Eurozone | Economics

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Five lessons from the Spanish Phoenix

Spain is enjoying a very positive news flow. After a brief wobble, 10 year sovereign yields are back below 3% (2.89% on 28 May). IBEX 35, the flagship equity index, is up 10% since the beginning of the year (against 6% for the Eurostoxx 30). S&P raised the credit rating by one notch to BBB and GDP growth came out at 0.4% qoq in Q1 2014, the third quarter in a row in positive territory and twice as much as the Euro area aggregate. On the political front, while many commentators had been forecasting a crippling polarization and atomization, the two traditionally dominant forces of the "governability arc", centre-right Partido Popular and centre-left PSOE, still came first in the recent European elections. While new and/or more radical parties are getting more traction, Spain has, by and large, escaped the "earthquake" which has shaken older democracies in Europe.

The turnaround of the Spanish economy has been impressive, with a particularly successful adjustment in the private sector, ex post vindicating Madrid's decision not to submit the country to a full-fledged programme in exchange for OMT. We now believe we have enough hindsight to draw some lessons from the Spanish experience. In a nutshell, (i) Spain appeared correct in focusing first on the most blatant imbalance – located in the private sector – rather than embarking on a "no matter what" fiscal consolidation. (ii) European support was of course crucial, sometimes in non spectacular ways (reducing the interest rate burden of the household sector helped cushion the demand shock). (iii) Cooperative unions matter as much as legislated structural reforms. (iv) A social fabric geared towards managing mass unemployment helps. (v) Incumbent governments pushing through unpopular measures can still win elections.

However, there is still much to be done. The accumulated output loss is significant: in Q1 2014 Spanish GDP was still 6.8% below peak, against -2.5% for the Euro area average. The unemployment rate continues to hover at around 25%, and the level of slack means the current phase of extreme disinflation (HCPI grew by only 0.3% yoy in April) would last. Nominal 10 year rates may be at their lowest level on record, but in real terms there are still 100 bps above the post monetary union average and significantly above our estimate of potential GDP growth (1.5% p.a). Progress on public deficits remains limited (7.1% of GDP in 2013). The country's balance sheet is on the mend, but it remains vulnerable to any exogenous shock.

On the political front, the sovereignist push in Catalonia remains a sore point, and it is unclear if a mono-colour government – normally consistent with more stability and more forceful action – can emerge from the general elections next year.

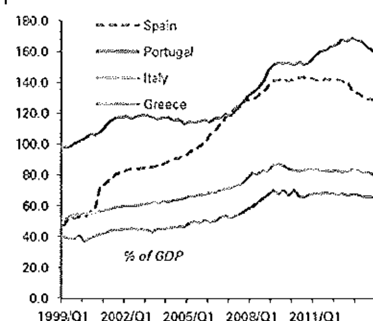
Beyond the historical narrative, we also look at the looming economic and political challenges for Spain. For every positive lesson, we therefore issue a warning. We think we have been sufficiently constructive on Spain at the height of the crisis to afford some prudence now.

Lesson #1 : Address the blatant imbalance first...

The knee jerk reaction of the European Commission and the ECB, as well as the IMF initially, was to propose to struggling European countries a potion heavy on fiscal austerity. This was a "one size fits all" approach. The success of the adjustment is, in our view, conditioned on the right diagnostic of the root of the crisis, which itself informs how policies should be prioritized. Even if the most obvious manifestation of the crisis in all cases was a steep increase in government bond yields, we note dealing with fiscal deficits should not always have been the main priority.

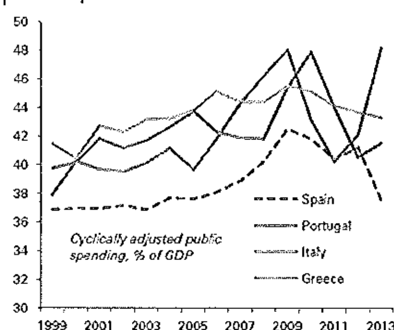
In 2008, it was obvious Spain was going through a fairly classical phase of overheating in the private sector, particularly in construction. In our sample of 4 struggling countries, Spain experienced the fastest rise in corporate debt between the beginning of monetary union in 1999 and 2007 (+81.6% of GDP). This leverage was increasingly unsustainable as profitability failed to follow suit: the aggregate gross saving of the non-financial corporate sector fell from 21% of debt to a trough at 0.4% of debt in the summer of 2007.

Figure 1: Massive increase in corporate debt before the crisis



Source: Eudata, Deutsche Bank

Figure 2: The Spanish public sector was never particularly over-developed



Source: EC, Deutsche Bank

Excess leveraging, given the lack of dis-intermediated funding, was reflected in an overweight banking sector. Total bank assets reached 274% of GDP in 2008, 100 percentage points more than in 1999. Conversely, there was no obvious sign that the public sector was particularly bloated. Before the recession started, cyclically-adjusted general government spending, excluding interest payments, stood at 38.9% of GDP, significantly lower than the Euro area average; the drift since 1999 had been moderate (2% of GDP).

What would have been the right approach? The Spanish government likely wasted a lot of its fiscal fire-power when embarking on a traditional stimulus in 2009. Rather, we think they would have benefited by immediately accepting a faster pace of public debt accumulation by combining the demand stimulus – cushioning the adverse consequences of de-leveraging - with a speedy recapitalisation of its banking system conditional on fast recognition of losses. At the time, Spanish public debt stood at 40% of GDP. This would have been financially manageable.

