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William Chislett

Summary

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Foreign policy

Spain and the UK: between a rock and a hard place over Gibraltar

The installation of a concrete reef by Gibraltar in disputed waters off the British territory, designed to encourage sea-life to flourish, enraged Madrid, which has long claimed sovereignty over the Rock at the southern tip of the country.

As a result of the 70 concrete blocks dropped on the seabed, Madrid imposed extra border checks on the Spanish side that have caused lengthy traffic queues of up to eight hours. Spain has similar reefs for environmental purposes in various areas of the Spanish coast.

British diplomats say there is little room for doubt in international law that the waters are British, despite the Spanish government's argument that they were not specifically referred to in the 1713 Treaty of Utrecht under which Spain ceded the territory to Britain.

Map 1. Gibraltar

Source: The New York Times.

Real Instituto Elcano

Spain also threatened to charge €50 to cross the border, saying that the additional revenue could help compensate Spanish fishermen for their losses.

The UK government London says the checks are excessive and break EU free-movement rules. The conservative Popular Party (PP) government of Mariano Rajoy insists they are needed to control smuggling, particularly of cigarettes. An EU team was due to arrive this month to monitor the border.

In a move that was reminiscent of the conflict over the Falklands in 1982 (another relic of the British Empire, invaded by Argentina), the Royal Navy's HMS Westminster docked in Gibraltar in the middle of August after a flotilla of Spanish fishing boats staged a protest about the reef.

In a reversal of the Spanish Armada, the Spanish fleet that sailed against England in 1588 and was defeated, other British warships joined HMS Westminster in what UK defence officials called a long-scheduled deployment in the Mediterranean and the Gulf. A British aircraft carrier, the Illustrious, sailed along the Spanish coast as part of the military training exercise.

Obviously, the two countries are not going to war. Spain, however, has threatened to join forces with Argentina and take the sovereignty issue to the United Nations, while the British government might take the case of border controls to the European Court of Human Rights.

In Spain, the spat between fellow members of NATO and the EU is seen as a diversion from the country's five-year recession and tough austerity measures, and the slush fund scandal in which the PP is embroiled.

The Gibraltarian economy is flourishing; it grew by 8% in 2012. Some 7,000 Spaniards cross the border every day to work from an area, known as the Campo de Gibraltar, whose unemployment rate is officially 40%.

José Manuel García-Margallo, Spain's Foreign Minister, told Parliament that Gibraltar owed its success to an offshore economic model based on 'deregulation, opacity and low taxation'.[1]

The squabble comes at a time when Gibraltar is celebrating 300 years of British rule. The anniversary has been marked by a set of four Gibraltarian stamps, which bear the Union Jack, a portrait of Queen Elizabeth and the words from the Treaty 'for ever, without any exception or impediment whatsoever' which Madrid regards as provocative.

While the previous Spanish government of the Socialist José Luis Rodríguez Zapatero (2004-11) sought to ease the tone over the contentious issue of sovereignty by agreeing to set up with London a trilateral forum (Spain, the UK and Gibraltar) to air grievances other than sovereignty, the PP killed this initiative

[1] The Minister's views are set out in an article for the *Wall Street Journal*. See http://online.wsj.com/article/SB10001424127887323639704579016690754718488.html.

by insisting on widening the forum to include local interests in the Campo de Gibraltar. The UK and Gibraltar rejected this. Had the trilateral forum still existed, Gibraltar would probably have informed the Spanish government about the reef and the current situation might have been avoided.

The Spanish and UK governments were studying the creation of some kind of mechanism to sort out the dispute. The devil is in the detail.

The PP government 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.

The trilateral forum was a modest step in winning the hearts and minds of Gibraltarians. The PP government's heavy-handed response to the artificial reef, though it has legitimate concerns over other issues such as money laundering, has only served to harden Gibraltarian attitudes to Spain and remind them of previous crises, particularly the closing of the border in 1969 by General Franco (not re-opened until 1982).

