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Summary

First NATO anti-missile-shield vessel arrives in Spain.
Record exports halve trade deficit, Moody's upgrades sovereign credit rating.
EU seeks clarification on 15 immigrant deaths.
Bank results improve, two executives face trial, IMF lauds reforms.

Foreign Policy

First NATO anti-missile-shield vessel arrives in Spain
The first of four US destroyers forming part of NATO's new anti-missile shield for Europe arrived at the naval base at Rota in southern Spain.

The USS Donald Cook, a multi-mission Missile Defence-capable Aegis Destroyer, will be permanently based at the station, established 60 years ago and strategically located near the Straits of Gibraltar and at the halfway point between the US and South-West Asia.

The ships have advanced sensor capabilities and interceptor missiles that can detect and shoot down ballistic missiles. Besides Spain, countries such as Poland, Romania, the Netherlands and Turkey will host installations and components of the anti-missile system.

Spain's previous Prime Minister, José Luis Rodríguez Zapatero, agreed Spain's participation in the anti-missile system in 2011 shortly before his Socialist party was ousted from office by the conservative Popular Party (PP) in the November election.

The increased US presence will result in the creation of many new jobs in a region with a very high unemployment rate.

Government to fast-track change to universal justice law in bid to appease China over arrests' order
The High-Court Judge Ismael Moreno, under the principles of universal jurisdiction, asked Interpol to issue orders for the detention of the former Chinese President Jiang Zemin, ex-Premier Li Peng and three other officials for questioning on charges brought by Tibetan human rights groups in Spain.

The case will probably not see the light of day as the day after the arrest orders were issued the Spanish parliament, where the ruling Popular Party (PP) has an absolute majority, voted to fast-track a law limiting judges' powers to pursue alleged human-rights abusers wherever they are in the world. '(China) is extremely dissatisfied with and resolutely opposed to the wrong actions of the relevant Spanish organ taken while ignoring China's solemn position', said the Foreign-Ministry spokeswoman Hua Chunying. 'Whether or not this issue can be appropriately dealt with is related to the healthy development of ties. We hope the Spanish government can distinguish right from wrong'.

Among other considerations, the PP fears the case could affect Spain's trade and investment interests with China.

Spain is a pioneer in the use of universal jurisdiction. Judges have sought to question or detain officials from Chile, the US and Israel in cases involving alleged genocide, torture or human-rights abuses. The most publicised case was the attempt by Baltasar Garzón, in 1998, to have General Augusto Pinochet, the former Chilean dictator, extradited to Spain for trial.

Spain to consider citizenship for Sephardic Jews
The government's draft bill that would allow citizenship for all those who could prove their Sephardic origins could benefit up to 3.5 million people.

The change is a conciliatory gesture towards the Sephardic Jews whose ancestors were expelled from Spain in 1492 for refusing to accept forcible conversion to Christianity, following the final episode of the long process known as the Reconquest of Arab Spain.

Alberto Ruiz-Gallardón, the Spanish Justice Minister, called the expulsions one of Spain's 'most important historical errors'. 'Now they have an open door to become once again what they should never have stopped being – citizens of Spain'.

Pinchas Goldschmidt, the President of the Conference of European Rabbis, called on Spain to apologise to the Jewish people for the expulsion rather than offering them Spanish nationality.

The largest community of Sephardic Jews is in Israel, followed by Latin America, Turkey and the US. The Spanish Embassy in Tel Aviv was flooded with inquiries after Madrid announced the change. Those who make successful applications once the new law enters into force would not have to renounce their current citizenship.

In a related development, Bayib Loubaris, Chairman of the association that represents the descendants of the *Moriscos* –who were expelled from Spain in 1609, more than a century after a strongly-resisted forced conversion to Christianity–, called for similar treatment. There are an estimated 300,000 people of *Morisco* stock in Morocco.

