FREE MARKET IS NOT TO BE BLAMED FOR THE PRIVATE DEBT BUBBLE: THE CASE OF SPAIN

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Abstract:
When reflecting on the causes of the current economic and financial crisis, the huge upsurge in private debt is one of the most cited reasons. Some people insist on blaming the private sector for this. According to them, the sustainability of its behavior has been clearly put into question by the recent events. But, what lies behind this exorbitant private indebtedness? This article is focusing on the Spanish case, with some references to the United States.

The Spanish economy is still suffering a very deep economic recession, with the highest unemployment rate of the whole European Union. At the end of 2010, this rate stands slightly above 20 percent, while the average in the European countries is around 10 percent.

One of the most cited causes for this, apart from some structural and real factors –e.g. low competitiveness and rigid labor markets- is that the Spanish economy suffered one of the most virulent housing and credit bubbles in the world in the decade before the onset of the crisis. In this bubble, housing prices skyrocketed, many workers and capital were attracted to booming sectors, and private debt increased to unsustainable levels. But as the bubble burst, the whole system collapsed, sending the economy into a serious downturn.

Furthermore, the Spanish government –as most world governments-, instead of letting the necessary and inevitable readjustment process work itself its way and clean up the malinvestment, has hampered recovery through stimulus packages, huge increase in budget deficits, and several measures to prevent a fall in housing prices.

Once we have outlined some of the problems the Spanish economy is going through, let us analyze the reasons behind the debt bubble.

Several macroeconomists and pundits analyzing the Spanish economy strongly emphasize that the debt excesses have been produced by the *private* sector, not by the government. They also claim that the increase in private debt was not consistent whatsoever with fundamentals, that is, with the evolution of the real economy–i.e. production, wages, and so on. In other words, private individuals got into debt in a much faster pace than their incomes would allow.

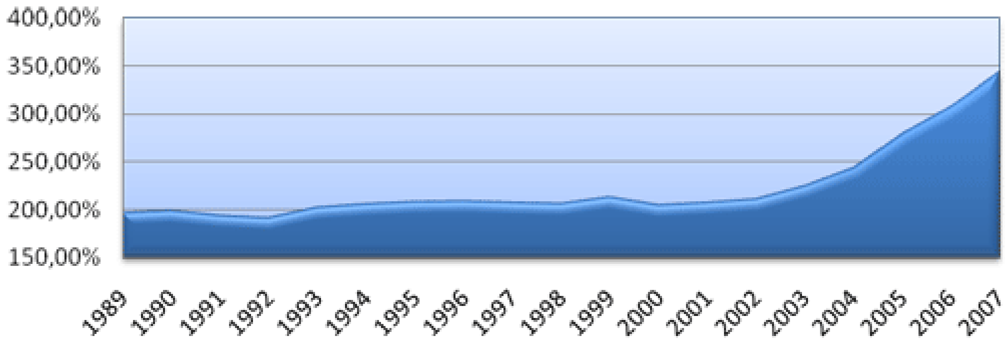
Some of them, with a clear Keynesian flavor, explain this phenomenon in the following way: economic agents have taken their decisions in a rational and correct manner, according to the information and expectations they had; but once those rational decisions are aggregated, it brings about catastrophic consequences for the economy as a whole. Optimum individual actions led to disaster at a macro-level, they hold.

Not incidentally, this is the same kind of argument Keynesians make to support government spending in the current situation: individuals cut consumption spending when the crisis comes, which is sensible and rational from an individual perspective, but that would mean a disastrous deflationary path for the economy. Thus, smart bureaucrats and politicians, who can see from the top what is going on at the bottom, have to spend, spend, spend, to sustain aggregate demand and avoid a downward spiral that would send us all to economic hell.

We should ask, however, what are the underlying causes that have pushed rational investors and economic agents to get into exorbitant levels of debt. Were they driven by an unstoppable greed which forced them to leverage in order to reap big profits, without thinking further on the consequences of that debt? Or is it something else?

