

Real Estate Watch

Spain

Economic Research Department
Second Quarter 2005



Interest rates and employment continue to underpin demand
Supply responds: a new record in housing development in 2005?
Buying could be more affordable than renting
Housing affordability: large differences between Autonomous Regions

Index

Closing date: May, 27 2005

Editorial	1
1 Economic Environment	2
2 Activity in construction	6
Box 1: "On measures against bad debts in commercial transactions"	10
3 The real estate market	11
Box 2: "Rental affordability"	14
4 Real estate financing	15
5 Topic of the Quarter: BBVA Affordability Indicator and results by Autonomous Regions	19
Box 3: "Housing affordability size matters"	21

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Editorial

2005 started with construction extremely buoyant and the information available suggests that the sector will continue to be dynamic throughout the year. A similar number of homes will be started as in 2004, which guarantees a high level of activity in building, although sales will fall slightly in the residential segment. In the market for offices and industrial premises, the tone of demand is more moderate.

In the first quarter of the year, the number of homes endorsed hit a new high, with the Mediterranean coast and the outskirts of the big cities the places to experience the strongest growth. The pace of sales, however, has slowed in the majority of markets and this has been reflected to some extent in prices.

The buoyancy of the real estate market is being clearly reflected in the performance of financing for housing, which was growing at rates of over 24% at the end of the first quarter of 2005. Low interest rates and the good conditions of new offers of property are attracting demand for lending from households. Moreover, the high level of housing production is requiring strong growth of lending to residential development, which was growing of rates of over 40% at the end of 2004. The stability expected in the performance of interest rates in the short term is driving the mortgage segment.

The upward revision of National Accounting figures has revealed stronger growth of the Spanish economy in the last four years, when both employment and per capita income increased faster than estimated in the previous figures. These figures are more in line with the behaviour of the financial variables and with the intense growth of the construction sector in recent years, which is already surpassing 16% of the total value of production in the Spanish economy.

In addition, the new figures for housing prices released by the Ministry of Housing, which have been drawn up on a new basis, put the prices at new levels, with average figures that are 6% lower than in the previous statistics. These new statistics are an improvement on the information existing to date, since the figures are extended to the provincial level and also show the number of appraisals and a new stratification of the sample, with average prices per square metre classified according to the final price of the home.

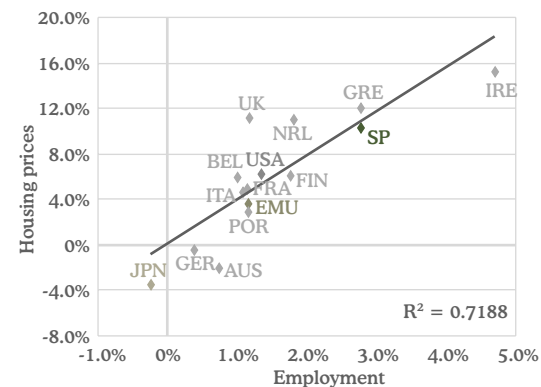
In an attempt to make housing affordability ratios more intuitive, the topic of the quarter in this issue of Real Estate Situation presents a new indicator which relates housing that households are able to buy, given their payment capacity, with the market price of the home. This indicator currently shows that Spanish households have a certain degree of solvency, which explains the high volume of purchases/sales taking place in Spain's residential market.

In the second part of the topic of the quarter, a more in-depth look is taken at the different housing affordability ratios observed in each Self-governing Region. These ratios were drawn up using the latest information available on the number of employed people per household and the new prices of housing and they show the differences existing between the different Self-governing Regions.

The current construction cycle is turning out to be the longest in the last 25 years. In view of the levels of activity attained in the sector, from a medium-term perspective it is clear that the present growth rates cannot be sustained. However, they can be expected to maintain a positive spread with the countries in Spain's environment, given the model of development of the Spanish economy - a model which relies on services to a greater extent than the countries in its environment.

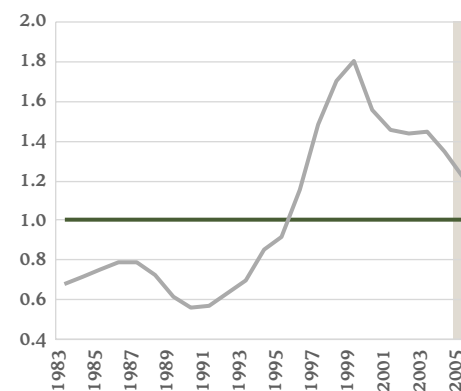
Housing prices and employment

Year-on-year variation. Average 1994-2004



Source: Eurostat, IMF and BBVA

BBVA affordability indicator



Source: BBVA

1. Economic environment

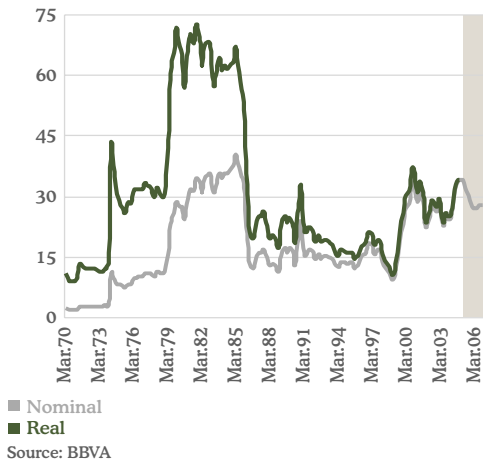
International

Table 1.1. Growth forecasts

	2003	2004	2005	2006
OECD	2.0	3.3	2.7	2.9
Non-OECD countries	6.4	7.2	6.2	5.9
WORLD	4.0	5.0	4.2	4.2

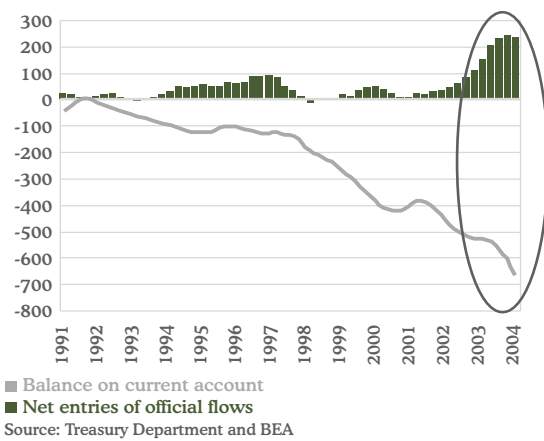
Source: BBVA

Chart 1.1. Price of the barrel of Brent in euros



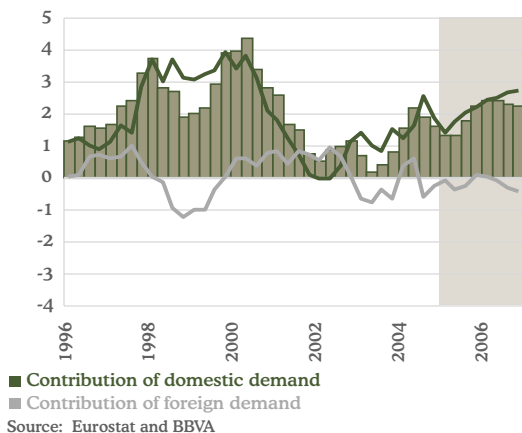
Source: BBVA

Chart 1.2. USA: balance on current account and official financing (12-month cumulative. Billions of dollars)



Source: Treasury Department and BEA

Chart 1.3. EMU: GDP and contributions to growth



Source: Eurostat and BBVA

After a very positive 2004 in terms of world growth, driven by expansive demand policies and the pull of the Chinese economy, growth can be expected to become more moderate in 2005 and 2006, as some of these drivers peter out and the effects of the increase in oil prices are felt. However, the world economy will foreseeably continue to expand, with a growth rate that is above the average for the last three decades. Together with the U.S., China will continue to act as the growth driver. The U.S. economy will continue to move towards its potential, albeit at a slower rate than in 2004, on the back of productivity, low capital costs and real interest rates, the sound financial situation of companies and recovery in the labour market.

In this sense, it should be noted that BBVA forecasts for 2005 and 2006 are based on a relatively optimistic scenario for oil prices in comparison with the consensus. The recent price hike to maximum levels is largely explained by a high risk premium which reflects transitory factors that will gradually disappear. Other raw materials prices will also slow progressively in the coming years. The adjustment of interest rates towards more neutral monetary conditions will continue to be very gradual, as it has been up to now, while technological changes, the credibility of the monetary authorities and the globalization of saving and investment contribute to keeping inflation expectations anchored, despite strong monetary expansion.

Nonetheless, the international outlook is not without uncertainties. Apart from doubts about the behaviour of oil prices, the possible difficulties the U.S. could encounter in financing its hefty and growing current deficit, the predominance of financial –and thus less stable– flows in international transactions, as compared to direct investment which does not seem to have fully recovered, and the possibility that the high liquidity has led asset prices to increase above fundamentals, could affect the firmness of future growth. The dollar has been –and in 2005 and 2006 will continue to be– the catalyst of some of these uncertainties, which will keep it at relatively depreciated levels with respect to its long-term equilibrium level. It has accumulated strong depreciation against the euro since 2002 and will remain at \$1.29 and \$1.28 per euro in 2005 and 2006 respectively, while it could depreciate further against some of the currencies of the most dynamic areas of the world, such as Asia, where it has so far dropped to a lesser extent.

EMU: on the path to cyclical recovery

In a relatively favourable context of world growth, the European economy seems to be having difficulties in returning to high growth rates in a sustained manner. Several factors have contributed to the delay: from the well-known structural problems, which restrict growth potential and make rapid adjustment difficult after a shock to the management of demand policies which, in view of the problems of implementing structural policies and reflecting a clear aversion to risk, focus on medium-term objectives, renouncing aggressive policies for stabilizing the cycle. But, over and above these considerations, there are factors which suggest that the cycle will recover in the coming years.

Despite the uncertainty which the recent downturn on confidence indicators has raised for the short term, the forecasting models for the medium term indicate that, in a favourable foreign context with moderation in raw materials prices, the conditions are right for the European economy to speed up in the second half of 2005 and 2006.

Growth will be led by investment, on the back of the strength of the global economy, the streamlined situation of companies and very favourable financial conditions. Albeit with a slightly longer delay, private consumption will benefit from the gradual recovery of employment and the favourable performance of financial wealth. Moreover, the position of saving and investment and the financial situation of the leading economic players and the economy as a whole is quite balanced, especially in comparison with that of other regions such as the U.S. This will be accompanied by demand policies which will remain relatively lax. After the "dismantling" of the CEP which the agreed reform involved in practice, it does not appear that fiscal policy will constitute a restriction in 2005 and 2006. And the absence of inflationary pressures, in an environment of well-anchored expectations, a relatively appreciated exchange rate and more moderate oil prices, will make it possible to maintain an accommodating monetary policy.

In the context of a highly-appreciated real effective exchange rate, the contribution of the foreign sector to growth will be slightly negative in 2005 and 2006, since the contractive impact of price-competitiveness on exports will be partially offset by the strength of world growth. Thus, the GDP's cyclical component will remain negative in 2005 and will only become positive in 2006. The absence of inflationary pressures in a context of a relatively appreciated exchange rate gives the ECB quite a lot of room to be "patient" as regards bringing interest rates back to normal. The continual downward surprises in its growth forecasts, which coincide with the same kind of surprises in its inflation forecasts, will mean that it will want to be sure of the solidity of the recovery before it starts pushing interest rates up again. Consequently, the ECB is not expected to raise interest rates until 2006, with gradual rises to around 3.25% at the end of next year.

The modest recovery in the European cycle is not without risks. Firstly, further appreciation of the exchange rate, on top of what has already been accumulated in the past few years, and/or the maintenance of oil prices at current levels would put a brake on the still incipient growth of activity. Secondly, a brusque adjustment of the imbalances in the global economy in general and in that of the U.S. in particular would also thwart recovery in activity in Europe. If this were the case, and in view of the recent inflationary tensions, the ECB could leave interest rates untouched and could even consider the advisability of further cuts.

Spain

As was described in the previous section, increases in interest rates in the region will not occur until 2006, which implies that the Spanish economy's financial conditions will continue to be comfortable. What is more, employment will continue to have a positive impact on household income and, thus, on consumption and residential construction. Imports will continue to increase at higher rates than exports, as a result of the faster growth of Spanish demand for consumption and investment and, to a lesser extent, because of the cumulative losses of price-competitiveness. In these conditions, the Spanish economy will continue to grow by just over 3% in the next two years.

