February 27, 2014

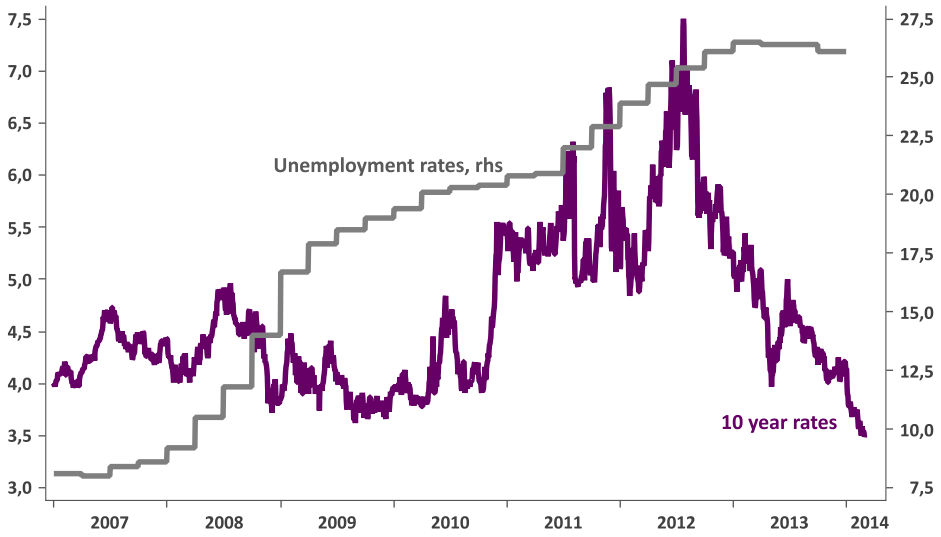
Thematic

Has Spain Found a Winning Strategy?

Moody's decision to upgrade Spain's sovereign debt rating last week is yet another sign that investor confidence is returning to the Iberian Peninsula—a region often held up as a model for crisis-stricken Southern Europe. The Rajoy administration hopes that lowering Spain's labor costs will boost the country's competitiveness, enabling it to export its way out of the crisis. With a battered economy and an arduous deleveraging process that will likely leave a lasting dent in domestic demand, many see this as the only strategy for Spain to get back on track to balanced growth—even if it comes at an immediate high social cost.

So is Rajoy's bet paying off? Has the Spanish economy picked up enough over the past few months to mark a lasting turnaround in the country's fortunes?

Government Borrowing Rates and Unemployment Rates in Spain



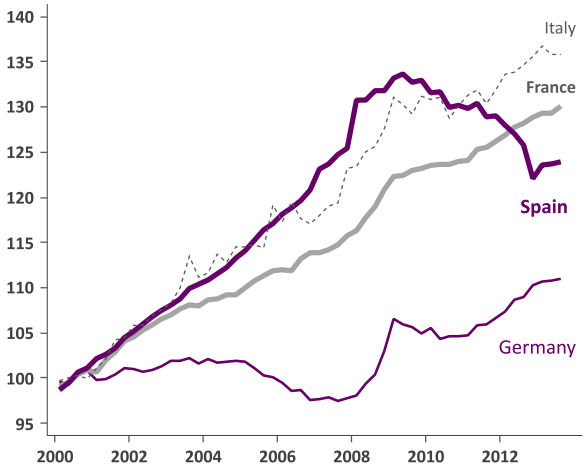
Sources : RichesFlores Research, Macrobond

A spectacular rebound in competitiveness…

At first glance, Spain seems to have made astonishing progress. Productivity is up more than 15 percent since the crisis, unit labor costs are down 8 percent, and its current account has swung from a hefty deficit before the crisis to a small surplus at the end of last year.

