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Foreign Policy

Spain Denounces Gibraltar's Tax Regime to the European Commission
The traditionally tense relations between Madrid and London over Gibraltar, a British territory claimed by Spain, deteriorated further when the government denounced the Rock's tax regime to the European Commission.

The move was made 10 days before Prince Edward, the youngest son of Queen Elizabeth II, and his wife visited Gibraltar on 10 June as part of the Diamond Jubilee celebrations. As a result of this visit, which angered Madrid, Queen Sofia cancelled her trip to London where she was to have attended a jubilee lunch.

In a provocative move, a giant image of Queen Elizabeth and the Union Jack, clearly visible from Spain, was projected onto the Rock of Gibraltar at the end of the celebrations.

Madrid says the tax regime, which came into force at the beginning of 2011 and lowers corporate tax from 22% to 10%, compared with the average of 30% in Spain, and is only applied to income generated in Gibraltar, contravenes EU treaties. Companies, which are registered in Gibraltar but do business in Spain and elsewhere, are exempt from the tax. The Spanish authorities say the tax system encourages companies to relocate in Gibraltar.

Last November, the EU Court of Justice barred Britain from enacting a corporate tax reform in Gibraltar, ruling the scheme would amount to illegal state aid for offshore companies. The court said the proposed tax system was 'designed in such a way that offshore companies avoid taxation', making it 'incompatible with the internal market' rules.

There is also an ongoing dispute over fishing by Spanish boats in waters claimed by Spain and Gibraltar. 'The British maintain the waters are theirs, we maintain that they are ours, and this discussion is going nowhere', José Manuel García-Margallo, the Foreign Minister, said. 'Whoever's waters they are and I say they are Spanish, it is evident that vessels from both flags must use them'.

The dispute was sparked when the government of Gibraltar abolished the Fishing Agreement of 1999 negotiated by the previous administration, which had granted the police flexibility and discretion in the application and policing of the Gibraltar Nature Protection Act of 1991.

The trilateral forum (Spain, the UK and Gibraltar), started in 2004 by the previous Socialist and UK Labour governments to air grievances but not sovereignty, is effectively dead and has been superseded by megaphone diplomacy.

Madrid wants a four-sided forum by adding the Campo de Gibraltar (the area in Spain close to the Rock and comprising several municipalities) to discuss issues of cooperation. It hankers after a return to the 1984 Brussels Process, which established a bilateral negotiating framework with the UK for the discussion of all issues including sovereignty. A return to such a process would reduce Gibraltar's influence.

Foreign Minister in Bid to Drum up Business in Brazil
José Manuel García-Margallo, the Foreign Minister, visited Brazil twice in two weeks as part of a drive to further Spanish business interests in the country whose economy is one of the fastest growing in the world. On his second trip, he accompanied King Juan Carlos and other ministers.

Spain is the second-largest investor in Brazil after the US, with a stock of direct investment of €46.5 billion at the end of 2011. Exports to the country were worth €2.4 billion last year and are growing at a rate of 14% this year. Among the main investors are Santander, the Eurozone's largest bank by market value, Telefónica, the world's fifth-largest telecoms operator by total customers, and Repsol, which recently announced a major offshore oil discovery. Santander generates a larger profit in Brazil than in Spain.

Infrastructure companies are interested in bidding for the high-speed train contract to link Rio de Janeiro and São Paulo, the two largest cities, the tender for which is expected to be concluded by the end of 2012. A consortium of Spanish companies won the contract last year to build the high-speed train link between Mecca and Medina in Saudi Arabia.

Official Development Assistance Continues to Fall
Spain's official development assistance (ODA) will fall this year to 0.23% of GDP from 0.29% in 2011 and 0.43% in 2010, far from the 0.7% figure that the United Nations recommends should be provided by developed countries for developing nations.

The government's international cooperation plan puts the amount of ODA for 2012 at €2.37 billion. Spain's cut over the last two years, because of its budget crisis, is the biggest among the 34 OECD countries.

Domestic Scene
French police arrested the military leader of the Basque terrorist group ETA and his deputy in a joint operation with the Spanish police.

Oroitz Gurruchaga Gogorza and Xabier Aramburu were detained in the south-western French village of Cauna while travelling in a stolen vehicle with fake number plates, according to the Spanish Interior Ministry.