The new National Accounting brings real figures closer to financial and foreign sector figures

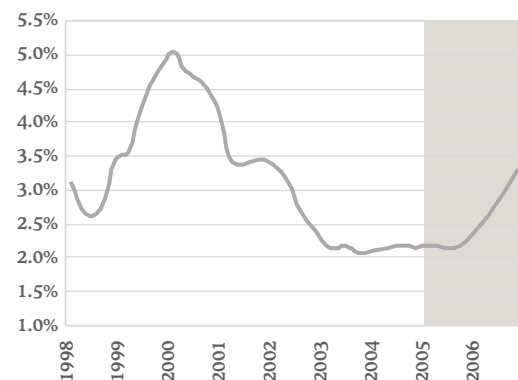
The INE has recently released the first Quarterly National Accounting figures adapted to base 2000, with information from the first quarter

Chart 1.4.
EMU: companies' average real financing cost*



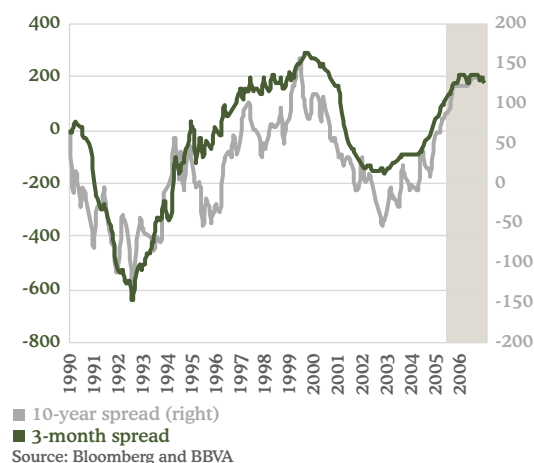
* Affected by the statistical change in bank interest rate series since 2003
Source: ECB

Chart 1.5.
EMU: 3-month interest rates and forecasts following a monetary rule



Source: ECB and BBVA

Chart 1.6.
10-year and 3-month interest rate spread between U.S.A. and EMU (in basis points)



Source: Bloomberg and BBVA

Chart 1.7.
Spain, GDP

Year-on-year growth rate

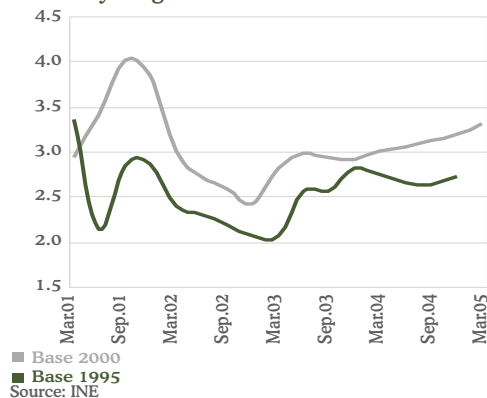
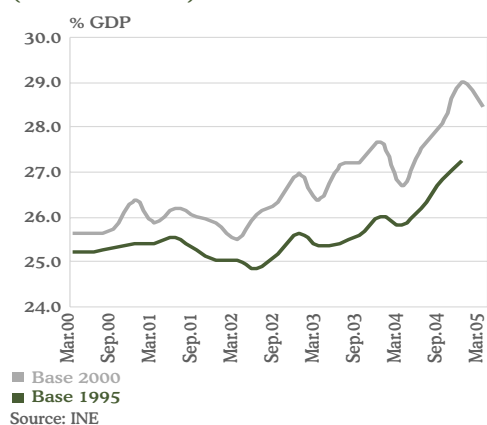


Chart 1.8.
National Accounting Employment



Chart 1.9.
Investment ratio
(% nominal GDP)



of 2000 to the first quarter of 2005¹. In comparison with the previous estimates with base 1995, growth is now higher and its profile has gone from two years of virtual stability at around 2.6% to rising from 2.9% to 3.3% (Chart 1.7). The many changes made make it impossible to attribute this profile of acceleration to any one of them in particular, although, given the size of the increase in population and employment (Chart 1.8) in the national accounts, this element appears to be decisive².

In any event, the new National Accounting figures give a more coherent global view of the information from the Spanish economy's real sector, financial sector and foreign sector. The relatively strong growth rates of household borrowing for home-buying or the deterioration of the foreign deficit are more consistent with the new employment and growth figures (a sign of the greater buoyancy of real household income) and investment, which is also rising and to a greater extent than previously estimated³ (Chart 1.9).

The situation is improving on the back of domestic demand

The Spanish economic situation improved in the early months of 2005, as is shown by both the faster GDP growth and the performance of different employment and spending indicators and activity indicators in certain sectors, such as transport. However, both business expectations and industrial activity are growing moderately as a result of the delayed recovery in the euro zone. In the short term, this delay will widen the Spanish economy's positive growth spread, which together with the deterioration accumulated in recent years by its competitiveness, will contribute to keeping the foreign sector's deduction from the GDP at relatively high rates.

Investment in construction grew by 5.5% in 2004, below the 2001-2003 figures. However, at the beginning of 2005 it rose and, in view of the latest information on the economic indicators, it should hold up in 2005, considering the inertia of the sector and the levels of work started. In this respect, in the first half of 2005 the indicator for the

¹ The greatest changes in methodology occurred in the method for adjusting prices (chain-based indices) and the accounting of Indirectly Measured Financial Intermediation Services (Servicios de Intermediación Financiera Medidos Indirectamente -IFMI). Moreover, the population and employment figures from the 2001 Census, the Ongoing Taxpayer Roll and the LFS were also added.

² The new estimates also reduced the increase in apparent job productivity in view of the heavier weight of the branches of activity with lower relative levels.

³ In 2004 the investment ratio rose from 26.5% of the GDP with base 95 to 27.8% with base 2000. For the same period, the estimate for the balance of current operations with the rest of the world (domestic saving) also rises -albeit to a lesser extent- from 22.2% of the GDP to 23.1%.

Table 1.2. Spain, GDP Base 2000

y/y rates	1Q04	2Q04	3Q04	4Q04	1Q05	2001	2002	2003	2004	2005	2006
Household consumption	3.3	4.7	4.7	4.8	4.8	3.2	2.8	2.6	4.3	4.5	4.0
Pub. admin. consumption	5.4	6.3	7.1	6.7	6.0	3.9	4.5	3.9	6.4	6.4	5.5
GFCF	3.4	3.1	4.9	5.9	7.5	4.5	3.3	5.4	4.4	6.9	5.7
Capital Goods	-2.5	-1.6	5.1	7.3	10.5	0.1	-2.9	1.9	2.1	7.9	7.0
Construction	6.0	5.4	5.2	5.3	6.1	6.8	6.2	6.3	5.5	6.3	5.0
Other Products	4.7	3.3	3.6	5.9	7.2	6.0	5.0	7.8	4.4	7.4	6.0
Var. stocks (*)	0.0	-0.2	-0.2	-0.2	-0.1	-0.1	0.0	0.2	-0.1	0.0	0.0
Domestic demand (*)	3.8	4.6	5.2	5.5	5.8	3.7	3.4	3.8	4.7	5.8	5.1
Exports	3.5	2.8	3.2	1.8	-1.7	4.0	1.7	3.5	2.7	0.3	2.5
Imports	6.2	8.0	9.2	8.8	6.0	4.2	3.8	6.2	8.0	6.7	7.0
Foreign balance (*)	-0.8	-1.5	-2.1	-2.3	-2.5	-0.2	-0.7	-0.9	-1.6	-2.3	-1.9
GDP mp	3.0	3.1	3.1	3.2	3.3	3.5	2.7	2.9	3.1	3.4	3.2

(*) contributions to growth

Source: INE and BBVA forecasts

state of the construction sector drawn up by BBVA⁴ registered its highest levels of the past four years. In the longer term, in a scenario where interest rates no longer contribute to the improvement in housing affordability and, given the clear signs of longer sales periods for residential developments, activity in the residential construction sector will start to gradually become more moderate.

The rest of investment, in capital goods and other products underwent strong growth in 2004, rising from an increase of 0.3% in the first quarter of 2004 to 9.2%⁵ in the first quarter of 2005, particularly notable performance given the relative foreign apathy. The consolidation of cyclical expansion in the rest of the euro zone, in the context of the favourable financial situation of Spanish companies, should serve to support the current investor cycle in 2005 and 2006.

At the same time as the outlook for the growth of exports and investments finally becomes favourable, the boost which the performance of household income and wealth in a context of record low interest rates is giving to consumer spending will be maintained. Consumer spending will grow above the GDP, with the dynamism of disposable household income underpinned by employment, which grew by 3.0% in 2004 in terms of employment equivalent to full-time, 0.9 points more than estimated up to now.

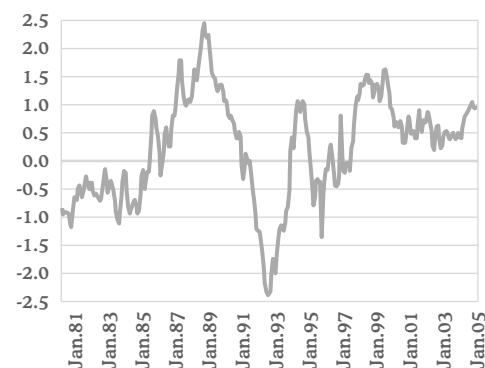
The strong growth of employment in the Spanish economy can be explained by the positive combination of factors which has led to a lower increase in real wages: the availability of immigrant labour supply which is more flexible than original Spanish supply, the reforms made in the labour market and the negotiating role played by employers and unions. In this respect, the revision of National Accounting produced a significant lowering in the variation of Unit Labour Costs (Chart 1.12), due to the intense slowing in average remuneration per salaried worker in the new scenario for population and employment.

The changes made in National Accounting require a degree of caution when it comes to valuing the economy's inflationary expectations on the basis of the performance of its deflators. The GDP deflator grew less in 2004 on base 2000 than on base 1995 (4.1% and 4.4%), while in previous years the rate was the same, regardless of the base considered.

All the same, the Spanish CPI will grow by 3.1% and 2.5% respectively in 2005 and 2006, which means that the spread with the EMU as a whole will be of 1.2 pp and 1.0 pp respectively, around the average registered between 1999 and 2004 (1.1%). In the first four months of 2005, the outlook for the Spanish CPI deteriorated as a result of some upward surprises in the prices of fresh food and the sustained rise in oil prices, which is expected to become more moderate in the second half of 2005 and 2006.

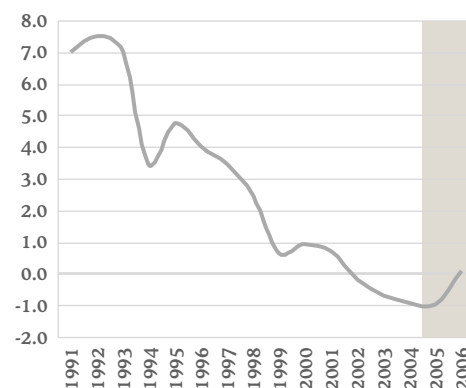
⁴ Standardized indicator with zero average and typical unit deviation which synthesizes the performance of different variables of activity, expectations and employment in the sector.
⁵ Aggregate of Capital Goods and Other Products. BBVA estimate.

Chart 1.10.
Indicator of the state of Construction



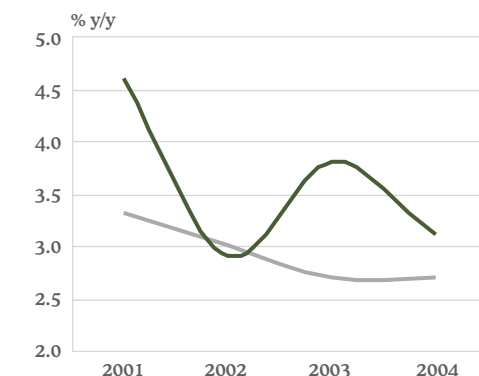
Source: BBVA

Chart 1.11.
Spain, real 3-month interest rates



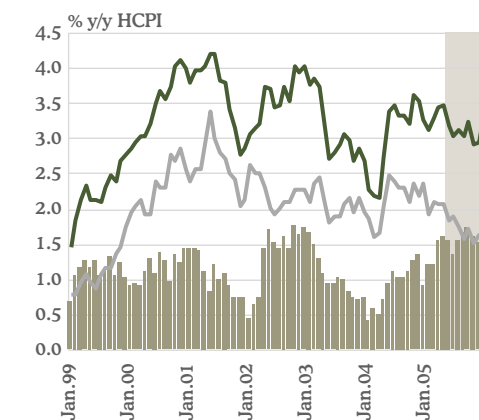
Source: BBVA

Chart 1.12.
Unit Labour Cost



■ Base 2000
 ■ Base 1995
 Source: INE

Chart 1.13.
Inflation



■ EMU
 ■ Spain
 ■ Spread
 Source: Eurostat and BBVA

2. Activity in construction

Europe: still not taking off

In the course of 2004, the contribution of construction was positive in the European Union as a whole, with a year-on-year advance of around 1.0%, in line with the gentle economic recovery. The quarterly profile does not show a clear trend and sector dynamism comes from the building segment. In the last decade, investment in building is losing weight in the European economy and currently accounts for 5.6% of the total economy, a similar ratio to that observed in the US and slightly higher than the weight it has in Japan.

Although in Europe as a whole construction activity has remained relatively stable, there are substantial differences between the different countries in the Union. Thus, in the countries in the centre of Europe, investment in construction in 2004 was lower than in 2003, as is the case of Germany, Belgium and Portugal, or increased very moderately, as is the case of France and Luxembourg, while in Spain, the United Kingdom and the new member states construction continued to grow at a good pace.

Looking at quarterly profiles, it can be observed that in both Germany and France or the United Kingdom, sector performance has been downward throughout 2004, with lows in the last quarter of the year. The increase in construction companies' backlog orders, especially in the new member states, anticipates an improvement in the level of activity in construction this year. However, despite the good performance of peripheral countries, the construction sector will not take off clearly in 2005, with similar growth rates to in 2004, due to the lack of both public and private investment in the civil works segment in the countries with the strongest economic clout. The still notable need to reduce public spending in some of the main EMU economies is leading to a significant decrease in the level of investment in civil works and this will continue through 2005.

