Special Report

Spain – Growth to ease but economy is increasingly resilient

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1. Introduction

In 2013, a double-dip recession left Spain languishing towards the bottom of the table of the 34 OECD members' growth rates (only Portugal and Greece were in worse shape at the time). Unemployment peaked at 26% and 10Y yields reached 7%. The government was obliged to bail out domestic banks which were stung by the bursting of Spain's enormous property bubble. Public debt, which was around 40% of GDP before the global financial crisis (GFC), soared to 100% and necessitated an EU/IMF bailout.

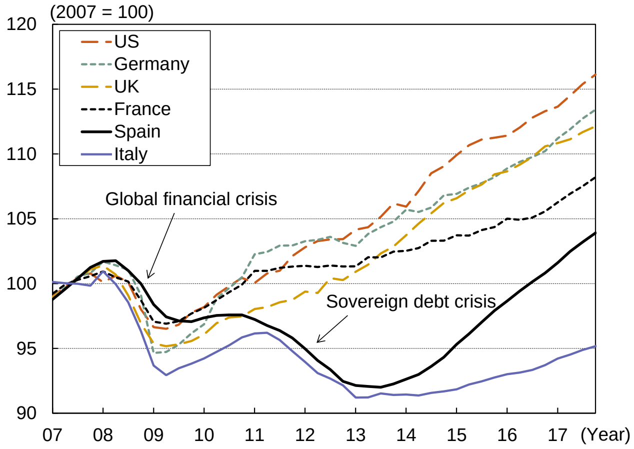
Five years on, the strength of the subsequent Spanish recovery is striking. GDP growth of 3.3% YoY in 2016 raised the country to fifth in the OECD ranking. This was backed up by 3.1% YoY last year and there is still plenty of momentum (including a carryover of 1.1pp into 2018's annual average). Plenty of challenges remain, and economic activity will likely ease, but Spain looks increasingly resilient as we watch for the next downturn.

2. The recovery continues

Chart 1 shows how Spain fared relatively well in the GFC compared to other European countries but then became mired in the sovereign debt crisis. The subsequent recovery from Q3 2013 is notable (especially when compared with Italy[1]). QoQ GDP growth has averaged over 0.7%. Recently, this has tended to be broad-based (Chart 2). Labour market reform, export competitiveness and several years of pent-up demand have all contributed to the recovery. Draghi's pledge to "do whatever it takes" to save the euro zone, and accompanying no-holds-barred approach to monetary policy, has undoubtedly helped as well.

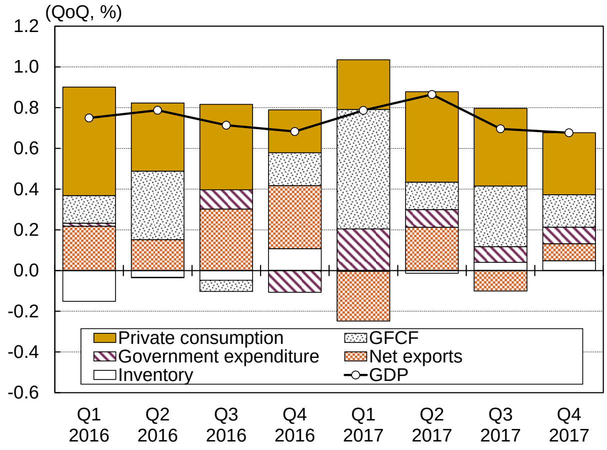
[1] See our report on Italy's challenges here: www.bk.mufg.jp/report/ecoeu2018e/specialreport_20180124.pdf