Domestic Scene

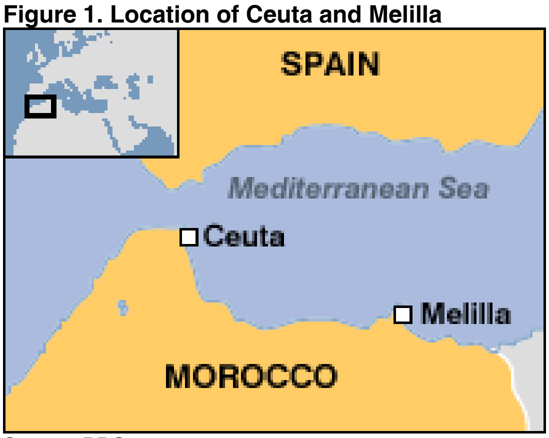
EU seeks clarification on 15 immigrant deaths
The European Commission sought an explanation as to why Spanish police fired rubber bullets and tear gas canisters at immigrants swimming from Morocco to Spain's North-African enclave of Ceuta. Fifteen of them drowned.

EU laws state that border surveillance measures must be proportionate to the objectives pursued, respect fundamental rights and human dignity and be carried out in accordance with laws on the protection of refugees.

Jorge Fernández, the Interior Minister, said the response was justified and proportionate when some 200 sub-Saharan Africans took to the sea. He said no one was hit by the bullets. It was later revealed that three of the Civil Guard reports failed to mention the firing of bullets.

Ceuta and the other enclave of Melilla are magnets for migrants as they are part of the EU (see Figure 1).

Figure 1. Location of Ceuta and Melilla



Source: BBC.

Government dismisses disarmament move by Basque ETA terrorists
The government dismissed the decommissioning of a small cache of weapons and explosives by the Basque terrorist group ETA, which was confirmed by a self-styled International Verification Commission.

Jorge Fernández Díaz, Spain's Interior Minister, called the move, which was filmed, a 'theatrical exercise'. 'The only thing Spanish society, the Spanish government and the Spanish state are working towards is the complete dissolution of ETA, without concessions and without conditions'.

ETA has assassinated more than 800 people in four decades. It declared an end to its armed campaign for an independent Basque Country in 2011, but has yet to lay down its weapons and to formally disband.

Two members of the commission were summoned for questioning by judges in Madrid about the identity and whereabouts of the ETA militants. The

Commission's head, Ram Manikkalingam, pledged to be 'transparent' and cooperate with the tribunal. Manikkalingam was the senior advisor on the peace process in Sri Lanka to President Kumaratuga, the previous president.

Rajoy mulls U-turn on controversial abortion reform

The Prime Minister, Mariano Rajoy, under pressure from within and outside his Party, told parliament the government might change its mind on excluding the existence of fetal deformity as one of the reasons for authorising terminations, which was one of the grounds under Spain's first abortion law in 1985.

The reform rolls back the legislation approved in 2010 by the previous Socialist government. It would no longer allow the procedure on demand until the 14^{th} week and thereafter until the 22^{nd} week in certain circumstances, and 16- and 17-year-olds would not be able to abort without their parents' knowledge. In most EU countries, abortion is a right in the first weeks of pregnancy.

Abortion would only be permitted in the case of rape or where there is a serious mental or physical health risk to the mother. The only valid reason for an abortion in the case of a fetal deformity would be if it is 'incompatible with the life' of the baby. To request an abortion, a woman would need the approval of two doctors outside the clinic treating her and would have to observe a seven-day reflection period.

Opinion polls shows a majority of people including a high proportion of the PP's supporters are against parts of the reform.

Celia Villalobos, the deputy speaker in parliament, broke with PP discipline and voted in favour of an opposition motion calling for the bill to be withdrawn.

German employers warn on Catalonia's independence

Some 60 German businessmen and executives issued a manifesto warning of the 'dreadful consequences' if Catalonia broke away from Spain.