The building segment was the most dynamic in 2004 in the European Union, with positive growth rates throughout the year which continued in the early months of 2005. Expansion was mainly focused on the residential sector, since growth in non-residential building was more moderate.

The low interest rates are producing a certain boom in housing demand, mainly in those economies where employment is generated. This impulse is leading to growth in the development business, producing an increasing number of building permits and more residential building. The non-residential segment is not yet showing an increase in activity, as a result of the excess supply which currently exists. The economic growth rate needs to be higher for demand for non-residential areas to take off.

Spain: expansion continues

The new National Accounting figures show that in 2004 the construction sector was more dynamic than in 2003, with an annual average growth rate of 5.5%, 0.8 percentage points lower than in 2003. This lower growth can be explained by the slowdown in civil works; in contrast, residential building presented a growing level of activity. In the first quarter of 2005, sector activity performed at a good pace and increased at a rate of 6.1%. All in all, the forecasts indicate that this will be a good year for construction.

The quarterly profile, however, suggests that the sector growth rate will speed up to some extent as the year progresses. In 2006, this trend will start to slow and construction will present an annual aver-

Chart 2.1.
Europe: GDP and Constr. GAV
Year-on-year variation

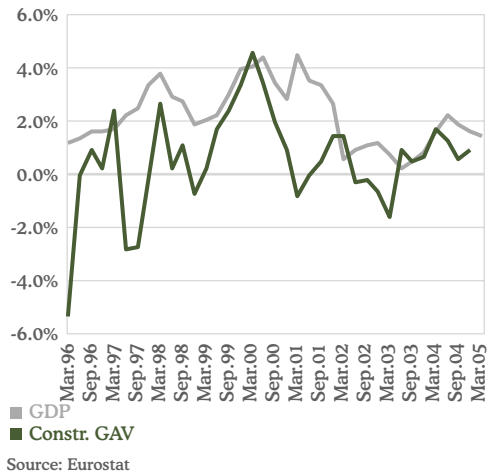
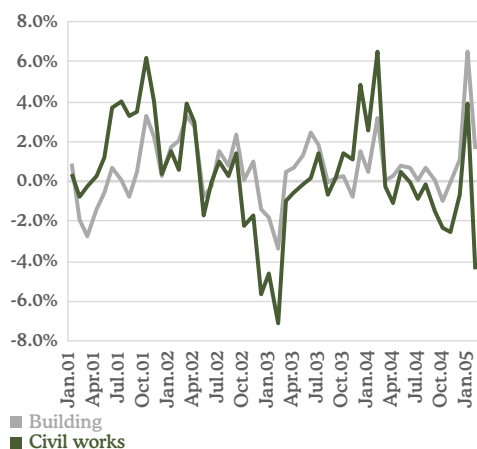


Table 2.1. Production in Construction
Year-on-year variation

	I 04	II 04	III 04	IV 04
Euro zone	1,3%	-0,1%	-0,1%	-0,2%
EU 15	3,2%	1,0%	0,4%	0,1%
Germany	-3,1%	-5,7%	-5,8%	-7,2%
Belgium	1,1%	-3,0%	-5,1%	-0,8%
Denmark	3,9%	5,1%	6,3%	4,0%
Spain	3,5%	0,7%	0,9%	0,9%
France	4,1%	3,0%	0,3%	-0,7%
Holland	2,9%	-0,1%	0,1%	2,6%
United Kingdom	9,8%	4,4%	1,1%	-1,2%
Portugal	-4,4%	-2,8%	-5,0%	-5,8%

Chart 2.2.
EMU: Activity in Construction
Annual variation



Source: Eurostat

age growth rate of around 5.0%. If these forecasts are met, 2006 will be the ninth year in succession that construction has grown faster than the GDP: the longest growth period in the sector in the last 25 years.

The good moment for construction is being very positively reflected in the opinions of sector entrepreneurs, who continue to be extremely optimistic as regards both the present situation and performance in the medium term. The high volume of work in progress and the good situation of backlog orders is making a decisive contribution to this view.

The good results of previous years have allowed many companies in the sector to diversify their products and move into new markets, which reduce the concentration of risks and gives companies greater manoeuvrability in adverse circumstances of some market or segment. All of this contributes to creating a more positive climate of opinion.

Materials and labour force: growing consumption

After a year when apparent cement consumption grew at a rate of 3.7%, in the first four months of 2005 it reached nearly 16 million tonnes, 4.2% more than in the first four months of 2004. The trend indicates some moderation in the performance of this variable in 2005, when it will increase at an annual average rate of 4%. The slower growth in the civil works segment, more intensive in terms of cement consumption, is the reason for this slowdown.

In the first quarter of 2005, the construction sector generated just over 100,000 net jobs, a year-on-year increase of 5.1%. This higher growth rate is due to the fact that residential building, more intensive in manpower, is the most dynamic segment in the sector.

Civil works: work holds up

In 2004, civil works remained at a similar rate to in 2003, with an average year-on-year increase of 0.7%. The quarterly profile shows that, after the general elections, activity in the segment picked up slightly as the year progressed. In the early months of 2005, the dynamism of civil works was similar to in the latter quarters of 2004 and everything seems to suggest that it will improve slightly over the year to grow at average rates of around 2%.

As a result of the high volume of work tendered in 2004, which grew by 24%, there was an increase in the volume of new contracting which will materialize in activity in the course of this year. In the first two months of 2005, work tendered amounted to a volume of over Euros 3,600 million, 0.9% more than a year earlier. While investment in roads and airports accounted for over a third of the total work tendered in 2004, this percentage rose to 55% in the first two months of this year.

In spite of this increase in investment in roads, the long-term trend is for a reduction in the weight of this item -years ago the most important of all- to the benefit of investment in railways, which have risen from representing 5% of the volume tendered in 1990 to 25% in 2004. The entry of private investment in toll motorways in recent years, through new financing formulae, has kept investment in new road infrastructures in Spain at a good level, with smaller initial outlays from the Administration.

Of total civil works tendered in 2004, a third corresponds to the Central Administration and the remaining two-thirds to Territorial Entities (Regional Governments and City Councils). Since 2002, both the Social Security and Regional Bodies dependent on the Ministry of

Chart 2.3.
GDP and construction

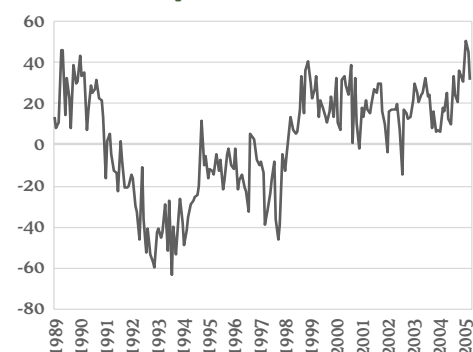
Annual rates of variation



Source: INE and BBVA

Chart 2.4.
Indicator of confidence in construction

Difference of replies



Source: European Commission

Chart 2.5.
Apparent cement consumption

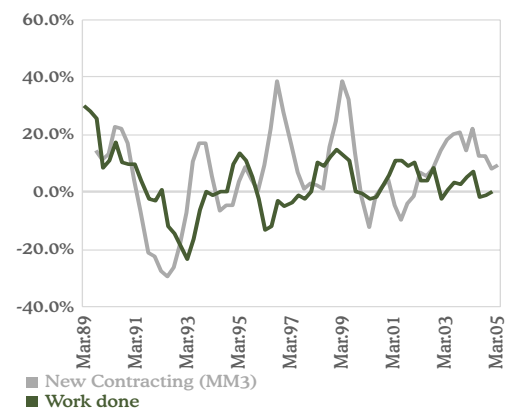
Annual rates of variation



Source: Seopan and BBVA

Chart 2.6.
Civil works

Annual rates of variation



Source: Ministry of Public Works

Chart 2.7. Public investment in infrastructure



Chart 2.8. Building

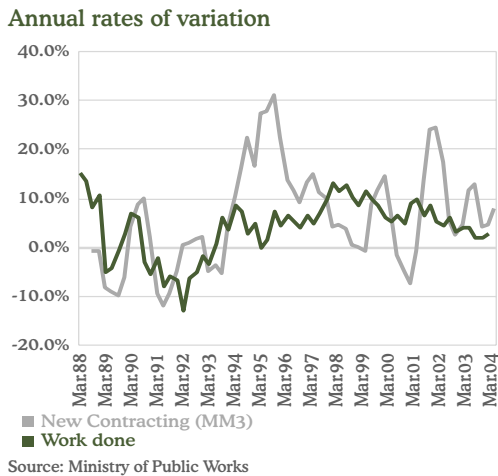


Table 2.2. Housing starts in Spain

	Total Spain	Large Cities	Cities/Coast Total (%)	Coast Holiday	Coast/Total (%)
2000	594,820	58,060	9.8%	333,231	56.0%
2001	561,186	59,958	10.7%	312,857	55.7%
2002	575,546	62,748	10.9%	310,517	54.0%
2003	690,207	64,814	9.4%	377,832	54.7%
2004	739,658	50,461	6.8%	399,012	53.9%
2004**	105,933	7,215	6.8%	55,926	52.8%
2005**	114,196	9,061	7.9%	61,979	54.3%
Variación	7.8%	25.6%		10.8%	

(*) Barcelona, Valencia, Malaga
Coast: Mediterranean, Canaries, Cadiz, Huelva
Large cities: Madrid, Barcelona, Valencia, Seville, Zaragoza and Malaga
(**) January-February figures
Source: College of Quantity Surveyors and BBVA

Table 2.3. Official tenders in Civil Works
Millions of Euros

	Total	State	Territorial Entities	Regional Bodies	Social Security
2000	11,740,010	5,194,891	6,358,029	186,085	1,005
2001	16,340,638	7,270,966	8,790,105	277,198	2,370
2002	19,610,613	8,220,894	10,850,632	537,711	1,376
2003	16,706,348	8,484,440	7,744,978	476,343	586
2004	20,752,375	7,749,925	12,694,093	307,920	438

Source: Ministry of Public Works

Public Works have been considerably reducing the volume of work tendered, which means that work increasingly relies on local investment. Thus, in the early months of 2005, the share of Territorial Entities rose to account for as much as 75% of the total tendered.

In the medium term, investment in infrastructures will continue at its current pace until transfers from the European Union are exhausted, which implies that the level of activity will remain similar to what it has been in these past few years. In the long term, the weight of investment in civil works will lose relative importance in the Spanish economy and will tend to draw in line with the low weight it has in the most developed European countries.

Building: growing

In 2004, building presented a good pace of activity, especially thanks to the buoyancy of residential building which hit a new record high in both the number of homes projected and the number completed.

This good moment for building is being reflected in both the current level of activity, which continues to grow at higher rates than those for the economy as a whole, and in new contracting, which is increasing. This guarantees that, in the medium term, the segment will continue to make a positive contribution to the GDP.

The survey on the situation in the construction industry shows positive performance -albeit growing more moderate- of the value of work done in the building segment. In this respect, it is residential building which is making the largest contribution to this growth, since non-residential building is at a moment of slower activity. Contracting of new work is moving at a good pace and has been on a positive trend since the middle of 2001.

The growth of backlog orders in hand of sector companies was reflected in a new increase in projects endorsed, which grew by 7% in 2004 to reach a total of nearly 740,000 homes. Of these, 92% were newly built and the remaining 8% were extensions or refurbishment. In the first two months of 2005, the trend has continued and the number of projects endorsed increased by 7% with respect to the first two months of 2004. This growth mainly occurred in the large cities and in coastal provinces, where it was above the average. These figures confirm that the development pattern of previous years is continuing, with strong growth of property supply in the most popular holiday areas.

By type of home, housing in apartment blocks, which use up the least land, is growing the fastest. Today, two of every three homes are in blocks, while four years ago this proportion was just over 61%. The sharp increase in the price of land is leading to more intensive utilization of an increasingly scant resource.

In this respect, since the beginning of this decade, the strong increase in demand in large and medium-sized cities has led to signifi-

cant growth of the property markets in neighbouring towns, known as the frontier effect.

This frontier effect is particularly clear in the case of Madrid, where the improvement in road infrastructures and relatively lower prices has led part of demand to move to other nearby towns and has given a real boost to the markets of adjoining provinces, such as Toledo, Guadalajara and Segovia, which have been going through an unparalleled building boom since the beginning of this decade. In other large cities, such as Barcelona and Seville, building growth is moving to the smaller towns which form the city's growing metropolitan area.

In 2004, a total of nearly half a million homes were completed, which was a year-on-year increase of 8%, reaching a new record in the volume of work completed. In the early months of 2005, the trend continued and a total of 74,000 homes were completed, 4% more than in the same period last year.

The non-residential segment remains stagnant

In 2004, the non-residential area to be built totalled 20.3 million square metres, a 9.1% downturn on the area endorsed a year earlier. In the first two months of 2005, the area to be built contained in the projects passed totalled 2.9 million square metres, down 5% on the area approved a year earlier.

In the course of 2004, the decreases in the area to be built occurred in the both the commercial and industrial segments and also in the office segment. In the first two months of 2005, the industrial segment picked up slightly while the number of projects for commercial and office space continued to fall.

The difficulties existing in some Self-governing Regions in developing shopping centres is leading to a downturn in the space on offer. In the case of offices, the surplus supply currently existing in the main markets is leading to a lower level of activity in this segment.