Indeed, there is no doubt that the exorbitant increase in total debt was mainly due to the private sector. While private debt skyrocketed especially after 2002, public debt didn't; it even fell after 1996. (All these data, along with very illustrative charts were elaborated by a thoughtful report, "Endeudamiento y capacidad de servicio de la deuda en España: 1989-2007", by the Observatorio de Coyuntura Económica (OCE) (Economic Trends Reporter) of the Spanish Instituto Juan de Mariana). The following graph shows the Debt/GDP ratio for the Spanish economy from 1989 to 2007, where a spectacular increase in debt took place after 2002.

Chart 1: Total debt/GDP ratio in Spain (1989-2007)



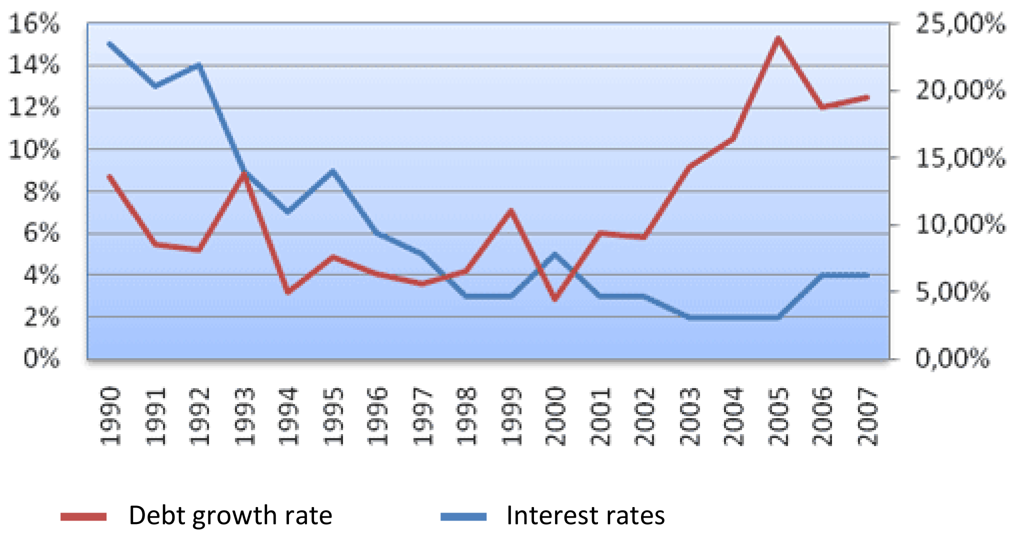
Debt/GDP

So, if the *private* sector –not the public sector- has been up to its neck in debt, would the free market –e.g. lack of limits on private indebtedness, lack of strict public regulations and controls, banks' greed- be responsible for all the problems that followed?

Only a very superficial analysis, that is, one that leaves out several key factors, can give a positive answer. What are those fundamental factors which are very often overlooked by mainstream economists and financial journalists and lead to the wrong conclusion?

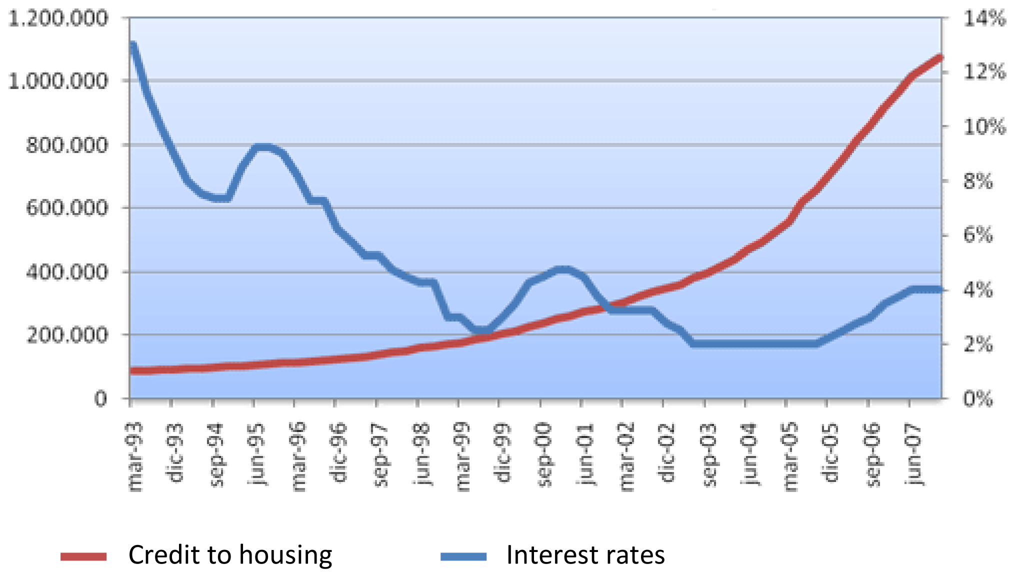
First and foremost, it is not a coincidence that private debt started to grow exponentially after 2002. One of the main reasons for this, though not the only one, would be the artificially low interest rates that the European Central Bank (ECB) kept for too long, in the context of expansionary and easy credit policies. As the next graph shows (the blue line stands for interest rates, represented on the left axis; while the red line stands for the rate of debt growth, represented on the right axis), the Spanish economy "benefited" from lower interest rates as it entered in the Euro monetary area at the very end of the 90s. You can see how the ECB kept interest rates at 2 percent for almost two years –a situation that some US economists might nonetheless envy, given the even worse behavior policies that Mr. Greenspan and the Fed imposed during the same period.