The preamble to the Constitution declares that 'Her Majesty's Government will never enter into arrangements under which the people of Gibraltar would pass under the sovereignty of another state against their freely and democratically expressed wishes'. In other words, Gibraltarians have the last word and it is highly unlikely they would ever vote to come under Spanish rule or even some kind of shared rule (the idea, as opposed to an actual agreement, was rejected in a 2002 referendum by 98.9% of votes, although it carried no legal weight).

Domestic scene

Catalans form massive human chain in push for independence
Catalans joined hands on their national day to form a human chain that stretched 480km from the border with France to the southern end of the region, in a move aimed at intensifying the pressure on the central government in Madrid for a referendum on independence.

The Popular Party government has not changed its position on the referendum, which requires its permission, as the Spanish constitution gives Madrid 'exclusive competence' on the authorisation of referendums. The only legal way to trigger a process that results in the independence of any region is through a constitutional amendment, which would require a large majority in the Spanish parliament, new elections and approval in a referendum held throughout the country.

The government reiterated its position that it is only prepared to discuss improvements to Catalonia's financing arrangements. Catalan nationalists claim they get a raw deal. Artur Mas, the Catalan centre-right Premier, complained in an article in the New York Times that Catalonia pays out more on average than other regions to the central government but receives less public expenditure per capita in return.[2]

[2] See http://www.nytimes.com/2013/09/11/opinion/global/a-referendum-for-catalonia.html?_r=0.

Mas, anxious to avoid a collision with the central government, appeared to be more conciliatory and offered to put back the referendum from 2014, the date first suggested, to 2016 after the next general election in Spain scheduled to be held no later than November 2015. He said he would strive for a negotiated settlement 'until the end'.

This change of strategy angered the more radically pro-independent Catalan Republican Left (ERC), which supports Mas's minority government and whose popularity is on the rise. The ERC won 11 more seats in the November 2012 parliamentary election in Catalonia for a total of 21 and Mas's Convergence and Union (CiU) lost 12 seats for a total of 50 in the 135-seat parliament.

The Socialists also reject the referendum, but accuse both Mas and Prime Minister Mariano Rajoy of inflexibility. They defend a reform of the constitution to make Spain a more federal state.

Meanwhile, the European Commission made it crystal clear that any breakaway territory would cease to be part of the EU and would have to renegotiate membership. 'If one part of a territory of a member state decides to separate, the separated part is not a member of the European Union', said the Commission's Spanish Vice-president, Joaquin Almunia.

Socialists edge ahead of the Popular Party in voting intention
For the first time since the Popular Party (PP) won the November 2011 general election, the Socialists would very narrowly win an election if held this month, according to a poll by Metroscopia (see Figure 1).

Figure 1. Voting Intention (% of valid votes) (1)

	November 2011 election	September 2013
Popular Party	44.6	30.1
Socialists	28.7	30.5
United Left	6.9	11.6
Union, Progress and Democracy	4.7	9.0

(1) Based on a voter turnout of 62%.
Source: Metroscopia.

The slush-fund scandal of Luis Bárcenas, the former PP treasurer in prison since June pending trial, and the continued high unemployment rate are taking a toll on the PP. Prime Minister Mariano Rajoy denies any knowledge of the fund and benefiting from it personally. Much of the funds came from construction companies in return for favours.

The Bárcenas case has eroded public trust in Rajoy: only 35% of PP voters said they had confidence in him, compared with 71% when he won the election.

September's results are based on a voter turnout of 62%, compared with 71.7% in 2011.

The economy

A glimmer of light in Spain's recession, thanks to exports and tourism…

The government returned from the summer break with some good news to trumpet. The economy shrank by only 0.1% in the second quarter over the first, according to INE, the National Statistics Agency.

This was the slowest pace of decline in two years (-0.4% in the first quarter) and suggests a recovery is finally underway, albeit a mild one and still with very high unemployment. Year-on-year growth was 1.6% negative.

