Spain

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Economic recovery has continued helping to stabilize government balances. Reforms still need to be accelerated, though, to sustain good performance to face future challenges including pension costs. Also, good news has been supported by cyclical improvements and less so by government policies. Stronger headwinds beyond the medium term could expose latent vulnerabilities.

Summary and conclusion

Economic recovery continues: Since the financial crisis of 2012, Spain has come a long way to stabilize its economy in particular as the fiscal deficit is brought down to less than 3%/GDP. In 2017, growth once again ended at 3 %. It will slow in the current year but still show a decent 2,5% rate of expansion. The external balance is in a steady surplus on the current account and inflation is moderate but clearly out of any depression scenario. The banking sector is improving with non-performing loans falling below 10% of banks' total loan books.

Qualifications: However, this optimism comes with certain qualifications. Much of the improvements stem from the external environment and a domestic cyclical recovery rather than stronger fiscal policies or invigorated reform efforts. Intrinsic strengths have lagged the apparent ones in many areas, including

- pension rights where reforms must prevent a return to growing deficits in the social security budget as the workforce declines early in the next decade for demographic reasons and emigration
- government finances: the fiscal deficit is vulnerable to higher interest rates from ECB and the latter may not be immune to more rapid Fed hiking than currently expected
- high government debt: at almost 100%/GDP this is not as extreme as in some other peripherals, but high enough to raise market concerns if combined with other adverse developments in the future

So far markets have remained overall calm to these and other underlying vulnerabilities. Treasury rates have been little affected by incipient financial turmoil in Italy of recent weeks. However, Spain's unfavorable Target-2 imbalances continue to grow having reached a third of annual GDP, almost as high as during the financial crisis in 2012. On a net basis, foreign direct investors are also turning away from Spain in contrast to the situation just a few years back. Their motivation may differ, but many of them may be aware of longer term uncertainties including political fragmentation in Madrid and the unresolved questions of secessionist movements.

Ratings: The external agencies have provided positive rating actions over the recent 12 months period referring to improved macro-economic metrics. We are less impressed against a backdrop of weakening political resolve to implement unpopular reforms or counter resistance from vested interests. While these problems may not come to a head anytime soon, if allowed to fester they may post a greater challenge for the next decade

Recent developments

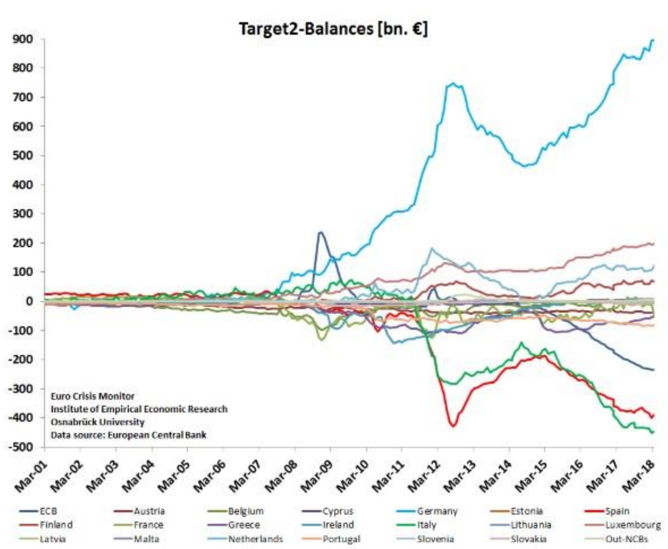
Decent growth continues: Growth moderated slightly last year, down 0,3pp (percentage point) from the year before but still achieved a decent rate of expansion at 3% driven by domestic demand and exports. For this year growth is expected to slow further to a rate of 2,5% reflecting softening demand in major export markets and reduced slack in the labour market notwithstanding still double digit unemployment numbers. The year started at a high note with 0,7% growth quarter on quarter (QoQ) the same as in the second half of 2017 but some momentum appears to have been lost in recent months as reflected in weaker than expected PMI (Purchasing Managers Index) and also softer retail sales and industrial production in April. Further intensification of the threatening global trade war and political turbulence in neighbouring Italy with financial sector spill overs in that country may also have taken a toll on investor optimism. As imports are set to outpace exports in the current year and consolidation of government finances continues, headwinds are rising for the economy. Some observers are seeing a sharper downturn of growth prospects to only 2,3% in 2018.

