

THE REAL ESTATE SECTOR AND THE FINANCIAL CRISIS: THE SPANISH EXPERIENCE

Eloísa Ortega

Director, Economic Analysis and Forecasting Department

CONFERENCE ON EUROPEAN ECONOMIC INTEGRATION
CEEI 2013

Vienna

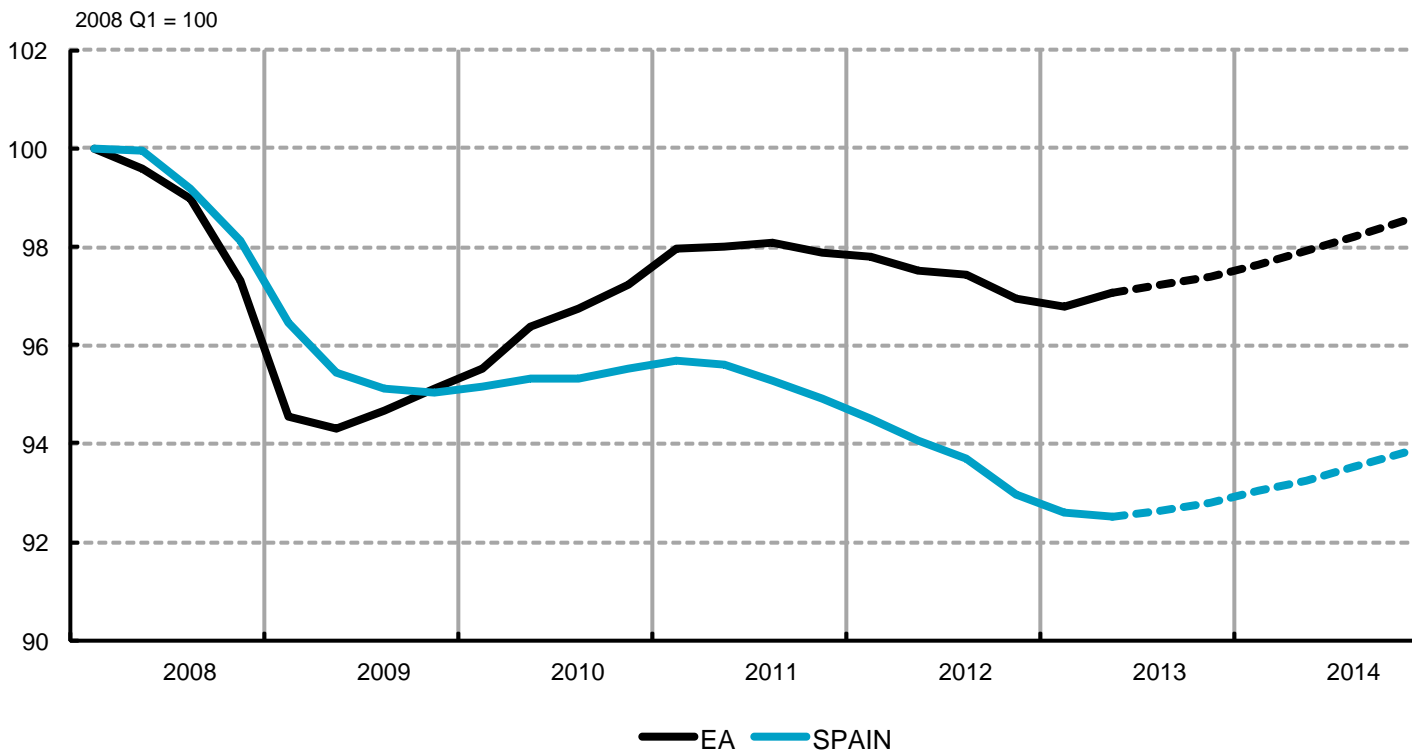
November 18, 2013

THE SPANISH ECONOMY IS OVERCOMING THE SECOND RECESSION IN THIS CRISIS BUT CHALLENGES ARE STILL CONSIDERABLE



To ensure a path of sustainable growth, domestic demand needs to pick up, the reallocation of productive and financial resources needs to be speeded up and the deleveraging of public and private sector needs to be completed