Chart 2.9.
Madrid and adjoining provinces
Housing starts. Number

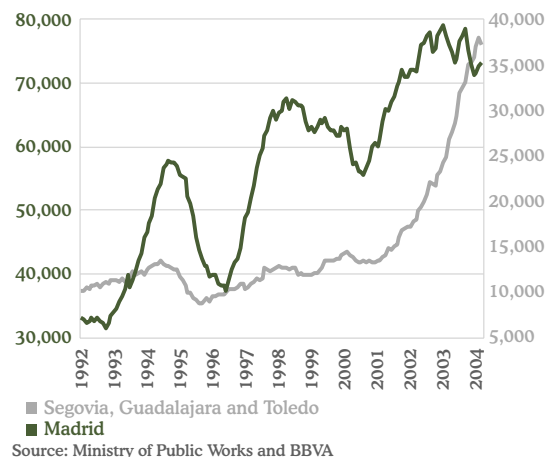
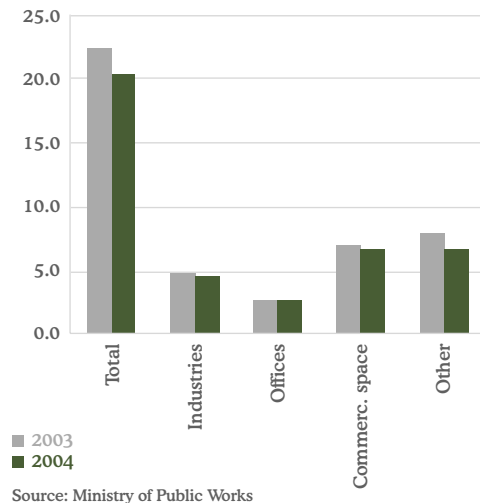


Chart 2.10.
Non-residential area to be built
Millions of m²



On measures against bad debts in commercial transactions

Act 3/2004, of 29 December, was published in the BOE (Official State Gazette) on 30 December 2004. This Act, which came into force the day after its publication, establishes measures for fighting default in commercial transactions. With the approval of the said Act, transposition to European Directive 2000/35/EC of the European Parliament was fulfilled, with a delay of more than two years. The origin of the Directive is to be found in a regulatory intervention provoked by the progressive deterioration of companies' profitability, especially in the case of small and medium-sized enterprises, largely due to the default in the payment of contractual obligations and the excessively long payment periods the soundest companies tend to impose.

The object of the Act is to lend more transparency to payment periods in commercial transactions in such a way that its application acts as a barrier against on going non-fulfilment of contracts and against the usual recourse of obtaining liquidity at the expense of creditors. To this end, the Act mainly establishes three measures: the establishment of a benchmark payment period of 30 days; penalizing bad debtors with the payment of a high default interest (seven points higher than the ECB's basic refinancing interest, unless the parties have agreed upon another rate, never below the legal rate on money plus 50 percent) and the obligation to pay debtors compensation for all collection charges when these are responsible for the delay.

Moreover, the Act includes other features such as the prohibition of imposing abusive conditions on suppliers to the detriment of the creditor, considering all the circumstances in the case (amongst them the nature of the product or service), the debtor providing further guarantees and usual commercial practices, and submitting the same to the Public Administration, fixing the maximum period for public bodies to pay suppliers at 60 days. Lastly, the dominion reserve pact is generally contemplated, whereby the seller keeps ownership of the goods sold until the final payment of the price, provided this has been previously expressly agreed.

The scope of this legislation covers all the payments deriving from commercial transactions between companies or between companies and the Administration. The Act is not applicable to payments involving consumers, interests related to the legislation in regard to cheques, promissory notes and bills of exchange and payments of compensation for damages, or to debts submitted to insolvency proceedings against the debtor; and commercial transactions which affect retail trade are subject to its specific regulations.

In respect of the real estate sector, we should highlight that the Act passed affects it in relation to payments to other companies, the Administration, and between the main contractors and their suppliers and subcontractors. Consequently, what is indicated in it would not be applicable to real estate development purchase/sales contracts where the buyers are individuals or legal entities that are not acting in the exercise of their independent economic or professional activity. A different matter would be the usual purchase/sale of land between companies in the sector and the establishment of long payment periods, normally linked to complying with the urban planning milestones, where we feel that freedom of agreements should take priority in accordance with the usual practices in these types of transactions.

In relation to agreements involving different players in building, works contractors, hiring services, etc., it is clearly applicable. Here what the Act establishes in relation to abusive clauses must be kept very much in mind, if the contractor imposes on suppliers or subcontractors payment conditions which are not justified by the conditions from which the contractor will benefit or by other objective reasons, since in this case, for example, collection of interim payments and the deferral of payment to suppliers or subcontractors, which are normally staggered over very long periods, would not be justified. Thus, until there is jurisprudence on the subject, an eye must be kept on the specific clauses referring to the payment system and default interest that could be declared abusive. In this respect, it would be advisable to contemplate in the said contracts the minimum default interest established in the Act, together with the debtor's provision of additional guarantees in periods which exceed the benchmark periods.

With bank bad-debt indices at minimum, 0.71% in February this year, the volume of loans granted by banks at record highs and all-time low interest rates, the application of this Act should come as a particular relief for small and medium-sized enterprises and for companies contracting with the Public Administration. If we add other legislative novelties to this, such as the case of the insolvency of individuals, in force since 1 September 2004, which contemplates the possibility of "honest" debtors -individuals- refinancing the payment of their debts, and a scenario of a foreseeable change in the economic cycle, we feel that the introduction of measures against bad debts is essential and necessary to make commercial transactions more secure in legal and economic terms.

3. The real estate market

In the early months of 2005, sales and prices accelerated in some of the main housing markets in Spain's environment

In the second half of 2004 and early months of 2005, prices and transactions accelerated in the residential market in both the U.S. and some of the leading European economies. In the power base of the pound sterling, however, the appreciation of real estate slowed significantly in response to rising interest rates.

In the first quarter of 2005, despite the increase in interest rates, in the different U.S. real estate markets sales accelerated across the board, which led to a national average increase in prices of around 15%, the highest rate in the present cycle. Today, the volume of housing sales in the US is double the figure observed a decade ago.

In contrast, in Canada, Australia and the United Kingdom, the increases in interest rates have led to a lower volume of housing demand, which has produced slower growth of sales and housing prices.

Throughout the present decade, in Europe as a whole, a growing increase in housing prices has been observed, reaching an annual average of 8% in 2004, nearly six points higher than inflation. The performance of this variable in the context of the EMU was very varied. Thus, while the housing markets remained apathetic in Germany and the countries in its environment, prices in the French and Italian markets rose to some extent.

The scant dynamism of the German economy is being strongly reflected in the real estate market, especially in the residential market, with a sharp decrease in demand and prices which are growing below inflation and have been corrected by around 20% in the last ten years. This situation is also occurring in Austria and, in the past year, in Holland as well. In contrast, in France and Italy prices are rising, which is boosting the residential market. In Ireland and Spain, demand continues to push prices up to two-digit growth rates.

In the long term, the increases in residential prices are related to the dynamism of the labour market. Thus, in the last decade, the highest increase in housing prices has occurred in countries where employment has grown to the greatest extent, as has been the case of Ireland, Greece and Spain. In countries where the economy has been less dynamic, the increase in prices in real terms has been more contained. In Japan, the reduction in housing prices in recent years is associated with the gradual loss in the number of jobs.

In Spain, the new price statistic reveals slight moderation

In the first quarter of 2005, the average price of housing in Spain was Euros 1,685.4 per square metre constructed, which was a year-on-year increase of 15.7%, according to the Ministry of Housing's new price statistic. The markets in Malaga, the Balearic Islands, Barcelona, Madrid and the Basque Country are the ones where prices remain above the national average, while the most dynamic prices were to be seen in the regions and provinces in the south and east, with increases in prices way above the national average.

This new statistic involves a change in base, with a revision of the price levels which implies average figures that are 6% lower than in the previous statistic, thus improving housing affordability ratios on a national level. In terms of Self-governing Regions, the lowest prices

Chart 3.1.
USA: housing prices and transactions

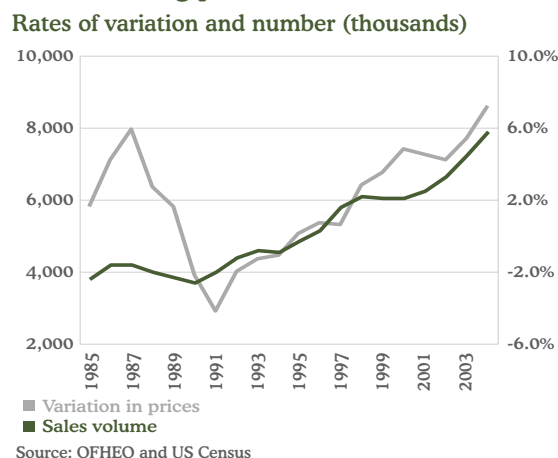


Chart 3.2.
Europe: housing prices
Annual rates of variation

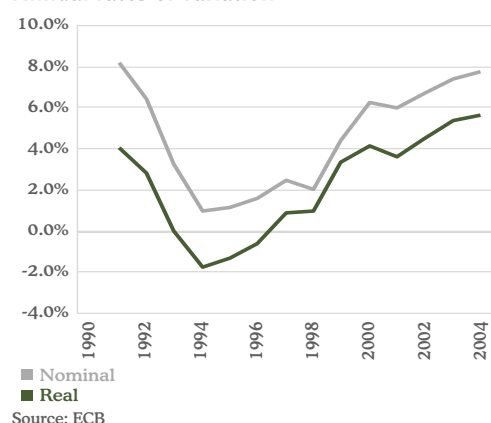


Chart 3.3.
Housing prices and employment

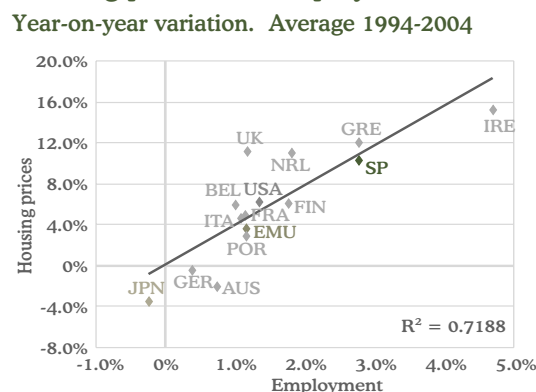


Chart 3.4.
Housing prices in Spain

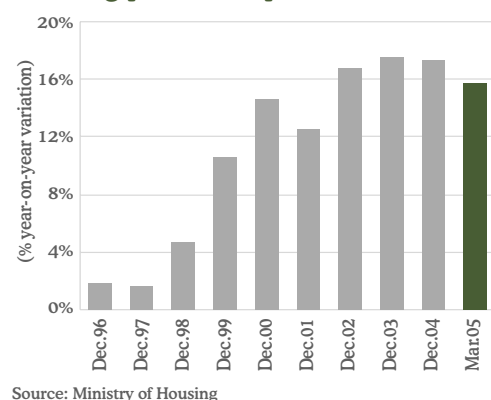
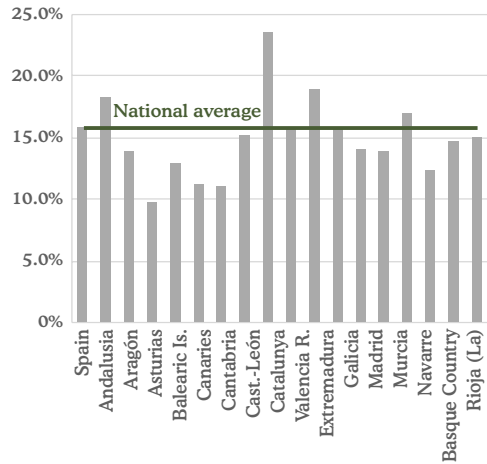


Chart 3.5.
Housing prices. 1st quarter 2005

Year-on-year change



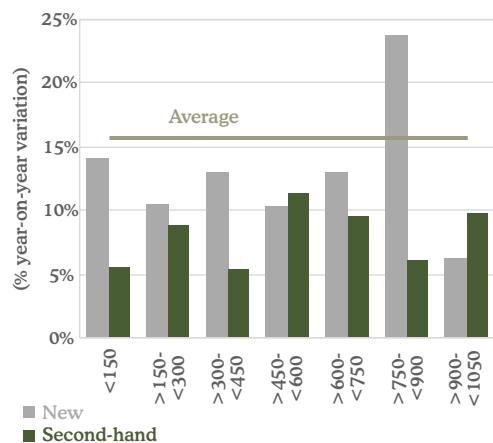
Source: Ministry of Housing

Table 3.1. Housing prices. €/m² built

	Average	Mar.05
Spain	1,544.9	1,685.4
Andalusia	1,278.1	1,391.2
Aragón	1,387.9	1,493.8
Asturias	1,340.3	1,424.1
Balearic Is.	1,749.9	1,890.2
Canaries	1,410.9	1,526.5
Cantabria	1,514.5	1,623.3
Cast.-León	1,154.4	1,228.8
Cast.-La Mancha	1,031.4	1,180.7
Catalunya	1,804.2	1,929.1
Valencia R.	1,220.8	1,349.8
Extremadura	759.3	836.3
Galicia	1,057.2	1,143.9
Madrid	2,404.4	2,617.4
Murcia	1,162.9	1,241.8
Navarre	1,410.5	1,531.4
Basque Country	2,250.1	2,444.6
Rioja (La)	1,221.7	1,398.1
Ceuta y Melilla	1,178.2	1,228.7

Source: IMF and BBVA

Chart 3.6.
Housing prices by stratum of final purchase prices



Source: Ministry of Housing

correspond to those where the adjustment was smaller or upward, as is the case of Extremadura and Castilla La Mancha, while in the regions with the highest prices, the adjustment was downward in every case, and larger in those with the highest levels, such as Madrid and Catalunya where the new prices are up to 15% lower than those in the previous statistic.