Furthermore, the continued boom in merchandise exports and in tourism, which has prevented Spain's recession from being deeper, helped Spain to generate a current account surplus of €1.35 billion in the first half, compared with a deficit of €16.97 billion in the same period of 2012, according to the Bank of Spain.

Around 100,000 companies are now regularly exporting, about half the total number, compared with about 40,000 before the onset of the crisis in 2008. This is a significant change.

The trade deficit was €2.71 billion, down from €15.64 billion in the first six months of 2012. This was due to a 9.4% growth in exports and a 1.7% fall in imports. The imported energy bill remains high.

The overall balance of payments (current and capital accounts) –a country's financing capacity or need– was €5.24 billion positive as against €14.58 billion negative. This was the first half-year surplus since 1997.

Food exports surpassed those of vehicles, traditionally a major item, and sales outside of the EU, the main destination, rose further, particularly to the Middle East (see Figures 2 and 3).

In the first half of the year, 34 million tourists came to Spain, 3.9% more year-on-year.

Figure 2. Exports by sectors, first half of 2013 (% of the total)

	% of total	Change 13/12	Rep (1)
Capital goods	21.2	18.7	3.6
Food	15.1	6.7	1.0
Automotive	14.5	5.9	0.9
Chemical products	14.3	6.8	1.0
Non-chemical semi-manufactured goods	10.8	-3.2	-0.4
Consumer manufactures	8.4	11.9	1.0
Energy products	6.9	10.7	0.7
Other goods	4.8	0.4	0.0
Raw materials	2.7	4.3	0.1
Consumer durables	1.5	2.2	0.0
Total	100.0	8.0	8.0

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

Figure 3. Distribution of exports by geographic areas, first half of 2013 (% of the total)

	% of total	Change 13/12	Rep (1)
Europe	69.4	4.5	3.2
Euro zone	48.6	4.7	3.0
North America	4.3	2.9	0.1
Latin America	6.2	9.4	0.6
Asia	9.1	18.1	1.0
Middle East	3.6	41.4	1.1
Africa	7.1	17.8	1.2
Oceania	1.1	36.3	0.3
Total	100.0	8.0	8.0

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

While the US, the UK, Germany, France and Italy have lost global market share to varying degrees over the last decade, mainly to China and other emerging countries, Spain's share of world merchandise exports has remained virtually unchanged at around 1.6% (see Figure 4), according to the World Trade Organisation (WTO).

Figure 4. Global market share of merchandise exports, 2000-12 (%)

Country	2000	2009	2010	2012
China	3.9	9.6	10.4	11.2
US	12.3	8.5	8.4	8.4
Germany	8.7	9.0	8.3	7.7
France	4.7	3.9	3.4	3.1
Italy	3.71	3.2	2.9	2.7
UK	4.5	2.8	2.7	2.6
Spain	**1.8**	**1.7**	**1.6**	**1.6**

Source: World Trade Organisation.

The macroeconomic reduced the risk premium on Spain's 10-year government bonds over German equivalents improvements and spurred the Madrid stock market and (see Figures 5 and 6). The yield on these bonds, which move inversely to prices, was below 4.50% in September, down from a peak of 7.75% in July 2012 and lower than Italy for the first time in more than a year. The average interest rate paid on debt issued by Spain's Treasury was 2.61% in just over the first eight months of the year. Morgan Stanley advised investors to buy 10-year Spanish government bonds and sell similar-dated Italian bonds. The Ibex-35 benchmark index reached a high for the year of 8,999,50 on 16 September.

Figure 5. Main Stock Market Indices (% change), 1 January- 17 September 2013

Index	
Ibex-35 Spain)	+10.9
Dax (Frankfurt)	+12.9
FTSE 100 (London)	+11.4
Euro Stoxx 50	+9.6
Dow Jones	+18.5
Nikkei (Tokyo)	+37.6

Source: Markets.

Figure 6. 10-Year Government Bond Yields (%) and Spreads over Germany's Bunds (pp) (1)

	Yield (%)	Spread (pp)
Germany	1.97	-
Greece	10.38	8.41
Italy	4.53	2.56
Portugal	7.14	5.17
Spain	**4.41**	**2.44**

(1) 17 September.
Source: ThomsonReuters.