Unemployment drops further: Last year unemployment dropped by almost 2pp to 16,7% of the labour force as the economy created 2,6% new jobs. The ongoing labour market improvements with unemployment now down 10pp from the peak of more than 26% in 2013 reflects both structural shifts in the Spanish economy and improved competitiveness. The construction sector has almost halved over recent years and has been replaced by an expanding services sector which is both more job rich and export oriented. As a result there has been a net gain in the generation of new jobs. At the same time, wage moderation has helped improve competitiveness. Unit labor costs have dropped 17% since 2008 according to some estimates helped by labor market reforms undertaken since 2012.

Unemployment still high and could remain double digit for many years. About half of all job-seekers have been unemployed for at least a year -- that is long term unemployed. Moreover the unemployment rate among youth is still twice the national average. This is in part due to changes in the market where most new jobs are on short term contracts normally representing low skilled jobs where employers have few incentives to train workers in contrast to workers in "indefinite" jobs. Short term contracts mean frequent job changes up to ten times or more a year. The danger is such may cement higher unemployment as these conditions erode work practices and attitudes eventually rendering workers less attractive on the market. The rapid fall in the unemployment rate also masks a growing rate of involuntary part time employment.

Price inflation at less than 2%: in 2017 consumer price inflation shot up from negative rates to 2% growth reflecting higher global oil prices which combined with hiked domestic tariffs for power. As the carry-over effects of these events are fading, price pressure for the current year is set to recede to around 1,6% on an annual basis provided as expected recent increases of the minimum wage of an accumulated 12% should have secondary spill-over effects on the national wage formation. After a steep fall since the Global Financial Crises (GFC) house prices have begun to rise again ending 6-7% higher by the end of last year.

External Balances: Solid merchandise exports, one of the main planks of Spain's recent recovery, is set to continue into the current year growing 18% in terms of value. Also exports of services continue growing including tourism but are increasingly accompanied by exports of professional and IT services. Notwithstanding strong growth of imports the current account surplus will remain solid at 1,6%/GDP, only slightly lower than last year. The capital account, in return,



is dominated by large scale capital flight in part reflecting sales of government bonds to the ECB under its quantitative easing program when the recipients continue to put the proceeds into banks of other countries while these are not willing to return the liquidity back to Spain. A rebalancing transaction then takes place between the central banks of Spain and the same of other Eurozone countries registered as so-called Target-2 balances (Conf. chart) to “close the circle”. This has resulted in a mounting imbalance between Bank of Spain on the one hand and mainly Bundesbank on the other. The persistent net FDI outflows over recent years also suggest negative sentiment on Spain among parts of the investor community. Last year these outflows amounted to $22bn, almost 2%/GDP.

Net external debt still deep in the red: Net external debt is lowly coming down and has dropped 6pp since 2015 reducing the net debt level to 89%/GDP – a far cry from the 6% net debt with the average of peers in the same rating class. That is a legacy of Spain’s accumulation of often large current account deficits in the past peaking at almost 10%/GDP before the GFC. Spain’s net international investment position is likewise also very negative to the tune of 86%/GDP (end 2016).

Policies

Spain graduates from the EDP. Last year the deficit narrowed further to 3.1%/GDP, 1.2pp below the result of 2016. That was much supported by reduced unemployment benefits and reduced interest payments on outstanding government’s debt. In the current year the deficit is set to decrease to 2.5%/GDP reflecting continued drop in unemployment and overall higher government revenues despite announced tax cuts for low income households. Provided the actual budget shortfall comes in below the 3%/GDP limit, Spain should finally able to mature from the excessive deficit procedure (EDP) of the European Commission.

Medium term projections: Based on recent trends the government projects the deficit to fall to less than 0,5%/GDP at the beginning of the next decade. Last year, the government financing requirements peaked at €34bn. about 18%/GDP without causing market concerns. That pattern stands to be repeated in the current year when the requirement drops off to 16%/GDP. For the next few years, the annual financing requirement is estimated to ease further as the remaining debt has quite long maturity of more than 7 years. Half of that debt is owed non-resident investors while almost all of it is denominated in euros.

But not yet out of the woods. Since the government deficit peaked at 11%/GDP in 2009, consolidation has come a long way. That said, though, last year Spain was still running one of the largest budget deficits in the Eurozone. That was in part due to the lower rate of increase in tax revenues than overall economic growth in nominal terms regardless of robust employment growth. The problem is that the new jobs are mostly in low productivity sectors with lower wage levels than in the sectors they replace. As a result, also social security contributions have begun to lag employment growth. In 2016, the social security budget turned into a shortfall of 1,6%/GDP. The number of pensioners will now continue to rise and combine with higher pension costs for the newcomers.