Nominal Unit Labour Cost

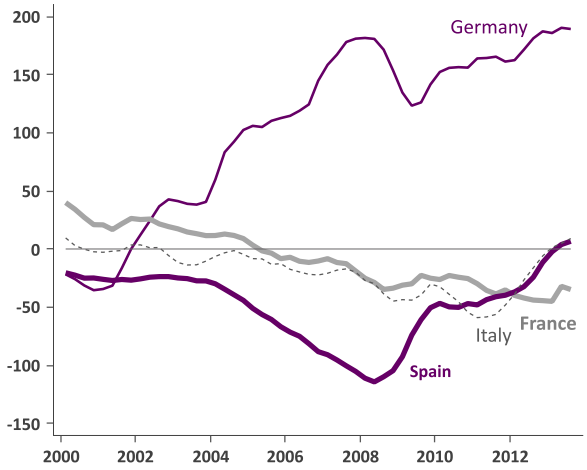
All economy, 2000=100



Sources: RichesFlores Research, Eurostat, Macrobond

Current Account Balance

4 quarter sum, Billion EUR

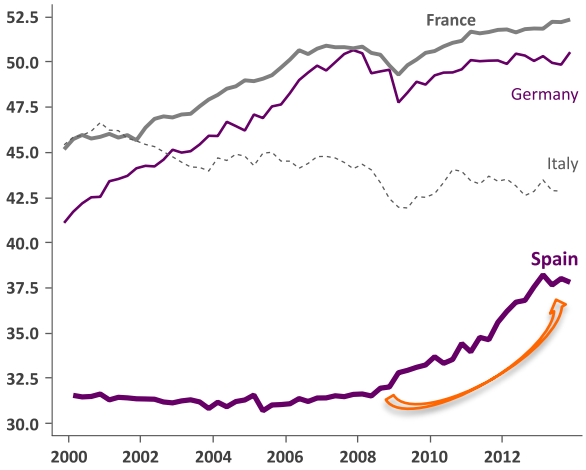


Sources: RichesFlores Research, Eurostat, Macrobond

The country has clearly started to regain some of the competitiveness it lost upon the introduction of the euro. That's especially true in manufacturing, where hourly labor productivity is now just ahead of Italy's, after being some 15 percent behind before the crisis. And productivity improvements are spreading from the construction industry into most of Spain's other sectors, with the notable exceptions of finance and leisure.

Hourly Productivity - Private Sector

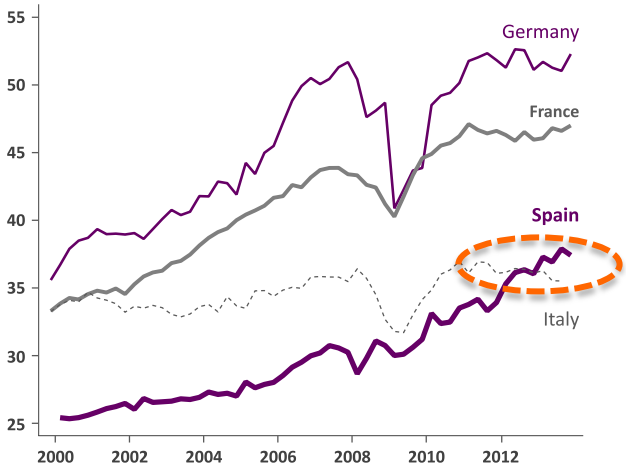
Value added/hour worked, EUR, 2005 constant prices



Sources: RichesFlores Research, Eurostat, Macrobond

Hourly Productivity - Manufacturing Sector

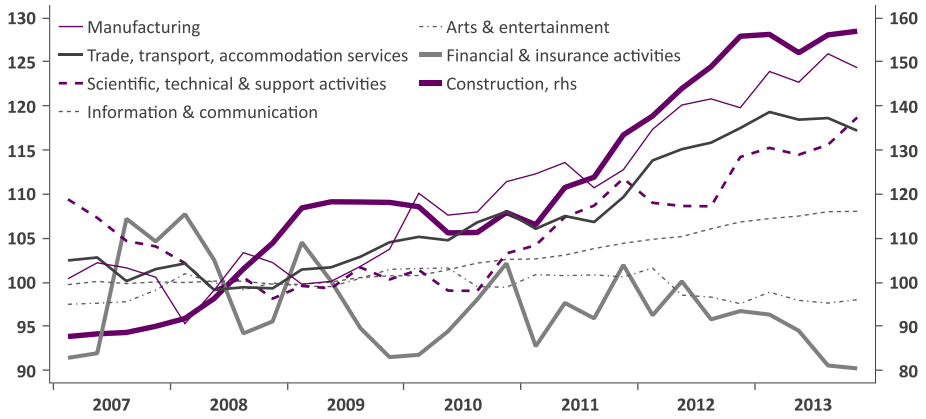
Value added/hour worked, EUR, 2005 constant prices