GDP LEVELS: SPAIN AND THE EURO AREA



THE OUTLINE OF THIS PRESENTATION



- 1. A brief review of macroeconomic imbalances before the outbreak of the financial crisis**
- 2. Adjustment and rebalancing after 2007**
 1. Excessive investment in the real sector
 2. Rapid expansion of credit and leverage in the private sector
 3. High current account deficits and high dependence on external savings
- 3. Some lessons to be learnt**
 1. Contribution of housing and indebtedness to the crisis
 2. Economic policy within EMU
- 4. Looking ahead**

THE OUTLINE OF THIS PRESENTATION



- 1. Macroeconomic imbalances before the outbreak of the financial crisis**
2. Adjustment and rebalancing after 2007
3. Some lessons to be learnt
4. Looking ahead

IMBALANCES BEFORE THE OUTBREAK OF THE FINANCIAL CRISIS



- **The Spanish economy expanded strongly in EMU: GDP growth averaged 3.6% after 1998, considerably above the euro area average**
- **Favourable financial conditions were key to explaining the surge in demand**
- **Supply reacted swiftly: population increased by 6 million people from 1999 to 2008 and women and immigrants boosted the labour force**
 - **BUT: Persistence of demand pressure in excess of supply capacity saw a number of macroeconomic and financial imbalances emerge**

IMBALANCES BEFORE THE OUTBREAK OF THE FINANCIAL CRISIS



- **Strong expansion of the residential sector**
- **Private sector indebtedness expanded forcefully**
- **Persistent cost and inflation differentials with the euro area**
 - Sizeable real exchange rate appreciation and loss of competitiveness
- **Overall, this led to high dependence on external finance**
 - High current account deficit

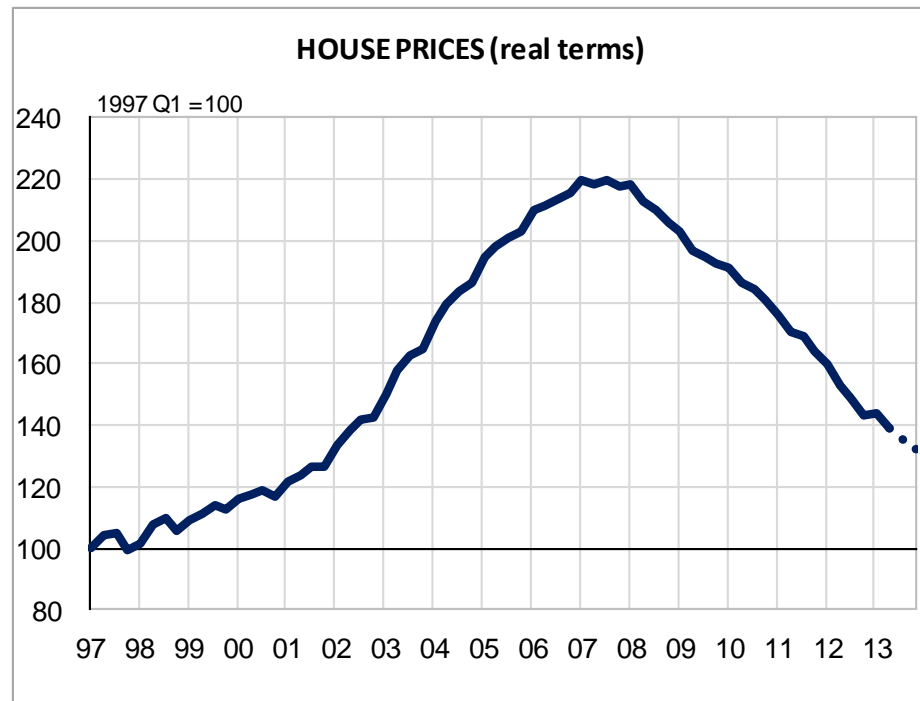
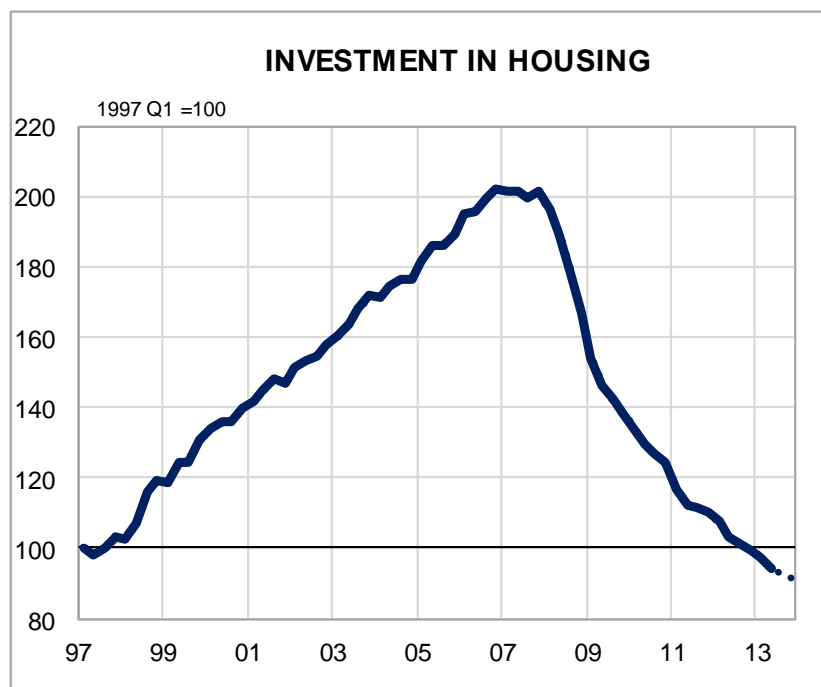
THE OUTLINE OF THIS PRESENTATION