… but unemployment hardly abates…

Unemployment fell by 225,000 in the second quarter to just below 6 million, the largest drop in more than five years, and the rate declined by 0.9 points to 26.3% (see Figure 7). Most of the 150,000 jobs created, however, were seasonal ones in tourism. The number of part-time jobs reached a record 2.75 million, 16.4% of total jobs. This rise is due to last year's labour market reforms which made these jobs more flexible.

Figure 7. Unemployment rates of Spain's regions, June 2013 (%)

Region	Unemployment rate
Andalusia	35.8
Aragón	21.9
Asturias	24.4
Balearic Islands	21.0
Basque Country	15.4
Canary Islands	33.7
Cantabria	22.3
Castilla and León	21.3
Castilla-La Mancha	30.3
Catalonia	23.8
Extremadura	33.7
Galicia	22.4
La Rioja	20.7
Madrid	19.5
Murcia	29.1
Navarre	18.3
Valencia	20.1
Spain	26.3

Source: INE.

Employment Minister Fátima Báñez unveiled plans to reduce the number of work contracts from 41 to five, which she said would make it easier for SMEs, in particular, to hire people.

The government has already lowered the cost of firing workers and given firms more flexibility to opt out of collective wage agreements and strike arrangements at company level.

The IMF proposed a pact in August between trade unions, employers and the government under which workers would accept further wage moderation in return for job creation and the government would reduce social security costs. All sides rejected it for a variety of reasons. According to an IMF simulation, based on a 10% wage cut, such a pact could result in the unemployment rate falling by 6 to 7 percentage points. Oli Rehn, the European Commissioner for Economic and Monetary Affairs, called for the idea to be given a try.

… and public debt surpasses 90% of GDP
Public debt continued to climb and stood at €942.7 billion at the end of June (92.2% of GDP), according to the Bank of Spain. This was higher than the forecast for the whole year.

In 2007 the debt represented 36.3% of GDP, one of the lowest levels in the EU. It is now higher than Germany's and the UK's.

Pension reform to end automatic indexation to inflation
Pension payments will rise by a minimum of 0.25% as of next year, well below expected inflation rates, and the maximum increase, when the system can afford it, will be capped at inflation plus a 0.25 pp top up.

The pay-as-you-go pension system in its current state is unsustainable, due to a combination of demographic factors (low birth rate and ageing), high unemployment, which has reduced the number of workers per retiree and weakened the financial health of the social security, and pension rises in pre-crisis years that cannot be sustained.

The reforms follow a report by a committee of experts that proposed a 'sustainability factor' (an annual formula for updating pensions). This formula is based on an intergenerational equity factor and an annual growth factor. The first one updates pension benefits for life expectancy –for a given base contribution history, an increase in the retirement period means a decline in the monthly pension benefit–. The other is a complex formula that determines the annual increase in pension benefits (see Figure 8). The reforms aim to ensure the system's solvency by adjusting pensions to balance the system.

Figure 8. Sustainability factor formula for annual pension benefit growth

Annual benefit growth	=	Average inflation	+	Growth of revenues in real terms	–	Growth in the number of pensions	–	Difference of new less expiring pensions	+	Convergence speed	x	Structural surplus or deficit of system

Parliament is expected to approve the reforms, which will help to reduce the budget deficit, by the end of the year.

Spain moves up a notch in competitiveness ranking, but weaknesses persist
Spain rose one notch in the World Economic Forum's Global Competitiveness Index 2013-14 to 35th place, but its already low position in three of the 12 categories that determine the overall rankings –macroeconomic environment, financial market development and labour market efficiency– worsened (see Figures 9 and 10). In the case of macroeconomic fundamentals and financial market development, the deterioration stemmed from the country's still unresolved crisis, though progress has been made in both areas, and in the other one, the impact of labour market reforms has yet to be felt and the reforms are also considered to be insufficient. The rankings are based on data in some areas and perceptions in others (drawn from surveys).

