Spain: Can the House Resist the Storm?

Employment Conditions

2000 - 2007: The Spanish economy, as well as those around the world, was experiencing fast growth with very high levels of spending. Because of the housing boom, the unemployment rate in Spain was decreasing relatively fast and in the second quarter of 2007, the lowest unemployment rate in Spain's history was recorded, being 7.93%. Housing was the key factor that allowed Spain to experience its most prolonged and stable period of economic growth in its contemporary history.

2008 - 2009: In the United States, the default of mortgage-backed securities triggered the collapse of the American economy. As a result, mortgages stopped being financed and many builders could not finish their projects because they could not find buyers. Gradually the list of unemployed workers from construction and the unemployment rate began to skyrocket in all the provinces of Spain. The unemployment rate almost doubled in a year and a half, and at the end of 2008 it stood at 13.79%. The number of unemployed increased from 1,773,200 people in mid-2007 to 3,206,800, almost double at the end of the following year. In the first quarter of 2009 the crisis worsened and more than 800,000 people joined the list of unemployed, which already exceeded 4 million people. At the end of 2009 the unemployment rate was already 18.66%. Two and a half million jobs had been destroyed in just three years. See Appendix A for a graph showing the evolution of the unemployment rate in Spain.

The Housing Boom and Consequences

In the early 2000s, Spain was undergoing a period of prosperity compared to other European countries and in the context of European integration, interest rates were low. As a result, investment opportunities in Spain were very attractive. Conjointly, a massive inflow of immigrants led to an increase in the number of workers. This in addition to a generation of northern European retirees was increasing the population growth. Additionally, the number of divorces were through the roof. All of these situations translated into more people needing places to live. Hence, heavy demand drove housing prices up. This was an opportunity for Spanish construction companies and banks to benefit from the low interest rates from the European savings. Banks in Spain were conceding credit with almost no requirements which made it easy for people to buy a house. Also, Spanish households consumption was very high causing the private debt to increase dramatically and Spain's current account deficit to grow. Nevertheless, expectations of future appreciation for housing prices motivated people to invest more in houses. At this point, building more houses was becoming extremely profitable for construction companies making the expansion for supply of houses enormous. As a result, housing prices were still going up.

Regarding the consequences, we must consider that housing made up a majority of the national wealth in Spain. Local and regional governments benefited from this as taxes represented a significant share of their revenue. As a consequence, taxes were useful for regional governments to balance their budgets and provide for different sectors such as health care and education. On the other hand, the rise of house prices increased wealth for those who had some residential investment. However, as buying a house became less affordable, the rest saw how their relative real wealth was declining. Hence, the boom led to a boost in wealth inequality.

Financial Crisis Contagion

The link that permitted the contagion of the international financial crisis to the Spanish economy was that foreign companies invested in American mortgage-backed securities, and they were badly damaged when default rates caused the value of MBS to collapse. The liquidity crisis in the US then spread internationally.

Reforms

Financial sector – The government increased the capital requirements of banks to limit exposure to sovereign debt. A new law increased the minimum requirement for tier-1 capital levels of 8% of risk-adjusted assets. It also imposed a capital requirement of 10% on financial institutions with less than 20% of their equity owned by third parties or that were heavily dependent on wholesale funding. To manage restructuring and aid in institutions increasing their capital, the government implemented the Fund for Orderly Bank Restructuring (FROB).

Fiscal adjustment – In our opinion, this was the most necessary reform to bring down the deficit in government expenditure. Within the first 8 months in 2011, the government deficit was reduced by 30.8 billion euros, which comes to 2.8% of the GDP. Continuing, the government put restrictions on regional governments from issuing debt unless they met their fiscal goals, and central and regional governments were not allowed to run a deficit above a set limit. In order to prevent people taking advantage of pension programs, the government passed pension reform, making partial retirement more costly by adding a clause that a minimum of 37 years of contribution needed to be fulfilled in order to receive pension and increasing the retirement age from 65 to 67. Lastly, in order to increase revenue and cut costs, the government decided to privatize major airports and auction spectrum for telephone services. These measures resulted in revenues between 12 and 15 billion euros.

Collective bargaining – A major issue for business organization was that negotiations between businesses and unions were a failure, which eventually led to the government passing a law which limited the automatic renewal of agreement to a maximum of 14 months. However, it allowed firms to opt out of the agreement if it weakened their position and gave superiority of negotiation at the firm level to those at the provincial level.

In our opinion, the government took bold and cost efficient decisions, which led to operations being run more smoothly and an increase in revenue. Also, increasing the capital requirement and not letting regional governments issue debt was a great move as this way the Spanish government makes sure that the banks or the governments do not default, providing stability. Lastly, we agree with pension reform because this contributes to more economic productivity.

Looking Ahead for the Spanish Economy

The Spanish economy has evolved primarily from the end of the 2008 crisis until now in a very positive way. For a third consecutive year the growth rate of the economy has been above 3%. GDP even exceeds its levels even before the outbreak of the crisis. 12 years ago approximately almost 3.8 million jobs had been lost, which by now 1.8 have been recovered. If the GDP is at maximum but employment is halfway, then the distribution of income must have changed during the crisis, so that employees have lost purchasing power, which has gone to remunerate capital.

Although there has been a big improvement to the Spanish economy, right now they sustain moderate growth following a long cycle of economic recovery. The future of the Spanish economy looks prosperous but constant, since 2018 it has lost some steam, as well as in 2019. but this moderation will be nothing else than a transition towards a phase of more gentle growth following a long cycle of economic recovery. GDP growth went from 2.9% in 2017 to 2.4% in 2018, following a 2.0% growth in 2019. This is reflected in two channels: the smaller boost from the foreign sector and the moderation in household spending.