1. Macroeconomic imbalances before the outbreak of the financial crisis
- 2. Adjustment and rebalancing after 2007**
3. Some lessons to be learnt
4. Looking ahead

RAPID DOWNSIZING OF THE RESIDENTIAL SECTOR AND MORE GRADUAL ADJUSTMENT IN HOUSING PRICES



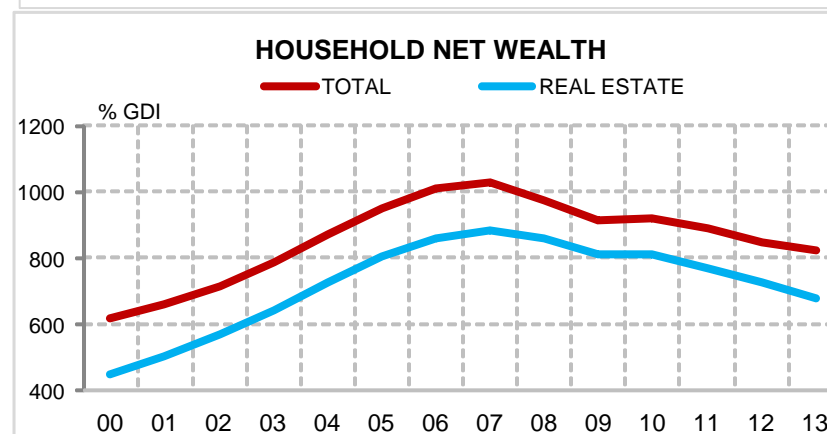
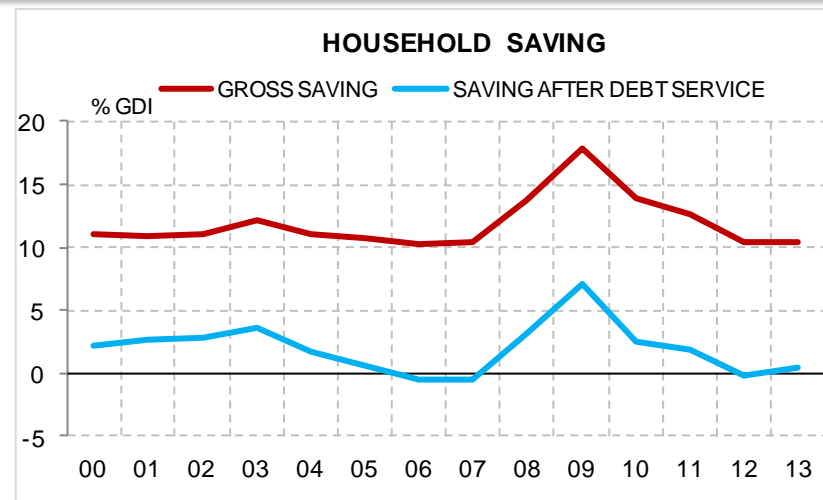
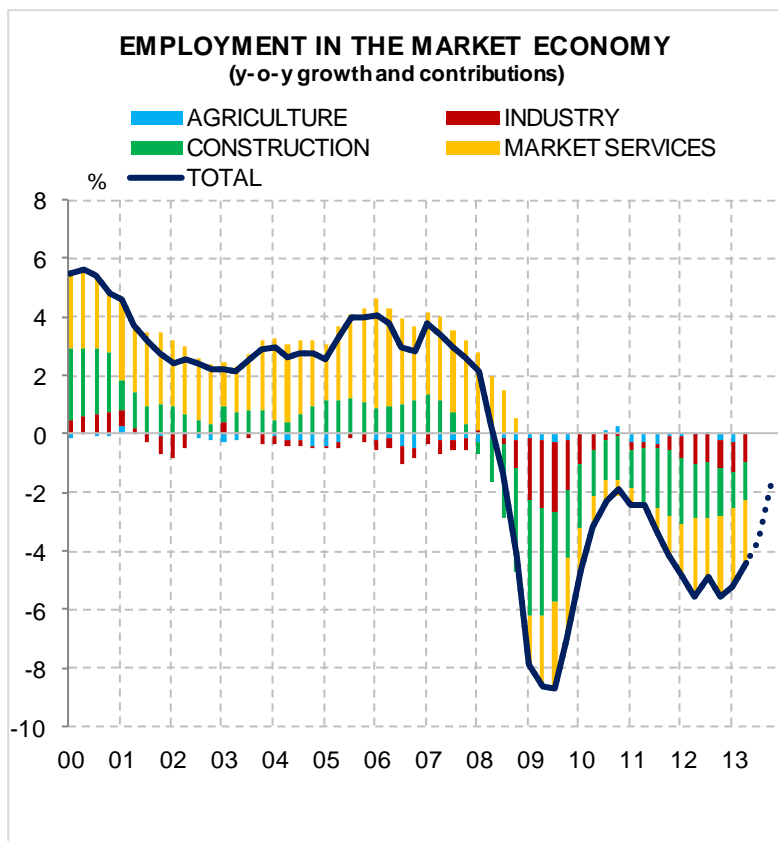
Residential investment has fallen 53% from its peak; House prices are down 37% in real terms. A more acute correction than in previous cycles. Sizeable stock of unsold homes and weak demand conditions, suggest correction could continue for a while.