The region's government is pushing for an illegal referendum on independence, which the central government insists will not take place as it is unconstitutional.

Not only would Catalonia be expelled from the EU and not be able to use the euro, but the 'dangers of a nationalist fervour, which in the last century, has brought immeasurable suffering to Europe, will not bring anything good to Catalonia' said the manifesto.

German investment in Catalonia, the economically most dynamic region (20% of Spain's total exports), is significant.

Juan Rosell, the chairman of Spain's main employer association (CEOE) and himself a Catalan, has long voiced similar fears.

Spain's corruption perceived as among the most widespread in the EU

More than nine out of every 10 Spaniards believe corruption is widespread in their country and six out of every 10 say they are personally affected by it, according to a the first survey of its kind across the continent conducted by the European Commission (see Figures 2 and 3). Both figures are well above the EU averages.

Figure 2. Current perception of corruption (%)

	Corruption is widespread in my country	You are personally affected by corruption in your daily life
Greece	99	63
Italy	97	42
Lithuania	95	29
Czech Republic	95	28
Spain	**95**	**63**
Romania	93	57
EU average	76	26
France	68	6
Germany	59	6
Denmark	20	3

Source: European Commission.

Figure 3. Experience with corruption over the past 12 months

	You were asked or expected to pay a bribe for services	You personally know someone who has taken bribes
Lithuania	29	35
Romania	25	14
Poland	15	12
Greece	7	31
EU average	4	12
Spain	**2**	**11**
France	2	16
Germany	1	9
UK	0	7

Spain's corruption is largely confined to the political class, unlike countries such as Lithuania and Rumania where the biggest culprit is the healthcare industry. Scandals such as the one known as Gürtel (175 people accused) and the Bárcenas case have implicated the ruling PP in bribery, money laundering and tax evasion, while in Andalusia, the Socialist General Union of Workers (UGT) is embroiled in a case involving the fraudulent use of public funds. Both cases are under judicial investigation. Francisco Granados, a former head of the presidency in the Madrid regional government, was forced to resign from the Madrid parliament and the national Senate last week after it was revealed he had a Swiss bank account with €1.5 million.

It is no coincidence that the countries least perceived as corrupt in the EU's survey are the Nordic nations, since for decades they have had demanding transparency laws. The Spanish parliament only approved the country's first transparency law last December (38 years after the death of General Franco, the country's former dictator), and it will not come into force for a year (two in the case of regional governments and town halls, where most of the scandals have taken place).

The profound crisis in the sector of savings banks, which threatened Spain's continuation in the euro zone, was due to a significant extent to a lack of transparency and political clientelism.

It was not until 1987, 10 years after Spain's first free general election since before the 1936-39 Civil War, that the first political party financing law was approved. By then the Popular Alliance (AP, the precursor of today's Popular Party) of Manuel Fraga had accumulated an enormous debt and the Socialists had taken on loans to finance its 'yes' campaign for the referendum on joining NATO which it was unable to repay.

The government's bill for the financial control of parties, which the cabinet approved this month, requires them to publish on their websites donations of more than €50,000 and the names of those lending money to them. These changes are an attempt to restore the severely eroded public confidence in political parties, politicians and parliament.

The Infanta Cristina questioned in court over corruption case

The *Infanta* Cristina, the eldest daughter of King Juan Carlos, became the first member of the royal family in Spanish history to appear in court to answer questions regarding a corruption scandal involving her husband's business activities.

Her husband Inaki Urdangarín is alleged to have defrauded regional governments of millions of euros of public money, through a not-for-profit company known as Noos. Both of them deny any wrongdoing, and have not been charged.

Cristina's answers to six hours of questions put by the judge were evasive, according to a transcript obtained by the newspaper *El País*. She used expressions such as she did not know or could not remember 533 times.

Urdangarín and a former business partner are alleged to have received €5.6 million in public money. The *Infanta* Cristina is suspected of spending some of that money on personal expenses, and there are also questions about what she knew about the business dealings.