Sources: RichesFlores Research, Eurostat, Macrobond

Productivity by Sectors

Value added per hour worked, at constant prices, 2008 = 100



Sources: RichesFlores Research, Macrobond

… But with limited ramifications so far

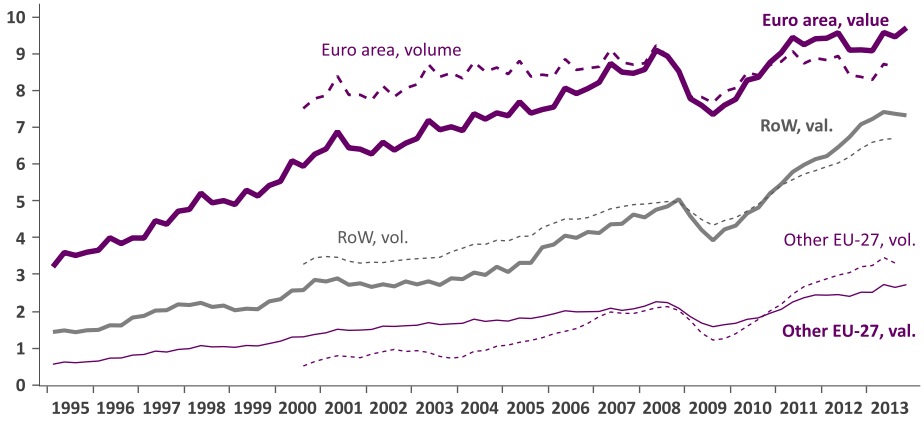
A closer look suggests those competitiveness gains are not all they're cracked up to be, however.

So far the benefits have been concentrated in just a few areas. While Spanish exports are doing remarkably well in high-growth markets, that is being more than offset by weakness in more sluggish regions.

- Exports to other eurozone countries fell 10 percent between their peak in January 2011 and their trough in the spring of 2013. However, since this trough exports have shot up 6 percent (as of last December)—twice the rate of recovery in French and even German exports. That points to the better competitive positioning of Spanish exporters relative to their currency union peers, and has given Spain the highest eurozone export growth rate of all E.M.U. countries since they started coming out of recession.
- Exports to the rest of the E.U., and particularly the U.K., have registered their best performance in two years thanks to the brighter British recovery. But that stellar performance has come at a price: exporters have had to slash their margins, as reflected in the marked difference between export growth measured by volume and at constant prices.
- Exports to the rest of the world are where Spain really stands out. At end-2013 they were up more than 30 percent from pre-crisis levels. And Spanish exporters enjoy lucrative profit margins in those markets since they have a fair amount of pricing power. Unsurprisingly, most of this export growth comes from the developing world, more specifically from Africa and the BRICs. Africa has become an increasingly important market for Spain over the past few years, but it's hard to say whether that is due to the better competitiveness of Spanish exports or the newfound vigor of African economies.

Spanish Exports

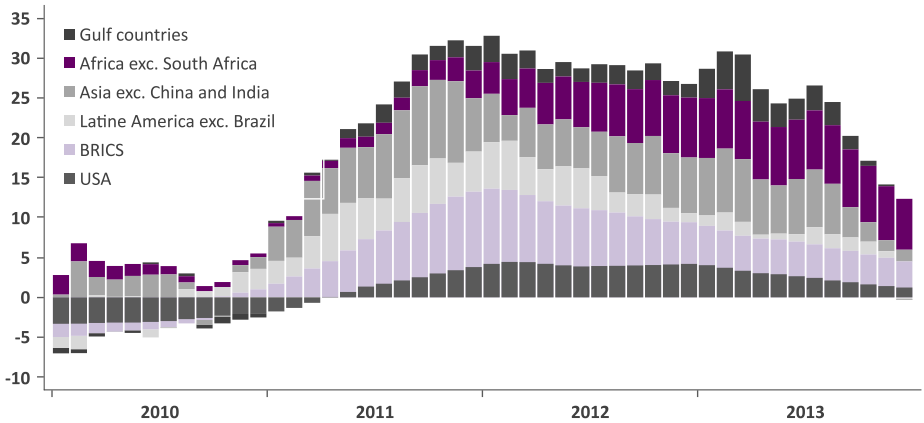
In billion, current and 2010 constant euros



Sources: RichesFlores Research, Macrobond

Contribution to Spanish Extra EU-27 Exports Growth

Over 24 months



Sources: RichesFlores Research, Macrobond

That's the good news. The bad news is that taken as whole, the growth in Spanish exports has actually slowed since early 2011. Export contribution to real GDP growth is both paltry and highly volatile. Although the first half of last year seemed to indicate that exports were finally gaining steam, the second half put a damper on those hopes. At end-2013, the year-over-year growth in merchandise export volumes was barely 1.8 percent—on par with most other eurozone countries.