Chart 1: Real GDP Recoveries



Source: OECD, MUFG Bank Economic Research Office

Chart 2: Contributions to Real GDP Growth



Source: INE, MUFG Bank Economic Research Office

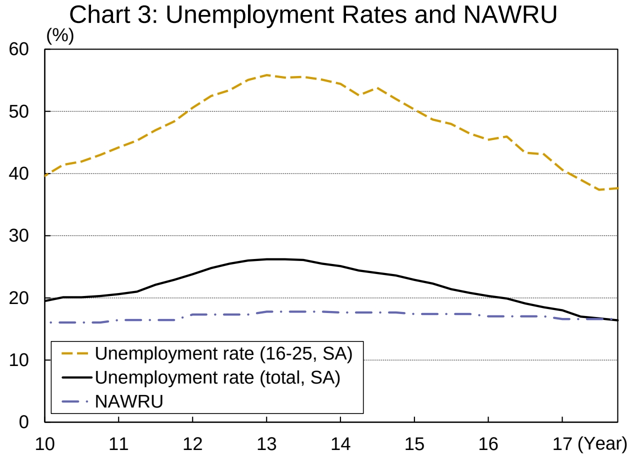
Recently, improving labour market dynamics are perhaps the most important part of the story. The unemployment rate peaked at 26.2% in Q1 2013. Youth unemployment (those aged 16-25) reached a staggering 55.8% in the same quarter (Chart 3). These rates have steadily improved as the comprehensive 2012 labour market reform measures started to take effect. The reforms sought to improve the persistent labour market duality issues in which post-GFC hiring tended to be on a temporary basis but permanent workers enjoyed strong job protection. Measures were introduced to reduce collective bargaining to the firm level (from sectoral or regional level) and reduce dismissal costs.[2]

[2] France is undergoing very similar changes under the Macron government. See our report here: www.bk.mufg.jp/report/ecoeu2018e/BTMU-Economic-Brief-France20180316.pdf

This appears to have helped. Unemployment has fallen to 16.4% in Q4 2017, the lowest since 2008 and in line with the European Commission’s non-accelerating wage rate of unemployment (NAWRU) estimate, a rough measure of the structural rate. While still high, it is worth noting that the 1980-2007 average rate of unemployment is 16.4% (the country has long wrestled with undeclared employment which may be a factor). Spain has not experienced what would be deemed “healthy” joblessness in other euro zone countries since the 1970s.

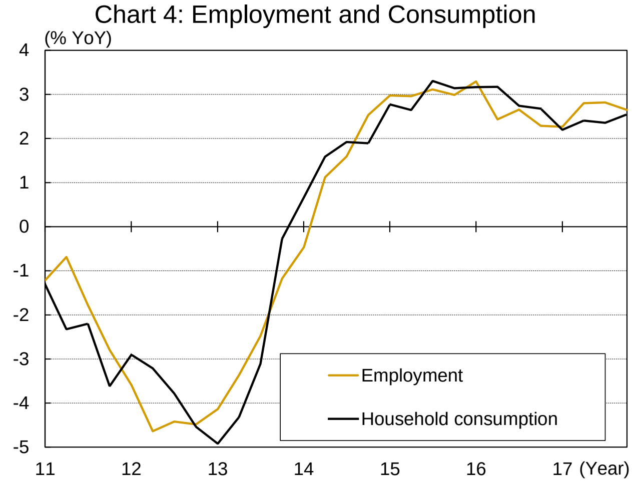
A healthier labour market supports economic activity. Consumption fell by 10.6% in real terms between the pre-crisis peak (Q1 2008) and the Q2 2013 trough. Recent years have seen steady growth, in line with employment gains (Chart 4). Much of this is likely to be pent-up demand after years of restraint. In real terms, household consumption of durable goods declined by a whopping 39% between Q1 2008 and Q4 2012. Since 2014 it has grown by an average of 8.6% YoY.

Chart 3: Unemployment Rates and NAWRU



Source: Eurostat, European Commission, INE, MUFG Bank Economic Research Office

Chart 4: Employment and Consumption

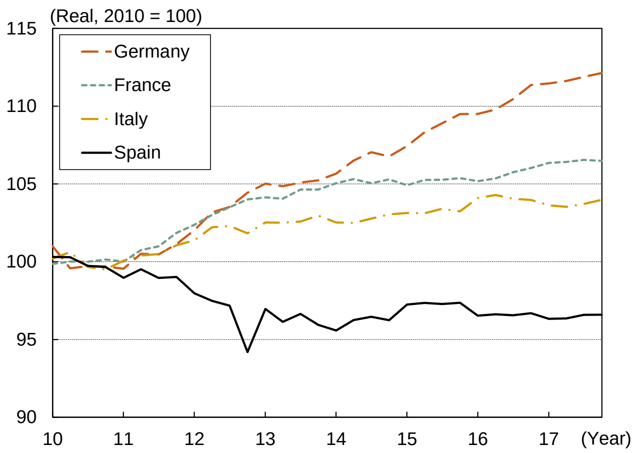


Source: INE, MUFG Bank Economic Research Office

Increasing employment has encouraged households to loosen the purse strings, but we are yet to see much pressure on wages. This has restored some of Spain's competitiveness. In the pre-GFC years wage growth tended to be well above productivity growth, making Spain's exports less competitive. There has been a reversal – Chart 5 shows how Spain's unit labour costs have held steady since 2013, while those of its trading partners have increased. This makes Spain's exports more competitive at a time when the euro zone (and most of the world) is enjoying a synchronised upswing. It is not surprising to see that exports (as % of GDP) have increased from 23% in 2009 to 34% last year. The current account deficit grew ever wider before the GFC, but there is now a persistent surplus.