The case, which started three years ago, has eroded the popularity of the monarchy and of King Juan Carlos. In a further move to restore confidence, the royal family unveiled the salaries and expenses of all its senior members. The family's overall annual budget for this year is €7.78 million (€8.89 million in 2010), much less than the sovereign grant awarded to the British royal family of more than £36 million.

The Economy

Record exports halve trade deficit, Moody's upgrades sovereign credit rating
Record exports of goods for the third consecutive year halved the trade deficit in 2013 to €16 billion, while the rating agency Moody's upgraded Spain's sovereign credit rating one notch to Baa2 in recognition of the re-balancing of the economy.

Exports rose 5.2% to €234.2 billion and imports were 1.3% lower at €250.1 billion. Exports covered 93.6% of imports, up from 87.7% in 2012. But for external demand's positive contribution to growth, Spain's recession would have been deeper. The economy shrank by 1.2% in 2013 (almost 7% since 2008).

Exports have also helped to turn around the current account from a whopping deficit of 10% of GDP in 2007 to an estimated surplus of around 1% in 2013.

The trade picture has changed enormously between the onset of the crisis in 2009 and 2013. Exports rose by €74 billion and imports dropped by €44 billion. The trade deficit peaked in 2007 at €100 billion.

The pace of export growth eased in the last months of 2013 while that of imports increased moderately, suggesting that domestic demand is beginning to pick up.

The surplus with the euro zone grew 42.3% to €10.9 billion, and trade with non-European countries increased (see Figure 4).

Figure 4. Distribution of exports by geographic areas, 2013 (% of the total)

	% of total	Change 2013/12	Rep (1)
Europe	68.3	4.3	3.0
Euro zone	49.0	4.1	2.0
North America	4.2	-4.7	-0.2
Latin America	6.4	8.6	0.5
Asia	8.9	10.3	0.9
Middle East	3.3	24.9	0.7
Africa	7.0	8.4	0.6
Oceania	1.2	12.8	0.1
Total	100.0	5.2	5.2

(1) Contribution in percentage points to the growth in exports.
Source: Ministry of Economy and Competitiveness.

Exports of capital goods were almost 11% higher and accounted for 20.7% of the total (see Figure 5).

Figure 5. Exports by sectors, 2013 (% of the total)

	% of total	Change 2013/12	Rep (1)
Capital goods	20.7	10.9	2.1
Food	15.2	4.9	0.7
Automotive	14.5	14.3	1.3
Chemical products	14.3	6.0	0.8
Non-chemical semi-manufactured goods	10.8	-1.0	-0.1
Consumer manufactures	8.8	9.8	0.8
Energy products	6.9	-1.7	-0.1
Other goods	5.0	-8.8	-0.5
Raw materials	2.6	1.9	0.0
Consumer durables	1.5	1.9	0.0
Total	100.0	5.2	5.2

(1) Contribution in percentage points to the growth in exports.
Source: Ministry of Economy and Competitiveness.

Moody's new rating puts Spain two notches above junk status, with positive outlook. The country lost its top credit rating at Standard & Poor's in January 2009, followed by Fitch Ratings and Moody's in 2010. Other rating agencies are expected to follow suit.

Moody's cited three reasons for the upgrading.

- The rebalancing of the economy towards a more sustainable growth model, away from the property sector and more export-oriented.
- The progress made in implementing structural reforms, particularly in the labour market and the public pension system, fiscal measures, changes to the fiscal framework for regional governments and the restructuring of the banking system.
- The improvement in the government's funding conditions since the height of the euro area sovereign debt crisis in mid-2012.

Spain's risk premium over the benchmark 10-year German bonds dropped below 200 bp this month, compared with a peak of 670 bp at the height of the crisis (see Figure 6).

Figure 6. 10-year government bond yields (%) and spreads over Germany's bund (p.p.)

