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Inside Spain 74

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Foreign Policy

China Shows Confidence in Spanish Economy with Promise to Buy Sovereign Debt
Li Keqiang, China's Deputy Premier, visited Madrid as part of a European tour. Business agreements worth some US$7.5 billion were signed and promises made to buy Spanish sovereign bonds and help ease the euro zone's public debt crisis.

'China is a responsible long-term investor in the European and particularly Spanish financial markets', Li was quoted as saying by the Chinese Foreign Ministry. No details were given. According to press reports, China will buy up to €6 billion of Spanish bonds. China has also offered to buy Greek and Portuguese public debt.

The deals included agreements to buy Spanish wine, ham and olive oil, a US$25 million contract for air traffic control systems provided by Indra and a co-operation agreement for Latin America between BBVA and China Development Bank. Most of the rest of the sum announced came from the US$7.1 billion acquisition in 2010 by Sinpoec, the Chinese oil and gas group, of a 40% stake in the Brazilian energy subsidiary of Repsol. China has been increasingly eyeing Latin America's natural resources.

Spain runs a large trade deficit with China. Its exports to the country were 33.6% higher in the first 10 months of 2010 at €2.1 billion, while imports from China amounted to more than €15.6 billion.

Chinese officials promised more facilities for Spanish direct investment in China.

Jorge Moragas, the Popular Party's international relations spokesman, criticised the Socialist government for not raising the issue of human rights in China. Moragas said David Cameron, the UK Prime Minister, Barack Obama, the US President, and Nicolas Sarkozy, the French President, all did so during their meeting with Chinese leaders in 2010.

Russian Expels Two Spanish Diplomats for Alleged Spying in Tit for Tat
Moscow responded to the expulsion of two Russian diplomats in Madrid by expelling last month two Spanish diplomats in the Russian capital accused of spying.

The Russians were ordered to leave Spain in November for 'conducting activities not compatible with their status', according to General Félix Sanz Roldán, the head of the National Intelligence Centre (CNI).

The incident was the most serious since Spain and Russia restored diplomatic relations in 1977. They were broken in 1939 after General Franco's forces won the Civil War. Russia supported the defeated Republic.

The Spanish government played down the incident as it did not want it to affect the cultural events that both countries will hold during 2011.

Armenia and Spain Sign Double Taxation Agreement
Edward Nalbandian, Armenia's Foreign Minister, made an official visit to Spain last month and signed a double taxation agreement. The country recently established an embassy in Madrid in a bid to develop greater political, economic and cultural relations. Trinidad Jiménez, Spain's Foreign Minister, accepted an invitation to visit Armenia this year.

Domestic Scene

Government Rejects ETA's New Ceasefire as 'Inadequate' and 'Arrogant'
ETA, the terrorist group that has killed 829 people in 43 years in its fight for an independent Basque country, declared a permanent ceasefire, which, it said, would be verifiable by the international community. The government rejected the group's statement as inadequate and arrogant.

This was ETA's 10th ceasefire of different types since 1981. The last one was announced in September 2010. The use this time of the words 'permanent' and 'verifiable' suggested the group was more serious than in the past.

The government, however, was not convinced of ETA's sincerity. 'The only communiqué we want to read from ETA is that ETA declares the end in a manner that is irreversible and definitive', said Alfredo Pérez Rubalcaba, the Interior Minister and Deputy Prime Minister. There was no mention in ETA's statement that it would lay down its arms and disband, as the government insists it must do.

ETA has been considerably weakened by the 2,021 arrests since 1996 in Spain, France and other countries (see Figure 1) and is under increasing pressure from its political allies to do something that would enable them to compete in May's municipal elections. The Batasuna party, regarded as ETA's political wing, is banned unless ETA lays down its arms or clearly separates itself from ETA.

Figure 1. ETA Arrests and its Mortal Victims, 2004-10

		2004	2005	2006	2007	2008	2009	2010
Killings	817 (1968-2003)	0	0	2	2	4	3	1
Arrests	1,330 (1996-2003)	148	95	45	125	86	124	68

Source: Interior Ministry.

'In recent months, from Brussels to Gernika, well-known personalities on the world level and many Basque social and political actors have stressed the need to bring a just and democratic solution to the centuries-old conflict', ETA said in its statement, which was read out by one of three anonymous people cloaked in black and wearing berets, gloves and white hoods. 'It is time to act with historical responsibility'.