Figure 9. The Global Competitiveness Index 2013-14 rankings and 2012-13 comparisons

Country	2013-14 rank out of 148	2012-13 rank out of 144
Switzerland	1	1
Finland	2	2
Germany	4	6
US	5	7
UK	10	8
France	23	21
Spain	**35**	**36**

Source: World Economic Forum.

Figure 10. Components of the Global Competitiveness Index

	Rank (out of 148)	Rank (out of 144)
Basic requirements (20% of the index)	38	36
Institutions	58	48
Infrastructure	10	10
Macroeconomic environment	116	104
Health and primary education	30	36
Efficiency enhancers (50% of the index)	28	29
Higher education and training	26	29
Goods market efficiency	63	55
Labour market efficiency	115	108
Financial market development	97	82
Technological readiness	26	26
Market size	14	14
Innovation and sophistication factors (30%)	32	31
Business sophistication	33	32
Innovation	34	35

Source: Global Competitiveness Reports, World Economic Forum.

The three most problematic factors for doing business are access to financing (138th), inefficient government bureaucracy and restrictive labour regulations. While Spain has obtained access to international financing markets at a more affordable cost, this has not resulted in easier access to loans for local companies, which still suffer from a very tight credit squeeze.

The country's main strength is its world-class transport infrastructure (6th) and –despite the very high unemployment rate– a large and skilled labour force, thanks to one of the highest tertiary education enrolment rates (8th). Spain scores particularly well in availability of scientists and engineers (18th). However, there are nowhere near enough jobs for them as Spain's economy is a long way from being knowledge-based. The country's capacity to retain talent is ranked 102nd, down from 82nd in 2012-13. The substantial drop in this ranking underscores Spain's brain drain: bright young scientists are increasingly working abroad.

Trade union membership remains unchanged over a decade

Spain's trade union affiliation stood at 16% between 2001 and 2011 and remained below the average for OECD countries (see Figure 11). The unions wield an influence out of proportion to the low membership.

Figure 11. Trade union membership, 2001 and 2011, in OECD countries

	2001	2011 (1)
Iceland	88.1	79.4
Sweden	77.3	67.7
Italy	34.2	35.1
UK	29.6	25.8
Germany	23.7	18.5
OECD	19.9	17.5
Spain	**15.9**	**15.9**
France	7.9	7.6

(1) 2011 or latest year available.
Source: OECD, Trade Union Density 2011.

Corporate scene

Leading companies generate higher share of revenues abroad
The companies that form the Ibex-35 benchmark index of the Madrid Stock Exchange generated 62% of their revenues abroad in the first half of the year, up from 60.4% in the same period of 2012 (see Figure 12).

Total revenues were slightly lower, however, at €230.2 billion, compared with €232.6 billion in 2012.

Figure 12. International revenues of Ibex-35 companies, first half 2013 (€ mn and % of total revenues)

Company	Sector	Total revenues (€ mn)	International (% of total)
Abengoa	Technology	3,402	82.2
Abertis	Motorways	2,305	63.8
Acciona	Construction	3,255	41.2
Acerinox	Metals	2,072	91.2
ACS	Construction & services	19,121	84.6
Amadeus IT Holding	Travel technology	1,595	94.9
Banco Popular	Banking	2,574	8.0
Banco Sabadell	Banking	2,462	3.8
Banco Santander	Banking	26,373	80.6
Bankinter	Banking	744	0.0
BBVA	Banking	11,831	63.8
BME	Stock market operator	151	0.0
Caixabank	Banking	4,769	0.2
Día	Supermarket chain	4,864	54.8
Enagás	Electricity	631	1.9
Endesa	Electricity	15,087	38.3
FCC	Construction	3,134	41.9
Ferrovial	Construction	3,758	67.0
Gas Natural	Gas	12,895	44.9
Grifols	Pharmaceutical	1,381	92.1
IAG	Airline	8,039	86.9
Iberdrola	Electricity	16,836	53.7
Inditex	Fashion retailer	7,655	80.7
Indra	Electronics	1,490	57.5
Jazztel	Telecoms	487	0.0
Mapfre	Insurance	9,239	61.8
Mediaset (Telecinco)	Media	425	1.6
OHL	Construction	1,685	74.2
Red Eléctrica	Electricity	856	1.9
Repsol	Oil	29,144	50.9
Sacyr-Vallehermoso	Construction	1,679	52.0
TécnicasReunidas	Engineering	1,395	96.4
Telefónica	Telecoms	28,563	76.9
Viscofan	Artificial casings	387	72.5
Total		230,283	62.0

