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Summary

Spanish-led consortium settles Panama Canal dispute
Migrants storm Spain's North-African enclave of Melilla
Tax reform proposal calls for cuts in income tax rates and rises in VAT
Foreign direct investment in Spain increases.
Bailed-out Bankia begins to be privatised

Foreign Policy

Spanish-led consortium settles Panama Canal dispute
The consortium of construction companies led by Spain's Sacyr settled its two-month dispute with the Panama Canal Authority over massive cost overruns that led to work being halted on widening the canal, a key route in world trade as it connects the Atlantic and Pacific oceans.

The deal calls for each side to put up US$100 million for immediate cash-flow needs in order to allow work to return to its 'normal rhythm' and be completed by December 2015, more than a year later than originally slated.

Another US$400 million will come from the Zurich Insurance Group, which earlier issued that much in so-called surety bonds. The bonds are normally used when a contract is broken, allowing a party to make a claim on the bonds to recover losses.

The deal, however, does not resolve the contentious issue of US$1.6 billion in cost overruns that sparked the dispute. This will be decided by independent arbitration panels.

The project is a landmark one for Spanish construction companies that have won mega contracts abroad. Failure to reach an agreement would have severely tarnished Spain's corporate image. The governments of Spain and Panama were closely involved in averting a pull-out by the consortium, 48%-controlled by Sacyr, and 48%-controlled by Italy's Salini Impregilo. A Panamanian firm and a Belgian company make up the other 4%.

Work on the waterway, opened 100 years ago, began in 2009 with the overall cost pegged at US$5.2 billion. The consortium's bid for its share of the work was well below that of its main rival.

Domestic Scene

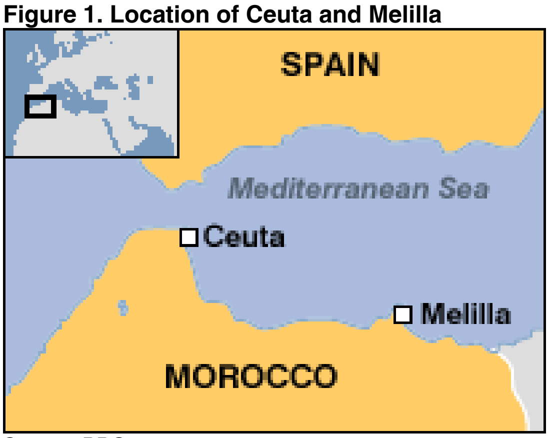
Migrants storm Spain's North-African enclave of Melilla

Some 500 migrants stormed their way into Spain's North-African enclave of Melilla, in the hope of a better life in the EU. It was the largest number in almost a decade.

The migrants climbed the fences that separate the territory from Morocco (see Figure 1). At least 28 of them and five Spanish police officers were injured. An estimated 1,000 people, mainly believed to be sub-Saharans, tried to force their way into the enclave.

The latest incident came after the European Commission criticised police for firing 145 rubber bullets last month at migrants trying to swim to the other Spanish enclave of Ceuta. Fifteen of them drowned.

Figure 1. Location of Ceuta and Melilla



Source: BBC.

Jorge Fernández Díaz, the Interior Minister, visited the enclaves after the deaths and said their borders would be fortified. More than €2.3 million will be spent on reinforcements, including lining the six-metre high fences that surround both cities with a type of mesh that will 'impede anyone from climbing', according to Fernández Díaz. More Civil Guards will also be deployed and a helicopter to help with 'dissuasion and detection' of migrants.

The Minister admitted police should not have fired rubber bullets. This followed a letter from Cecilia Malmström, the European Commissioner for home affairs, who asked if their firing 'could have provoked panic among the group of immigrants' and led to the deaths.

Ceuta and Melilla have become increasingly targeted by migrants. A total of 4,354 migrants entered the two enclaves illegally last year, up from 2,804 in 2012. The number who arrived in Melilla in the first two months of this year was 530, three times more than the monthly average in 2013. The latest influx brought the number of arrivals in Melilla to 1,033, 34 less than in the whole of 2013.

Fernández Díaz said the situation at the enclaves was a problem for all of Europe and not just Spain, and needed to be resolved 'in cooperation with the EU'.

The stock of Spaniards resident abroad surpasses 2 million

The number of people with Spanish nationality living abroad rose 6.6% in 2013 to 2.05 million (see Figure 2), belying the impression given in the Spanish media of a massive exodus fuelled by the country's very high unemployment rate.

