

# Can Spain Sustain?

**Its economic growth has been the envy of Europe. But if construction slows down, the consequences could be dire** BY JAMES GRAFF

A generation ago, San Sebastián de los Reyes was a sleepy bedroom community of 27,000 people at the northern tip of greater Madrid. The high point of the local calendar was the traditional festival of Cristo de los Remedios in late August, when residents celebrated with fireworks, bullfights and bull running. The rest of the year, the demands of the town's residents were relatively simple: clean streets, regular garbage pickup and an early bus down Burgos Road to Madrid, where the jobs were.

These days, San Sebastián de los Reyes refers to itself as Sanse — "a way of modernizing our corporate image," explains Rubén Holguera, its deputy mayor and councillor for urban development. The town's population has grown to 70,000, many of them well-salaried young people who grew up with the town. They still go all-out during Cristo de los Remedios, but now there are plenty of other things to do during the rest of the year.

In 2004, Plaza Norte 2, a mega-shopping center with a golden cupola, 225 shops and 14 cinemas, started drawing shoppers from all corners of Spain. Last year the town opened a new 2,500-sq-m multisports center featuring swimming pools, basketball courts and putting greens. And last month it inaugurated a new youth center, with a theater, concert hall, workshops and mediatheque, where kids can surf the Internet, watch movies and listen to music. The keys have just been handed over to the first of 5,000 new houses, the bulk of them moderately priced, in La Dehesa Vieja (the Old Meadow). By the time that development is complete next year, the Madrid metro will have extended its Line 10 to include three new stations in Sanse, which has become essentially an airy, upscale barrio of one of Europe's most dynamic capitals. "We have a well-educated population, a vibrant town and almost full employment," says Holguera.

San Sebastián de los Reyes appears to be but one sunny page in Spain's storybook economic transformation over the last generation. What was once a diffidently autarchic appendage to the Continent has become an important economic locomotive for all of Europe. Spain's economy grew 3.4% last year, over twice the euro-zone average, and is expected to best the average again this year by a full percentage point. Spanish companies like phone-giant Telefónica, construction and infrastructure consortium Grupo Ferrovial, real estate developer Metrovacesa and financial conglomerate Santander Group have become Continent-wide — and even global —

players. Last week Ferrovial concluded a €15 billion takeover bid for BAA, the company that runs Heathrow, Stansted and Gatwick airports.

But Holguera, whose principal job is managing coherent expansion for his changing hometown, is among the growing number of people worried that Spain's impressive growth depends too much on one churning mammoth: the construction industry. That sector accounts for more than 16% of Spain's economic output, roughly twice the average of euro-zone countries. "Everybody wants to own a house, but even middle-class people are having serious problems paying their mortgages," he says. Eventually, Holguera fears, the market could collapse, turning Sanse from a symbol of expansion into an icon of the Big Squeeze. It's not only that the construction trade supplies an inordinate number of jobs for Spain — 12% of total employment as opposed to 8% in the E.U. as a whole. It also funds the sports center and theater — not to mention the garbage pickup — in Sanse and in hundreds of towns and cities like it. Holguera says that roughly half of his municipality's services are funded by taxes, licenses and fees on construction; in the booming communities along the Mediterranean coast, that figure can reach as much as 70%. "Our situation depends now on growing, always growing," he says. "I don't see it collapsing all at once; this isn't Latin America or East Asia in the late 1990s. But in Spain we still don't have the capacity of France or Germany to absorb problems and still guarantee services to our people." Manuel Prados, president of adicae, an association of financial-services consumers, says 40% of Spanish households have trouble getting to the end of the month. And even some who don't have trouble found themselves vulnerable with the launch of an investigation last month into two large firms that solicited billions of investments in postage stamps.

