits the speed of the process (Ayuso, 2013). Even so, some progress is being made.

Thirdly, Spain's external deficit has experienced a very substantial correction. The net lending position swung from 10 per cent of GDP in 2007 to a surplus of above 1 per cent in 2013. This correction is partly explained by a surge in exports, a development indicative of the improved competitiveness and greater presence abroad of Spanish firms, which is probably partly related to the sluggishness of the domestic market. Exports increased by 14 per cent in real terms in the above-mentioned period and, at current prices, rose from a share of somewhat more than the one-quarter of GDP at the start of the crisis to one-third of GDP in mid-2013, an increase of eight percentage points. Also notable was the smaller relative share of exports to the euro area, a sign of the growing geographical diversification of sales abroad, which underpinned the buoyancy of exports at a time when world growth was tilting progressively towards the emerging economies. In this period, real imports decreased by 18 per cent. It can be assumed that this weakness of imports has a large cyclical component, although it is possible that in some segments purchases abroad are being partially replaced by domestic production (see Figure 10.4).

Overall, the behaviour of exports and imports reflects the fact that the adjustment channel of competitiveness began to function, although with delay. Using unit labour costs (ULCs) as a proxy for cost competitiveness, the Spanish economy had absorbed by the end of 2013 almost the entire loss of competitiveness accumulated during the decade before the crisis vis-à-vis the euro area (see Figure 10.5). Together with countercyclical



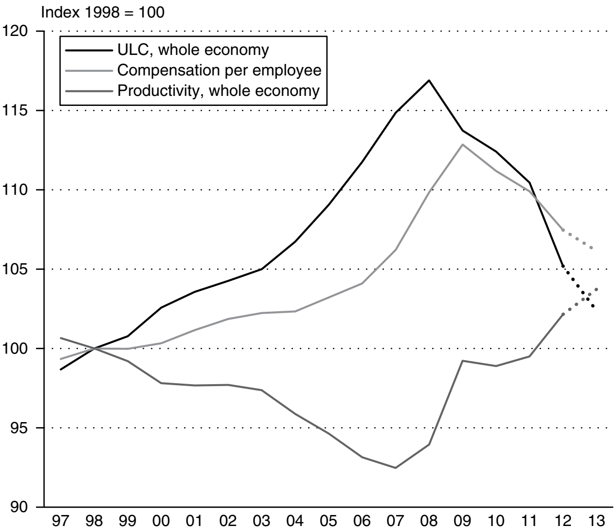
Source: Eurostat, Instituto Nacional de Estadística and Banco de España.

Figure 10.4 Spanish net lending/net borrowing broken down by production segments

labour productivity developments, moderation in the compensation of employees since 2009 has caused a sizable fall in ULCs.

The reduction in the nation's net borrowing by 11 percentage points of GDP from the beginning of the crisis was accompanied by a movement of the opposite sign in the public and private sectors (see Figure 10.6): the lending of non-financial corporations and households increased by 18 percentage points, mainly as a result of the sharp adjustment in investment and also because of the efforts by both sectors to clean up their balance sheets and reduce their leverage; by contrast, the public sector went from a surplus of nearly 2 per cent of GDP in 2007 to a deficit of 6.8 per cent in 2012 (which does not take into account the impact of financial support).

As a result of the significant correction of the external deficit, the expansionary trend in the net debtor position vis-à-vis the rest of the world has been halted, but not sufficiently so as to reverse it (Figure 10.7). Although external financing has resumed since end-2012, as the result of the European financial support, the acceleration of adjustments and reforms in the Spanish economy and the commitment by the European



Source: Eurostat, Instituto Nacional de Estadística and Banco de España.