The last 'permanent' truce lasted nine months in 2006 and ended with a bomb attack at Madrid's Barajas airport that killed two people.

Four Civil Guard Officers Jailed for Torturing Two ETA Members
A court in the Basque city of San Sebastián convicted four members of the paramilitary Civil Guard for torturing two members of ETA after they were arrested for their involvement in the bomb blast at Madrid's Barajas airport in 2006.

The four, out of a group of 15 policemen on trial, were given sentences ranging from two to four and a half years.

Igor Portu and Martín Sarasola were arrested in 2008 and accused the police of beating them. The court was told that Sarasola had a gun pointed at his head, and Portu was plunged several times in a river and forced to drink the water.

They were later found guilty of the bombing which killed two Ecuadorean immigrants in a car park and wounded 41 people.

New Anti-smoking Law Comes into Effect
A much tougher anti-smoking law came into effect this month banning smoking in enclosed public areas and near school playgrounds and hospitals and on television broadcasts. It replaced the one in force since January 2006, which the government recognised was inadequate.

The former law allowed bars and restaurants under 100 square metres (the great majority) to choose whether to allow smoking or not and display their decision. Not surprisingly, almost all of them opted to continue to allow smoking. This law was much softer than the ones introduced in the UK, Ireland, Italy and Turkey.

In 2006 (latest figures), 53,155 people over the age of 34 died in Spain because of illnesses related to smoking (15% of total deaths from all causes). Caring for these victims of smoking is costly for the public health system.

Dominic Brisby, Chairman of Altadis (the company formed by the merger of Spain's Tabacalera and the French SEITA and a subsidiary of Imperial Tobacco), told the newspaper *El País* that the new law was 'the most radical in the world and it will fail. There are only a couple of countries with more radical laws, such as Bhutan, a Third-World country where people travel by donkey'.

The government rejected claims by the hotel and catering trade that the new law would be bad for business as all bars and restaurants were now on the same footing.

Male-inflicted Domestic Violence Rises in 2010
A total of 71 women were killed by their partners in 2010, 16 more than in 2009 when it looked as if the authorities were beginning to have some success in their campaign to get to grips with the problem (see Figure 2).

Figure 2. Domestic Violence Deaths, 2003-10

Year	Number of Deaths
2003	71
2004	72
2005	57
2006	69
2007	71
2008	76
2009	55
2010	71

Source: Secretary of State for Equality.

Meanwhile, the number of people killed in road accidents in 2010 dropped by 173 to 1,730 and was less than half the number in 2003.

Spain Overtakes France as Europe's High-Speed Rail Leader

The opening of the high speed train service from Madrid to Valencia, Spain's third-largest city, last month made Spain's Europe's leader in this field of transport. The new line reduces the travel time for the 438 km from four hours to 90 minutes.

Spain now has 2,056km of high-speed rail track, more than France (1,896km) and Germany (1,285km). Further routes planned or under construction would bring Spain's network to 5,525km, more than Japan (3,625km) but less than the global leader China (13,134km).

By 2020 Spain wants to have 90% of the population within 50km of a high-speed rail station.

Spain's first high-speed line was opened in 1992 between Madrid and Seville, and coincided with the Expo 92 world fair held in the south-western city.

Some economists question the wisdom of investing so heavily in high-speed trains (an estimated €45 billion so far), given that Spain has fewer potential passengers than France or Germany.

The Economy

Spain Braces Itself Against Sovereign Debt Contagion from Portugal

The government stepped up its offensive to convince the international markets that Spain should not be bracketed with Portugal in the event that the neighbouring country has to accept a bail-out similar to those already in place for Greece and Ireland.

Presenting a report on the economy in 2010, Prime Minister José Luis Rodríguez Zapatero was adamant that Spain would stick to its programme of already announced reforms and austerity. This would enable the economy to return to growth averaging 2-2.5% over the next five years (see http://www.la-moncloa.es/NR/rdonlyres/F6C7C8CD-E056-4F18-84F3-1994E9CE460C/135548/Informe_Eco_Pre.pdf). He pronounced the word 'reform' around 50 times in a speech that lasted less than 40 minutes.