Can Spain stay the course? It seems almost churlish to ask. So much wealth has been created in the last two decades that Spaniards appear largely immune to the "declinism" that plagues France, Italy and Germany. The two main political parties, Prime Minister José Luis Rodríguez Zapatero's ruling Socialists and Mariano Rajoy's conservative Popular Party (PP), spit and scream over everything from Franco's legacy to gay rights; last week the PP broke off all relations with the government to protest what Rajoy called its "ignominious" dealings with the banned Batasuna party to negotiate an end to the Basque separatist terrorist group ETA. But economic policy is one area where the idea of the "two Spains" has little grip.

That is due in large part to Spain's abiding ardor for the European Union. "Everybody in Spain agrees that we have to make sure our fiscal and economic policies are in line with Brussels," says Antonio Argandoña, professor of economics at the Barcelona campus of the IESE business school. "There's a consensus on these questions to the point that there's no real discussion." Pedro Solbes, Zapatero's Minister of Economics and Finance, established a reputation for fiscal probity both as a Minister in previous Socialist governments and as European Commissioner for Economics. His presence has helped the government shore up support from Spanish businesses that might otherwise think themselves better served by conservatives.

What worries some economists, though, is that Spanish citizens, too, all seem to want the same thing and be willing to go into debt to get it. Spain's rate of home ownership is 85%, far and away the highest in the Organization for Economic Cooperation and Development (O.E.C.D.). Because of the high level of mortgage debt, Jamie Caruana, governor of the Bank of Spain, warned last year that by the end of 2004, "The cushion of saving available ... had fallen to practically zero for Spanish households." Ricardo Vergés, an economist who earlier this year completed the first accounting report on housing for the National Institute of Statistics, is spooked by what he found. "We have €7.4 billion in mortgages. If you divide that by the national income, you see that we're indebted 130%. We're on a direct route to catastrophe. Our children will have to pay back amounts that will reach almost half of their incomes. It's a kind of economic slavery, and it can't be sustained." Granted, not many share that dire outlook. Just because Spain can't continue growing like it has doesn't mean its economy will catastrophically self-destruct. "Our central scenario is a soft landing," says Claude Giorno, who analyzes the Spanish economy for the o.e.c.d.; he sees the construction market slowing gradually rather than collapsing. But even he concedes that future growth must come from somewhere.

Spain's phenomenal building spree is not merely froth. It is grounded in a number of demographic realities: Spain had its baby boom relatively late, from 1965 to 1975, says José Antonio Herce, chief economist of Grupo Analistas, a private consulting firm in Madrid. He attributes the flourishing real estate market in recent years in large part to that population joining the housing market. "We also discovered divorce, which has contributed to a big jump in the number of households," says Herce. "And we've seen the arrival in the last five years alone of some 4 to 5 million immigrants."

Some of those drivers will fade with time, but the greatest of them won't: the sun. An estimated 2.5 million residences in Spain — more than 10% of the total residential stock — are owned by non-Spaniards. Last year foreigners bought 20% of the 650,000 new housing units that went up in Spain. They are drawn more than anything by the prospect of vacations or retirement in "Europe's Florida." "It's a question of supply and demand," says Karl Morris, managing director of Simple Overseas Properties in Benalmadena, near Málaga. "Flights are getting cheaper and Brits, Germans, Irish or French, for example, can be in Málaga in less than 2 1/2 hours. Many of them come once for a month or six weeks and then decide to retire to Spain."

But the boom is flattening off. Housing prices, up by 17% in 2004 and a further 13.9% last year, are expected to grow by 9.8% this year and 8% in 2007. The competition is sharpening for foreign buyers: houses in Croatia and Morocco are cheaper. Spain's good schools, health care and modern infrastructure will keep European snowbirds coming, but foreign buyers are already scarcer. "Until last year we were selling 20 to 25 properties, mostly to British, but now it is down to 18 to 20 a month," says Francisco Toro, director of Mark-Sol real estate agency in Fuengirola on the Costa del Sol. "When we get a client now, we must cosset him and treat him like gold dust. We have to work harder and spend more money on publicity."