WITH STRONG MACROECONOMIC IMPACT: SIGNIFICANT DIRECT AND INDIRECT EFFECTS ACROSS THE ECONOMY



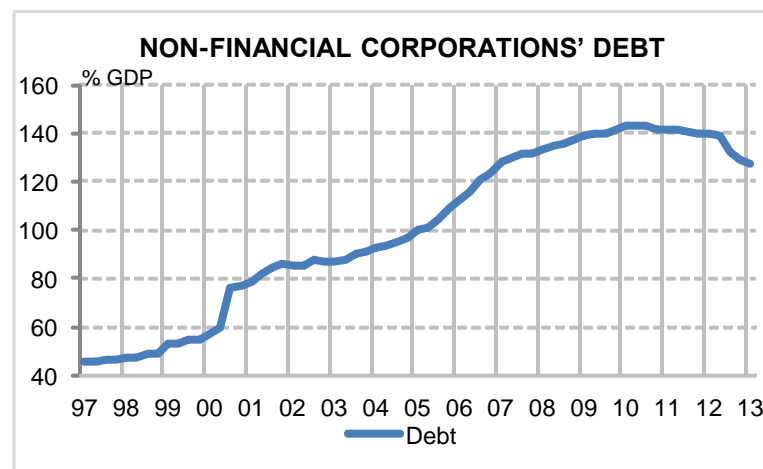
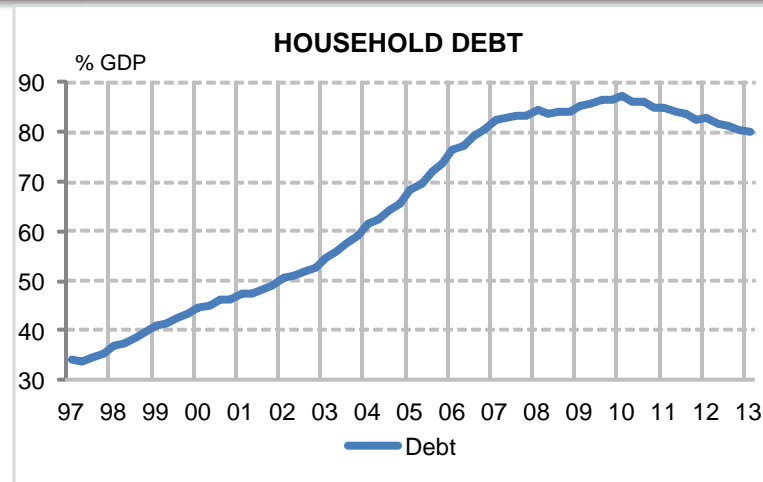
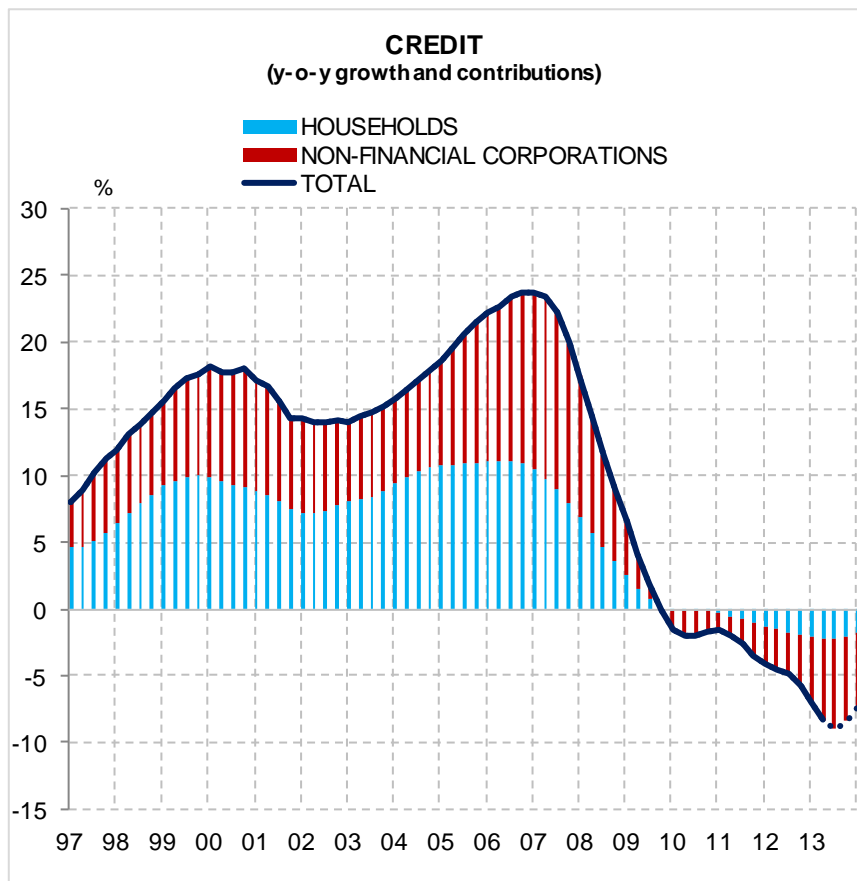
Housing is a very labour-intensive economic activity: strong effects of the sector's shrinkage via employment losses for the economy with repercussions in other sectors. Wealth effect not so relevant for consumption, except through increase in precautionary savings



DOMESTIC CREDIT GROWTH HAS FALLEN INTO NEGATIVE TERRITORY AND PROGRESS IS BEING MADE IN DELEVERAGING PRIVATE SECTOR



Decline in credit is the result of demand (still high level of debt) and supply factors (worsening of borrowers' credit quality and financial market fragmentation across the euro area).
Deleveraging in a recessionary environment is a slow process