Chart 2: Interest rates and debt growth in Spain (1989-2007)



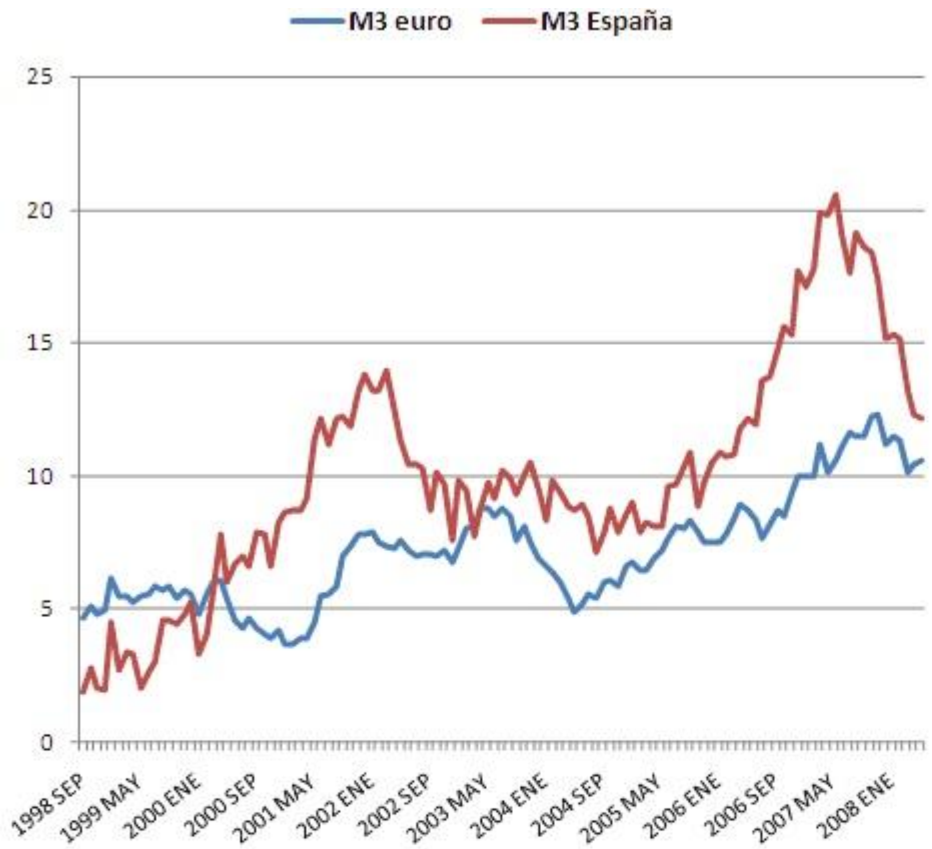
The graph above shows the clear correlation between lower interest rates and faster growth of the debt. This empirical fact can be explained by basically two main reasons. Firstly, the drop in interest rates is one of the key drivers which make the cost of getting into debt fall. And secondly, lower interest rates also increase the present value of future investments, as the discounted cash flow approach clearly shows. Hence, as a result of the easy money policies led by the ECB –and also by other central banks, such as the Fed-, the appeal to get into debt was remarkably increased (the influence of low interest rates on the Spanish credit expansion, which was especially filtered through the housing sector, was also analyzed by the OCE in a different report, “El crédito bancario a la construcción en España: 1989-2007”). You can see in the following graph the high correlation between lower interest rates and the increase in the level of credit destined to the housing sector. The red line stands for credit given to the housing sector, represented on the left axis; while the blue line stands for interest rates, represented on the right axis.