	Yield 24 February (%)	Spread over Germany (p.p.)
Germany	1.68	–
Greece	7.52	+5.84
Ireland	3.17	+1.49
Italy	3.63	+1.95
Portugal	4.87	+3.19
Spain	**3.57**	**+1.89**

Source: ThomsonReuters.

Black economy flourishes since the onset of the economic crisis
Spain's black economy accounted for 24.6% of GDP in 2012, up from 17.8% in 2008, according to a study released by the Finance Ministry.

The size of the unofficial economy goes some way toward explaining how Spain has managed to cope with an unemployment rate of 26% without any major social unrest.

The construction boom in the decade before 2008, the engine of the economy, created a huge reserve of black money. Of an estimated €253 billion black-economy transactions, some 70% involved €500 bank notes, a denomination that hardly circulates in Spain.

As well as slashing spending, the previous and current government raised taxes in order to cut the high budget deficit. This increased the incentive to go underground. At the same time, efficient control of tax fraud and evasion leaves a lot to be desired.

Spain has only one tax inspector per 1,928 taxpayers, compared with 729 in Germany. According to the Socialist UGT trade union, between January 2012, shortly after the PP took office, and November 2013 1,327 people retired from the Tax Agency and most of them have not been replaced. The total number of people working in the tax system has fallen by more than 20% over the past five years.

A committee of tax experts, appointed by the government, is due to present its report on tax reform by the end of this month. Among the measures being considered are an increase in the standard VAT rate to 23% from 21%, reduced deductions, and lower corporate and personal income tax rates.

Spain needs to bridge its traditional gap on a sustained basis between public spending and tax receipts. Expenditure averages around 40% of GDP over the length of an economic cycle and tax receipts about 35% of GDP, leaving a shortfall (budget deficit) of 5% that has to be financed. Spain's tax burden dropped from 37.3% in 2007 to 32.9% in 2012 (see Figure 7). The other three large euro zone countries increased their tax burdens.

Figure 7. Tax revenues as a percentage of GDP, 2007 and 2012

	2007	**2012**
France	43.7	45.3
Germany	32.5	33.8
Italy	43.2	44.4
Spain	**37.3**	**32.9**

Source: OECD.

Spain improves in innovation indicator

Spain continued to be ranked 20th out of 28 countries in the 2013 innovation indicator published by the German foundation Deutsche Telekom Stiftung and the German employers' association (BDI), but its score out of 100 improved from 23 to 31 (see Figure 8).

Figure 8. Innovation ranking (score out of 100) (1)

	Score out of 100
1. Switzerland	75
6. Germany	59
7. Finland	57
13. UK	53
16. France	50
20. Spain	**31**
21. Italy	19

(1) Out of 28 countries.
Source: Deutsche Telekom Stiftung and BDI.

The global indicator is based on 38 sub-indicators that measure the capacity for innovation in five sectors: the economy, science, education, public sector and society.

Corporate Scene

Bank results improve, two executives face trial, IMF lauds reforms
The 2013 income statement of Spain's banking sector paints an improved picture. The attributable profits of six of the largest banks (Santander, BBVA, Caixabank, Popular, Sabadell and Bankinter) were four times higher than in 2012 at €7.8 billion, but well below the more than €18 billion in 2008, the last 'normal' year. Banks were hard hit by their massive exposure to toxic real estate assets following the collapse of the property market.

The nationalised Bankia is not included here, although it is the fourth-largest bank, because its figures distort the picture. It posted a loss of €19 billion in 2012, the biggest ever in Spain's corporate history. In 2013, it generated a profit of €608 million.

The IMF's final progress report on Spain's financial sector reform, published on 20 February, said Spain's efforts have substantially reduced the likelihood of threats spreading from banks to the rest of the economy.[1] Solvency and liquidity had improved, but non-performing loans (NPLs) continued to rise and profitability is low (see Figure 9). The NPL ratio was a record 13.6% at the end of last year, excluding the toxic assets in the bad bank SAREB.