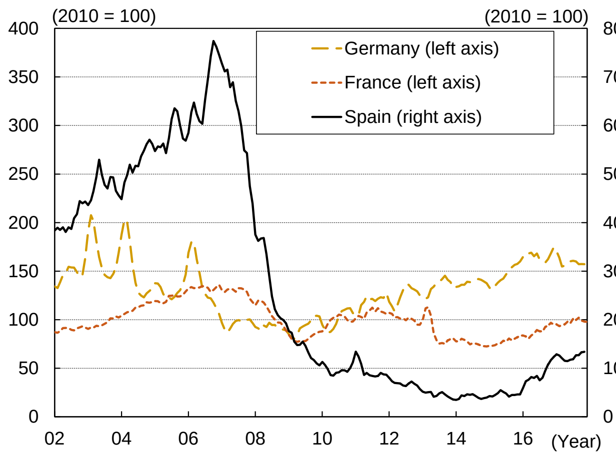
There are even signs of green shoots in the construction sector. A return to the heady boom years is unlikely (and undesirable) but activity does seem to have bottomed out. House prices have returned to positive growth territory and the European Commission's construction confidence indicator is now above its long-term average. Chart 6 shows that the amount of permits issued for residential buildings (in terms of floor area) has slowly started to improve. This is important. Gross fixed capital formation is still some way off the pre-crisis peak in real term, with residential construction unsurprisingly the main drag. As we detail in the next section, we expect a slowdown in household consumption. If this is the case, some support from construction investment will be welcome.

Chart 5: Unit Labour Costs



Source: ECB, MUFG Bank Economic Research Office

Chart 6: Residential Building Permits, M^2 of Floor Area



Source: Eurostat, MUFG Bank Economic Research Office

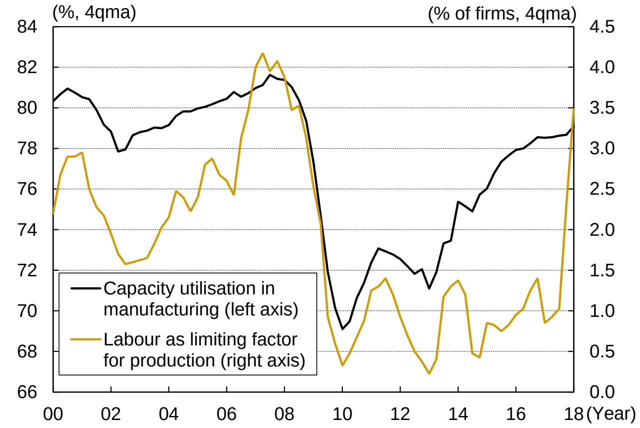
3. Growth to ease

Growth is likely to ease from the rates seen in recent years despite the supportive factors listed above. After 3.1% YoY GDP growth last year, the Bank of Spain looks for 2.7% in 2018 and 2.3% in 2019. Spain is likely to continue to outperform its euro zone peers, albeit less dramatically.

The first reason for slower growth rates is the emergence of capacity constraints. Chart 7 shows that capacity utilisation in manufacturing is approaching the pre-GFC highs. Firms have been reluctant to invest in equipment since the GFC and labour has been a cheap substitute. However, the number of firms citing labour as a limiting factor for production has increased rapidly of late – despite unemployment still above 16%. This could reflect a skills mismatch problem. Emigration from Spain soared after the GFC, peaking in 2013 with half a million people. 48% of those were prime age workers between 25 and 39 years old. Of those that stayed, high youth unemployment has often left young people without relevant experience or on-the-job training.