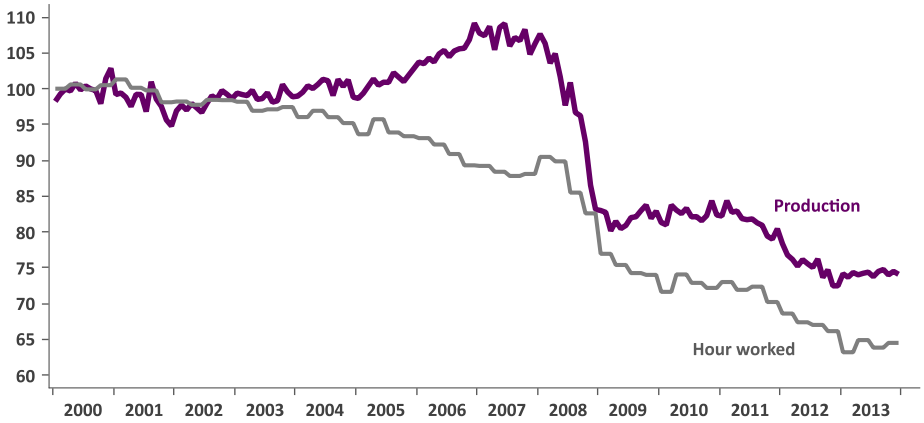
Annual Growth of Spanish Exports, in volume, %

Sources: RichesFlores Research, Macrobond

As a result, Spain's improved competitiveness has brought few benefits to the broader economy. Industrial production has stopped contracting, but it is not expanding either. Since early last year it's been stuck at some 32 percent below its pre-crisis high. The number of hours worked fell in 2013: less severely than in the two prior years, but it has yet to bottom out—let alone pick up.

Production and Hour Worked in Industry

Manufacturing sector, Q1 2000 = 100

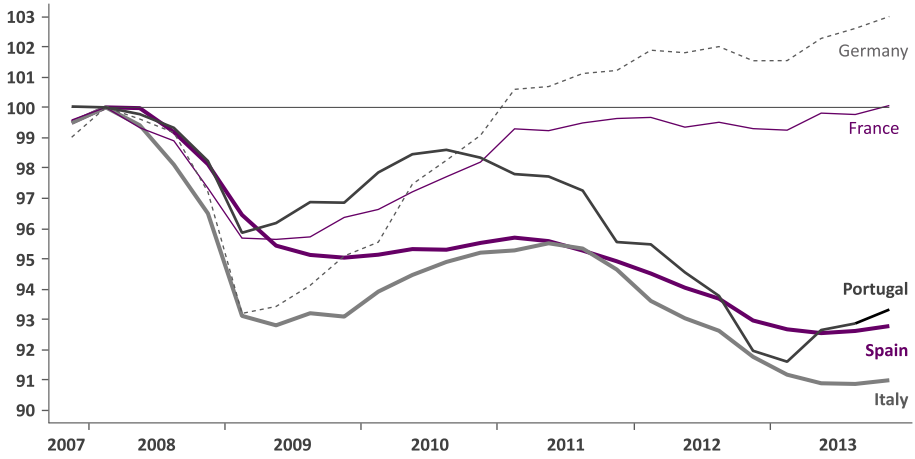


Sources: RichesFlores Research, Macrobond

Admittedly, the falloff in GDP may seem less dramatic, but it should not be minimized. Between the first quarter of 2008 and the end of 2013, output shrank by 7 percent.

Spain is clearly not out of the woods yet. While there have been undeniable productivity gains, considerable work still needs to be done to turn this advantage into a structural growth driver.