All in all, this new statistic is an improvement on the information existing so far, since the figures extend to the provincial level and, also include the number of appraisals and a new stratification of the sample, classifying average prices by square metre, according to the final price of the home.

Thanks to the provincial information, it is easier to distinguish between the performance of the different markets within the same Self-governing Region, especially in the largest ones. The new stratification also shows whether the variations in prices were concentrated in some housing segments or in others. Although, for now, the new figures only refer to 2004 and the first quarter of 2005, the opportunity of having a long series available significantly increases the possibilities of analysis.

In this respect, the disaggregated prices show that, in the first quarter of 2005, prices rose very sharply in some coastal provinces such as Valencia, Cadiz, Almeria and Girona, with year-on-year rates of over 20%, and also in the provinces nearest to Madrid, such as Toledo and Cuenca, which registered increases of over 20%. In contrast, it was in the provinces of the Ebro valley and the Cantabrian cornice that prices rose way below the national average.

The highest prices were observed in Madrid, Barcelona and the provinces in the Basque Country, where they were in excess of Euros 2,000 per square metre built in every case. However, in Extremadura or provinces like Jaen, Teruel or Palencia, average housing prices were below Euros 1,000 per square metre.

It can be extrapolated from the new figures that, after three years of rising at a rate of around 17%, housing prices in Spain increased more slowly in the early months of 2005, with a year-on-year rate of 15.7%. Less dynamic demand is leading to longer sales periods, a reduction in transactions and gentler price increases.

In fact, the number of appraisals was down by 5% with respect to the previous year. This figure could be overestimated by the fact that Easter Week fell in the first quarter of the year. However, the figure shows a decrease in transactions deriving from the slower pulse of the market in the first quarter of the year.

On analyzing the increase in housing prices by stratum, the rises observed are below average growth, especially in the second-hand housing segment. This can only be explained by a decrease in the weight of the cheaper homes in the weighting used to estimate the average.

Overall, fewer homes are being bought in Spain, as is shown by the downturn in the number of appraisals, but they are becoming more and more expensive. This would mean that it is necessary to have more income to access the housing market and this implies that the lower income brackets, which buy the cheapest houses, are increasingly being left out of the market.

In the coming months, the increase in housing prices will continue to slow. The decrease in transactions, together with the reduction in foreign investment funds in properties, which to February this year were registering a cumulative annual downturn of 15%, will gradually reduce the pressure on prices, in a context where, moreover, alterna-

tive investments are starting to be attractive once again and offering similar yields to the real estate market.

However, the fact that interest rate hikes in the euro zone are more remote and the positive performance of the macroeconomic situation serve to soften this slowdown in the market. Thus, at the end of the year housing prices can be expected to grow at rates of nearly 12%, falling to 6% in the course of 2006.

Affordability shows more positive figures

With the new figures for housing prices, the affordability indicators show that lower levels of financial effort are required to buy a home. Thus, in relation to salaries, in the first quarter of 2005, the price of a home was equivalent to 8.3 times the gross annual salary. This falls to 5.4 times when weighted household income is considered. This ratio is in line with that observed in other countries in Spain's environment.

This ratio has deteriorated in the past seven years because housing prices have grown consistently above household income. This trend is not sustainable in the long term, as it would generate some problems of affordability for an increasing number of households. Housing prices which are more than seven times higher than gross household income, in the context of current interest rates, would mean a financial effort that exceeds one third of gross household income for an average household to acquire a home. A percentage which exceeds basic financial risk ratios.

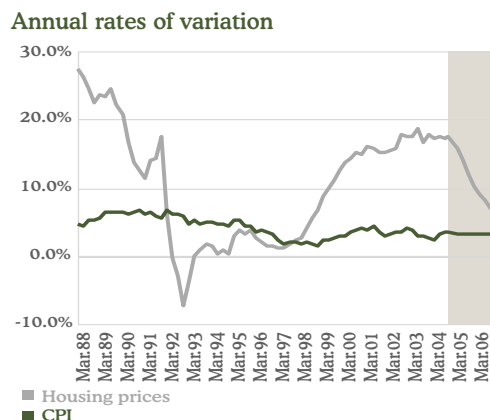
At current prices, in the first quarter of 2005, a household had to put 25% of its weighted gross income into (considering 1.54 workers per household) buying an average home of 90 square metres, with a 25-year mortgage at market interest rates. A percentage which falls to 20% when tax deductions are considered.

The performance of this indicator in the past few years shows some deterioration of the relation between mortgage payments and household income. In any event, current ratios denote a situation of certain solvency for a good part of demand, although they are not as positive as at the beginning of this decade.

However, the present low interest rates, which will remain stable in 2005, guarantee the high financial capacity of Spanish households. In this respect, in the first quarter of 2005, an average family had a purchasing capacity of over Euros 200,000, hitting a new all-time high.

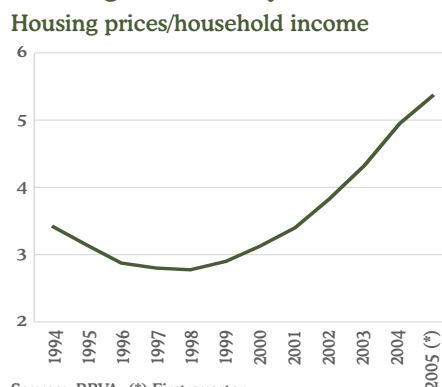
In the topic of the quarter in this issue, a new housing affordability indicator is introduced; this indicator attempts to synthesize in just one ratio the relationship existing between housing prices in the market and households' purchasing capacity.

Chart 3.7.
Housing prices and CPI



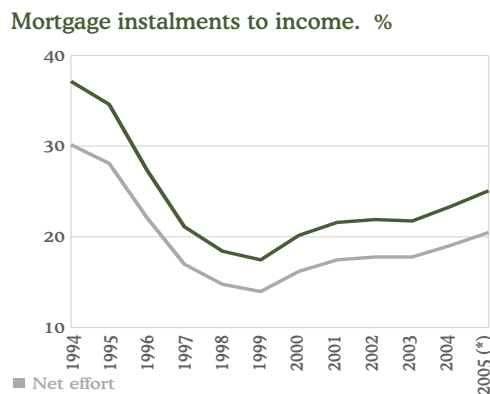
Source: INE, Ministry of Public Works and BBVA

Chart 3.8.
Housing affordability



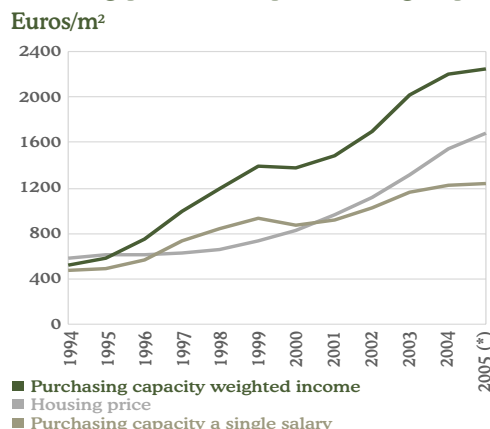
Source: BBVA. (*) First quarter

Chart 3.9.
Housing affordability. Financial effort



Source: BBVA. (*) First quarter figures

Chart 3.10.
Housing prices and purchasing capacity



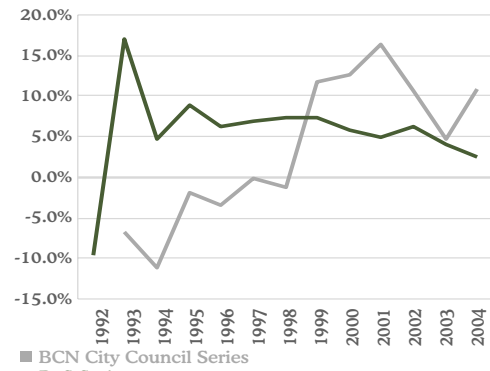
Source: Ministry of Public Works and BBVA. (*) First quarter figures

Rental Affordability

In the 2001 census, the number of rented permanent homes in Spain was estimated at 1.67 million, which represented 11% of total permanent homes. Of this total, one out of every three homes was to be found in the markets in Madrid and Barcelona, where rental has a significantly higher weight: 16% in Madrid and 28% in Barcelona. In the past few years, the new homes built mainly went to ownership, which implies that the weight of rented housing in the total has continued to fall.

Rental prices

Annual rates of variation



Source: BBVA with BoS and BCN City Council figures

Barcelona: real estate market

	Rental Cost €/year	Household Income €/year	Rent/ Income (%)
1992	6,705	15,972.3	42.0%
1993	6,246	17,170.3	36.4%
1994	5,544	17,957.2	30.9%
1995	5,436	20,198.0	26.9%
1996	5,247	21,791.4	24.1%
1997	5,238	22,787.4	23.0%
1998	5,166	24,036.1	21.5%
1999	5,769	25,261.1	22.8%
2000	6,489	26,863.0	24.2%
2001	7,542	28,383.9	26.6%
2002	8,334	29,711.2	28.1%
2003	8,721	30,948.0	28.2%
2004	9,666	32,057.1	30.2%

Note: It refers to a 90 square meters apartment.

Source: Ayto. Barcelona, Ministry of Housing and BBVA

The lack of statistical data on rental prices in Spain is a major obstacle to better knowledge of this market. In this respect, the Bank of Spain has estimated a quarterly series of housing rental prices in Spain starting from the average area of the housing (1991 Census), the number of rented homes (1991 Census), the spending on rentals from the 1991 Survey on Household Spending and the performance of the CPI in rentals. According to these estimates, at the end of 2004, renting a home cost a national average of around Euros 3,400 a year. These figures, however, are not a totally in line with those observed in today's rental market, so they may not fully reflect the real situation and could be misleading.

In some local markets, the rental prices observed in 2004 were much higher than the average rents estimated by the Bank of

Spain. Thus, in the case of Madrid, the supply of housing for rental was between €10 and €12 per square metre per month in the central district and between €6 and 8 per sq. metre in the rest of the city. In Barcelona rents were at similar levels, with an average price of around €9 per square metre. The fact that in Madrid and Barcelona, which account for a third of the market, the figures for 2004 give an average rent of around Euros 9,600 a year would suggest that the Bank of Spain figures could be underestimated. Also as regards the historical performance of rents, the BoS estimates and the figures observed for Barcelona differ considerably (Chart 1).

A local example: rental in Barcelona

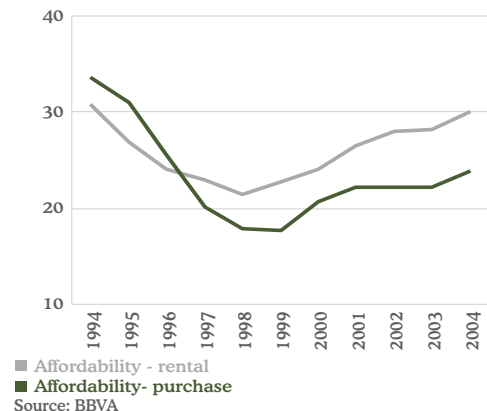
Although it is not possible to estimate affordability indices for rented housing in Spain, because of the lack of information, the existence of a historical series of rental prices for the city of Barcelona makes it possible to go a little further in the analysis. Indeed, in Barcelona one in every four permanent homes is rented, which implies that the rented housing ratios are around the European average. Besides being in short supply, the housing for rental existing in Spain is relatively concentrated in the large cities, where the rental tradition is more deeply rooted and their markets are more representative.

In 2004, renting a 75-sq. metre home cost Euros 9,660 p.a. on average in the city of Barcelona, which implied putting 30% of the gross income of an average household into paying the rent. In 2004, this ratio was slightly above the historical average and involved nearly ten points more effort than in 1998, when it reached its minimum level. Since 1996, the economic effort involved in renting a home in Barcelona has been higher than the effort required to buy a home, which explains the scant development of rentals and the growing demand for home-buying.

The gradual introduction of rental agencies announced by the different Administrations (both Central and Local and Regional Governments) could provide strong backing for a market which has not yet established itself in Spain: in the past few years, following the trend of the past four decades, rentals have lost weight in relation to total housing and currently account for just under 10% of the stock, according to the data in the latest survey conducted by the Ministry of Housing in the early months of 2005.

Barcelona: housing affordability

% income



Source: BBVA

4. Real estate financing

Lending to the private sector in the euro zone continues to grow faster in the early months of 2005

Private sector financing in the EMU increased at a year-on-year rate of 7% in the first quarter of the year to reach Euros 7.7 billion.