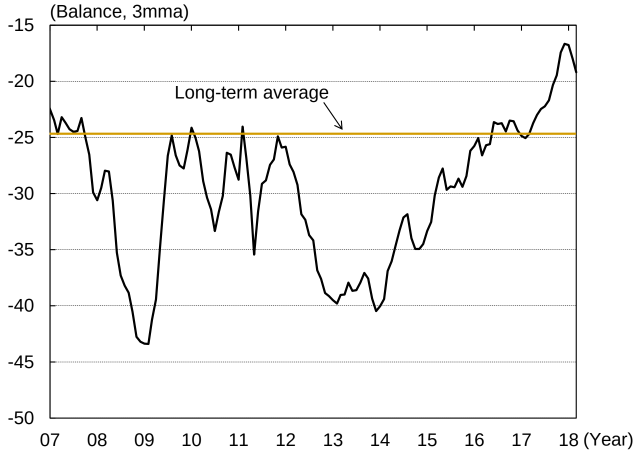
For those that do have a job, it may now be time to think about repairing personal finances. The Bank of Spain reported the saving rate at 6% in 2017, the lowest since 2008. Chart 8 shows that saving intentions over the next 12 months have now increased well above the long-term average. Increased saving will reduce household vulnerabilities (and those of retail banks) when the next downturn arrives. But it does mean that consumption is likely to contribute less to GDP growth. The catch-up effect from pent-up demand as consumers purchase 'big ticket' items (such as washing machines or televisions) which they had put off during the crisis years is likely to decline as well.

Chart 7: Capacity utilisation and firms citing labour as limiting factor for production



Source: European Commission, MUFG Bank Economic Research Office

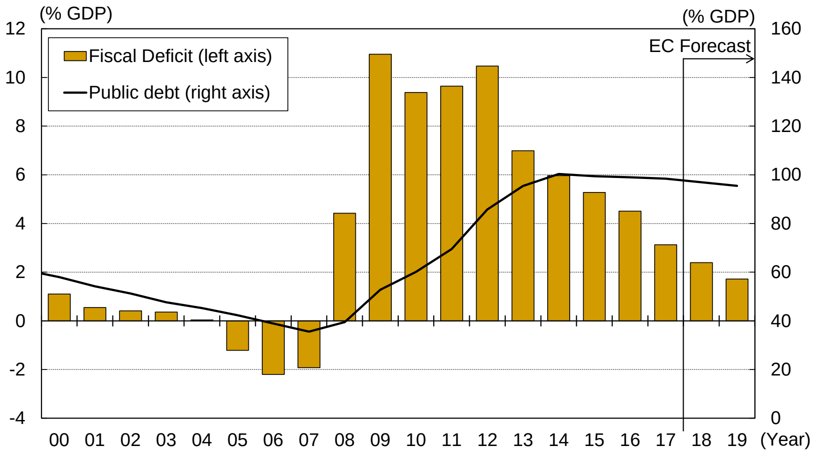
Chart 8: Saving Intentions Over Next 12 Months



Source: European Commission, MUFG Bank Economic Research Office

Against this background, there is unlikely to be much support from either fiscal or monetary policy. On the former, Spain remains one of two countries subject to an excessive deficit procedure from the European Commission (along with France). Government debt and the deficit both soared in the wake of the GFC (Chart 9). Public spending was unsustainably high as tax revenues plunged after the property boom.

Chart 9: Public Debt and Fiscal Deficit



Source: European Commission, MUFG Bank Economic Research Office

The government's austerity program has since narrowed the fiscal deficit to 3.1% of GDP in 2017. This remained above the 3% Maastricht target, though. The country is still without a budget for this year (the treatment of Catalan separatists is causing an impasse – see discussion below). The proposal contains a few pockets of easing in social spending and infrastructure (with one eye already on the 2020 election perhaps) but on the whole the tight policy stance will continue.

In terms of monetary policy, we expect the ECB will extend its net asset purchases, at an even slower pace, until December this year. After this attention will turn to the first rate hike. Increases are likely to come very gradually but higher mortgage rates will be a headwind for the still very fragile residential housing market in Spain.

