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**Article**

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# The Global Economic Crisis: Spain's Housing Bubble

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*Housing bubbles have been discussed and closely linked to current world economics since 2008. This paper takes a case study approach to the situation in Spain in terms of its economy, the housing market and the ongoing economic crisis. Unique aspects of the Spanish culture and historical idiosyncrasies are included for the reader to compare and contrast various international settings and economic machinations. Micro and macro factors are incorporated in order to allow the reader to evaluate the complexity of the ongoing crisis, options and potential alternatives. The unique burden the Spanish housing bubble places on young adults, those most dramatically affected by Spanish unemployment levels, is also broached.*

***Keywords:*** *International Economics; Case Study; International Business; EU*

***JEL Classification**: F6*

## 1. Introduction

A housing bubble can be defined as a run-up in housing prices fueled by demand, speculation and the belief that recent history is an infallible forecast of the future (Investopedia, 2013). It usually starts with an increase in demand, opening the door for speculators that believe they can make a profit, followed by a drop in prices caused by the decrease in the aforementioned demand. Historically housing bubbles are repeated every 13 years and last about 2.5 years and cause about 4 per cent loss in GDP (Investopedia, 2013).

The real estate bubble in Spain has had a huge impact on the country's economy and the way people there live and invest. Some well positioned individuals in Spain were able to take advantage of the bubble and improve their financial investments in the process. One such case was the family of Enrico. Enrico's family changed homes three times specifically due to the speculative bubble, taking advantage of the rising prices of properties by willingly selling their home at a peak in price. But in 2008, the bubble burst in Spain, not long after the USA had triggered world attention with its own housing crisis.

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## 2. Premise

The situation in Spain right now does not look promising. Few families can afford to buy houses and yet the building of new houses continues due to work in process and planned building prior to 2008 that has not stalled. Most of the ongoing projects are very high cost projects and planners hope by simply slowing the building process, conditions will improve once the project is complete. Builders do not want to abandon work in progress due to the investment already incurred, despite projections that these projects will not get the expected and needed financial return (Foxman, 2012). This process will cause a domino effect, eventually taking away jobs and leaving empty houses and high debt. Banks are left with real estate properties that have no market value. Many families have tied up all their liquidity and leverage in real estate and have found themselves financially overextended. The whole country of Spain is suffering due to the housing bubble created and its resultant economic crisis.

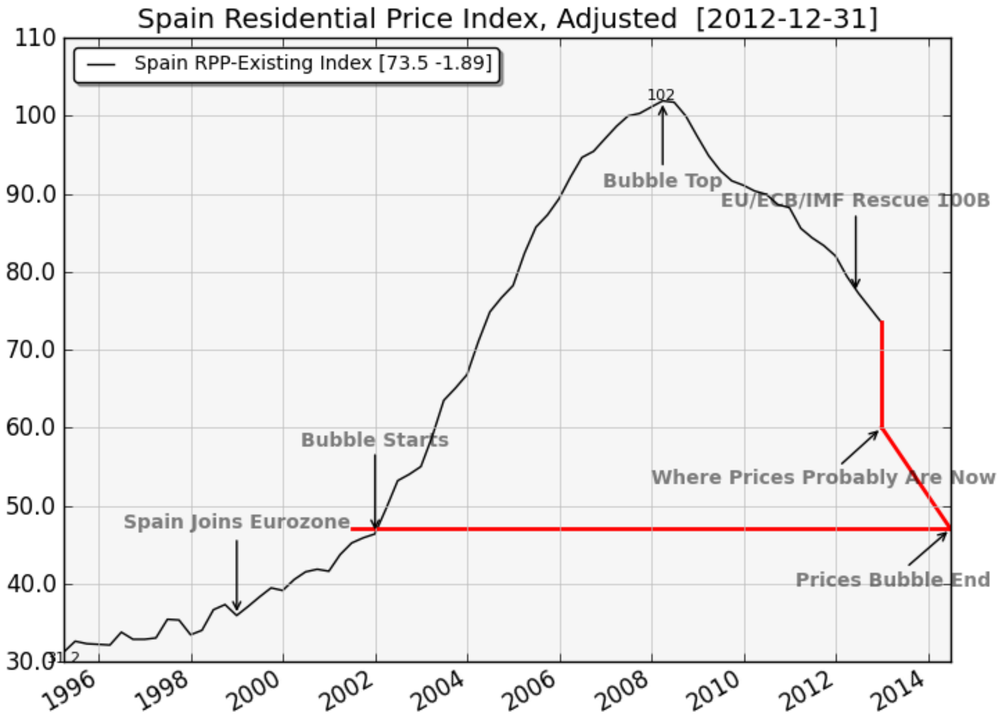


***Figure 1.*** *"Market oracle"*

Figure 1, offers a timeline of different stages of the Spanish housing bubble. Starting in 2002, primarily as a result of joining the Eurozone, residential prices started to rise dramatically and this continued until 2008. Correlated to the global economic crisis of 2008, demand for Spanish real estate started dropping. In 2012, the ECB (European Central Bank) and the IMF (International Monetary Fund) offered 125 Billion bailouts to banks. Spain accepted these bailouts due to increasingly urgent calls from across Europe and the United States (Minder). The prediction at the time were that prices would continue to decrease lower than they were before the bubble started.