Portugal's cost of borrowing has jumped to euro-era highs, reflecting nervousness in sovereign bond markets about Lisbon's ability to fund its maturing debt. Spain's bond yields have also risen, but are still significantly lower than Portugal's. The Spanish 10-year bond yield was 5.33% on 14 January compared with Portugal's 6.86%. This followed some relief on 12 January when Portugal sold more than €1.2 billion in 10-year bonds at lower-than-expected interest rates, while Spain easily sold €3 billion in five-year bonds at 4.59%, up nearly a percentage point from last year. There was strong demand for Spanish debt, showing there is plenty of appetite for the government's bonds and that a degree of confidence is returning as a result of the reforms.

The two countries' respective premiums over the benchmark German bond, which denotes international confidence, were 2.31 pp and 3.84 pp (see Figure 3). It is widely believed that once 10-year bond yields reach around 7%, regarded as a critical level, it makes no financial sense to pay such a high rate of interest. Portugal would then have no option but to seek a bail-out or have one forced on it by the EU. Spain would then be the next country in the eye of the storm. Greece sought a bail-out 16 days after its 10-year yields reached 7% and Ireland 20 days. Once the markets lose confidence in a country, this takes on a dynamic of its own. Spain's debt repayments this year represent 23.4% of its outstanding debt compared with 21.8% in Portugal, 19.6% in France, 21.5% in Germany and 18.8% in Italy.

Figure 3. 10-year Government Bond Spreads Over Bunds (pp)

	September 13	October 18	November 16	December 14	January 14
Greece	+9.15	+6.57	+9.11	8.84	+8.27
Ireland	+3.41	+3.68	+5.82	5.45	+5.49
Italy	+1.42	+1.35	+1.59	1.62	+1.65
Portugal	+3.34	+3.19	+4.21	3.51	+3.84
Spain	**+1.73**	**+1.63**	**+2.00**	**2.54**	**+2.31**

Source: ThomsonReuters.

Spain's macroeconomic indicators are also better than Portugal's, although Spain has a serious and longstanding problem of declining competitiveness (see Figure 4). While inflation in booming Germany was 1.7% in 2010, in depressed Spain it was 2.9% 3%. Spain's budget deficit reduction programme, however, (from 11.1% of GDP in 2007 to the EU ceiling of 3% in 2013) is proceeding on schedule so far.

Figure 4. Spain and Portugal Economic Indicators, 2010 (1)

	Spain	Portugal
Budget deficit (% of GDP)	9.3	7.3
Public debt (% of GDP)	62.8	83.5
Unemployment rate (%)	20.0	11.0
GDP growth (%)	-0.3	+1.3

(1) Official estimates.
Source: Eurostat.

'With this collection of measures, initiatives and reforms that we are getting under way, we want not only to ensure we overcome the crisis but also make the necessary changes so that our country is well positioned in this increasingly demanding and competitive world in which we live', said Rodríguez Zapatero.

According to the distinguished Spanish economist Guillermo de la Dehesa, Chairman of the Centre for Economic Policy Research (CEOPR), Spain is 'too big to be rescued' as its stock of public and private debt and loans in the hands of banks from the rest of the euro zone amounts to €476 billion. Were the country to be rescued, this would trigger a much deeper crisis in the 17-member euro zone.

7Government Strives to Hammer out Pension Reforms
The government and trade unions were locked in tense negotiations on reforms to the state pension system. The main disagreement is over raising the legal retirement age from 65 to 67 years.

The Prime Minister, José Luis Rodríguez Zapatero, plans to approve the reforms on 28 January regardless of whether there is an agreement. The Unions, allies of the ruling Socialist party, have threatened a general strike. Both sides are anxious to avoid a showdown. The last general strike over labour market reforms on 29 September was poorly supported.

The government appeared willing to keep the 65-year age limit for those who have paid into the social security system for 41 years (which would qualify for a full pension) as of 2027. These contributors are a tiny minority. The number of years for calculating the pension, currently the last 15, would also be raised.

The number of pensioners in Spain is forecast to rise from 8.6 million to 15.3 million in 2040. The cost in GDP terms is currently lower than the EU-27 average but is set to rise much more sharply than revenues (see Figure 5). Spaniards are living significantly longer than they did 30 years ago (average life expectancy is 81 years).

Figure 5. Cost of Pensions (% of GDP in 2008)

Country	Cost
Italy	15.0
France	13.6
Germany	12.3
Sweden	11.8
EU-27	11.7
Spain	**9.2**
UK	8.7

Source: Eurostat.

The pension reform is yet another element in the government's strategy to restore international confidence in the economy.

OECD Urges Deeper Reforms
Spain needs deeper reforms than those already implemented by the government if it is to put public finances on a sustainable footing and reduce the unemployment rate substantially, according to the Organisation for Economic Co-operation and Development (OECD).