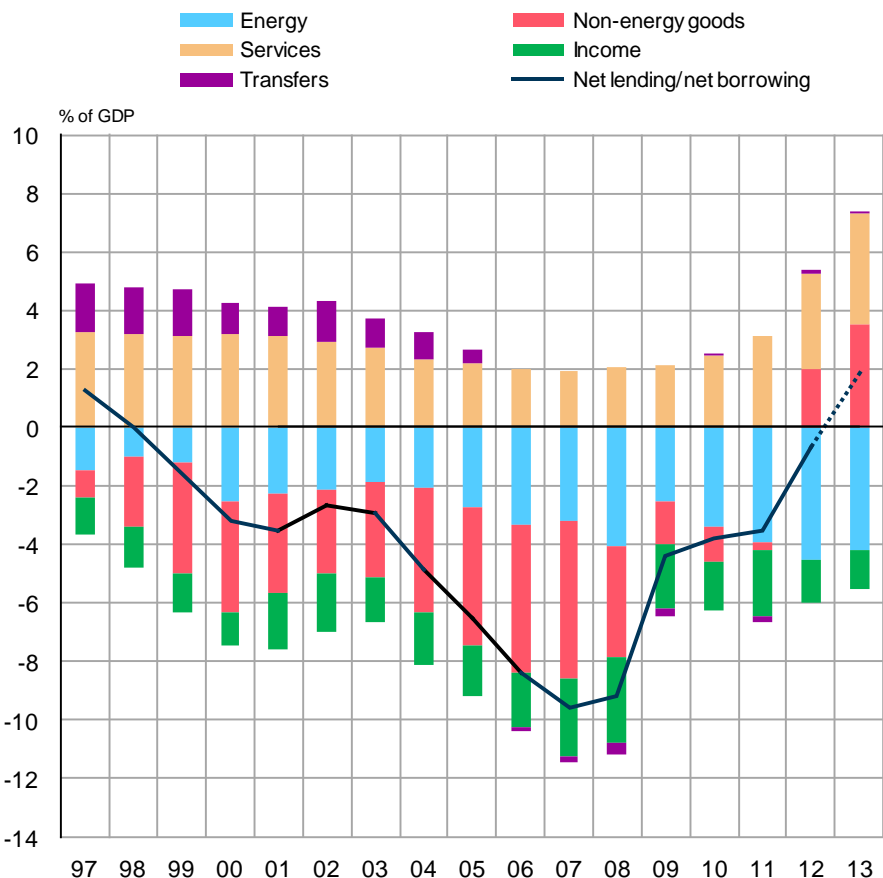


VERY SUBSTANTIAL CORRECTION OF EXTERNAL DEFICIT SINCE 2007

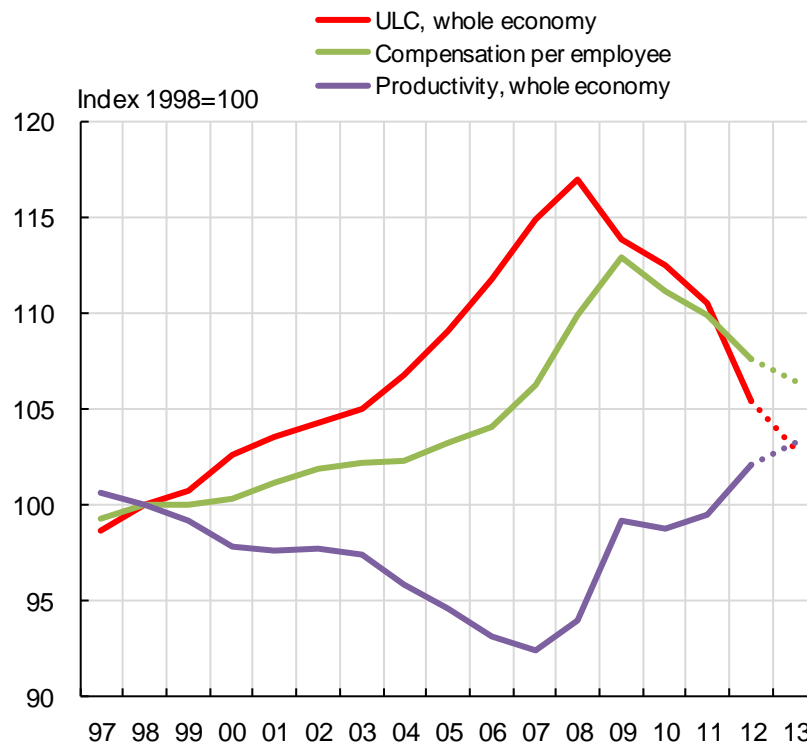


Progress in correcting the external imbalance has been significant thanks to competitiveness improvements (plus weak internal demand, increasing export base and geographical diversification).

NET LENDING/ BORROWING



RELATIVE ULC: Spain versus Euro area