However, this average growth conceals varying performance between the different countries in the EMU. Thus, Germany, which accounts for 30% of the EMU's lending balance, has been making a negative contribution to the growth of the aggregate since 2003, while smaller economies like those of Spain or Ireland (with weights of 13% and 3% respectively) continue to be the countries making the proportionally largest contributions, 33% in the case of Spain and 9% in the case of Ireland.

In the first quarter of the year, the sharp increase in lending to the private sector in Italy and the larger contribution of French and Spanish lending were the main drivers of aggregated lending growth in the EMU. This was partially offset by the slight moderation registered in the Netherlands.

Overall, the faster growth of the last quarter was largely explained by lending to companies, since financing home-buying remained stable during the period. Even so, this type of lending continues to lead the increase in total lending, with growth rates of nearly 10%. However, as occurs in total lending, there are substantial differences between one EMU country and another.

One of the factors which could explain this performance is the disparity between interest rates. Although progress has been made in the process of harmonization, notable differences are still observed between the interest rates in different EMU countries. This can be explained by a series of factors. Firstly, by the different types of loans offered by financial institutions in each country. Thus, for example, in Spain nearly all the loans for home-buying are granted at a floating rate, while in the rest of the euro zone –despite losing weight-loans at a fixed rate predominate. As they are indexed to official interest rates, the starting rates are more attractive in countries with mortgages at floating rates, which does not mean that the mortgage will be cheaper over the life of the loan.

Secondly, the competitive environments differ. Until the European lending market becomes more integrated, competition is still exclusively marked by the domestic market and there is a very wide range of markets in the EMU. Moreover, competition tends to be fiercer in markets in expansion.

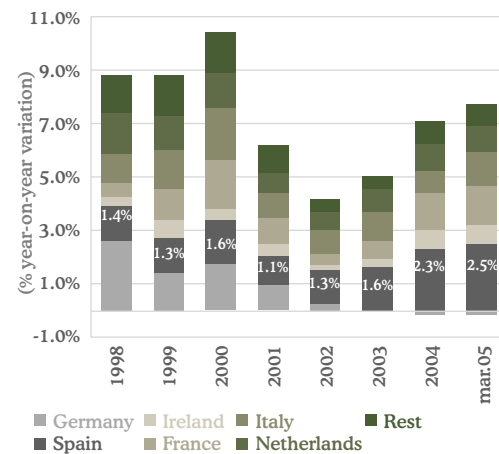
Lastly, there are different risk profiles in mortgage portfolios in the different countries¹, and in the percentage of loan defaults which mark differences in the average spreads imputed in mortgages by financial institutions. Indeed, the three countries with the lowest interest rates (Finland, Ireland and Spain) are also the countries with the lowest bad debt ratios.

The interest rates on loans for home-buying are at all-time lows in all of the EMU countries. This trend continued in the first two months of this year, with mortgage rates falling in the different EMU countries, with the exception of Spain, as can be observed in adjoining chart.

The evolution of mortgage rates bears out the view of financial institutions which can be drawn from the latest survey on bank loans. As

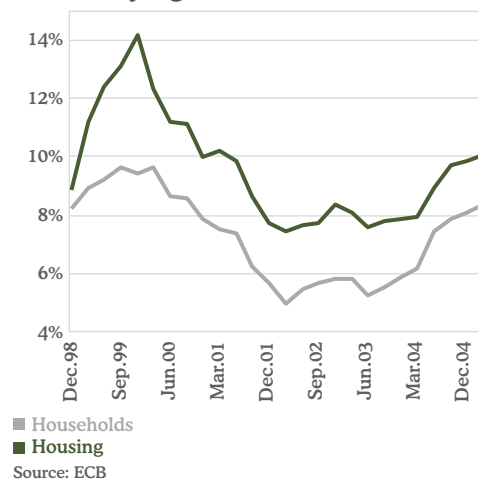
¹ As can be seen in the latest report published by Mercer Oliver Wyman "Risk and Funding in European Residential Mortgages: responding to changes in mortgage demand".

Chart 4.1.
Contribution to the growth of lending at OSR in the EMU



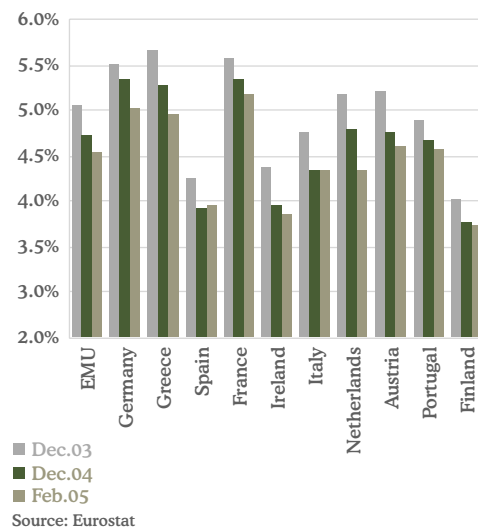
Source: ECB

Chart 4.2
Lending to households and lending for home-buying in the EMU



Source: ECB

Chart 4.3.
APR on lending for housing



Source: Eurostat

Chart 4.4.
Survey on bank loans

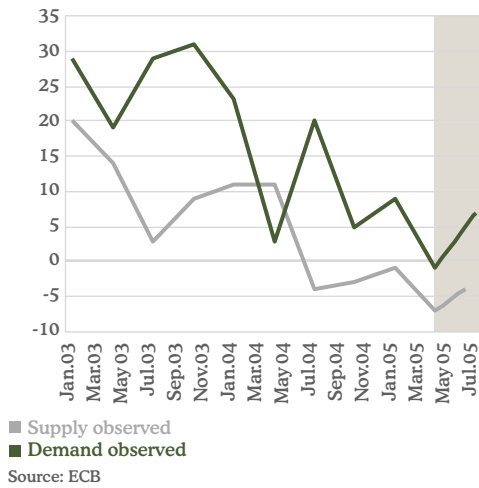


Chart 4.5.
Real growth of lending to the real estate sector

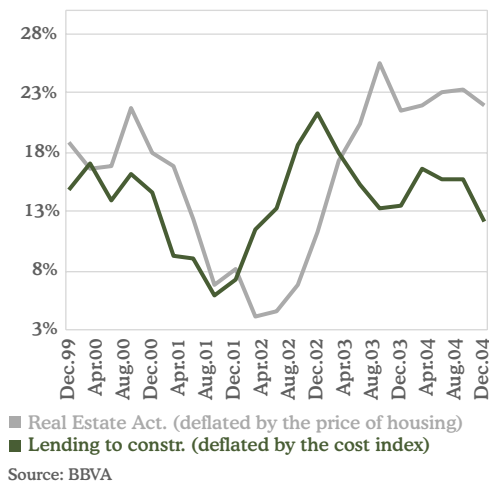
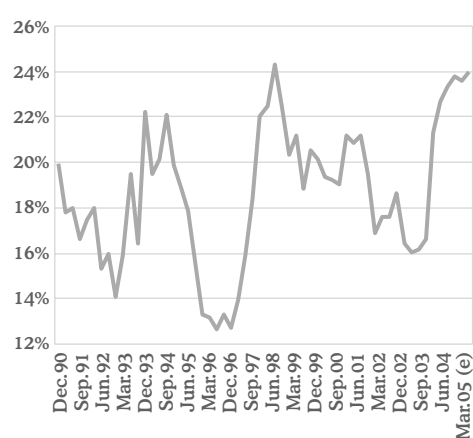


Chart 4.6.
Managed lending for home-buying



a result of competitive pressures, European financial institutions slightly lowered their lending standards in the first quarter of the year, mainly by reducing the margins applied to interest rates on lending for home-buying. In contrast, in the latest survey conducted in Spain, a slight tightening was expected during this period.

In spite of this, the expansive supply policy of financial institutions has not been reflected in demand for loans, which has remained stable in the majority of European economies. In fact, for the first time since this survey has been made, although it was not reflected in the balance, European banks have noticed a slight downturn in demand for loans for home-buying. However, they expect demand for this type of loan to increase in the second quarter of the year and will also continue to slightly ease the standards for granting loans.

The mortgage market in Spain already accounts for 57% of total lending on banks' balance sheets

In Spain, the buoyant demand from companies and individuals is maintaining mortgage growth at rates of over 24%.

Thus, despite slowing slightly, in the last quarter of 2004, real estate lending continued to increase sharply; loans for both construction and development registered record growth rates.

In the case of loans to construction, all the chapters -with the exception of lending for public works which fell sharply (-7%) increased at rates of over 20% in 2004. Part of this growth can be explained by the large increase in construction costs (7% at the end of 2004), largely as a result of the sizeable increase in raw materials prices. In fact, if lending to construction is deflated by sector costs, it slowed to a greater extent than in the last quarter of 2004. Even so, activity figures suggest that this slowdown will not grow any stronger in the first quarter.

In the case of loans to real estate activities, when the balance is deflated by the housing price, it continued to present growth as strong as that observed in 2003, in line with the buoyancy of the market observed at the end of last year.

Lending for home-buying continues to expand

As far as households are concerned, in the first quarter of 2005, the growth of managed credit (including securitization) for home-buying remained very strong, at levels of nearly 24%. In spite of this, the statistics for new lending transactions published by the Bank of Spain show that there was a slight slowdown in the number of new lending transactions for home-buying in the first quarter of the year. Thus, the increase in the lending flow in this period was of 15% as compared to 22% in the same period the preceding year. This performance is in line with that observed in the appraisal statistics and the slight moderation in prices observed in the first quarter of the year. However, seasonal factors (Easter Week) could be underestimating this slowdown.

The fact that future increases in official interest rates are further away and the strong growth of employment are underpinning the growth of demand for financing and so the slowdown which may occur over the year can be expected to be moderate.

The situation of household assets continues to be sound

Although household borrowing -which is already above 100% in terms of disposable income- will continue to increase sharply, the asset situation of households continues showing no signs of deterioration.

The low interest rates means that interest charges are still falling. Moreover, there are also no signs of deterioration in the payment of their obligations since the bad debt ratio in lending for home-buying remains at minimum levels (0.3%). Lastly, the strong appreciation in real estate is still reinforcing the asset position of households, whose total wealth already accounts for over 620% of the GDP.

In fact, the strong appreciation of real estate in the past few years limits the impact that a sudden downturn in housing prices could have on the financial system. As can be seen in the chart, if housing prices were to fall by 20% in the year 2006, only the loans granted with a loan-value ratio of 100% in 2004 and of over 80% in 2005 would face a situation of negative wealth² (i.e. the debt would be worth more than the asset acquired with it).

In the previous issue of Real Estate Situation, reference was made to how the Household Financial Survey (HFS) showed that the number of households that were in a delicate financial situation in 2002 was very low. According to recent studies and as a result of the positive performance of interest rates and banks' risk management, this ratio has actually improved in the last two years³.

On the other hand, when the Spanish HFS is compared to that of other countries which conduct similar surveys⁴, it is observed that although the ratio of debt to the income of households in the lower income brackets is much higher in Spain, this situation is reversed when it is related to assets.

This is due to the fact that low-income households in Spain mainly become indebted to acquire property, while in other countries property-ownership at these income levels is much lower, and debt is concentrated to a greater extent on consumer goods.

In this respect, the will to pay is greater in households which are borrowing to buy their permanent homes, especially in the lower income brackets. Moreover, a larger proportion of the assets of banks in comparison to households is supported by collateral.

Thus, the better quality of the mortgage portfolio and the less severe possible losses in the face of an increase in bad debts puts the Spanish financial system in a good relative position in comparison with other developed economies.

Lending growth continues to drive the issue of real estate securities

The strong lending growth has led banks to continue to turn to the markets to obtain sufficient funds to maintain the current expansion.

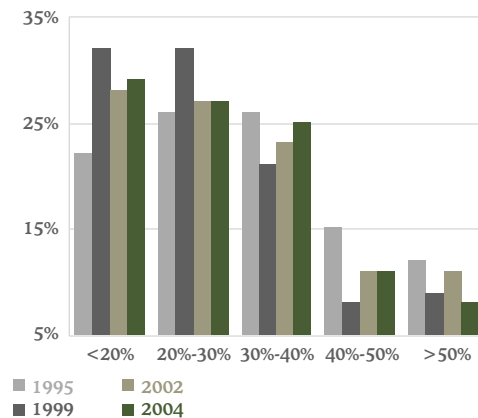
After the slowdown which took place as from the second half of 2004, banks turned anew to the securitization of the loan portfolio as an instrument for obtaining liabilities. Thus, in March, loans amounting to one billion euros, of which 40% were mortgages, were securitized. Consequently, the percentage of the portfolio of lending for housing securitized already stands at over 11.5%. The advance information for the second quarter suggests that the securitization process has continued this trend. The issue of bonds also grew sharply in the first two months of the year with securities worth Euros 12 billion being placed in the market.

² To consult the methodology, see Hernández, C.: "La vivienda: un riesgo controlado para la Banca", BBVA, *Real Estate Situation*, April 2003.

³ In this sense, the mortgage insurance company Genworth has published a study based on a universe of 700,000 mortgages which finds an improvement of two percentage points in the debt ratios of households which took out mortgages in 2004 in comparison with 2002.

⁴ For further information, see Bóver, O. *et al.* "La situación patrimonial de las familias españolas: Una comparación macroeconómica con EE.UU., Italia y el Reino Unido". Bank of Spain's *Boletín Económico*, April 2005.