Figure 2. Spanish nationals resident abroad by continent

	1 January 2014	1 January 2013	Change
Europe (1)	691,593	656,841	+34,752
Africa	17,273	16,618	+655
Americas	1,302,596	1,214,985	+87,611
Asia	27,475	24,484	+3,001
Oceania	19,101	18,320	+781
Total	2,058,048	1,931,248	+126,800

(1) Excluding Spain.
Source: National Statistics Office.

The countries with the largest increases in Spaniards were Argentina (+18,723), Cuba (+10,878), Ecuador (+10,858), the US (+8,889) and France (+8,594). The increase to Germany, one of the countries favoured by young Spanish adults, was 6,162.

Of the 2.05 million Spaniards residing abroad, 14.7% are under the age of 16, 62.6% are between 16 and 64 and 22.7% are over the age of 65.

The flow of Spaniards seeking jobs abroad, as opposed to the stock, has risen considerably in the last few years, giving the impression of an exodus. In the case of Germany, it is estimated that for every three Spaniards that seek a job there two return after a certain time and so do not form part of the registered foreign population.

Research last year by Carmen González Enríquez of the Elcano Royal Institute showed that the number of native Spaniards (ie, those born in Spain) officially registered as living abroad only rose by 40,000 between January 2009 and January 2013, which represented less than 0.1% of Spain's population.

This figure, which raised eyebrows as it was regarded as surprisingly low, is based on official Spanish statistics cross-checked with data in the countries where Spaniards reside, and the differences are not significant. Moreover, Spain's foreign-born population of 6.4 million is more than three times higher than the number of Spanish citizens living abroad.

Former Public Works Minister ordered to post €29.5 million bond in fraud case
Magdalena Álvarez, the Public Works Minister in the previous Socialist central government and the current vice-president of the European Investment Bank (EIB), was ordered to post a €29.5 million civil liability bond related to a case of alleged fraud involving a regional government fund in Andalusia.

Álvarez was economy chief for Andalusia between 1994 and 2004 at a time when the region's Socialist government set up a fund to help struggling firms make severance payments to laid-off workers.

Judge Mercedes Alaya considers Álvarez to have been a key player in the purported scam involving an estimated €140 million that was siphoned off between 2001 and 2010.

Álvarez, who could face embezzlement and corrupt practices charges, denies wrongdoing. She said she would appeal against the bond and not resign from the EIB.

The Economy

Tax reform proposal calls for cuts in income tax rates and rises in VAT
Spain should reduce its individual and corporate income tax rates, remove numerous tax breaks, gradually lower social security payments by companies, increase VAT in some areas and make the whole system much simpler, according to the recommendations in the report on tax reform commissioned by the Finance Ministry.

The government will use the non-binding proposals of a group of experts to create a tax reform bill that is expected to go to parliament by June. A similar procedure was used last year for pension reform.

Spain's tax revenues have plummeted since the bursting of the property bubble in 2008 and a five-year recession. The tax take, far too dependent on revenue from a property boom which collapsed in 2008, has fallen by almost €50 billion in the last six years. At the same time, public spending has soared because of the surge in unemployment and the ballooning public debt (95% of GDP, almost three times higher than in 2007).

Meanwhile, the size of the black economy –and hence tax evasion and fraud– has grown to an estimated 24.6% of GDP in 2012, up from 17.8% in 2008, according to an official study. The *Círculo de Empresarios*, a business association, estimates lost tax revenue at €70 billion.

Tax receipts as a percentage of GDP dropped from 37.3% of GDP in 2007, at the peak of the decade-long boom, to 32.9% in 2012, the lowest level among the large EU economies.

Spain urgently needs to bridge its traditional gap on a sustained basis between public spending and tax receipts, or otherwise it will never get to grips with its budget deficit. The deficit has dropped from a high of 11.2% in 2009 (surplus of 1.9% in 2007) to around 7% in 2013, which is still more than twice the EU threshold of 3% (a figure that Spain is committed to reaching in 2016) and despite the spending cuts.

Spain was initially supposed to have reached the 3% figure last year, but the European Commission gave the government greater leeway. The government cannot ask for another postponement without eroding the increased international confidence in the economy that it is keenly trumpeting.

Expenditure averages around 40% of GDP over the length of a 'normal' economic cycle (not the case at the moment) and tax receipts about 35% of GDP, leaving a shortfall (budget deficit) of 5% that has to be financed. Unless this and future governments are prepared to keep on cutting public spending, the only way to bridge the gap is through boosting tax revenues, particularly cracking down seriously –for the first time in Spain's post-Franco democracy– on tax fraud and evasion.