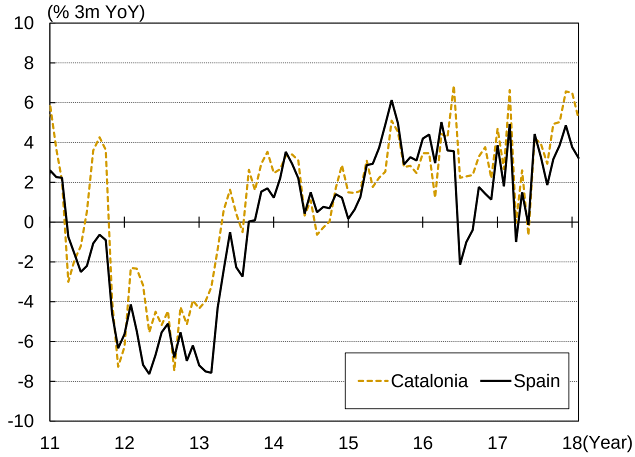
4. Selected issues

(1) Catalonia

Catalonia, a semi-autonomous region of Spain, held an independence referendum on 1 October 2017. 90% of voters backed independence, although turnout was low. The Constitutional Court of Spain had declared the referendum illegal but separatists in the Catalan regional parliament symbolically declared independence on 27 October. The Spanish government responded by taking direct rule of the region and called a regional election. Members of the deposed government were arrested or fled abroad. In the election, pro-independence parties won a narrow majority but, almost four months later, Catalonia still does not have a government.

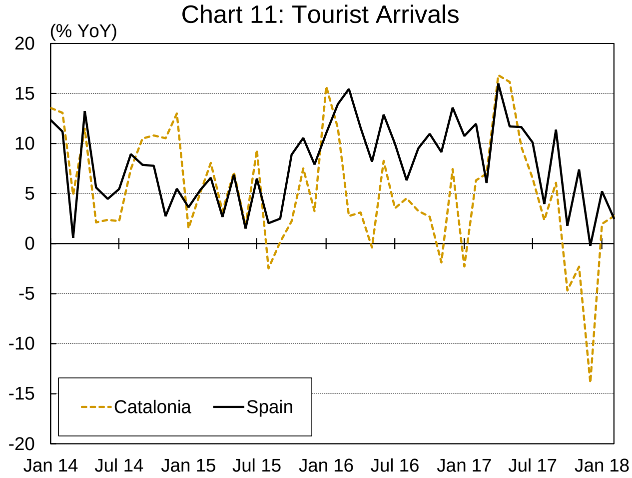
The evidence suggests that the Catalan 'crisis' is becoming more of a slow-burner. Bond spreads have narrowed, credit default swaps are trading lower and the economic policy uncertainty index has fallen dramatically since October. In terms of the real economy, Catalan industrial production has held up well and even outperformed the rest of Spain (Chart 10). Tourism is a key industry for Catalonia and the sector was affected badly after images of violent protests were broadcast around the world. However, Chart 11 shows that there has been a clear rebound in the number of tourist arrivals.

Chart 10: Industrial Production



Source: INE, MUFG Bank Economic Research Office

Chart 11: Tourist Arrivals



Source: INE, MUFG Bank Economic Research Office

(2) National politics

The Catalan issue is affecting politics at a national level. After two inconclusive general elections and a long impasse, Mariano Rajoy has continued as prime minister in a minority government. His government has set out its proposals for the 2018 budget (a continuation of austerity but with some plans to reduce taxes for workers on low incomes and increase payments for pensioners). The minority government has to rely on support from opposition parties for the budget to be approved. In particular, it will need to convince the PNV (a nationalist group from the Basque region) to vote in favour of the motion in order to secure a parliamentary majority. The PNV has indicated that it would like to see the situation in Catalonia resolved before it would be willing to offer its support.

The 2017 measures will be extended until this year's budget is passed. It is not an unusual situation – the 2017 budget was not implemented until late May last year. But it does point towards wider risks. It suggests that this Partido Popular (PP) government would struggle to pass any meaningful reforms. While the 2012 labour market measures were wide-ranging, and seem to have had an effect, unemployment remains above 16% six years on. Spending on education and training in particular could help with skills mismatch problems. In addition, Rajoy's PP party is embroiled in a corruption scandal. Early elections (ahead of the next scheduled in the summer of 2020) are a possibility.

(3) Brexit

Taking a wider view, the UK's departure from the EU could affect Spain. In general, Brexit is less of a worry for the EU27 as we progress toward a final deal[3] and the global upswing seems likely to cushion any negative effects on the continent. But some sectoral concerns remain. For Spain, this means the tourism sector. Spain is much more exposed than other large euro zone countries with tourism exports to the UK worth around 1% of GDP (Chart 12). Monthly tourism data is volatile but there is little evidence of a significant decline in Brits traveling to Spain (Chart 13), despite the depreciation in sterling.