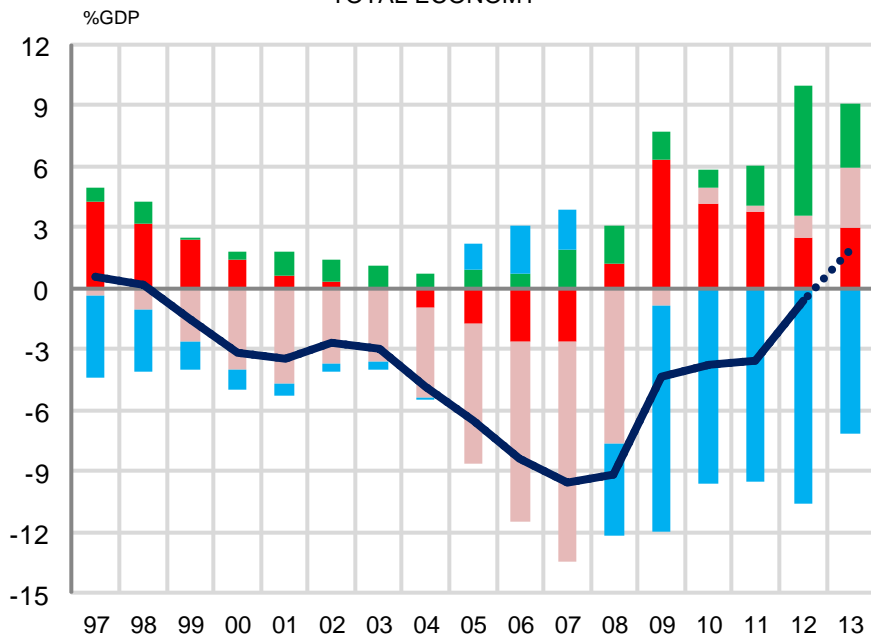
STABILISATION OF THE NET INVESTMENT INTERNATIONAL POSITION



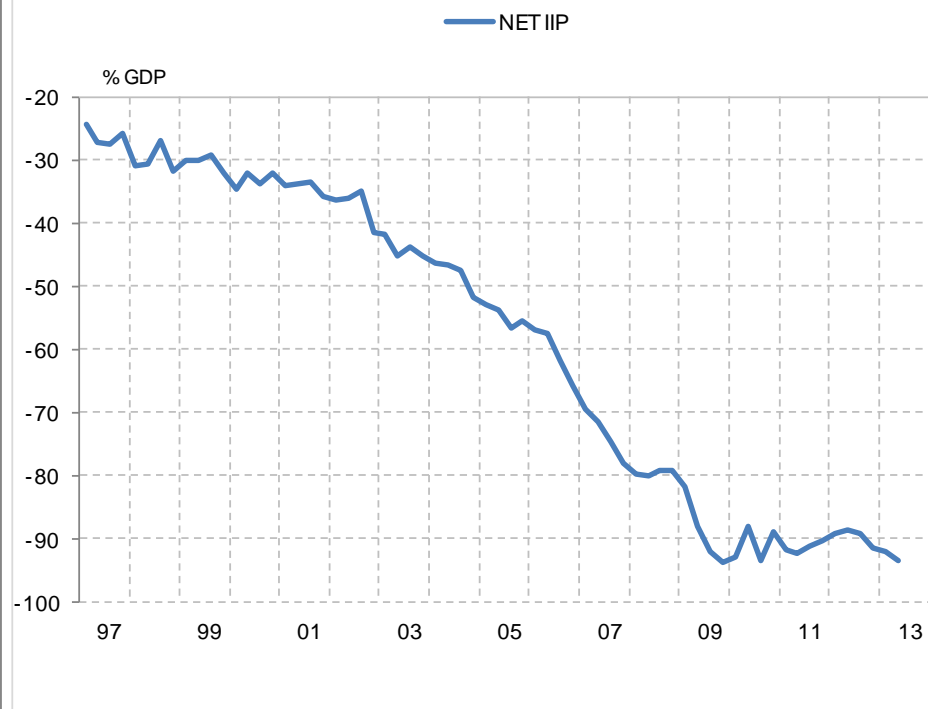
Improvement in the external position due to net lending of households and non-financial corporations. Large increase in public deficit has emerged. Sustained surpluses on the current account balance are needed to bring down the NIIP on a sustainable basis