Figure 10.5 Relative unit labour costs: Spain versus the euro area

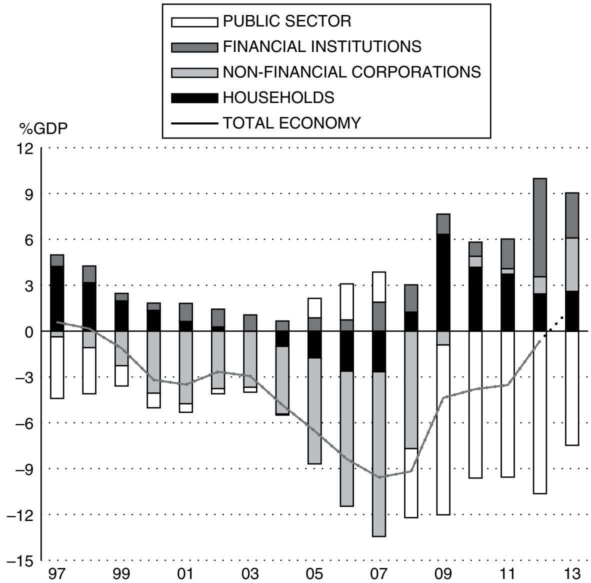
Central Bank (ECB) to address the risk of break-up of the euro through the outright monetary transactions programme, sustained surpluses in the current account are needed to start bringing down the net investment position towards more sustainable levels.

10.4 SOME LESSONS TO BE LEARNT

Among the numerous lines of analysis engendered by the turbulent period the Spanish economy has gone through in the course of these years, this section tries to summarize certain lessons to be raised on two particular issues: the contribution of housing and credit to the dynamics of the crisis; and some implications for economic policy over the business cycle.

As we have seen, the real estate market played a key role in generating macroeconomic and financial imbalances during the upswing. Afterwards, the collapse in the residential sector was an essential element behind the dynamics and the depth of the crisis. All in all, adjustment in the housing sector has had a strong macroeconomic impact with significant direct and indirect effects across the economy.

To understand the magnitude of these effects it is worth reviewing

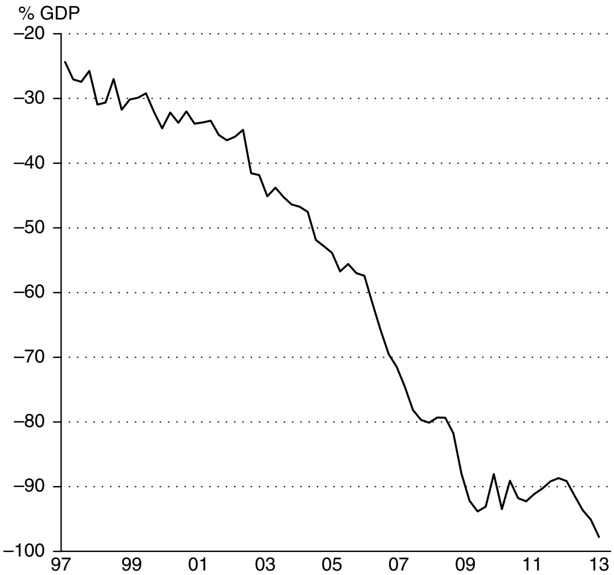


Source: Eurostat, Instituto Nacional de Estadística and Banco de España.

Figure 10.6 Spanish net lending/net borrowing by economic sectors

some of the cyclical features of the real-estate market. Investment in housing is traditionally the demand component that tends to generate the most pronounced cyclical fluctuations, not only in Spain but also at the international level (see Leamer, 2007; Alvarez and Cabrero, 2010; Marqués et al., 2010; Maza and Peñalosa, 2011). Two characteristics of the housing market are fundamental in this regard. Firstly, investment in this market is susceptible to substantial swings, since changing expectations of asset prices or interest rates can exert a considerable influence over market dynamics. Secondly, residential investment is a very highly employment-intensive sector and maintains strong links with other productive branches. Adding to the volatility of residential investment, the contractionary phases of the real-estate cycle are usually more acute and briefer than expansion periods, a phenomenon which underscores the catalyst role of this investment component in recessions. In Spain's case, the weight of residential investment in GDP, which took 12 years to peak, needed only four years to return to its starting level (in 2011).

This form of adjustment means that, in a short period of time, a large quantity of labour is driven out of the market at a time in which important



Source: Eurostat, Instituto Nacional de Estadística and Banco de España.

Figure 10.7 Net international investment position of Spain

spillovers to other industrial and services branches emerge. This development can have permanent repercussions unless there is extensive labour market flexibility, a sufficient level of training on the part of the labour affected, and flexible product markets that help to reallocate productive resources across the economy.