[3] See our report on progress in the negotiations here: www.bk.mufg.jp/report/ecoeu2018e/specialreport_20180409.pdf

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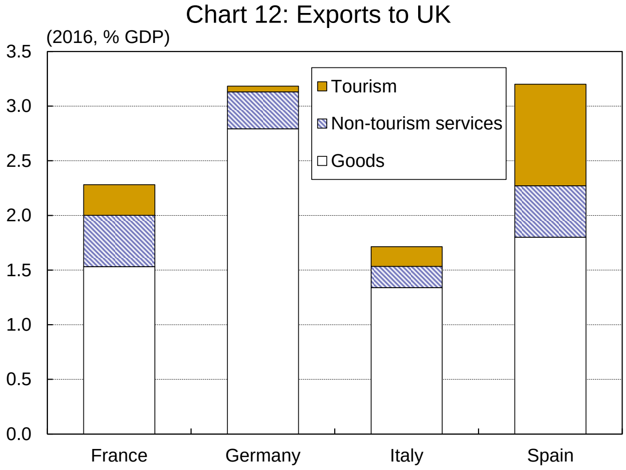
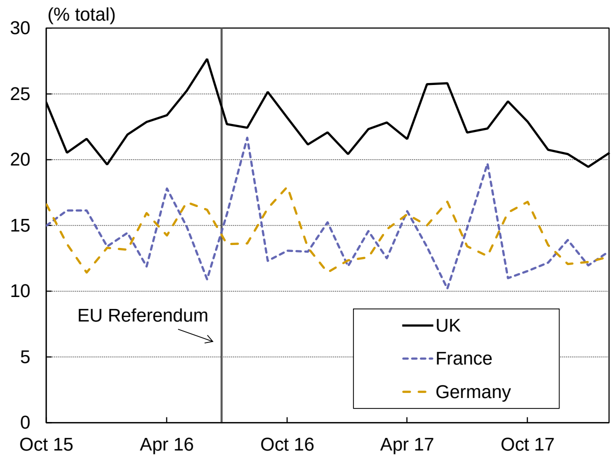
Chart 12: Exports to UK



Source: ONS, MUFG Bank Economic Research Office

Chart 13: Tourist Arrivals



Source: INE, MUFG Bank Economic Research Office

Brexit presents another issue for Spain – that of Gibraltar. The 6.7km^2 British overseas territory on the south coast of Spain voted strongly to remain in the EU, but also strongly rejected a joint sovereignty proposal at referendum in 2002. Spain asserts a claim to the territory but for now sees Brexit as a way of winning concessions rather than sovereignty. Brexit will not be straightforward for Gibraltar. Thousands of people cross the border from Spain to work there every day. Banking, insurance and gambling are the most important industries for Gibraltar, which has its own tax regime. These services are mainly sold in the UK.

Once the UK leaves the EU, an option would be to give Gibraltar membership special status, similar to the arrangements made for French overseas territories as well as European microstates such as Monaco and Andorra. For Spain to accept this, the UK may have to offer increased co-operation on border controls, tax and management of Gibraltar's airport. Recent reports suggest a deal is likely to be reached by the summer.

Lastly, Brexit may prompt some reversal of the 'brain drain' of young Spanish workers who have moved to the UK to seek opportunities. The ONS reports that there was a 25% YoY decline in national insurance registrations of Spanish nationals in the UK in 2017. If there is a return of young, experienced and multilingual workers this could help with skills shortage problems.

5. Conclusion

Spain's convergence with the rest of the euro zone since 2013 has been very encouraging. Important structural reforms, very easy monetary conditions and sensible fiscal policy have all contributed. The labour market has improved considerably which has supported consumer spending, and renewed competitiveness has boosted exports.

With the recent slew of softer euro zone data, and threat of a global trade war, thoughts turn to how Spain will cope with the next downturn. There are clear vulnerabilities. Both public debt, at 98% of GDP, and unemployment, at 16.4%, remain high. The former exploded in the wake of the enormous property market crash. Tax revenues crumbled and the government had to bail out mortgage lenders (€54bn was spent bailing out banks, around 20% of GDP). Now, despite easy monetary policy, there are few signs of asset bubbles in Spain and bailouts on a similar scale are very unlikely. The government debt ratio will continue to improve with tight fiscal policy and strong GDP growth.

Turning to unemployment, the 2012 labour market reforms which improved employer flexibility are important. These should help prevent a return to the 25% plus unemployment rates that occurred in the crisis. It is also worth noting that while the current rate looks high, it is actually in line with the pre-GFC average. Nonetheless, there is more to be done in terms of labour market reform to reduce the rate further. In particular, active policies to help young people would be beneficial. Unfortunately the current state of Spanish politics – a weak minority government in power – reduces the chances of further meaningful reform.