They were arrested just over a year after Gurruchaga's predecessor was detained in northern France. His arrest brought to 15 the number of ETA suspects captured since the group announced a 'definitive' ceasefire last October.

ETA, which is blamed for 829 killings in its more than 40-year violent campaign for an independent Basque nation in northern Spain and southern France, has yet to hand in its weapons.

The Interior Ministry said Gurruchaga, 30, joined ETA in 2008 and rose through the organisation's ranks to become its military and recruiting chief.

ETA is pressing for direct talks with the French and Spanish governments, but both have rejected any negotiations.

Spain has Fifth-Highest Proportion of NINIs
Almost one-quarter of those between the age of 18 and 24 in Spain are neither studying nor working (known as NINIs in Spanish), the fifth-highest proportion in the European Union (see Figure 1).

Figure 1. Young People who do not Work or Study (% of 18 to 24 year olds)

	2011	2007
1. Bulgaria	27.9	24.0
2. Italy	25.2	20.1
3. Greece	24.4	15.7
4. Ireland	23.9	12.5
5. Spain	**23.1**	**13.8**
9. UK	18.4	14.9
22. Germany	12.3	10.2

Source: Eurostat.

The increase in Spain's rate of NINIs between 2007, the economy's last 'normal' year, and 2011 was one of the highest among the 27 EU countries. Just over half of those aged between 16 and 24 are currently unemployed in Spain, double the country's overall jobless rate.

The Economy

The EU's €100 billion Rescue of the Banking System Fails to Calm the Markets
The EU's agreement to grant up to €100 billion for Spain's troubled banks did not assuage the markets and reduce bond yields and the risk premium –the difference between Spain's 10-year bond yields and those of low-risk Germany–.

The 10-year yield reached a new euro-era high of more than 7%, a level that triggered a full bailout of Greece, Portugal and Ireland (see Figure 2). Luis de Guindos, the Economy Minister, admitted the high yield could not be sustained for very long. The cost of insuring against a Spanish debt default rose 26 basis points to 621 bp, equating to annual costs of US$621,000 to insure US$10 million of debt over five years. The higher cost of credit default swaps underscored market nervousness.

Figure 2. 10-Year Government Bond Yields (%) and Spreads over Germany's Bunds (pp) (1)

	Yield (%)	Spread (pp)
Germany	1.41	-
Greece	26.19	+24.79
Italy	6.06	+4.66
Portugal	10.64	+9.23
Spain	**7.17**	**+5.66**

(1) 18 June.
Source: ThomsonReuters.

The rescue followed the part nationalisation of Bankia (hard hit by real-estate losses), the limited access to raising funds in the sovereign bond markets and a growing flight of capital (see Figure 3).

Figure 3. The Cost of Rescuing the Eurozone

	Rescue funds (€ bn)	GDP in 2011 (€ bn)	Funds as % of GDP
Greece	247, May 2010 and Feb 2012	215	87
Spain	**100, June 2012**	**1,100**	**11**
Portugal	78, May 2011	171	45
Ireland	67.5, November 2010	156	43

Mariano Rajoy, the Prime Minister, put a brave face on what represented a climb down from the government's earlier position that a rescue package was not needed at all. He portrayed the loan as a victory, a remark that irritated EU governments.

Rajoy insisted the loan was solely to recapitalise banks. He said that but for the reforms and austerity measures taken in his first five months in office 'what was put forward would have been a bailout of the Kingdom of Spain. Because we had been doing our homework, what did happen was the opening of a line of credit for our financial system'.

All the Eurozone leaders who agreed to accept a full bailout and stringent conditions have been voted out of their jobs. The Popular Party is still well ahead of the Socialists in opinion polls, though support for it has dropped.

Guindos claimed the loan 'has nothing to do with a rescue'. It came after the IMF issued a 77-page report which said the Spanish banking sector was suffering a 'crisis unprecedented in its modern history'.[1]

There are worrying parallels between Spain and Ireland's crisis, which began with banks weighed down by bad real-estate loans and dragged down the sovereign.

'The government wants us to believe we have won the lottery or the Three Kings have arrived and this is not the case', said Alfredo Pérez Rubalcaba, the leader of the Socialists, the main opposition party (referring to the 'Three Kings' or Three Wise Men, who are traditionally the bringers of Christmas presents).