Chart 3: Interest rates and credit to the housing sector in Spain (1993-2008)



One might claim that these low interest rates were not necessarily the result of easy money policies by the ECB. But monetary data from the official central banks force us to reject that claim. The next graph shows the growth rates of M3 both in Spain (red line) and in the European Monetary Union (EMU) (blue line).

Chart 4: Growth rate of M3 in Spain and in the European Monetary Union



Source: European Central Bank and Bank of Spain. Statistical report June, 2008[1]

A key fact to note in this graph is that the credit expansion affected Spain much more than other countries. As the so-called 'Cantillon Effect' tells us, new money enters into circulation in a gradual and uneven way, having different effects on different people and economic sectors. This is more or less what would have happened among different countries of the EMU. But in this case, the divergence has been extraordinary, as Juergen Donges said in 2006, claiming that almost all the liquidity injection from the ECB had ended up in Spanish banks to fund the housing excesses.[2]

There might be several reasons for this extraordinary credit attraction of Spain, but here we will only mention the most relevant one. The underlying cause was well expressed by the economist Wilhelm Röpke more than 70 years ago when he wrote:

> *The willingness of the banking system to give new credits does not in all circumstances suffice to bring about a credit expansion. To this end, a second condition must be*

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[1] This graph has been taken from "La crisis financiera internacional y el crack financiero español" ("Global Financial Crisis and the Spanish Financial Crash") (p.10), by Alberto Recarte.
[2] Interview with Donges. El Economista, 11 July 2006 (p.24). This is quoted, along with a very informative graph illustrating how Spain and Ireland attracted most of the credit expanded by the ECB, in Ricardo Verges, "Auge inmobiliario: el desenlace" (p. 2).

fulfilled, viz., the existence of entrepreneurs who are willing to take new credits for investment purposes so as to render the credit expansion really effective by enlarging the volume of circulating media instead of merely enhancing the liquidity of somebody.[3]

Thus, low interest rates may create the conditions for banks to lend and increase the supply of credit. But without a strong demand for credit by consumers and entrepreneurs, which may be a consequence of economic growth, positive expectations and confidence on the future of the economy, the credit expansion may not take hold.

But precisely, the Spanish economy started to experience high growth of GDP –an average of 3.38 percent between 2001 and 2006-while other European economies such as Germany and France had much lower rates, 1.07 and 1.77, respectively. The same happened with the booming Irish economy, growing at a rate of 5.47 percent during those years. Both countries therefore attracted the freshly created money (especially in the housing sector) and hence experienced artificial economic booms—that is, an expansion of economic activities beyond what the, already favorable fundamentals, were commanding.[4]

Another consequence of this credit expansion was the increase of Spain's current account deficit, which relative to GDP started to rise at the end of the 90s and exploded after 2002[5], being one of the highest in the developed world.

Now that we have seen how low interest rates and easy money policies have contributed to fuel the credit bubble, there is still one very important question remaining: whether we have to lay the blame on free market or, on the contrary on government interference in the marketplace?

As a matter of fact, interest rates are greatly influenced by central bank--an institution that Professor Jesús Huerta de Soto labels a "financial central-planning agency" in his masterpiece "Money, Bank Credit, and Economic Cycles". In other words, the financial markets, and the whole operation of money and banking, which are the key elements that determine interest rates, and indirectly the level of private debt, are extremely regulated.[6]

Besides these mechanisms that have encouraged private debt, there are many others that interventionist economists usually take for granted, without thinking of some of their perverse unintended consequences. Indeed, there are important policies that encourage the kind of risk-taking behavior –reducing private prudence and responsibility- that many pundits are now complaining about.