Real GDP, Q1 2008 = 100

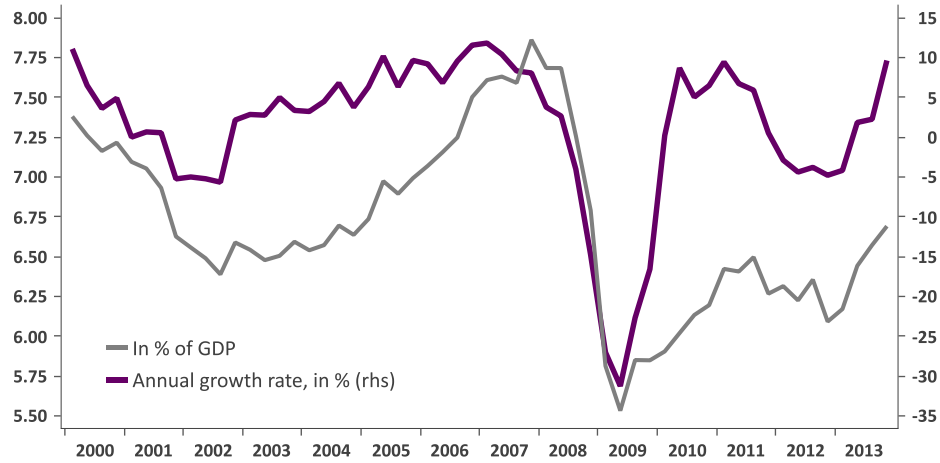


Sources: RichesFlores Research, Macrobond

Starting (almost) from ground zero

Spain's manufacturing base has weakened substantially since the start of the new century and especially since the onset of the crisis. It won't improve until there is a significant increase in capital spending, but recent trends indicate that such a reversal is not in the cards. Capital spending rates are hovering at rock-bottom levels and foreign direct investment, while up slightly in 2013, has shown only anecdotal evidence of actually improving the country's competitiveness.

Investment in Transport Equipment and Machinery

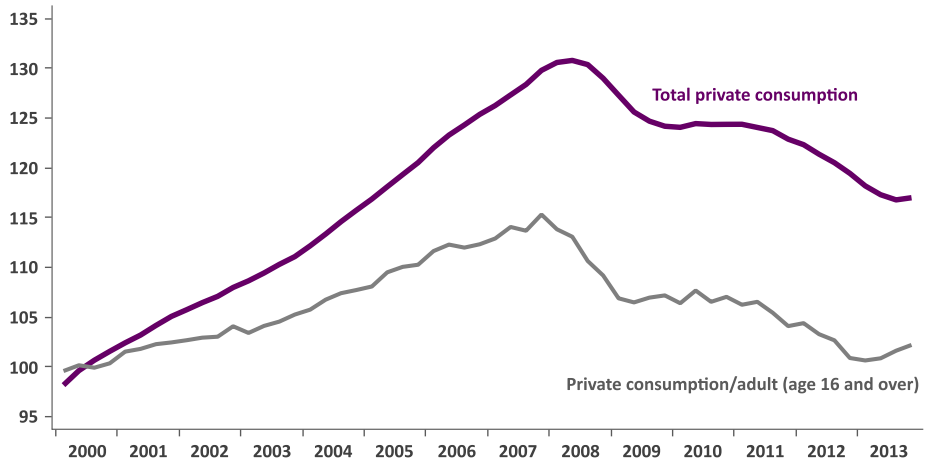


Sources: RichesFlores Research, Macrobond

Companies' reluctance to invest in capital equipment can be explained by a combination of shrinking domestic demand and trouble getting loans from beleaguered Spanish banks.

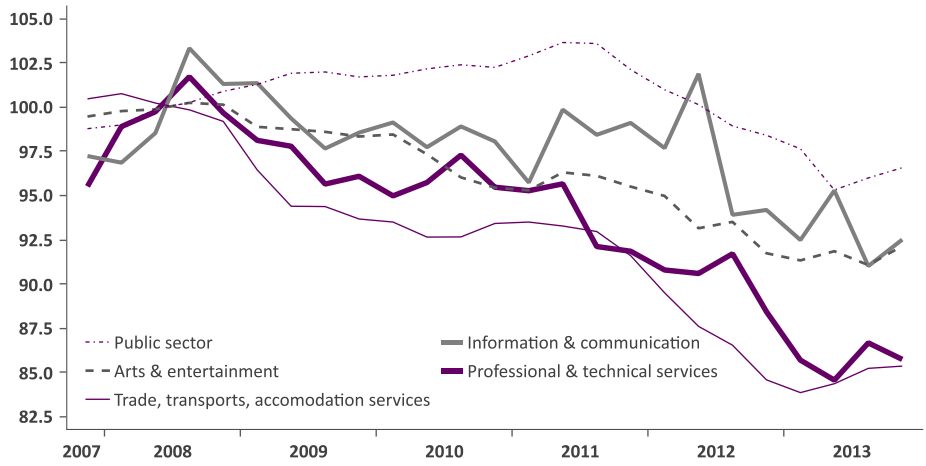
Average consumer spending per adult aged 16 and over has plunged by over 15 percent in Spain since the crisis. Total consumer spending is down over 10 percent. That has translated directly into less business for local manufacturers and for the local services industry—which accounts for over 70 percent of Spain's GDP. The recent uptick in exports is nowhere near enough to make up the shortfall. The hardest-hit service sectors are leisure, retail, and services to households—with major repercussions on the country's job market.