In its latest report on the country produced every two years and published last month, the OECD points out that although the depth of Spain's recession as of 2008 is broadly similar to that of other European countries in GDP shrinkage terms the rise in unemployment and in the budget deficit has been proportionately and strikingly much larger. The jobless rate is currently 20% (8.3% in 2007) and the budget deficit reached 11.1% of GDP in 2009 (surplus of 1.9% in 2007). Two million jobs were lost in the past two years in Spain, 60% of them linked to the once-booming construction sector.

The OECD welcomed last September's labour market reforms, which make it easier for firms to have dismissals accepted as 'justified' and so reduces their costs, but said the law 'still leaves much room for judicial interpretation' (see http://www.oecd.org/dataoecd/33/22/46654901.pdf for an overview). As a result, it is ‘not clear to what extent the legislation will change the practice whereby firms prefer to pay upfront the highest severance payment in order to avoid going to court’. If the measures fail to make it significantly easier for firms to have dismissals accepted as ‘justified’ the government needs to rectify this, the OECD said.

The reform of the collective wage bargaining system (conducted predominantly at the sectoral and provincial levels) gives firms some flexibility to opt out of agreements, although the statutory extension of bargaining remains in place. The OECD says the legal extension principle may have to be scrapped although that would not be easy as it would conflict with constitutional law.

On the budget deficit, the OECD said some 60% of it was structural and this, coupled with the expected increase in ageing spending, was spooking the markets.

Further progress was needed in product market regulation in order to become more competitive and lower prices. It said entry barriers for large-surface retail outlets imposed by regional governments should be lowered and shop opening hours liberalised in those regions where restrictions remain.

With 40% youth unemployment, Spain needed to reduce the number of students leaving school without upper secondary education (32% of them are early school leavers, double the EU average). This would have a double dividend as it would raise human capital for the long term and would postpone entry of young and unskilled workers into a depressed labour market.

On water, which is scare in many areas of Spain (a country subject to periodic droughts), the OECD said the country should improve the management of its resources through pricing.

Spanish Banks ‘Third Strongest’ in the Euro Zone

The financial strength of Spanish banks is the third strongest in the euro zone after Finland and France, according to the credit rating agency Moody’s (see Figure 6).

Figure 6. Soundness of World Banks, Average Rating of Financial Strength by Countries

Country	Rating
Canada	B
Singapore	B
Finland	B-
Chile	C+
Brazil	C+
US	C+
France	C
Spain	**C**
Italy	C
Germany	C-
UK	C-
Portugal	D+
Ireland	D-

Source: Moody’s.

The country’s commercial banks, led by Santander and BBVA, as opposed to some savings banks (known as *cajas*), have generally withstood well the financial crisis.

Among the reasons for this is the stock of provisions built up during the bonanza years of the Spanish economy, thanks to Bank of Spain's counter cyclical regulations, which are being used to cover the growing volume of non-performing loans (NPLs). The NPL ratio of the whole banking system was 5.66% last October (latest figure), the highest level since January 1996.

Spanish Stock Market Underperforms the Rest of Europe in 2010, Outperforms in January

The Spanish stock market was the worst performer in Europe in 2010 and the fourth in the world after Venezuela, Greece and Cyprus (see Figure 7). The Ibex-35 fell 17.4% (in contrast, the FTSE 100 gained 10.2% and returned to the levels last seen in June 2008). The market began to rally strongly, however, in the middle of this month amid signs of improved investor sentiment towards Spain. The Ibex-35 rose 8.6% between 10 and 14 January.

Figure 7. Main Stock Market Indices (% change in 2010/09 and 1-14 January)

Index	2010	January 1-14
Ibex-35 Spain)	-17.4	+5.3
Dax (Frankfurt)	+16.0	+2.3
FTSE 100 (London)	+10.3	+1.7
Euro Stoxx 50	-10.3	+4.6
Dow Jones	+10.9	+1.8
Nikkei (Tokyo)	-1.6	+2.6

Source: Markets.

As a result of the poor performance in 2010, Spanish blue-chip companies slipped down the global league by market value (see Figure 8).

Figure 8. The World's Largest Companies in 2010 by Market Value (€ billion)

	Market Value, 2010	2010 Ranking	2009 Ranking
Telefónica	74.4	50	39
Santander	66.0	65	36
Inditex	34.9	163	189
BBVA	33.9	170	79
Iberdrola	31.6	184	147
Repsol YPF	25.4	261	222

Source: Bloomberg.