Rising structural primary deficit: The consolidation of Spain's budget deficit much belies the underlying fundamentals. Most of the improvement is actually due to recent years' more favorable economic environment and has less to do with fiscal policies. On the contrary, the structural primary deficit, the part which the government has direct control over, has actually deteriorated from a surplus of 1,5% /GDP in 2014 to a deficit of 0,3%/GDP in 2017.

High government debt for the foreseeable future. The structural deficit means that Spain's fiscal position will remain vulnerable to shocks for years going forward. Last year the debt/GDP level peaked at almost 100% and is estimated to fall to around 98% by the end of the current year. That is still up by more than 50pp from before the GFC. The government projects the debt ratio to fall below 90%/GDP by 2022. For that scenario to unfold will depend on relatively favorable circumstances including continued decent global growth and domestic interest rates rising no more than 200bsp for government bonds. Also, domestic developments must avoid misguided policies or adverse political events.

Structural policies still in the balance: A host of reforms initiatives in 2012 and 2013 did much to address rigidities in domestic labor and product markets. Since then, however, the implementation effort has weakened in part due to legal obstacles but also the increasingly fragmented political situation in Parliament. For example last year the further implementation of the "Law on the Unity of the Market" was stopped after several provisions were declared unconstitutional by courts. This law aimed at reducing regional barriers to trade while facilitating company growth. Other structural issues relates to

- A segmented workforce where 42% of the participants have less than secondary schooling – about twice as much as the European average.
- Incomplete pension reforms where entitlements should be linked to life expectancy and the statutory retirement age is lifted to 67 years to strengthen long term sustainability of the system.

However, there have also been successes including the effort to replace the low corporate tax for small firms with targeted support for start-ups which used to act as a disincentive for firm growth.

Banks on a sounder fundament: Banks remain adequately capitalized with CET-1 (Common Equity Tier 1) at 12% of risk weighted assets although that includes also deferred tax credits usually regarded as a lower quality capital. At the same time credit fundamentals have improved markedly with the levels of non-performing loans (NPL) and foreclosed assets dropping to 9% of the average loan book. Banks' clients have also deleveraged significantly. Debt has fallen to 62%/GDP for households and below 65%/GDP for corporates, down by almost a third from before the crisis as companies have begun to rely more on accumulated earnings to finance new activities. Banks' return on equity is still lower than cost of capital but for the time being Spanish banks can enjoy ample liquidity and cheap funding from the ECB including through TLRTO[1] lending from the latter. Moreover, the 13 largest entities of Spain's banking system can now benefit from the Single Supervisory Mechanism under the ECB (European Central Bank) but it is also noted that IMF's (International Monetary Fund) most recent FSAP[2] recommends the authorities to focus more on enhancing anti-money laundering efforts for Spain's financial system.

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[1] Targeted Longer Term Refinancing Operations, ECB
[2] Financial Sector Assessment Program, IMF

Politics

Catalonia: Last year's referendum yielded a vast majority for independence of the province but with a poor turnout that could be used to invalidate the result. Regarded as illegal from the central authorities, the government invoked Article 155 of the Constitution of 1978 which allows direct rule from Madrid in certain circumstances. It then arranged new elections for the region. This time turnout was higher and yielded a small majority for anti-independence forces while pro-independence parties were still able to capture a small majority in the regional assembly. Shortly after, the latter used this to declare independence.

With a fifth of Spain's total economy Catalonia is of paramount importance to the whole country. So far the political tensions have hit mostly the secessionist province itself. Fearing more turbulence 3000 companies have quickly moved their headquarters out of Catalonia and 1000 others have also registered tax residency in other parts of the country. At the end of last year Catalonia's tourism sector began to suffer and many other activities cooled down operations.

Most observers agree there is only a low probability of the province leaving the federation anytime soon. They point to general political fatigue permeating the regional population. But that may not guarantee the problem will go away. In Madrid the Basque Nationalist Party (BNP) has for several years been king-maker in a fragmented parliament. This continues to be the case under the new socialist-led minority government in office since a few weeks ago. BNP, which fights for the independence of the Basque province, has used its key-position to obstruct legislation processes in Parliament including the annual approval of the government budget in part to show its sympathy with Catalonia. As the new government is as a staunch defender of the sovereign integrity as the outgoing, the situation in Parliament may remain unsettled until new elections eventually change its composition. Next legislative elections are due in 2020.

Apart from the Catalonia matter, policy making in Madrid is hampered by an increasingly fragmented national assembly of widely differing political views following two inconclusive polls in 2015 and 2016. The situation has in many cases proved a stumbling block to structural and fiscal reform efforts.