Source: National Securities Market Commission.

First half bank earnings improve

Bank profits began to improve in the first half of 2013, largely as a result of setting aside a smaller proportion of income to cover bad loans. The net profit of Santander, the euro zone's largest bank by market capitalisation, jumped 29% year-on-year to €2.26 billion and almost more than for the whole of 2012. Non-performing loans accounted for 5.18% of Santander's overall loan book, half the average for the whole banking sector in Spain.

BBVA, the second-largest Spanish bank, came close to doubling its profits in the first half. Net earnings rose 95% to €2.88 billion. Both Santander and BBVA, whose combined assets in Spain account for around one-quarter of the country's total, were helped by their units abroad, which offset the poor results in their domestic market (see Figures 13 and 14).

Emerging markets accounted for 56% of Santander's profits and 58% of BBVA's gross income.

Figure 13. Distribution of Santander's attributable profit (% of total) by operating segments, first half of 2013 (1)

	% of total
Brazil	25
UK	13
Mexico	12
US	12
Spain	**8**
Rest of Latin America	8
Chile	6
Poland	5
Rest of Europe	5
Germany	5
Portugal	1

(1) Excluding Spain's run-off real estate.
Source: Santander.

Figure 14. Distribution of BBVA's gross income by countries (% of total), first half of 2013

	% of total
Spain	**29**
Mexico	28
South America	23
US	10
Turkey	5
Rest of Europe	3
Asia	2

Source: BBVA.

Bankia, the nationalised savings bank which received €24 billion in EU aid, posted a profit of €192 million in the first half after suffering Spain's biggest-ever corporate loss in 2012 (€19.02 billion).

While profits improved, the banking sector's non-performing loans continued to rise and at the end of June (latest figure) reached a record 11.6% of total loans. This figure excludes the bad loans in the 'bad bank' Sareb.

Sareb made its first sale of real estate assets valued at €100 million to private equity group HIG Capital in August.

The Bank of Spain released the definitive figures for 2012. Banks' consolidated losses amounted to €55.58 billion compared with a profit of €1.5 billion in 2011 and a profit of €20.17 billion in 2009. Most of the losses (€45 billion) came from banks in the government's state bank rescue fund known as Frob.

The return on assets dropped from 0.54% in 2009 to -1.39% in 2012.

FCC wins €6 billion construction contract in Saudi Arabia
FCC was awarded one of the contracts to build the Riyadh metro, the longest in the world.

The €6 billion follows the awarding of the contract in 2011 to a Spanish-Saudi consortium including OHL to build and operate the high-speed railroad between Mecca and Medina.

FCC, together with Samsung (Korea), Alstom (France) and other companies, will build lines 4, 5 and 6 of the city's subway system.

Ferrovial to build first cable-stayed bridge in Ontario for €78 million
Ferrovial, another of Spain's big construction companies, is to construct the first cable-stayed bridge in the Canadian province of Ontario for €78 million.

Telefónica wins UK contract to provide smart meter technology
Telefónica was awarded a contract worth around €1.5 billion to provide the technology behind the national rollout of 53 million 'smart' utility meters across the UK.

Técnicas Reunidas to build natural gas plant in Algeria
The engineering company Técnicas Reunidas won the €750 million contract to design and build the natural gas processing plant in Algeria with the capacity to produce 13 million cubic metres of the fuel a day.