Spanish Real Consumption, Total and Per Capita, 2000=100



Sources: RichesFlores Research, Macrobond

Full-Time Equivalent Employees in Services, 2008=100



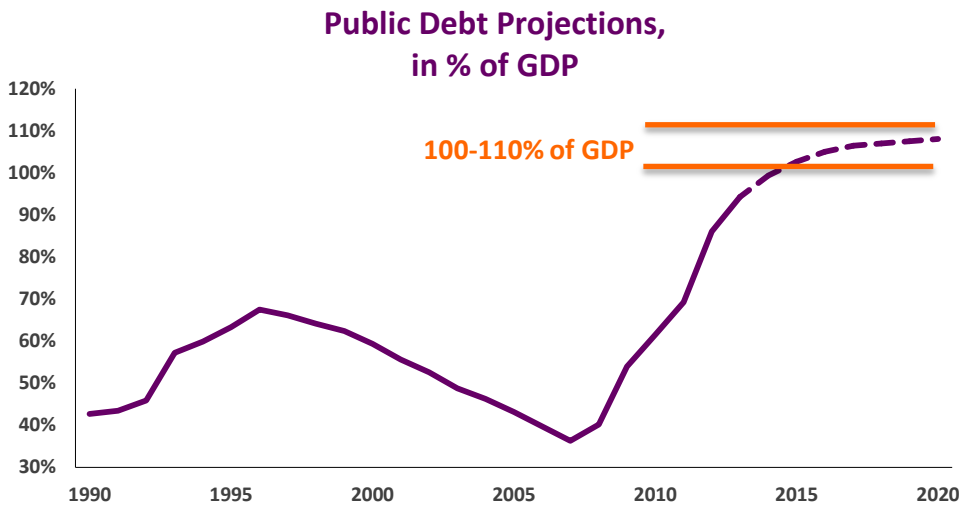
Sources: RichesFlores Research, Macrobond

Spain may be out of the recession, but it is still far from a return to healthy fundamentals. It will probably be several years before the economy reaches growth levels high enough to reverse the upward spiral in public debt.

And looking more closely at public debt, we still see it following the same upward trajectory we outlined a year ago (see our forecasts for Spain in our Feb. 3, 2013 article "The Deleveraging Mirage: A Careful Look at Italy Today"). On the one hand, we have sharply reduced our estimate of the country's apparent interest rate (the ratio of debt service to debt) due to the

improvement in its financing terms. On the other hand, we have also cut our real GDP growth forecast for 2015 and beyond. We now feel our initial estimate of 2.5 percent a year is too high, given the reduction in growth potential we saw over the past few quarters—unemployment ticked up again and growth in the labor force slowed further—and given the country's virtually non-existent inflation. An average annual growth rate of 2 percent seems more likely. We also believe that Spain's primary surplus will improve less quickly than previously thought now that some of the pressure is off from the European Union. All these factors mean we have the same outlook for Spanish public debt as we did in early 2013.

Despite a slight dip, we believe it will continue to swell and cross the 105 percent of GDP mark in 2016 or 2017—and stay above that mark for the following five years.



Source: RichesFlores Research

Restoring Spain's public finances to health will be a long, slow process; we don't see its debt trajectory changing course any time soon.

That's not necessarily cause for alarm in the near term, but it *is* a stark reminder that:

1- Without a marked improvement in domestic growth potential, Spain will not be able to stop the rise in its debt-to-GDP ratio.
2- The renewed investor confidence in Spain remains highly vulnerable to even the smallest hiccups in its economic recovery—especially if export growth stalls—and to any abrupt changes in the political climate.
3- The country is still saddled with a huge debt burden that won't be getting lighter any time soon and therefore represents a serious long-term problem. Then again, on that count, Spain clearly has a lot of company in the euro area.

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