At first sight it would seem that the proposals of the committee of experts would lead to lower tax revenues as a percentage of GDP. The cuts in tax rates, however, would be offset by closing loopholes, eliminating exemptions, removing some products and services from the reduced VAT bracket of 10% (the standard rate is 21%) and tackling the black economy. The cut in the corporate tax rate from 30% to 20% would be accompanied by the removal of tax breaks that have enabled large companies to pay an effective rate of less than 5%. The key is to widen the tax base.

'The experts are agreed that comprehensive reform of the fiscal system should allow growth and creation of employment, accelerate fiscal consolidation and contribute to the reduction of the high levels of external debt of the Spanish economy', said Manuel Lagares, head of the committee that wrote the report.

The committee says the maximum personal income tax rate should be cut to below 50%. It currently stands at 52%, well above the EU-27 average of 38.5% and the euro zone average of close to 44% (see Figure 3).

Figure 3. Maximum individual income tax rates (%)

	1995	2000	2013	1995-2013 (pp)
Germany	57.0	53.8	47.5	-9.5
France	59.1	59.0	45.0	-14.1
Italy	51.0	45.9	43.0	-8.0
Spain	**56.0**	**48.0**	**52.0**	**-4.0**
UK	40.0	40.0	45.0	5.0
EU-27	47.4	44.8	38.5	-8.9
Euro zone	49.0	47.1	43.7	-5.3

Source: Report of the committee of experts on reforming the Spanish tax system.

In order to combat tax evasion and fraud, Spain needs to strengthen the Tax Agency. According to the latest OECD figures, Spain has one tax employee per 1,928 taxpayers compared with 860 in France, 729 in Germany and 862 in the UK. Spain's spending on tax management is also well below that of the main European economies (around 0.1% of GDP compared with 0.5%).

Employment shows signs of growing, Brussels lifts GDP growth forecast
The number of social security contributors rose in February by 61,557 in net terms to 16.21 million, 0.4% more than a year earlier and the first increase in 68 months.

The main year-on-year increases were hotel business (30,346), education (46,964) and scientific and technical activities (18,349). Construction (-56,345), once the engine of growth, continued to shed jobs.

Since 2008, the total number of social security contributors has fallen by 3 million and the unemployment rate has trebled to 26%. According to BBVA's research department, the level of employment will not return to its pre-crisis level until 2025.

The European Commission raised its GDP growth forecast for Spain this year to 1% from 0.5% (see Figure 4). Some private sector economists put growth higher.

Figure 4. European Commission forecasts for 2014

	GDP growth (%)	Inflation (%)	Unemployment (%)	Budget deficit (% of GDP)
France	1.0	1.2	11.0	4.0
Germany	1.8	1.4	5.2	0.0
Italy	0.6	0.9	12.6	2.6
Spain	**1.0**	**0.3**	**25.7**	**5.8**
UK	2.5	2.0	6.8	5.2
EU	1.5	1.2	10.7	2.7

Source: European Commission.

Investment in capital goods will grow by 5.8% in 2014 compared with 1.2% last year, according to European Commission forecasts, and the current account will continue in surplus after returning to the black last year for the first time since 1986 (see Figure 5). The surplus is forecast at 1.6% of GDP, more than double the 0.7% in 2013. The greater investment is a sign of economic recovery and is particularly needed to maintain the momentum of merchandise exports, which last year were a record €234.2 billion.

Figure 5. Investment in capital goods (% change) and current account balance (% of GDP), 2014

	Investment (% change)	Current account (% of GDP)
France	3.2	-2.0
Germany	4.8	6.7
Italy	5.3	1.3
Spain	**5.8**	**1.6**
UK	8.7	-3.3
EU	4.8	1.7

Foreign direct investment in Spain and Spanish investment abroad grows

Gross foreign direct investment in Spain increased 8.8% in 2013 to €15.8 billion and net investment after deducting divestments was 36.3% higher at €11.9 billion. Both figures exclude special purpose entities (SPEs) and hence are productive investment.[1]

The improvement reflected the increased investor confidence in Spain and the opportunities available in an economy that is only just beginning to recover from a five-year recession, albeit weakly.[2]

The most noteworthy feature was the 82% drop in divestments (from €22.7 billion in 2012 to €4.0 billion in 2013). Almost 80% of the gross investment was capital increases, while new ventures only accounted for 1% and acquisitions the rest. Among the most notable investments was the acquisition by Berkshire Hathaway, run by Warren Buffett, of Caixabank's life insurance business for €600 million. The purchase by Bill Gates, co-founder of Microsoft, of a 6% stake in FCC for €113.5 million is not included because it is below the 10% requirement for inclusion.

The main investor country was the Netherlands with 14.2% of the total (see Figure 6).

