Any hope that a revival of Spain’s housing market could help kick-start the country’s economy is likely to prove misplaced

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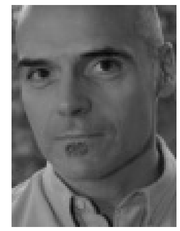
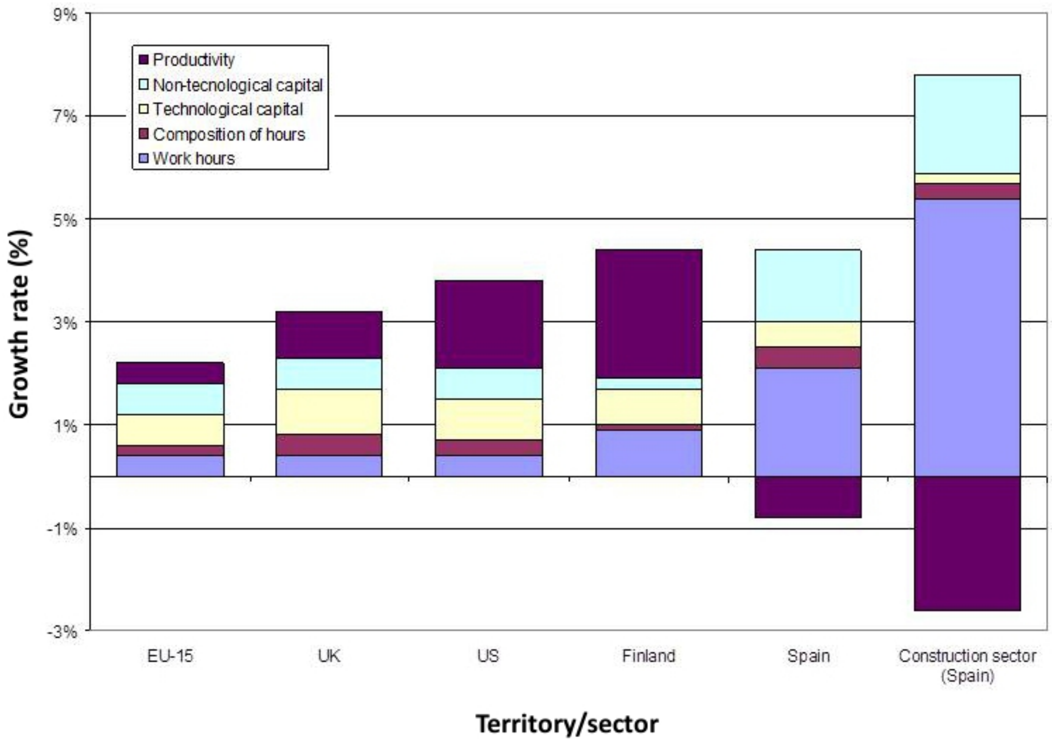
Recent months have seen house prices in Spain rise for the first time in six years, after the housing sector was badly hit by the financial crisis. **José García Montalvo** *writes that one of the most damaging aspects of the crisis in Spain was that the housing bubble experienced during the 2000s was also accompanied by declining productivity. He notes that the underlying picture in the real estate sector remains fragile and that in contrast to previous economic crises in Spain, a revival of the housing market is unlikely to offer a route to economic recovery.*



It is well known that one of the culprits of the Spanish economic crisis was the housing sector, as was the case in many other countries such as Ireland and the United States. The size of the Spanish housing bubble was huge: in just a few years the ratio of housing prices over household disposable income doubled from 4 to close to 8. But the worst part of the housing bubble and Spain’s “marvelous decade” was the decreasing productivity of an economy concentrated on building houses, alongside the institutional corruption tied to the development of land and the housing business. In fact, an important part of the current corruption problem in Spain stems from the easy money of the prodigious years of the housing bubble.

From the outset, many pundits tried to explain the Spanish crisis as the result of an international shock. The figure below shows that they are wrong. Economists disagree on almost everything, but there is one point in which we all agree: an economy in which productivity does not grow has no future. The Spanish economy grew very fast during the “marvelous decade” but with decreasing productivity. The growth was the result of more bodies working more hours with the same old tools. The figure shows that the decomposition of growth for the whole economy was a small-scale replication of the decomposition in the construction sector, which accounted for 18 per cent of GDP at the peak of the bubble and explained 20-25 per cent of the growth of the Spanish economy.

