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

2008 Q1 = 100

- EA
- SPAIN
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
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 competiveness
- 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
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.
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.
Progress in correcting the external imbalance has been significant thanks to competitiveness improvements (plus weak internal demand, increasing export base and geographical diversification).
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.
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.
SOME REFLECTIONS ON ECONOMIC POLICY

• 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
THANK YOU FOR YOUR ATTENTION