Some risks facing the Spanish economy is that unemployment still remains high, as it is right now at 13.9%. Another issue concerning the Spanish labour market is the low level of active population compared to the potential workforce, which makes us assume that many people have stopped looking for jobs. Finally, despite the big economic growth and recovery, according to the latest data by the Spanish Statistical Office, 21.6% of the population still lives in poverty threshold.

Factors that Contributed to the Global Financial Crisis

A study conducted by the University of Chicago Booth surveyed two panels of US and European economic experts on what they believed to be the most significant causes of the global financial crisis. Out of twelve possible causes, the top five noted by the experts were flawed financial sector regulation and supervision, underestimated risks (financial engineering), mortgages (fraud and bad incentives), housing price beliefs, and rating agency failures.

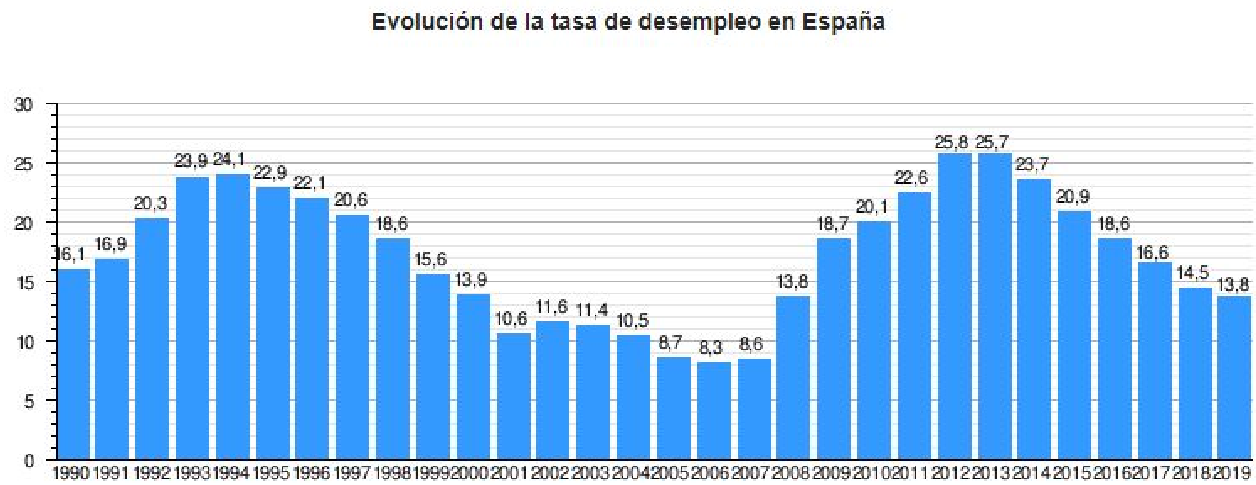
In the years leading up to the crisis, the extremely low interest rate environment in the US caused a flow of liquidity in the market. In particular in the US, one of the main issues began with the use of mortgage-backed securities (MBS). Special purpose vehicles (SPVs) would buy MBS as well as issue other financial instruments. Subprime loans were bundled into securities where the true level of risk was unknown to the investor. These securities and instruments would then receive falsely high ratings from agencies. When interest rates began to rise and housing prices collapsed, many people defaulted on subprime mortgages. Because so many institutions were invested in MBS, these defaults triggered the start of the crisis. Additionally, a lack of regulatory oversight allowed financial institutions to take on excessive amounts of leverage. This amount of leverage is dangerous as in times of financial distress banks would be unable to pay their obligations.

A key difference between the United States and Spain is the provisioning system that Spanish banks utilized. During boom periods, Spanish banks set aside credit provisions to have reserves in case of future default. This took a temporary toll on profits, but during 2008 the profits of the major Spanish banks grew as major banks in the US were on the verge of collapse. Also, the construction sector was a more significant portion of Spain's economy. This sector was hurt in both countries due to the collapse of the housing bubble. However, in Spain the construction sector accounted for 11% of GDP and nearly 13% of employment. Therefore, the collapse severely threatened future growth as unemployment rose and consumption decreased.

2020 Outlook

We think that a recession is possible at the end of 2020. Right now, the market in the United States is doing well and unemployment is at an extremely low level, however, there are signs of worry that point to a future recession. First, the current business cycle has been in one of its longest periods of expansion. In 2019, the US Treasury Yield curve inverted, which is usually an indicator that a recession is on the horizon within 12-18 months. One of the biggest threats to the global economy is the CoronaVirus outbreak. China is the world's second largest economy, and now thousands of people have been quarantined and are not spending money in China or around the world on tourism. Corporations such as Starbucks have closed hundreds of stores, and there are global supply chain effects as well. This will have a negative effect on global consumption. European, US, and Chinese central banks have been flooding the market to increase the money supply, and this further demonstrates the central banks' concerns for a future recession.

Appendix A:



References:

https://www.elblogsalmon.com/mundo-laboral/asi-ha-evolucionado-el-paro-en-espana-desde-que-estallo-la-crisis

https://journals.openedition.org/ccec/3212?lang=es

https://www.investopedia.com/articles/economics/09/financial-crisis-review.asp

https://www.rba.gov.au/education/resources/explainers/the-global-financial-crisis.html

https://www.economist.com/leaders/2020/02/13/how-chinas-coronavirus-epidemic-could-hurt-the-world-economy

https://review.chicagobooth.edu/economics/2017/article/what-contributed-most-financial-crisis