All these factors help to explain why adjustment in the housing sector has had such a strong direct and indirect macroeconomic effect in Spain. The shrinkage of the sector spread to the rest of the economy almost immediately through a process of labour shedding. The subsequent economy-wide reduction in output and the fall in real estate prices had a direct contractionary effect on disposable income and wealth that triggered a series of second-round effects on residential investment and its complementary industries. Carry-over effects on activity and employment were aggravated by the fact that labour and product markets were not flexible enough to facilitate cross-sector reallocation of resources or a more balanced reaction of wages and employment when shocks emerged.

On the financial side, the Spanish case reveals the difficulties of digesting household and business deleveraging processes strongly linked to real-estate activities. On the one hand, residential adjustment in a context of a protracted recession can have damaging effects on bank balance sheets as the risk of default by real-estate companies, and to a lesser extent households, increases, which can generate a general tightening in financing conditions in the economy. On the other hand, following the build-up in debt, the private sector is confronted with the need to deleverage, which compounds the already contractionary environment.

Finally, the external deficit is a variable of singular importance in a monetary union. The events of recent years show that the accumulation of excessive deficits will ultimately be punished by financial markets, which in the end may re-establish country risk and, thereby, hamper the financing of deficits. And this is all the more true if the external deficits have been the consequence of a strong increase in private sector debt essentially linked to residential investment, alongside persistent losses in competitiveness.

The Spanish economy's experience from 2007 to 2013 allows certain lessons to be drawn for the economic policy domain (Ortega and Pañalosa, 2012). Focusing on the issues covered in this chapter, the strong volatility of residential investment and of house prices may, under certain circumstances, have highly adverse cyclical consequences. Accordingly, to maintain a suitable degree of macroeconomic stability, developments in the real-estate market and financial resources earmarked for housing investment must be closely monitored, using the instruments available to curb the expansionary dynamic of the residential cycle. This must involve the elimination of any bias towards home ownership in the tax code. And, more importantly, a macroprudential framework needs to be built in order to reduce the role of the real estate sector in the creation of macroeconomic imbalances. Finally, measures to make the labour market and the economy more flexible are essential to foster the price and cost adjustments needed to enable the surpluses of labour and other productive factors to be reallocated across sectors.

To avoid the build-up of an external imbalance, early diagnosis and correction are required. To this end, it is essential to have room for manoeuvre to make use of domestic economic policies within EMU. In this connection, a restrictive fiscal policy and greater liberalization of goods and factor markets should have been pursued, to lessen demand pressures and allow a sharper adjustment of costs and prices. That requires a more restrictive fiscal policy during the upturn (which may not be easy, if we recall that Spain had a fiscal surplus in 2007, which was not enough) and timely implementation of the structural reforms needed.

10.5 CHALLENGES AHEAD

The economic crisis in Spain has been unusually deep. The starting position of the Spanish economy in 2007 was characterized by a number of macrofinancial imbalances that had built up over the expansionary phase and that heightened vulnerability to financial shocks.

Remarkable effort has been made to adjust and rebalance the economy (through fiscal consolidation, structural reforms and restructuring of the financial system). But there are still some very fundamental issues to be addressed, namely, how to speed up the absorption of unemployment and how to reduce the high level of public and private indebtedness. This is challenging, since on the one hand there is no margin for implementing demand policies and, on the other hand, deleveraging by itself will exert contractionary pressures on demand. Against this background it is absolutely vital to speed up the process of reallocation of resources and to increase productivity through the implementation of supply-side policies. That requires the determination to maintain the focus on structural reforms. Economic policies can improve the resilience of the economy.

The long expansion up until 2007, the severity of the crisis and the difficulties in kick-starting the economy highlight the need to avoid complacency in economic policy management in boom phases, and the urgency of adapting the structure of goods and factor markets and the behaviour of agents in Spain to the requirements that a monetary union imposes.

NOTE

1. With the exception of the period running from the beginning of 2010 to the first quarter of 2011, when the level of GDP barely rose (+ 1 percentage point).

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