Outlook

Improved macro performance: Since the height of the Euro-crisis in 2012, Spain has come a long way in stabilizing financial balances, including of the government and the banking sector. Government deficits are down to well within the original Maastricht criteria of a 3%/GDP ceiling and banks have regained some profitability and seen their portfolio of bad loans coming down significantly although still remaining at a high 9%/GDP. Unemployment is down to less than 17% of the workforce 9pp lower than its peak some six years ago. The emphasis of the economy has shifted to tradables, including tourism and other services, and become more export oriented helping turning around the external balance into a surplus. This has all been achieved while preserving Spain as a well-diversified and quite wealthy economy.

But that comes with some qualifications: That said, though, many of these positive developments come with qualifications not being structural in nature or well-deserved thanks to government perseverance. The labour market improvements belie large involuntary part time employment and deteriorating job quality. In 2018, Spain may well record the largest cyclically adjusted fiscal deficit among euro-zone countries -- the new yardstick of the EC (European Commission) -- when comparing government policies within the EU. By contrast, the narrowing fiscal deficit rather reflects improvements outside the government's control, including the cyclical recovery, both domestically and externally, and the reduction of interest rates due to ECB quantitative easing. It is noted that the economic recovery has overall been stronger than expected over several years but not led to better than expected cyclically adjusted fiscal outcomes. In fact, fiscal targets of the annual stability program agreed with the EC have repeatedly been missed by wide margins.

Short term strengths: For the next couple of years, however, good performance should prevail. Annual growth will come down but still maintain a decent rate of expansion above 2% a year, some 25 to 50 bsp above potential. Inflation may edge up but still remain below 2% a year. The external balance will continue to post surpluses on the current account supporting the gradual deleveraging of Spanish companies.

Long term challenges: But near-term strengths do not much improve Spain's long term viability. With very high government debt at 98%/GDP and much of it financed on flexible interest rates even though nominal maturity is long, debt dynamics are vulnerable to monetary tightening from the ECB. The latter should not be underestimated. The US may soon overheat and prompt Fed to hike rates more than markets expect today, to which the ECB is unlikely to remain immune. That may blow up recent years' fiscal consolidation by the Spanish government. Demographics are presenting rising challenges. The working age population is in decline while the share of retirees is climbing fast. The balance on the social security budget has turned into a deficit and any improvement depends on unpopular reforms. Such are not facilitated in a revolving doors situation of weak coalition governments in a fragmented political environment including secessionist movements.

The upshot is that Spain's economy is more than immediately meets the eye. It has nevertheless prompted positive rating actions over the last 12 months period from two of the external rating agencies lifting the sovereign from the B-level into the higher A-level. That may be well argued within a short to medium term framework. For a longer horizon, by contrast, such ratings seems hostage to Spain's several intrinsic vulnerabilities.

Spain: Risk Profile

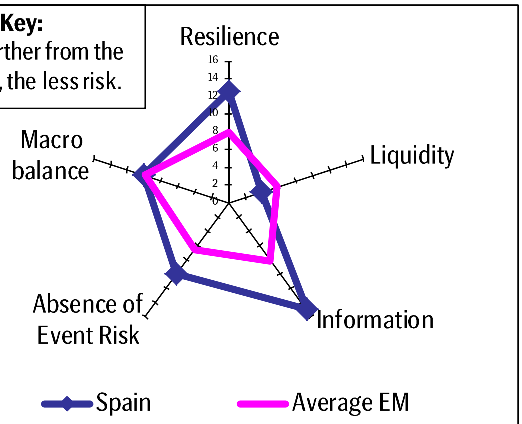
Key figures	**2018**
Population (mil)	46,4
GDP/capita ($)	32 316
Real GDP (% chg)	2,5%
Inflation (%)	1,6%
Curr.Acc. Balance (% of GDP)	1,6%
Reserves/imports (months)*	1,6
Budget balance (% of GDP)	-2,4%
Government debt (% of GDP)	97,0%

* Excludes Spain's notional share of ECB reserves

External ratings:
Fitch: BBB+
Moody's: Baa2
S&P: BBB+

Peers:
Slovenia
Italy
Ireland

Chart Key: The farther from the centre, the less risk.



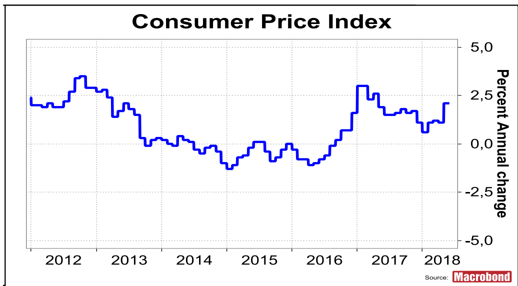
Graph: Spain's strong democratic institutions boost the resiliency and information scores. Macroeconomic weakness includes the excessive fiscal deficit. Event risk reflects risk of new turmoil within the euro-zone which we believe to once again to be on the rise.