Figure 6. Main investors in Spain by country of ultimate origin, 2013 (% of total)

	% of total
Netherlands	14.2
Spain (1)	12.4
UK	11.8
France	11.2
Germany	8.6
US	8.2
Rest of countries	33.6

(1) Investment by Spanish companies via their subsidiaries abroad or jurisdictions such as Luxembourg and the Netherlands.
Source: Registry of Foreign Investments.

Investment was concentrated in four sectors: financial and insurance activities (€3.1 billion, +42%), manufacturing industries (€2.6 billion, -38.5%), real estate (€1.7 billion, +66.7%) and construction (€1.4 billion, -21.7%) accounted for 57% of the total.

Investment funds have been snapping up at bargain prices real estate repossessed by banks or in the hands of the 'bad bank' Sareb. Property prices have fallen by more than 30% since the bursting of the property bubble in 2008.

[1] See the definition at http://glossary.reuters.com/index.php?title=SPV.
[2] See the author's more detailed analysis 'Spain: foreign direct investment on the rise' at http://www.realinstitutoelcano.org/wps/portal/web/rielcano_en/contenido?WCM_GLOBAL_CONTEXT=/elcano/elcano_in/zonas_in/international+economy/ari19-2014-chislett-spain-foreign-direct-investment-on-the-rise#.UzHWDqhdWSo.

Gross Spanish direct investment abroad, excluding SPEs, increased 2.7% to €15.7 billion and net investment soared 994.5% to €10.9 billion, reversing the situation in 2012 when net investment was €1.2 billion negative because of large divestments.

Capital increases amounted to €12.8 billion, new ventures €495 million and acquisitions €2.4 billion.

Just over one quarter of the gross investment was in Germany (see Figure 7).

Figure 7. Immediate destination of Spanish investment abroad, 2013 (% of total)

	% of total
Germany	26.1
UK	11.0
Luxembourg	9.9
Netherlands	7.6
Brazil	6.1
Italy	4.8
Rest of countries	34.5

Source: Registry of Foreign Investments.

Financial and insurance activities (€7.5 billion) and manufacturing industries (€2.9 billion) accounted for two-thirds of the investment.

Spain's crisis increases inequality disproportionately, says OECD

The average income of Spanish households dropped by some €2,600 between 2008 and 2012, one of the biggest falls in the euro zone, while between 2007 and 2013 Spain accounted for as much as 55% of the rise in unemployment in the entire zone. Forty five per cent of the 5.8 million jobless are long-term unemployed.

These are some of the bleak figures in the OECD's latest Society at a Glance report (see Figure 8).

Figure 8. Spain: selected social indicators

	Pre-crisis		Latest year	
	Spain	EU (1)	Spain	EU (1)
Annual disposable income (US$) (2)				
Average	22,000	22,900	20,200	22,900
Bottom 10%	5,700	7,900	3,700	7,700
Total fertility rate	1.46	1.63	1.36	1.59
Unemployment rate (%)	8.0	6.6	26.6	11.1
NEET rate (%) (3)	12.8	10.7	19.6	12.7
Income inequality				
Gini coefficient (4)	0.309	0.288	0.338	0.291
Gap bet. richest & poorest 10%	8.7	6.9	13.1	7.4
Public spending (% of GDP)	22.1	22.5	27.1	25.1
Health spending per capita (US$) (5)	2,900	3,100	3,100	3,200
Conf. in the government (%)	53	50	36	41
Conf. in banks (%)	54	65	18	43

(1) Unweighted average of 21 EU countries.
(2) Latest year PPPs and prices.
(3) Youth neither in employment, education nor training.
(4) A coefficient of zero expresses perfect equality.
(5) Latest year PPPs.
Source: Society at a Glance 2014, OECD.

The jobs crisis and resulting income losses have not been equally shared, however. Employment difficulties are very concentrated in the most disadvantaged households. The poorest 10% faced income losses at a rate of 14% per year, resulting in a fall of more than one third during 2007-10. This is by far the largest drop among the 34 OECD countries. The top 10% income earners in Spain lost only around 1% per year. As a result, income inequality has surged.

The report says the country's social protection system was poorly prepared for tackling a mounting employment crisis. Four out of every 10 unemployed do not receive unemployment benefits, and income support provided by safety-net benefits is low, typically amounting to around half the poverty line. The elderly and pensioners have been much better protected.