Car Sales Continue to Fall

Fewer than one million cars, a key yardstick of consumption, were sold in Spain in 2010 for the second year running, although the number was higher than in 2009 (see Figure 9). The outlook for this year is worse than in 2011, according to industry experts, as the government's scrappage scheme (May 2009-July 2010) scheme has ended.

Figure 9. Car Sales, 2006-2010

Year	Number	Change(%)
2006	1,634,595	-0.9
2007	1,614,835	-1.2
2008	1,161,176	28.1
2009	952,772	-17.9
2010	982,015	+3.0

Source: Anfac.

Spain's Tax Revenues Plummet the most among OECD Countries

Spain's tax burden (receipts including social security contributions as a percentage of GDP) suffered the largest fall among developed countries between 2007, the last ‘normal’ year of economic activity, and 2009, highlighting the weakness of the country’s tax system.

The burden dropped by 6.6 points to 30.7%, the lowest level since 1986 (29%), the year that Spain joined the EU (see Figure 10), according to the Organisation for Economic Co-operation and Development (OECD).

Figure 10. Total Tax Revenue (% of GDP) (1)

	1975	2000	2006	2007	2008	2009	07/09 (chnge) pp
France	35.4	44.4	44.0	43.5	43.2	41.9	-1.6
Germany	34.3	37.2	35.6	36.0	37.0	37.0	+1.0
Italy	25.4	42.3	42.3	43.4	43.3	43.5	+0.1
Spain	**18.4**	**34.2**	**36.7**	**37.3**	**33.3**	**30.7**	**-6.6**
UK	34.9	36.4	36.6	36.2	35.7	35.7	-1.9
US	25.6	29.9	28.2	27.9	26.1	24.0	-3.9

(1) Including social security contributions.
Source: OECD.

In terms of GDP shrinkage, Spain’s recession is no worse than that of most other EU countries but its jobless rate of 20% is around double the EU average. High unemployment means fewer tax payers. Tax evasion also remains widespread and the black economy has been growing.

Such a large fall means that, short of raising tax rates very sharply, which would not be realistic or politically feasible, the government’s efforts to cut the budget deficit from 11.1% of GDP in 2009 to the EU limit of 3% in 2013 rely very largely on spending cuts that are unprecedented in Spain in the last 35 years.

The reduction in the burden also reflects the tax cuts made in 2009 (a €400 rebate for everyone regardless of their income and lower corporate tax for SMEs). The rebate has since been eliminated, the standard VAT rate raised from 16% to 18% and the rich are taxed at slightly higher rates.

The OECD urges the government in its bi-annual survey of Spain, published last month, to reform its property taxes, which contribute less to revenues than in many OECD countries, particularly when taking the abolition of the wealth tax in 2009 into account (see Figure 11). The revenue from these taxes is also very volatile as it depends on the housing market, which has been in the doldrums since the bursting of the country’s property bubble in 2008. It is estimated there are at least one million unsold homes.

A significant part of corruption in Spain at the municipal level is related to the reclassification of land from agricultural and other uses to that for building homes in order to compensate for the relatively low revenues from property taxes and pay for the ambitious plans of some town halls.

Figure 11. Structure of Tax Revenue, 2008 (% of total revenues)

	Personal income tax	Corporate income tax	Social security contributions	Property tax	Goods & services	Other taxes
France	17.4	6.8	37.2	7.8	24.5	6.4
Germany	26.8	5.2	36.4	2.3	28.9	0.3
Italy	26.8	8.6	31.1	4.3	4.3	24.4
Spain	**21.3**	**8.3**	**36.8**	**6.7**	**25.1**	**1.8**
UK	29.9	9.9	19.2	11.6	28.8	0.4
US	37.9	8.9	24.5	11.7	17.0	0.0
OECD	25.3	10.8	25.2	5.6	30.9	2.1

Source: OECD.

Santander Acquires General Electric's Mortgage Business in Mexico

Santander, the euro zone's largest bank by market capitalisation, agreed to acquire the mortgage business of GE Capital, the finance arm of General Electric, making it the second-largest mortgage provider in the country.

The bank reportedly paid US$162 million for the US$2 billion business. GE Capital's sale was part of its strategy of shedding non-core assets.

Santander has the third-largest bank in Mexico. The acquisition will help it to grow in the market.