If fully drawn, the loan would add 9.5 percentage points to Spain's public debt as a proportion of GDP, pushing it to 90% (35.5% in the first quarter of 2008).

Given Spain's double-dip recession and a jobless rate of 24%, the markets are concerned that Madrid will not be able to pay off the debt. The Spanish economy is twice as big as the other three rescued countries combined.

[1] http://www.imf.org/external/pubs/ft/scr/2012/cr12137.pdf.

Moody's downgraded Spain's credit rating by three notches on 14 June to just above junk status, but it still merited an investment grade rating because of 'the underlying strength of the Spanish economy and the government's clear desire to reverse the debt trajectory through a strong fiscal consolidation program'.

The weak part of the financial system is the savings banks (*cajas*). The number of *cajas* (unlisted and hence thinly transparent) has been reduced from 45 to nine over the last three years. Seven of them were merged in 2010 under the previous Socialist government to form Bankia through a shotgun marriage. Bad loans represented 8.72% of the system's total credit at the end of March, the highest since April 1974.

The two biggest banks, Santander and BBVA, which account for one-third of total assets and three-quarters of profits, are solid, although their ratings have been pulled down by the problems in the *cajas* and *ex-cajas* (now banks).

Spain's banking crisis is a classic one of imprudent lending and lack of oversight (hampered in the case of the *cajas* by politicians on their boards), similar to the US savings and loans crisis of 25 years ago, and nothing to do with sophisticated financial instruments. José Luis Rodríguez Zapatero, the former Prime Minister, boasted two years ago that Spain had 'perhaps the most solid financial system in the world'.

Construction and real-estate loans grew from 10% of GDP in 1992 to 43% in 2009, and amounted to about 37% of GDP at end-2011, according to the IMF report. Between 1997 and 2007, 5.7 million new homes were built, an estimated 680,000 of which are still unsold. The stock of unsold homes is around one million if unfinished properties are included. The banks have become major property owners as a result of unpaid mortgages and developers that went bust. House prices have fallen 25% since the peak of the property market in 2007 and are expected to decline a lot more.

The LeFrak Organisation, with one of the largest real-estate portfolios in the US, has expressed interest in acquiring Spanish homes if sold at sufficiently attractive prices.

The Madrid stock market, one of the word's worst performers, rallied in the week before the rescue was announced (+8%), but only rose 2.5% in the first week after it (see Figure 4).

Figure 4. Main Stock Market Indices (% change), 1 January- 18 June 2012

Index	
Ibex-35 Spain)	-23.9
Dax (Frankfurt)	+5.9
FTSE 100 (London)	-1.4
Euro Stoxx 50	-6.9
Dow Jones	+4.3
Nikkei (Tokyo)	+3.1

Source: Markets.

Meanwhile, it looked as if the government would win from the EU an extra year to lower its budget deficit to 3% of GDP from 8.9% in 2011. Oli Rehn, the EU's senior economic official, said Madrid could be given until 2014 provided it reined-in regional governments, responsible in 2011 for most of the overshoot in the overall budget deficit, from a target of 6% of GDP to 8.9%. Catalonia is the most indebted region (see Figure 5).

Figure 5. Regional Debts (% of regional GDP), 2011

Region	% of GDP
Andalusia	9.8
Aragón	10.2
Asturias	9.1
Balearic Islands	16.3
Basque Country	8.1
Canary Islands	8.8
Cantabria	9.3
Castilla y León	9.4
Castilla-La Mancha	18.0
Catalonia	20.7
Extremadura	10.9
Galicia	12.3
La Rioja	11.2
Madrid	7.9
Murcia	10.1
Navarre	12.9
Valencia	19.9
Combined deficit	13.1

Source: INE.

Bank Restructuring Entity Denounces Irregularities at Banco de Valencia, Bankia Investigated

The government's Fund for Orderly Bank Restructuring (FROB) denounced Banco de Valencia, which was nationalised last November, before the *Audiencia Nacional* court for alleged irregularities discovered during its investigation of the bank's accounts.

Banco de Valencia was headed by José Luis Olivas, a former Popular Party (PP) premier of the autonomous region of Valencia, for a decade. Olivas was also Chairman of the savings bank Bancaja, one of the seven *cajas* that merged in 2010 to create Bankia, which was part nationalised in May and of which he was Vice-chairman until he resigned in 2011.