[1] See the author's Spanish banking analysis at http://www.realinstitutoelcano.org/wps/portal/web/rielcano_en/contenido?WCM_GLOBAL_CONTEXT=/elcano/elcano_in/zonas_in/ari11-2014-chislett-spain-banking-crisis-light-in-the-tunnel#.Uwsf9_RdXwc

Figure 9. Selected financial soundness indicators, 2007-13 (% or otherwise indicated)

	2007	2010	2012	2013 (latest available)
Solvency				
Regulatory capital to risk weighted assets	11.4	11.9	11.5	12.1
Tier 1 capital to risk weighted assets	7.9	9.7	9.9	10.9
Profitability				
Return on average assets	1.1	0.5	-1.4	0.5
Return on average equity	19.5	7.2	-21.5	7.4
Operating expenses/gross income	43.1	46.5	45.3	47.1
Asset quality				
Non-performing loans (€ bn)	16.3	107.2	167.5	191.0
Non-performing loans to total loans	0.9	5.8	10.4	13.6
Exposure to construction sect. (€ bn)	457.0	430.3	300.4	258.0
of which: non-performing	0.6	13.5	28.2	33.0
Households- home purchase (€ bn)	595.9	632.4	605.3	586.3
of which: non-performing	2.3	5.4	7.5	8.5
Liquidity				
Loan-to-deposit ratio	168.2	149.2	137.3	124.9

Source: Bank of Spain, European Central Bank, Bloomberg and the IMF's fourth progress report on Spain's financial sector reform (February 2014).

Rogue bankers are finally being investigated and in the cases of Roberto López Abad, the former general manager of the collapsed CAM savings bank, and Juan Ramón Avilés, chairman of CAM's control committee, it looks as if they will be the first to be brought to trial. They are accused of embezzlement and improper management. CAM was intervened by the state in 2011 at a cost of around €15 billion and sold to Banco Sabadell for €1.

The government's Fund for Orderly Bank Restructuring (FROB) recently stepped up its investigations, ordering 90 reports to be drawn up in order to ascertain the responsibilities of former *caja* executives in the collapse of banks. Spain is a long way from the situation in the City of London where nearly 6,000 bankers, brokers and financial advisers have been sacked or suspended for misconduct since the start of the financial crisis in 2008, according to the Financial Conduct Authority.

Iberdrola wins Mexico €584 million contract in stepped up move from Spain

Iberdrola won a build-own-operate contract for the €584 million combined-cycle project in the Mexican state of Chihuahua, consolidating its position as the country's leading private sector producer.

Mexico is a key plank of Iberdrola's €9.6 billion investment plan until 2016, which will see the company increasingly moving away from Spain and into the UK (41% of total investment), Latin America (17%) and the US (17%). Growth at home is stymied by a stagnant economy and rising renewable-power levies.

Ignacio Sánchez Galán, Iberdrola's chairman, is a severe critic of the government's erratic energy policy. 'We will invest mainly in energy projects and countries which enjoy predictable and stable regulations', he said. 'At this point we are more British, American and Mexican than Spanish'.

Sacyr and OHL win €710 million motorway contract in Chile
Sacyr and OHL, two construction giants, teamed up and won the €710 million contract to construct and operate a motorway in Santiago de Chile.

Both companies have a high-profile presence in the country, having won other civil engineering and infrastructure projects. Sacyr currently has five motorways covering 676km, while OHL is building Terminal 2 of the Valparaíso port.

The contract was awarded at the end of January after a consortium led by Sacyr ceased work on expanding the Panama Canal over a cost row. The project to expand was originally expected to cost about US$5.25 billion, but overruns could increase that to near US$7 billion. The consortium's winning bid was US$1 billion lower than that of the nearest competitor.

Work on the canal re-started this month while negotiations for a definitive solution continued.