Figure: Sources of growth of market production in Spain and selected territories (1996-2005)



***Note:* Each coloured bar represents a different element, with bars above 0% indicating growth and bars below 0% (productivity for Spain and the construction sector in Spain) showing a reduction.**

Since the beginning of the housing crisis we have seen a large drop in the number of housing starts (from 750,000 in 2006 to 30,000 in 2013) and house prices (44 per cent). In correspondence with this debacle in the housing sector, 1.5 million workers lost their jobs in the construction sector. The financial sector was also largely impacted by the burst of the bubble, since 60 per cent of the total credit of the economy was concentrated on the housing sector (loans to developers and construction companies, and mortgages to families). After 280 billion euros of provisions and 62 billion euros of new capital (41 billion of them public financial assistance) the Spanish banking sector seems to be in good condition, as reflected by the results of the latest stress test of European banks.

A quick look at previous recoveries from economic crises in the Spanish economy shows that a basic sector for the improvement of GDP and unemployment was, fittingly, the housing sector. It is somewhat naïve to think that this time it will happen again. However, in recent weeks there has been news about crowds of customers in front of property developments and queues of shoppers in the early hours of the morning. The confirmation of the first increase in housing prices since the beginning of the crisis, in the second quarter of 2014, according to INE, has also contributed to improved expectations about the possibility of a quick recovery in activity and prices.

The reality is, for the moment, quite different from that vision. You could say that while the Spanish property sector has regained a pulse, it is still at the level of a resting cyclist. In fact the price index of the Department of Public Works, based on appraisal prices, continues to fall and the index of house prices produced by the official notaries fell 5.8 per cent for the same period as the INE reports an increase. Worst of all, the latest data published by the official notaries, referring to August, show that prices further continued this fall to 8.6 per cent. On-going price adjustment is finally generating an increase in transactions, which the latest figures estimate at 14 per cent.

It is worth reviewing the conditions of supply and demand in the housing sector to assess its likely evolution. On the demand side there has been a clear change in expectations about the prospects of the sector. The purchase of real estate assets by international investment funds, which began about a year ago, has moderated pessimism and put a limit on the rate of decline in prices as sellers are more reluctant to sell for large discounts. The lowering of interest rates on deposits has produced the return of small local investors to the housing market in search of bargains on houses they could rent afterwards.

As maturing deposits at 2.5-3 per cent get renewal offers at 0.8 per cent, the return on renting, at 5-6 per cent, looks very attractive. In fact, investors in this market represent 28 per cent of buyers. Financial institutions, after an intense competition to produce SME loans, now appear to be turning their interest toward household mortgages. The data show that in July (the latest data available) home mortgages were growing at 28.8 per cent, although the base was very small. The increased funding has reduced the share of homes bought in cash by 10 percentage points, but it remains a very high proportion (around 45 per cent) fundamentally because of the participation of investors.

However, the medium and long run prospects for housing demand are poor: the Spaniards in the prime age group searching for their first home are falling at 1.5-2 per cent annually. The young people who are getting to the age of buying their first home were born in a period when Spain had one of the lowest birth rates in the world. Also current salaries at these ages are not consistent with the new solvency conditions required to get a mortgage.

On the supply side there is still a large inventory of new homes for sale. Depending on the source, this number oscillates between 600,000 and 700,000. It is true that part of this inventory is located in areas without predictable demand for many years, but there are unsold new homes almost everywhere. The reality is that even if we believe the official statistics on the stock of new housing, the current rate of reduction is extremely slow (3.3 per cent in 2013). Meanwhile the banks, despite accelerating the pace of selling the properties on their balance sheet, continue accumulating more real estate than they are able to sell. In the first six months of 2014 the portfolio of real estate assets in the balance sheet of banks has increased by 7 per cent.

We are witnessing, therefore, a stabilisation period in the Spanish housing sector, where price declines are finally generating transactions. It is likely that the market will continue to oscillate for a while between limited optimism and a lack of confidence. This is reflected, for instance, in the forecast of analysts. While the latest report from Fitch talks about single digit price increases in the coming quarters, Standard and Poor’s predicts further price falls until 2016.

Current supply and demand conditions in the Spanish housing sector tell a story of a market searching to stabilise its situation. It would be illusory to think that the real estate sector could be, this time around, the source of a strong recovery in the Spanish economy.

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