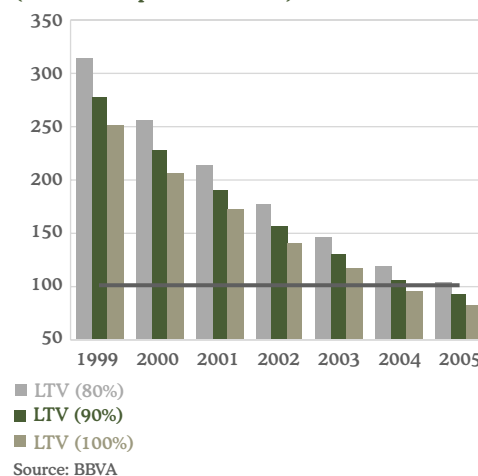
Chart 4.7
Mortgage indebtedness ratio



Source: Genworth

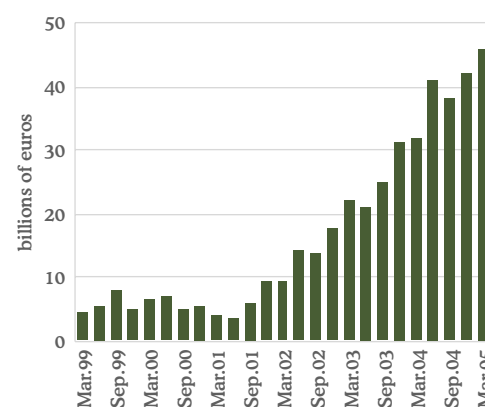
Chart 4.8
Coverage of mortgage collateral to current lending

(20% fall in prices in 2006)



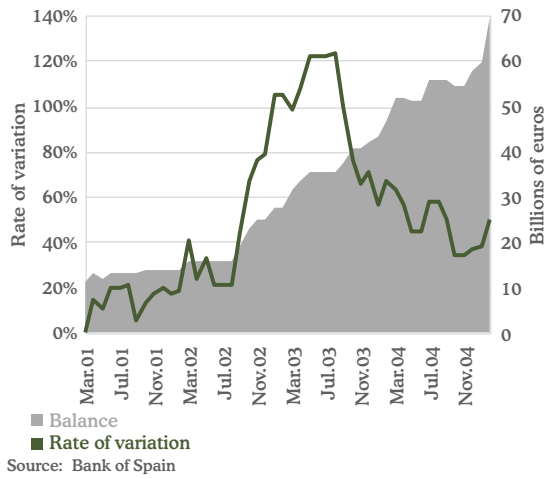
Source: BBVA

Chart 4.9
Issuance of securitization funds
(12-month moving average)



Source: Bank of Spain

Chart 4.10
Mortgage-backed bonds



In Europe, Spain continues to be the country in the euro zone with one of the largest volumes of mortgage securitization. Only the United Kingdom presents larger issuance of this type of security. Something which, however, is being affected by the moment in the cycle of the Spanish real estate market, as was mentioned earlier. Although this does not mean that this type of funding is not undergoing substantial development which will make the Spanish financial system one of the most diversified in regard to mortgages funding.

The delayed increases in interest rates make the slowdown more moderate in 2005

The doubts still surrounding economic recovery in Europe suggest that the EBC will keep official interest rates unchanged until the first half of 2006. With this outlook, mortgage rates will begin to reflect this increase at the end of this year at the earliest.

Moreover, the positive performance of employment (it grew by over 5% in the first quarter of the year) is also helping to boost demand for mortgages.

However, the deterioration in affordability ratios stemming from the continual increase in property prices is the reason why an increasing segment of the population is having difficulties in moving into the market, which is reducing demand for lending.

Thus, in spite of the good tone of the macroeconomic fundamentals, a slight slowdown in demand for lending is to be expected during the rest of the year, which will become more intense as financial conditions worsen.

5. Topic of the Quarter: BBVA affordability indicator and its results by Self-governing Region

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Introduction

In the last decade in Spain, women have moved into the labour market in large numbers and the employment of young people has increased significantly. A larger proportion of households with two incomes and the slightly later age of emancipation of young people, who have started work at younger ages than in the eighties, have led to a substantial increase in the number of workers per household. This has meant that in the last ten years household income has grown faster than it would have done if wages rises alone were taken into account. This improvement in real household income, together with other socio-demographic and financial factors, has led to strong housing demand which has produced a hike in residential prices.

Since the beginning of the nineties, BBVA's Research Department has been drawing up and maintaining a set of indicators in respect of the effort involved for Spanish households in accessing housing. The object of developing these indicators with all their nuances was to provide better more in-depth knowledge of the real conditions of residential demand. To bring together and summarize all the information obtained, a summary indicator has been drawn up, with a widely-recognized methodology¹, and adapted to the realities of the Spanish market, which we call the "BBVA Affordability Indicator".

To enrich the analysis, the calculation of this indicator has been extended to include the Self-governing Regions, since the housing affordability ratios by Region, estimated on the basis of a single salary does not explain the performance of the variables indicative of this market at a regional level in recent years.

The sections below present the steps taken to draw up the BBVA Affordability Index and its application as regards the Self-governing Regions, together with an analysis of the first results obtained. The chapter ends with a set of proposals which should make it possible to improve access to a home.

BBVA Affordability Indicator

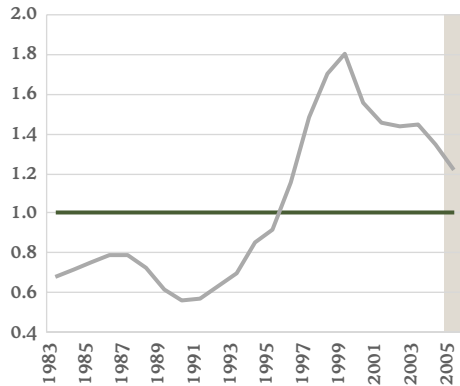
In an attempt to make housing affordability ratios more intuitive, a new indicator has been created which relates the homes households can acquire, in relation to their payment capacity according to prevailing financial conditions, to the market price of the home.

Thus, the acquirable home can be defined as the one which a household with average income can buy without the financial effort surpassing limits of economic prudence, considering financial conditions, the amount of the loan, interest rates and the repayment periods existing in the market at each moment in time.

To look more closely at this indicator, let us assume that a household decides to acquire a home with a mortgage. It puts one third of its gross annual income (this percentage is established as financial precaution to avoid undesirable situations for the households economies) into paying this mortgage. Thus, in 1995, considering the eco-

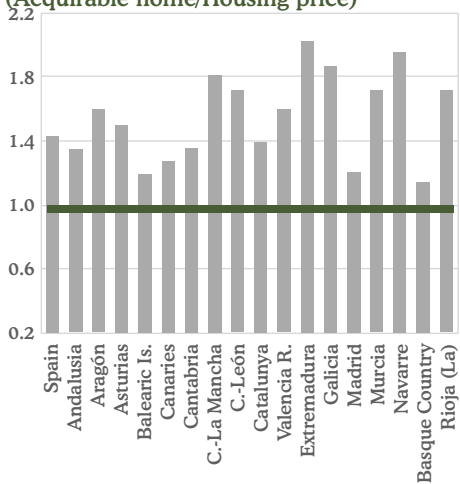
¹ To calculate this indicator, the methodology used by the National Association of Realtors to calculate the "Housing Affordability Index" was followed and adapted to the Spanish residential market.

Chart 5.1.
BBVA affordability indicator



Source: BBVA

Chart 5.2
BBVA affordability indicator
(Acquirable home/Housing price)



Source: BBVA

conomic conditions existing that year (loans for 80% of the price of the home, a 10-year repayment period and an interest rate of 16.7%), an average household, with gross annual income of Euros 13,750 could make annual payments amounting to Euros 4,580, which would allow for nearly Euros 42,000 in funding and, together with the down-payment, would give a purchasing capacity of nearly Euros 52,000. As the average price of housing in 1995 was Euros 54,600, exceeding the purchasing capacity, the BBVA indicator was below 1 that year.

In 2004 with income of Euros 18,250, interest rates of below 3.5% and 25-year repayment periods, the same households had funding capacity of nearly Euros 160,000, which together with the 20% down-payment, made it possible to acquire a home of up to Euros 200,000. As the average national price of a home was Euros 140,000, below the purchasing capacity of an average household, the BBVA indicator was above 1.

In short, the indicator aims to measure the coefficient between what households can pay and the prices existing in the market; thus, values on this indicator of above one suggest that the average household's purchasing capacity exceeds market prices, while values of below one indicate that these households cannot acquire an average-priced home without additional effort.

In view of the behaviour of these two variables in the past few years, households' payment capacity has increased way above the increase in the price of housing in Spain, which has implied that the payment capacity/housing price relation has remained above one from 1996 until today. After hitting a high of 1.90 in 2001, the BBVA affordability indicator is showing values of 1.40 for the last quarter of 2004.

For 2005 and 2006, the outlook indicates that the trend of previous quarters will continue and that the BBVA affordability indicator will draw nearer to one, to stabilize at around 1.10 at the end of 2006, when the increases in housing prices will be similar to the increases in households' payment capacity.

The profile of moderation shown on BBVA's affordability indicator since the end of the nineties can also be observed on a national scale, with certain nuances, at the level of the Self-governing Regions. In this respect, after the strong improvement on the BBVA affordability indicator between 1995 and 2000 in the Self-governing Regions as a whole, since then a deterioration has been observed in the same in the regions where housing prices have increased to the greatest extent, like in the case of Madrid and Murcia, while this indicator has improved substantially in the regions where the property market has been less active, as is the case of Extremadura and Galicia.

As can be observed in Chart 5.2., it is in the Regions of Madrid, Balearic Islands and in the Basque Country where the BBVA affordability index is currently near to one, which would suggest that in these regions the financial effort required by households to acquire a home is close to the limit of their purchasing capacity. This indicates that there is a growing section of the population who are encountering more and more difficulties in buying a home.

At the opposite extreme are Extremadura and Galicia, where the home-buying capacity of an average household is still way above the prices existing in the market. This does not mean that in these regions, and especially in the towns, there are no households with problems in buying a home, but the number of them is undoubtedly much lower than in the areas where these ratios are lower.

In affordability, size matters

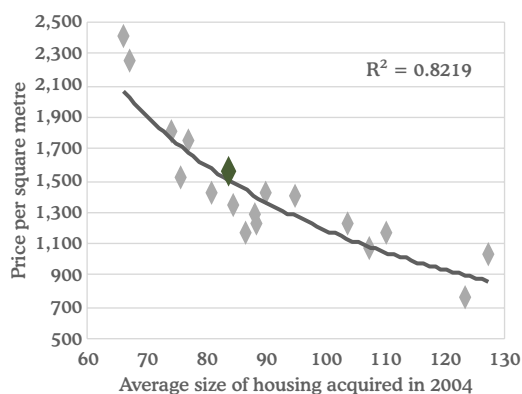
To calculate the affordability ratios, the average size of the stock of housing on a national level (90 sq. metres) is generally used. However, the average size varies according to the Self-governing Region and depends on such diverse factors as income, geographical characteristics, climate, the size of the towns, population density, and, as can be observed in the chart, on price levels. Thus, there are sizeable differences between the Balearic Islands or Castilla La Mancha where the average home is around 100 sq. metres, and Asturias or the Basque Country where the average is around 80 sq. metres.

As regards the size of the home, two contradictory structural movements are seen at the national level. On the one hand, homes are gradually becoming smaller as Spanish families are having fewer children and because of the increase in single-parent families, which should lead to increasing demand for smaller homes. On the other, the relationship existing between the level of income and the consumption of square metres per inhabitant appears to indicate that this ratio should increase in Spain in the medium term, as a result of the growth of the Spanish economy.

Even so, while the structural changes will gradually be seen in the medium and long term, it is the economic situation that to a greater extent dictates the changes in housing demand in the short term.

Thus, on analyzing the relationship between the price and size of the home, in the Regions with higher average prices (Madrid and the Basque Country), the average homes bought are found to be the smallest¹ and vice versa.

Price and size of housing



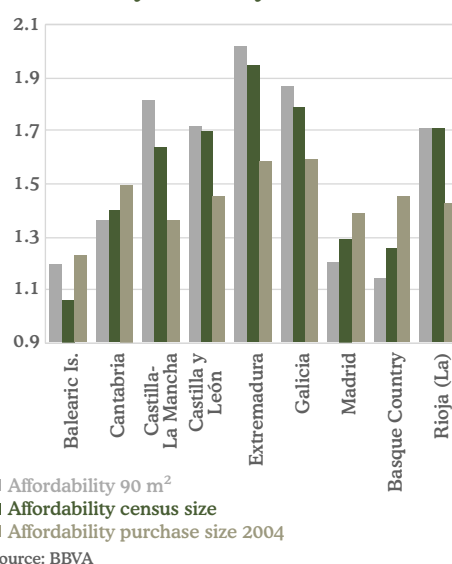
Source: BBVA

¹ The average size of housing acquired in 2004 by Self-governing Region was estimated on the basis of the INE statistics for housing mortgages, crossing the average mortgage by Region with the average price of housing as published by the Ministry of Housing.

Moreover, this relationship also depends on the degree of households' affordability to housing. When housing prices grow faster than income, the reaction of demand (largely people buying their permanent home) would be to either opt for a smaller property or to physically move away from the area initially chosen.