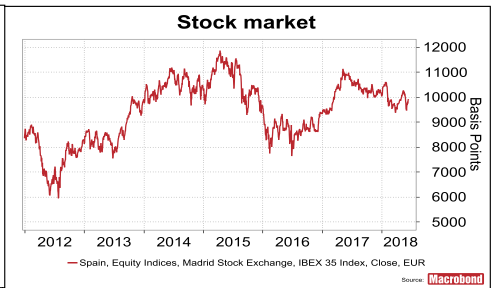
Key data:	2013	2014	2015	2016	2017	2018	2019
GDP (bill.US$)	1362	1379	1198	1238	1315	1500	1634
GDP/capita (US$)	29235	29670	25798	26644	28319	32316	35208
GDP (%chg)	-1,7%	1,4%	3,4%	3,3%	3,0%	2,8%	2,3%
Investments/GDP	20%	21%	21%	21%	22%	22%	22%
Budget balance/GDP	-7,1%	-6,0%	-5,3%	-4,6%	-3,1%	-2,4%	-2,0%
Govt debt/GDP	101%	100%	99%	99%	98%	97%	96%
CPI inflation (% chg)	1,4%	-0,1%	-0,5%	-0,2%	2,0%	1,6%	1,6%
Money demand (%chg)	-4%	-10%	-7%	-3%	-5%	-5%	-5%
Stock prices Avg.	880	1067	1081	879	1035		
Interest rates	0,2%	0,2%	0,0%	-0,3%	-0,3%	-0,3%	-0,1%
Exch. Rate ($)	1,33	1,33	1,11	1,11	1,13	1,23	1,29
Trade/GDP (%)	47%	48%	48%	47%	49%	51%	52%
Oil price (Brent)	$109	$99	$52	$44	$54	$71	$70
Millions US $							
Export of goods	312 812	317 842	277 393	280 933	310 582	366 872	410 835
Imports of goods	331 424	347 545	302 151	300 217	337 534	394 837	434 496
Other:	39 360	43 849	38 142	43 055	52 591	51 516	44 297
Current account ($ mill)	**20 748**	**14 146**	**13 384**	**23 771**	**25 639**	**23 551**	**20 636**
(% of GDP)	1,5%	1,0%	1,1%	1,9%	1,9%	1,6%	1,3%
FDI	24 739	-7 287	-30 906	-18 356	-22 402	-43 821	-45 135
Loan repayments	-1 240 785	-1 152 843	-1 069 941	-1 114 441	-1 165 839	-1 316 953	-1 427 452
Net other capital flows	1 185 085	1 130 895	1 077 150	1 101 244	1 157 431	1 334 652	1 450 889
Balance of payments	**-10 212**	**-15 089**	**-10 313**	**-7 783**	**-5 170**	**-2 570**	**-1 063**
Reserves	28 499	29 286	38 711	44 375	49 024	52 158	54 194
Total debt	2 231 230	2 296 620	2 015 940	2 068 940	2 164 360	2 444 900	2 650 040
o/w short term debt	1 066 000	951 000	903 000	946 000	989 630	1 117 904	1 211 702

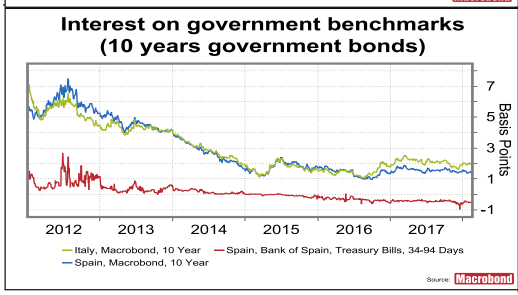
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

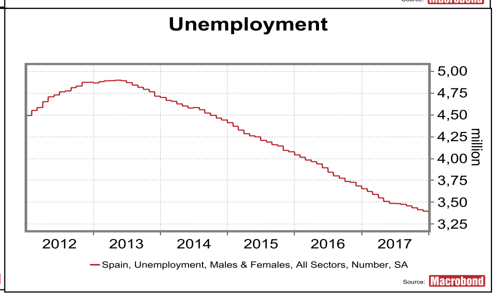
Rating history					
Fitch (eoy)	BBB	BBB	BBB+	BBB+	A-
Moody's (eoy)	Baa3	Baa3	Baa2	Baa2	Baa1

Type of government:	
Next elections	2020
Other:	
Latest PC deal	None
Latest IMF arrangements	None









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