NET LENDING / NET BORROWING

- HOUSEHOLDS
- NON-FINANCIAL CORPORATIONS
- FINANCIAL INSTITUTIONS
- PUBLIC SECTOR
- TOTAL ECONOMY



NET INTERNATIONAL INVESTMENT POSITION



THE OUTLINE OF THIS PRESENTATION

1. Macroeconomic imbalances before the outbreak of the financial crisis
2. The process of adjustment and rebalancing
- 3. Some lessons to be learnt**
4. Looking ahead

CONTRIBUTION OF HOUSING AND CREDIT TO THE SPANISH CRISIS



- **Housing investment played a key role in generating macroeconomic and financial imbalances during the upswing**
- **Collapse in residential sector is key to the depth and dynamics of the crisis in Spain**
- **Why residential investment generates sharp cyclical fluctuations**
 - Highly sensitive to changes in market expectations (interest rates, asset prices)
 - Highly employment-intensive sector with the risk of large quantity of labour flooding the labour market in a housing crisis
 - Important spillovers on other industrial and services branches

CONTRIBUTION OF HOUSING AND CREDIT TO THE SPANISH CRISIS



- **Carry-over effects on activity and employment might increase if labour and product market inflexibility fails to provide for cross-sector reallocation of resources**
- **Adjustment in the residential sector could have adverse financial consequences:**
 - Following the build-up in debt, deleveraging of the private sector is needed, which compounds the already contractionary environment.
 - Damaging effects on bank balance sheets in that risk of real estate companies and households defaulting increases.
 - General tightening of financial conditions
- **Rapid rise in private and external debt increased Spanish vulnerability in the context of the euro area crisis.**



- **To reduce the role of the real estate market in creating macroeconomic imbalances**
 - Additional macroprudential instruments
 - Structural and labour market policies conducive to price and relative cost adjustment and reallocation of resources
- **To ensure sustainability of the external deficit**
 - Need for early diagnosis and to implement economic policies to prevent an external imbalance build-up
 - *A more restrictive fiscal policy during the upturn*
 - *Greater liberalisation of the goods and factor markets*

THE OUTLINE OF THIS PRESENTATION

1. Macroeconomic imbalances before the outbreak of the financial crisis
2. Adjustment and rebalancing after 2007
3. Some lessons to be learnt
4. **Looking ahead**

CHALLENGES AHEAD



- **Remarkable effort has been made to adjust and rebalance the economy**
 - Fiscal consolidation
 - Structural reforms
 - Restructuring the financial system
- **Correction of Spain's main imbalances are under way but major issues pending :**
 - Continue the internal devaluation process and speed up the absorption of unemployment
 - Reduce the high level of indebtedness
 - Speed up reallocation of resources across sectors
- **Economic policies can improve the resilience of the economy:**
 - Complete the established roadmap for restructuring the financial sector
 - Maintaining a sustained path of deficit reduction
 - Deepening the structural reforms in goods and factor markets



ELOÍSA ORTEGA

THANK YOU FOR YOUR ATTENTION

BANCO DE **ESPAÑA**
Eurosistema

DIRECTORATE GENERAL ECONOMICS, STATISTICS AND RESEARCH