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[3] See "Crises & Cycles", by Wilhelm Röpke, 1936 (p. 125).

[4] See "Los precios de la vivienda y la burbuja inmobiliaria en España: 1985-2007", by the OCE, for a detailed examination on the causes and degree of the housing bubble in Spain.

[5] See graph here.

[6] On this point, see also the analysis of the state-banking nexus, which Chris Matthews Sciabarra brilliantly develops in his article "A Crisis of Political Economy".

These policies include government guarantees that implicitly or explicitly assure private agents that their losses, in case of bad luck, will be socialized at the expense of taxpayers. This is the spirit of the "too big to fail" doctrine-- the most well-known and clearest illustration of 'moral hazard' at work where an economic agent will behave recklessly because his actions are riskless. Furthermore, the existence of widespread deposit insurance, which creates the illusion that depositors' money is completely safe, reduces discipline and market competition in the banking sector, thereby worsening the 'moral hazard' problem.

These policies have been in place in Spain as well as in the United States for many years. In the US, the so-called Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac, other public agencies such as the Federal Housing Administration (FHA), the Federal Deposit Insurance Corporation, numerous regulations such as the Community Reinvestment Act (CRA) and of course, the Federal Reserve System, have greatly contributed to the irresponsible behavior of market agents we pointed out above.

But, what are the most relevant factors that explain the enormous diversion of funds and credit through housing in Spain? After all, Spain did not suffer from Fannie and Freddie, FHA, CRA, and so on. Unfortunately, Spain had to put with similar interventionist problems.

The discussion here does not deny the existence of *non-monetary* factors. On the demand side, for instance, there was a real increase in housing demand led by an intense immigration process. Precisely, it might be the case that real growth in this sector took place first, and then, as credit filtered through the Spanish economy, the growth was turned in an unsustainable boom. Besides, there were important supply-side factors related to housing interventionism. The Spanish housing and construction sector is much regulated; building plot supply is quite limited and restricted by law and discretionary political decisions, and there are some legal restrictions to rental market (under the Urban Lease Act, "Ley de Arrendamientos Urbanos"), making rents higher than otherwise would be. Some Spanish experts on this issue regard this sector as one of the remnants of socialist central planning. One of the most pervasive facts is the control that local politicians (namely, mayors) exert over housing, in a context of discretional decisions and corruption cases. As local income taxes mainly depended on housing transactions, they were interested in encouraging and keeping the housing bubble.

An additional key issue here is the existence of Savings Banks (Cajas de Ahorro), important semi-public credit institutions in Spain, which are effectively politicized. Thus, as fiscal revenues were positively related to a flourishing housing sector, the *Cajas* were politically encouraged to direct credit to housing. As data shows, these financial institutions have been the most exposed to the housing boom, with about 70 percent of their lending directed to that sector, while this figure is "only" 50 percent in the case of private banks. [7] Nowadays, there is a political debate over the reform of the Cajas' system, given that these institutions are the ones who have performed the worst.

[7] These figures are quoted from a 2008 report from the OCE report "El crédito bancario a la construcción en España". This fact, showing the worse performance of public –or semi-public- versus private financial institutions, is consistent with the German experience. See "Subprime Crisis and Board (In-)Competence: Private vs. Public Banks in Germany", CESIFO WORKING PAPER NO. 2640.

Hence, the fact that private debt –not public debt- played the most important role in the credit bubble, destabilizing the whole financial and economic system, would not mean whatsoever that free markets are responsible for that. Actually, free markets did not really prevailed, so they cannot be blamed. Private agents took their decisions induced by distorted macroeconomic signals –e.g. artificially low interest rates, cheap credit- and encouraged by too ambitious—and often corrupted--government policies. This explains why they took the wrong investment decisions.

The economic crisis in Spain was a typical manifestation of the business cycle as it is viewed by Austrian economists - that is, *systematic* long-term economic errors (mal-investment) caused by omnipresent and badly inspired government intervention.