The influx of foreign cash has its darker side, too. Arrests earlier this year of 25 people in Marbella — including the mayor, her deputy mayor, two city councillors and the former chief of urban planning — offer a sobering glimpse of the potential corruption such a hot market can breed. Charges (which are denied) include influence peddling and kickbacks that politicians allegedly turned around into helicopters, thoroughbred horses and art collections. For the first time in modern Spanish history, the government ordered the dissolution of Marbella City Council and installed a temporary team to run the town. On taking office the new incumbents found the cupboards bare and thousands of unpaid bills, making the millionaires' jet-set resort virtually bankrupt.

If there's a silver lining to what can seem an unsustainable boom, it's this: Spain's property business has generally become more professional and sophisticated during the years of plenty. It's difficult to get a mortgage anywhere in Spain without a down payment of at least 20%, says Begoña Iturriaga, head of investment at IREA, Spain's biggest independent real estate consulting company. "Developers and banks are generally pretty conservative in Spain," she says. "There'd

have to be a dramatic drop in housing values to endanger banks." In fact, expertise gained in Spain's fat years has propelled companies to seek success abroad — thus hedging their exposure to the domestic market. Metrovacesa's €5.5 billion purchase last year of French developer Gecina made it the largest publicly traded real estate developer in Europe, and the country's biggest banks are reaching out, too. "We haven't seen the end of the expansion of Spanish banks into the rest of Europe," says Herce, citing the Santander Group's 2004 purchase of Abbey National and Banco Bilbao Vizcaya Argentaria's continued search for acquisitions. "They've learned how to collateralize loans, as well as the ins and outs of personal retail banking, and they've gotten very good at it."

But what's good for developers and bankers isn't necessarily good for consumers, or for the Spanish economy as a whole. "Capital and investment going into construction isn't going into other activities," says Herce. Partly as a result, Spain's productivity gains in recent years are almost nonexistent. Spain has created more jobs than the rest of the euro zone combined over the last four years, but too many of them are low-quality jobs on construction sites. The country's infrastructure has profited greatly from European Union subsidies, which are bound to disappear in coming years as needier recipients in the east move to the front of the line.

And then there's inflation, which remains the Achilles' heel of the Spanish economy, currently running at an annual rate of 4.1%, almost twice the euro-zone average. "Since Spain entered the euro zone, its high inflation rate has been consistently weakening its competitiveness," says the O.E.C.D.'s Giorno. Largely as a result, Spain's net foreign balance has dived over recent years.

There's no easy solution in sight. Higher interest rates would reduce inflation, but could at the same time greatly endanger the already stretched household budgets of Spanish consumers. Some 90% of Spanish mortgages are variable-rate

loans, so an interest hike would cause real pain. Squaring that circle would be a difficult task for any central bank. But the European Central Bank in Frankfurt can't worry too much about cooling down Spain when the economies of much of the rest of the euro zone — witness Germany and Italy — are in cryonic suspension.

Clearly, the Spanish government has to rely on its own efforts. Late last year it presented an ambitious National Reform Program that promises, among other things, an improvement to Spain's mediocre higher-education system and a doubling of the country's expenditures for research and development. The government wants to encourage flexibility in Spain's overly segmented labor market and encourage mobility by getting more Spaniards to rent instead of buy. "We need to promote rentals, not only because of the high prices of homes and high levels of mortgage debt, but because there is so much unoccupied housing, which the government sees as 'anti-economic,'" says Salvador Arancibia, spokesman for Spain's Housing Ministry. "In response we have created subsidies to help young people rent their own apartments, passed a housing plan that offers incentives to construction companies to build rental housing, and created a public entity designed to invigorate the rental market."

It won't be easy, even in San Sebastián de los Reyes. Earlier this year, the town put up 130 houses to purchase and received 3,500 applications; when it offered 118 units up at subsidized rental rates but without an option to buy, only 600 families expressed an interest. "We're growing, but we have feet of clay," Holguera says.

Yet anyone betting against the Spaniards' ability to change hasn't digested just how radically, even joyously, they've embraced it in recent years. Putting a basically healthy economy onto a better long-term footing is an enviable task. Spain is better suited than most of its neighbors to make it work. **2,489 words**

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