The economic upturn, beginning this year, will not quickly put an end to the social and jobs crisis. More needs to be done to help families benefit quickly. The OECD suggests that Spain should reduce the number of VAT exemptions or preferential rates (something proposed in the tax reform report by a group of experts, see above) on food, energy or transport as, compared to social assistance benefits, they provide poorly-targeted support for low-income groups. This is because the rich consume more than the poor. Reduced rates and evasion cost Spain 65% of VAT revenue, one of the highest ratios in the OECD, where the average is 45%.

Land prices continue to fall
The average price of land fell 21% in 2013 to €147.9 a square metre, continuing the fall begun in the middle of 2007 with the bursting of the property bubble when the average price was €285.

The most expensive land is in the city of Barcelona (€487.9 per square metre) and the least for cities of more than 50,000 inhabitants in the region of Asturias (€150.8).

Corporate Scene

Bailed-out Bankia begins to be privatised
The government began to reduce its 68% stake in Bankia, which was nationalised in 2012 and bailed-out by the European Stability Mechanism, through an initial offer of shares worth 7.5% of the bank that netted €1.3 billion.

Bankia was created at the end of 2010 from the merger of seven ailing savings banks and headed by Rodrigo Rato, the former managing director of the International Monetary Fund. It was massively exposed to the property sector and crippled when the property bubble burst.

The bank, the fourth largest in Spain, received €18 billion of the €41 billion bail-out designed to rescue the financial system. Spain exited the bail-out in January 2014.

Bankia returned to profit in 2013 after a loss of €19.2 billion in 2012, the largest in Spanish corporate history.

The government plans to sell off further small stakes this year, but no more than 18% in total, because it wants to maintain control for now.

'This is truly a sign of the shift in perception and of the reality of our financial system', said Economy Minister Luis de Guindos.

In a separate development, the problem mortgage loans of the seven banks that form part of the Ibex-35 benchmark index of the Madrid Stock Exchange increased by 42% in 2013 to €24.5 billion and accounted for 6.5% of total mortgages, up from 0.5% in 2008.

This surge underscores the extent to which job losses, after five years of recession, are eroding the capacity of families to service their mortgages.

Including properties repossessed by banks because the owners cannot repay their mortgages, the non-performing loan ratio in mortgages is estimated at around 10%.

Vodafone in €7.2 billion deal to buy cable operator Ono
Vodafone agreed to buy Spanish cable operator Ono for €7.2 billion. The company offers cable TV and internet services and has 1.9 million customers.

The deal followed Vodafone's acquisition of a controlling stake in the German cable operator Kabel.

Penguin Random House buys Alfaguara
Penguin Random House is to buy Alfaguara and several other editorial brands for €72 million.

Alfaguara is owned by Santillana, a leading publishing house controlled by Prisa whose other interests include *El País*, Spain's most-read quality newspaper. *El País* is saddled with a high debt burden, which it has been restructuring. Santillana will keep its educational publishing, which generates the bulk of its income.

Moody's upgrades Santander and BBVA
Moody's boosted the debt ratings of Santander and BBVA, Spain's two largest banks, from Baa2 to Baa1 and from Baa3 to Baa2, respectively.

The upgrades followed the agency's lifting of its outlook for the Kingdom of Spain (debt upgraded to Baa2 with positive outlook). An institution cannot have a debt rating higher than that of its country.

The agency said Santander's risk-absorption capacity remains resilient despite ongoing asset-quality pressures. Its non-performing loan ratio increased to 5.64% at the end of 2013 from 4.54% in 2012. This was mainly due to the increased level of problem loans in Spain. Santander has been able to cope with increased provisioning efforts while maintaining very high pre-provision profitability metrics compared with its international peers.

Amancio Ortega, world's third-wealthiest individual, adds US$7bn to his fortune

Amancio Ortega, the former chairman of the fashion retailer Inditex (best known for its Zara brand), retained the third spot in the latest ranking of the world's billionaires by the magazine *Forbes* with US$64 billion, up US$7 billion. Twenty-five other Spaniards appeared in the list of 1,645 billionaires (see Figure 9).

Figure 9. Top 10 Spaniards in the Forbes ranking of billionaires (US$ billion)

Rank	Person and company	Fortune (US$ bn)
3.	Amancio Ortega (Inditex)	64
227.	Sandra Ortega Mera (Inditex)	6.1
305.	Juan Roig (Mercadona)	4.8
466.	Rafael del Pino (Ferrovial)	3.4
663.	Daniel Mate (Glencore)	2.6
687.	F.J. Riberas Mera (Gonvarri)	2.5
687.	J.M. Riberas Mera (Gonvarri)	2.5
687.	Juan Manuel Villar Mir (OHL)	2.5
731.	Juan Abelló (Torreal)	2.4
731.	Manuel Jove (Fadesa)	2.4

Source: Forbes.