As can be observed in the chart, the BBVA affordability indicator² is "adjusted" when the average purchase price is introduced. Thus, the Regions in an easier situation of affordability have access to larger homes, while those with problems of access opt to reduce the size of the property bought.

Affordability ratios by Autonomous Region



Source: BBVA

Thus, when affordability ratios are calculated for the different Regions with the average size acquired during the year, the differences between the affordability indicators falls sharply and the typical deviation is reduced by more than 50%. This seems to indicate that households buy homes taking maximum advantage of their financial capacity and adapting to market supply as it stands at each moment in time.

² For further information, see the topic of the quarter.

Estimated employment and household income by Autonomous Region

Starting from the methodology developed in 2002 to estimate the number of employed people in each household and the degree of affordability to housing in Spain, which was published in the issue of BBVA Real Estate Situation in July that year², BBVA's Research Department estimated a set of ratios for affordability to housing by Self-governing Region on the basis of weighted household income, which provides fuller knowledge of the conditioning factors of this market in the different Self-governing Regions.

The publication of the definitive data of the 2001 Census, in relation to the structure of Spanish households, has made it possible to estimate the number of people in employment in each household, not only on a national scale but also at the level of the Self-governing Regions. These figures were compared to those corresponding to the 1991 Census. In this way, two ratios were obtained for the number of people in work per household for each Self-governing Region: one for 1991 and another for 2001.

Moreover, with the quarterly LFS figures for households in Spain and the total number of people in work, the quarterly path of the performance of the ratio of employed people per household was constructed for the country as a whole. This quarterly performance was extrapolated to the Census figures for each of the existing Regions for 1991 and 2001. The result was an initial estimate of the wage-earners per household ratio by Self-governing Regions.

With these new ratios of employed people per household, the weighted income per household was calculated for each Self-governing Region, on the basis of the wage costs compiled by the INE. Moreover, progress was made in making an initial estimate of household purchasing capacity and its evolution from 1994 to 2004 by Self-governing Region. To complete the analysis, using the average appraisal values of housing published by the Ministry of Housing, the new figures for the BBVA Housing Affordability Indicator was obtained for each Self-governing Region. These complementary results enrich the existing affordability figures by Self-governing Region which started from a single wage as an indicator of household income.

The different affordability indicators, results by Autonomous Region

Since the beginning of the nineties, the number of people working in each household has risen significantly in Spain, rising from 1.36 people employed per household in 1991 to 1.54 in 2004. In terms of timing, as can be seen in Chart 5.3, the profile of this behaviour is unquestionably related to economic performance: with economic growth, the number of employees per household increases and vice versa. The increase in the degree of female labour and the continuous decrease in unemployment amongst young people are leading the indicator to rise and, in view of the positive outlook for the creation of new jobs in Spain, will continue to do so in the short and medium term.

Moreover, considering the substantial increase in the immigrant population and that the number of workers per household in this group of people is above the national average, the trend mentioned in the previous paragraph can be expected to intensify.

This increase in the number of employed people per household has also occurred, to a greater or lesser extent, at a regional level, where the percentages have increased significantly in all the Self-governing

Chart 5.3.
GDP and employed per household
Year-on-year variation

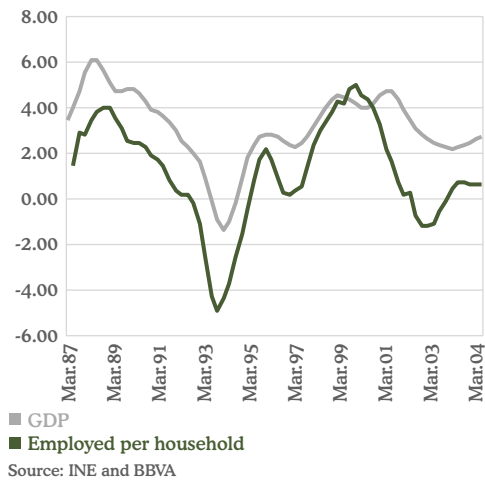
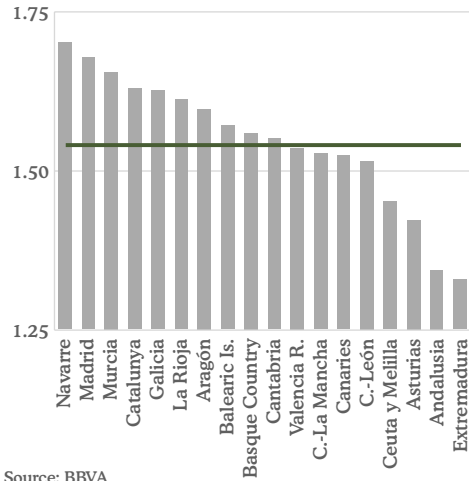


Chart 5.4
Employed per household



² At that time the Weighted Affordability Indicator was defined on the basis of the number of employed people by household estimated for the whole of Spain by BBVA. In this respect, the Report on the Economic Situation for December 2004 published by Caixa Catalunya, estimated the number of employees per household by Self-governing Region, which complemented the national results mentioned earlier.

Regions, especially in the period 1994-2002, when job creation was particularly dynamic. Self-governing Regions such as the Canaries, Murcia and Navarre presented the highest increases in employment, while in Asturias, Aragón and Galicia, performance was below the national average. In 2004, this ratio ranged between minimums of 1.33 and 1.34 employed people per household in Extremadura and Andalusia to maximums of 1.68 and 1.70 people in work per household in Madrid and Navarre, as is shown in Chart 5.4.

The different performance of employment and wages in the different Self-governing Regions has produced some inequalities in the households' financing capacity depending on the Region where they live. Overall, the borrowing capacity has improved substantially in all the regions in the last decade. This was due to four factors: the increase in employment and better wages on the one hand, and the lower interest rates and the longer repayment periods for loans on the other.

While the performance of the two last factors was relatively similar in all the Self-governing Regions, the evolution of the first two factors has reflected the peculiarities of each region. Today, the high ratio of employed people by household and higher wages mean that in the regions of Madrid, Navarre, Catalunya and the Basque Country household borrowing capacity is way above the national average. At the other extreme, Extremadura, Andalusia and the Canaries have the lowest capacity (Chart 5.5).

In the past four years, the improvement in households' borrowing capacity, which is the reason for the buoyancy of the Spanish real estate market in the last decade, has been negatively affected by the constant increase in property prices, which has led to the strong deterioration of the indicators most frequently used to measure the effort households have to make to access a home. In this respect, the relationship between the price of the home and household income has worsened considerably since the end of 2000, especially in Madrid, the Balearic Islands and the Basque Country, regions where the housing prices are equivalent to more than six times gross household income (Chart 5.6).

As a result of this, the financial effort required to buy a home, measured as the relationship between the mortgage payments and monthly income, has deteriorated significantly in all the Self-governing Regions since the beginning of 2000, especially in those where prices are highest (Chart 5.7). In spite of this, it is no more than one third of weighted salaries per household in any of the regions.

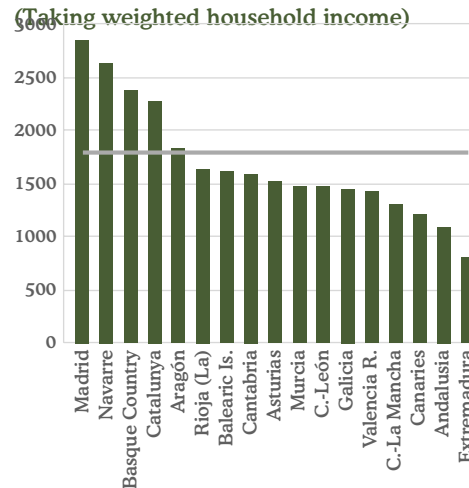
Conclusions and recommendations

In the past four years, despite the ongoing improvement in employment and wages, the lower interest rates and the longer repayment periods, the hefty increase in housing prices have led to a deterioration in the main housing affordability indicators, revealing tougher conditions for demand.

Today, in some Self-governing Regions, such as Madrid, the Balearic Islands and the Basque Country, BBVA's affordability indicator is at levels close to one, which suggests that the financial effort required to buy a home in these regions is near the limit of their purchasing capacity. This indicates that there is a growing section of the population which is finding it more and more difficult to buy a home. At the other extreme are Extremadura and Castilla-La Mancha, where an average household's capacity for acquiring a home is still way above the prices existing in the market.

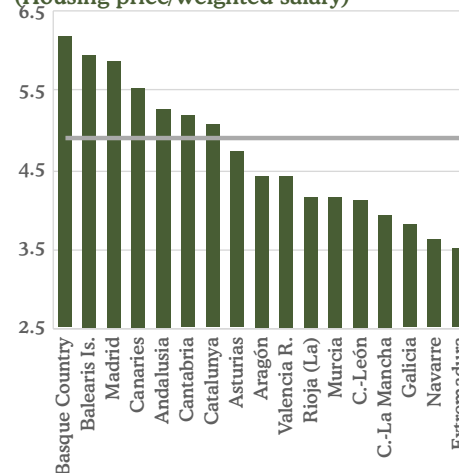
The forecasts suggest that the indicator will deteriorate to an even greater extent in the next two years, when residential prices are expected to perform in parallel to the evolution of households' purchasing capacity.

Chart 5.5.
Purchasing capacity. €/m²
(Taking weighted household income)



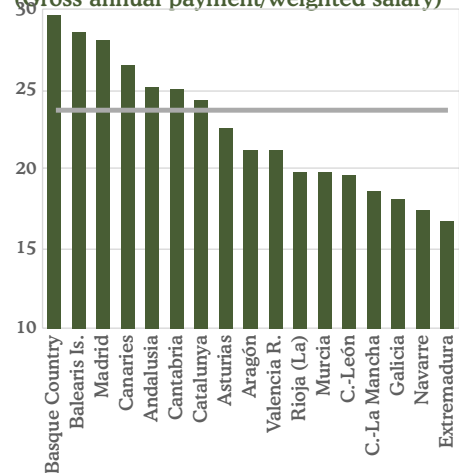
Source: BBVA

Chart 5.6
Home-buying effort
(Housing price/weighted salary)



Source: BBVA

Chart 5.7
Affordability to housing
(Gross annual payment/weighted salary)



Source: BBVA

In this respect, a set of medium and long-term measures could be developed on both a national and local scale to improve home-buying conditions. These would improve aspects of both the real state market and the financing conditions.

In respect of land, the mechanisms for obtaining urban land need to be reformed so that it is not only possible to obtain the amount of land necessary for urban development but it is also possible to do so in a reasonable period of time. For this, it would be necessary to introduce the possibility of private initiative playing a greater role in development processes and to reduce the time required to obtain the permits and licences required to develop and adapt the land. In the medium and long term, an improvement in physical communications, through investment in infrastructures, would make it possible to put sufficient land on the market to prevent unnecessary restrictions, which make the end product more expensive, being generated.

As regards financial conditions, there more is limited room for improvement. Thus, apart from lengthening repayment periods, the improvements that can be made are more related to new financing schemes than to an improvement in existing schemes. In this respect, products with delayed or increasing repayment or methods which contemplate payments that are not constant could be an advance in this field.

In respect of housing policy, the results of the BBVA affordability indicator by Self-governing Region show that the affordability problems are concentrated in some regions while they are limited in others. Thus, while income is seen to be way below the average in the regions in the south of Spain, it is in the more highly-developed regions such as Madrid and the Basque Country, where income is way above the average, that the problems of buying a home are much greater.

Here, a policy aimed at boosting the rental market is crucial, especially in the towns in the regions with the most serious problems of affordability. The foreseeable deterioration in the ratios for buying a home due to the increase in interest rates could rebalance the buy-rent decision in favour of the latter. For this to happen in a clear way, the rental market needs to be more agile and efficient than it is at present.

Table 5.1.

	Employed per household	Weighted wage income	Price of an average 90 m ² home	Effort (Years)	Acquirable home	Affordability (Payment/Weighted income)	BBVA affordability indicator
Spain	1.5	18,254	139,041	5.2	198,151	24.7	1.4
Andalusia	1.3	16,385	115,029	5.6	154,868	26.5	1.3
Aragón	1.6	17,717	124,911	4.9	199,157	23.1	1.6
Asturias	1.4	18,063	120,627	4.7	180,835	22.0	1.5
Balearic Islands	1.6	16,902	157,491	6.8	187,026	32.3	1.2
C anary Islands	1.5	15,086	126,981	5.9	161,755	27.9	1.3
Cantabria	1.5	16,971	136,305	5.7	185,200	27.0	1.4
C.- La Mancha	1.5	15,587	92,826	3.7	167,537	17.5	1.8
C.- León	1.5	16,740	103,896	4.0	178,529	18.9	1.7
Catalunya	1.6	19,698	162,378	6.0	225,822	28.5	1.4
Region of Valencia	1.5	16,205	109,872	4.7	175,370	22.4	1.6
Extremadura	1.3	14,702	68,337	3.3	137,612	15.5	2.0
Galicia	1.6	15,481	95,148	3.7	177,110	17.7	1.9
Madrid	1.7	22,051	216,396	7.0	260,509	33.1	1.2
Murcia	1.7	15,322	104,661	4.7	178,542	22.1	1.7
Navarre	1.7	20,603	126,945	4.0	246,879	19.0	1.9
Basque Country	1.6	21,084	202,509	6.6	231,385	31.1	1.1
Rioja (La)	1.6	16,530	109,953	4.3	187,437	20.5	1.7

Source: BBVA

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