In a separate but related move, Eduardo Torres-Dulce, Spain's Attorney General, ordered the country's anti-corruption unit to investigate whether there were grounds to take 'penal' action against the management of Bankia.

Bankia revised its 2011 results from a net profit of €309 million to a loss of nearly €3 billion and asked the state for a bailout of €19 billion, the largest bailout in Spanish history.

There is mounting public anger over the collapse of Bankia and the salaries of its directors. More than 350,000 shareholders, mainly small savers, have seen the shares they acquired in Bankia's €3 billion initial public offering last year plummet by more than 70%.

Several groups are planning a civil action against Bankia on the grounds that its prospectus 'did not reflect the true financial situation' of the bank. This would be the first such legal action in Spain.

Rodrigo Rato, the former Chairman of Bankia and Economy Minister in a previous Popular Party government during the 1990s, renounced a severance payment of €1.2 million so he can be free to work elsewhere in the financial sector.

The government is resisting calls to create an official commission to investigate Bankia.

Bank of Spain Governor Throws in the Towel before his Term Expires

Miguel Ángel Fernández Ordóñez, the Governor of the Bank of Spain since 2006, quit his post on 10 June, one month before his term expired, following the government's criticism of his handling of the country's banking crisis, sparked by the 9 May nationalisation of Bankia, the third-largest lender.

He was replaced by Luis María Linde, a former Director General of the Bank of Spain, who was appointed to the bank's board last month. As Linde is 67, he will only serve three years of the six-year mandate because 70 is the statutory age for retirement from the top central-bank post. This will enable the ruling Popular Party to appoint another governor who will remain in the post until 2021, well beyond the next two general elections scheduled, respectively, for 2015 and 2019. Elections are held every four years, unless brought forward, while the post of central bank Governor lasts six years.

Fernández Ordóñez, who held various key positions in previous Socialist governments, denounced a 'smear campaign' against the prestige of the Bank of Spain. He asked to be able to explain his management of the crisis to parliament, but the ruling Popular Party (PP) with a large majority, voted for him instead to appear before a closed-door committee. The refusal to allow Fernández Ordóñez to explain himself in public went against the spirit of the new Transparency Law.

The Socialists did not oppose the PP's move. Both parties are heavily involved in Spain's ailing and politically-influenced savings banks, seven of which formed Bankia in 2010, and neither side wants to open up a can of worms.

Fernández Ordóñez blamed the central bank's slow response to the banking crisis on the lack of appropriate regulations, the resistance of the central and regional governments to take measures and technical factors. He said the current and previous governments' reluctance to use public funds for rescuing banks meant a bank for toxic assets was ruled out, and the strong political and trade-union interests in the savings banks (unlisted institutions) hampered restructurings. Another factor was the continued deterioration of the economy (currently in a double dip recession), much longer than expected by all Spanish and international institutions.

Bank of Spain inspectors called for Fernández Ordóñez's resignation in a letter to Mariano Rajoy, the Prime Minister, dated 16 May. He announced he was quitting almost two weeks later.

The nationalisation of Bankia days after the Bank of Spain approved its proposals to meet new banking rules was the last in a series of events that questioned the central bank's credibility and further eroded the already flagging international confidence in the government. Bankia, most of whose board members are close to the ruling Popular Party, received €4.5 billion of public funds in 2010, and asked for another €19 billion on May 25.

The central bank's autonomy was also undermined by the government's decision to appoint two foreign consulting firms to conduct a valuation of the banks' books.

Fernando Restoy, the Deputy Chairman of the National Securities Market Commission, was appointed Deputy Governor of the Bank of Spain.

Large Companies Defend Spain's Solvency and Strengths
The chairmen of Spain's leading companies went on the offensive, saying the crisis was not as dire as that painted by international organisations and the media.

The Business Council for Competitiveness (*Consejo Empresarial de Competitividad*), headed by César Alierta, Chairman of Telefónica, the world's fifth-largest telecoms operator by total customers, said a risk premium –the difference between 10-year government bond yields and those of Germany– of 150 basis points was more consistent with Spain's economic fundamentals than the more than 500 bp charged at the moment by the markets.