## 3. Analysis

There were both international factors as well as internal factors in Spain that led to this situation. First of all, Spain belongs to the Eurozone, so its economy has to compete with other European countries under a fixed exchange rate regime (Gentier). In order to compete with other European countries Spain had to develop industries such as real estate, tourism and construction. Because inflation was high in Spain, the production of tradable goods was not enough to compete against other top European economies such as Germany; this caused Spain to link its GDP exclusively to the housing market, creating an illusion of wealth.

Second, Spain's Central Bank used a currency devaluation policy and has enjoyed a long period of very low interest rates (Gentier). In Spain, the population has always been encouraged to buy houses. Renting is an expensive option due to high renting rates. It was actually cheaper to pay for a mortgage than to rent. The government encouraged people to buy and the banks made it even easier with affordable mortgages with low interest rates. This caused the private Spanish debt to rise dramatically: it represented

64.6% of the GDP in 2009, compared to 31.6% in 2001 (Gentier 345).

Migration from other European countries also rose. The migratory balance increased by 800% between 1998 and 2002 (Dorgan). Additionally, foreign investments increased considerably in Spain's coastal areas, boosting the housing effect. People saw the opportunity to speculate with real estate, buying and selling in short-time operations just like Enrico's family. Other factors that led to the housing bubble were the desire for people to move out of their parent's house, encouraged by government campaigns and low mortgage rates, and the increase in urban population.

## 4. Discussion

Just when everyone in Spain was enjoying the financial benefits of the housing bubble, the 2008 global economic crisis hit. Unemployment began rising and of course, these people had mortgages and loans to pay, but no income available to them. For example, Fernando and Sara friends of Enrico, bought a home in 2007. After both of them lost their jobs, they were forced to move out since they could not afford the mortgage. Now, the young couple lives with their parents, yet still owe 90,000 euros to the bank because in Spain, one is not free of mortgage repayments once the bank has repossessed the property (Hadzelek and Rodriguez).

The aftermath of Spain's housing crisis is not promising. Right now, banks hold more troubled real estate assets than non-troubled ones and bad loans account for 8.95 percent of total loans, the highest in 18 years (Foxman). The total amount of housing increased between 2001 and 2008 by 20%, while population only increased by 13% (Gentier). There are between 6 and 8 million properties that are either vacant, being constructed or available on the rental market ("The dire state"). Furthermore, 800,000 used homes are in the market, banks have foreclosed on 300,000 homes and 150,000 are in the process of foreclosing. Figure 2, shows how demand was surpassing construction between 1994 and 2007, and then in 2008 dropped significantly leaving thousands of houses empty, construction companies broke and an unprofitable housing market.