The main points of their report issued almost three weeks before the banking system was rescued by EU funds are:[2]

- The economy, currently in a double-dip recession, will bottom out at the end of 2012.
- Total net external debt was 42% of GDP in 2011, a sustainable level.
- The budget deficit target of 5.3% of GDP this year is possible if assets are sold.
- Foreign direct investment is more than financing the current account deficit (around 2% of GDP this year compared with 10% in 2007), and the continued inflows (€19 billion in 2011 and a stock that represents 44% of GDP, double that of Germany) underscore the country's attractiveness.
- The ailing banking system, hit by the bursting of the property bubble as of 2008, can withstand a fall of up to 50% in house prices as the provisions for non-performing loans will represent by the end of the year around 20% of GDP. Prices have so far fallen by about half this amount.

[2] http://spainglobal.com/frame.htm?files/Informe-Crecimiento-y-sostenibilidad-de-la-economa-espaola.pdf.

- Labour market reforms (lower dismissal costs and more flexibility for companies in sector-wide wage bargaining agreements) will enable 700,000 jobs to be created in the medium term as these two factors are responsible for around half of the structural factors that explain Spain's huge differential with the average EU unemployment rate (currently 14 pp higher at 24%).
- Unit labour costs have fallen by almost 6% since 2009.
- Exports of goods have risen by €54.6 billion since 2009 to €214.5 billion in 2011, an improvement equivalent to 5.1% of GDP and a faster pace of growth than Germany, France and Italy, albeit from a smaller volume. The number of companies that exported last year was a record 122,987, 14% more than in 2009.
- Spain has a significant number of multinational companies.[3]

Food Exports Overtake those of Cars…

Exports of food surpassed those of the motor industry for the first time, even though the bulk of cars produced in Spain are sold abroad. Food exports were worth €538 million more than those of cars (see Figure 6).

Figure 6. Structure of Spanish Exports, First Quarter 2012

Sector	Value (€ mn)	% of total
Capital goods	10,269	18.8
Food	8,501	15.6
Motor	7,963	14.6
Chemical products	7,830	14.4
Semi-manufactured goods	6,397	11.7
Manufactured consumer goods	4,727	8.7
Energy products	3,904	7.2
Raw materials	1,467	2.7
Consumer durables	810	1.5
Total (including other exports)	54,445	

Source: Ministry of Economy and Competitiveness.

Car sales are generally a good barometer of the health of an economy, while food is less susceptible to and ups and downs of economic cycles. European car markets are increasingly feeling the pinch. Sales in Spain were 8% lower in May than a year earlier; the total number sold this year is forecast to be the lowest since records were first kept in 1989 and on a par with Morocco, whose economy is a tenth of the size of Spain's.

According to the Spanish Federation of Food and Drinks Industries, Spain could be exporting more processed food products than Italy within five years' time.

… High Tech Exports Remain Low

Spain is enjoying an export boom, though not as strong this year as in 2011 and 2010, but sales abroad of high-tech components still account for a relatively small proportion of total exports.

[3] See http://www.realinstitutoelcano.org/wps/wcm/connect/1c14da804b56129c9a2dfecd53a3a90d/Chislett_Atlas_Spain_Brand.pdf?MOD=AJPERES&CACHEID=1c14da804b56129c9a2dfecd53a3a90d.

According to the latest comparative figures from the World Bank, Spain's high-tech exports accounted for only 6% of the total in 2010 (see Figure 7), a low level given the degree of development and size of the economy, the Eurozone's fourth biggest.

Figure 7. Exports of High Tech Products by Selected EU Countries (% of the total)

	2010	2007
France	25	18
Hungary	24	24
UK	21	19
Germany	15	14
Sweden	14	12
Italy	7	6
Poland	7	3
Spain	**6**	**5**

Source: World Bank.

Tax Amnesty Comes into Force

The tax amnesty announced in March and aimed at securing €2.5 billion of extra revenue for the cash-strapped government came into force on 4 June and lasts until the end of November.

Individuals and companies can regularise their income tax situation by paying a 10% flat rate on previously undeclared income, with no penalties or criminal liability.

The Spanish Association of State Tax Inspectors called the amnesty 'unethical' as it 'undermines the conscience of honest taxpayers'. According to an opinion poll by Metroscopia, 76% of respondents reject the amnesty because it is unjust and only 19% support the government's thesis that it is an extreme decision at a difficult time for the economy.