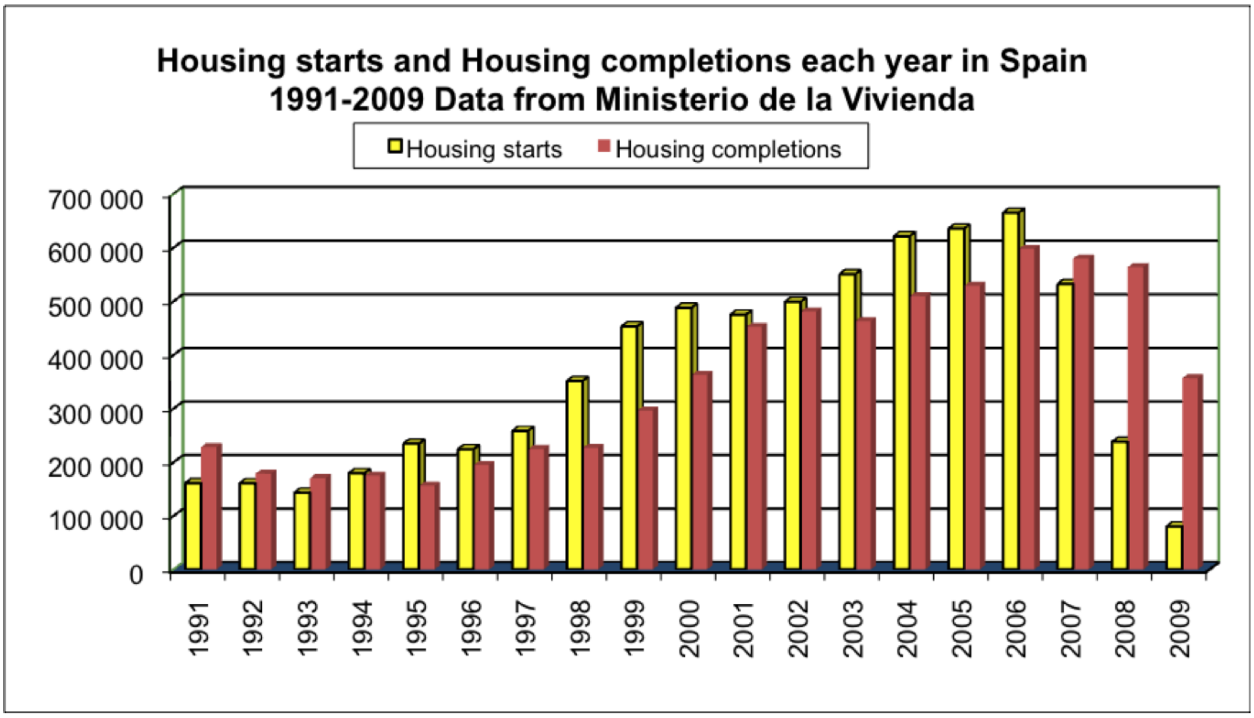


***Figure 2.*** *Housing starts and housing completions in Spain, 1991-2009*
*Source: Gentier*

What alternatives does Spain have to diminish the cost of the housing crisis and start an economic upswing? First, consider the bailout option. As stated, the ECB gave 100 billion to the banks in 2012. At the end of 2012, Spain was requesting another 39.5 billion for their banks. Even though the banks have not been good at managing the situation, in Spain's case bailing the banks out means trying to help the creditors (people that deposited money) and trying to keep the cash flowing in order to give Spain a chance to turn the crisis around. If the banks do not get bailed out, Spain could be forced out of the European Union for not keeping up with the economic standing of other countries. That would be disastrous for Spain due to the economic opportunities and growth that membership in the European Union produces. Enrico, and other citizens like him, feel that the banks being helped are not in turn helping them, because they have to help the government (public debt) first. It seems that a country like Spain, which heavily relies on tourism and services must be bailed out in order for the government to keep offering those services.

On the other hand, countries like Iceland have refused a bailout successfully. They imposed austerity measures and let their three main banks fail. They focused on improving the economy of the public by imposing temporary controls to the spending of the population. Could this be an option for Spain? Letting the banks fail usually makes the investors lose money but guarantees the safety of the people's money. The main problem in Spain is that the banks are linked closely to European banks (due to the euro) and letting them fail could seriously damage existing financial markets. Also, the situation in Spain is a lot more complicated than Iceland.

Another measure that could work in order to reduce the number of vacant houses would be to promote renting. As of now, income tax is very high for renting, which heavily forces home ownership. In 2002, 79.7% of the gross wealth of households was related to real estate, compared to 38.4% in the U.S. (Harrison). If the tax was reduced, many empty houses would be rented, given the owners cash flow to keep up with overdue mortgages.

Recently, some private-equity foreign firms are buying Spanish real estate. This is very positive for the economy. Miami based H.I.G Capital is buying a majority stake in a package of 939 homes known as Project Bull (Bjork). Since February of this year, foreign investors are starting to come back to the Spanish market. Also, Spain is planning to offer residency permits to foreigners who buy houses priced at more than 160,000 euros ("Spain seeks"). This measure is a very interesting one, and could help the banks sell the thousands of houses that are empty. Also, foreigners would revitalize the economy with their everyday spending.

It is obvious that the current situation does not allow for young people to buy houses. A housing bubble of this magnitude cannot be fixed in a short period of time. People want to buy houses, so demand is there; if the economy can turn around, these empty houses will eventually be filled. The government should try to balance between the population needs and banks' needs. It is not an easy task and they will be required to analyze every possibility before making decisions.

## 5. Conclusion

Spain seems to be following the right steps towards economic improvement. Enrico and many young Spaniards like him support the bailout of the banks mainly because they believe Spain needs this money in order to improve. Tourism and services are extremely important to the Spanish economy and Enrico believes it is critical to save the banks to continue a successful presence in these industries. As a short-time decision, Enrico and many like him believe the government should do what it can to encourage renting. This is a generation raised on home ownership, independence from parents and independent living.

Moving forward, it seems important for banks and investors to keep in mind previous mistakes and not let the huge demand and financial growth blur the fact that risky low interest rate loans are not the way to go. Instead, more austerity and steady growth would be the key to not inflating the bubble again. Central Banks historically have a lagging action plan on recessions and bubbles which means the process of growth comes at a slow pace.

## 6. Questions for Discussion

1. Were there prevention measures Spain failed to take to avoid the bubble?
2. Do you think joining the Eurozone was a good idea for Spain?
3. Is Spain's banking system in good shape now?
4. How do you feel about IMF and ECB bailouts.
5. What could the government do to prevent a housing bubble again?
6. The case states 'the situation in Spain is a lot more complicated than Iceland'. Compare and contrast the current situations of the two economies.

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