The opposition Socialist party is seeking a court injunction to paralyse the amnesty.

The move is similar to one taken by the Italian Prime Minister Mario Monti, who last November decided to expand the tax amnesty put in place by his predecessor Silvio Berlusconi in 2009.

Spain's Public Pensions among the more Generous

Spaniards receive the sixth-highest public pension among the 34 OECD countries in terms of the pension as a proportion of net earnings (see Figure 8).

Figure 8. Public Pension Payouts: Net Replacement Rates for Average Earners (% of salary)

	Pay as you go (PAYG)
Greece	111.2
Austria	89.9
Spain	**84.9**
Italy	71.7
France	60.4
Germany	56.0
UK	37.4

Source: OECD Pensions Outlook 2012.

Private pensions are voluntary in Spain and the income they provide accounts for a very small share of incomes in old age. Less than 20% of Spain's working-age population has a private pension plan, a situation that is worsening because of the country's very high unemployment rate (24%).

Various pension reforms were made last year, as part of austerity measures to cope with growing pressure on the system from the rapidly ageing population and narrow the gap between contribution revenues and expenditures (currently estimated at 5% of GDP for Spain in 2060). Spain's life expectancy at normal pension age rose from 13.1 years in 1958 to 18 in 2010.

The normal pension age is to be increased from 65 to 67 between 2013 and 2027 and the early pension age lifted from 61 to 63 (61 in times of economic crisis). The number of years of contributions for full benefit has been increased from 35 to 37. There will also be an automatic link between pension parameters and life expectancy as of 2027.

Corporate Scene

Repsol to Invest €19.1bn, Abandons Oil Drilling in Cuban Waters
Repsol plans to invest €19.1 billion over the next four years in a bid to recover from the nationalisation in April of its YPF unit in Argentina. At the same time, it announced it would cease drilling for oil off the coast of Cuba as its exploration well had come up dry.

More than three-quarters of the investment will be spent on exploration and developing new oil discoveries. The goal is to increase production from 300,000 barrels a day in 2011 to 500,000 barrels in 2016, excluding YPF. The focus will be on other countries in Latin America, particularly Brazil. Last month Repsol announced that three recent discoveries by its Brazilian unit Repsol Sinopec contained an estimated 1.2 billion barrels of oil equivalent.

Repsol was drilling in Cuba with Statoil of Norway and ONGC of India. They got round sanctions under the US trade embargo on Cuba by using a rig with less than 10% of US technology. Other international oil companies are still exploring the area.

Antonio Bufrau, Repsol's Chairman, said the investment would be financed from the company's cash flow and would not involve increasing its debt.

Telefónica to Cut its Stake in China Unicom by Half and Spin off German Unit and some Latin American Assets
Telefónica, the world's fifth-largest telecoms operator by total customers, is to sell close to half its stake of 9.6% in China Unicom to its parent group, China United Network, for €1.1 billion in order to reduce its debt.

The move, which cuts its stake to 5%, followed an earlier announcement to sell its German division and some Latin American assets in order to reduce its debt. The company has not yet spelled out which Latin American subsidiaries might be sold or when the listings would take place.

Telefónica entered China Netcom in 2005 as part of an international diversification strategy and almost doubled its holding in 2011.

The disposal is similar to that of Banco Santander, Spain's largest bank, which is in the process of selling its Colombian business to Chile's Corpbanca for US$1.16 billion as part of a plan to plug, in its case, a capital shortfall in the wake of Spain's property crash.

Abengoa to Build Big Solar Energy Farm in California
Abengoa, the renewable energy developer, is to build one of the largest solar energy farms in the US in California's Imperial Valley in a contract worth US$360 million.

Inditex Bucks the Profits Trend
Inditex, the owner of the Zara clothes chain, increased its net profits 30% to €432 million in its first quarter and during this period (February to April) opened 91 stores in 26 countries. Inditex's fiscal year ends in January and not in December.

Técnicas Reunidas Wins First Contract in Canada
Técnicas Reunidas, the engineering company, won a €615 million contract from an Alberta oil-sands operator to execute the engineering, procurement and construction of bitumen upgrading facilities.