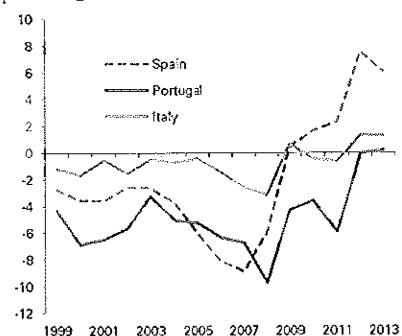
Hesitations in addressing banks' balance sheets – reflecting a too closed governance/supervision regime – cost Spain dearly. The persistent crisis constantly increased the market's estimate of the recapitalisation needs. At the same time, as the public debt trajectory was deteriorating, the capacity for the government to credibly raise the relevant amount was cash was increasingly

questioned. Spain could have broken the banks/sovereign nexus immediately. It failed to do so.

However, Spain found a manageable second-best policy equilibrium by resisting an overly harsh fiscal adjustment, allowing a convincing adjustment of the private sector to take place without triggering a self-perpetuating recessionary spiral. These days may seem long gone, but Madrid got into a fierce dispute with the European Commission (and some of its European peers) in the spring of 2012 upon unilaterally revising down its fiscal target. Spain's approach at that time, together with the recognition that programme countries such as Portugal were drifting in spite of complying with the troika's recommendations – spearheaded the conversion to "fiscal realism" which allowed for a general slowdown in fiscal consolidation in Europe. To be fair, Spain's stance against all-out austerity is owed as much to internal political difficulties – in particular fraught relationship between the central government and the regions –as to strategic planning.

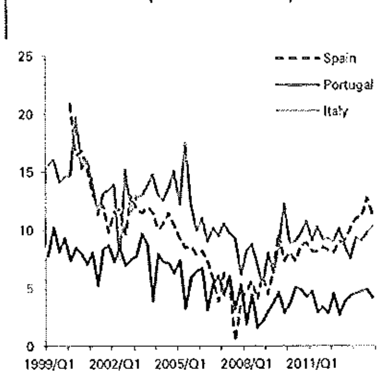
Meanwhile, progress in the corporate sector was rapid. The non-financial corporate sector shifted from a borrowing requirement peaking at a staggering 9% of GDP at the end of 2006 to a net lending position of 6% of GDP at the end of 2013, thanks to a swift restoration in profitability, reflecting a significant drop in labour costs. A large share of these internal resources has been used to deleverage. As of Q4 2013, corporate debt stood at 129% of GDP against a peak at 143.5% in 2010. At the same time, the remaining debt is much more sustainable. Gross saving – which in national accounting is a concept close to after-tax profit – at the end of 2013 stood at 11.3% of debt (against 0.4% at trough in 2007), above Italy, in spite of the low level of leveraging in that country.

Figure 3: Shift in the corporate sector from net borrowing to net lending



Source: EUdata, Deutsche Bank

Figure 4: Profits as a % of corporate debt have improved swiftly



Source: EUdata, Deutsche Bank

This means Spain is now generating enough internal resources to be independent from a still struggling banking industry. There is potential for some rebound in investment. In addition, now that profitability has been restored, we note Spanish businesses no longer need to shed labour and can afford to be a bit more generous on wage growth.

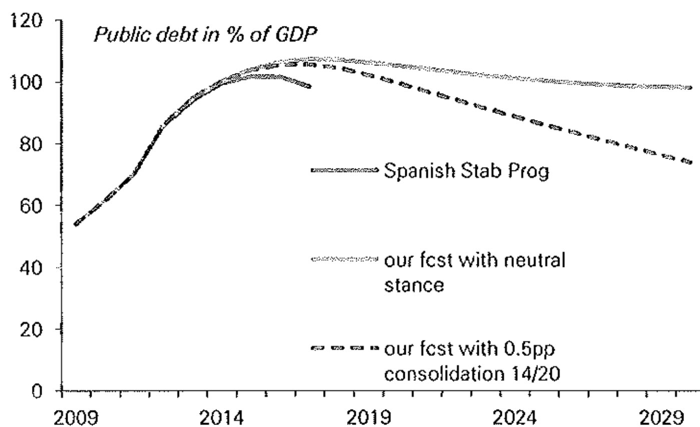
Warning #1: ...but Spain will likely long remain an overleveraged country

Spain's public deficit stood at 7.1% of GDP in 2013, the fourth highest in the Euro area after Slovenia and Greece and more than twice the region's average.

The last instalment of the capital injection in banks cost 0.4% of GDP. The European Commission expects some improvement in 2014, at 5.6%, only 0.1% above the government's target in the latest Stability Program, but under its usual "no policy change" assumption for the following year, Brussels actually expects a deterioration in the deficit in 2015, back to 6.1% of GDP. Obviously, this contrasts with the Spanish's Stability Programme (4.2% of GDP), consistent with bringing the deficit below 3%, as per the trajectory negotiated with Brussels, by 2016.

The government's program is based on a continuation of the discretionary consolidation effort at a pace of 0.5% of GDP (cyclically-adjusted balance) per year from 2015 onward, down from 1% of GDP in 2014. This would bring public debt back below 100% of GDP by 2017 from a peak in 2015 at 101.7% of GDP. Our own debt trajectory – taking into account a 0.5% tightening stance each year until 2020 - is less optimistic, with public debt moving back below 100% in 2020 only. The main difference over 2015-2017 with the Stability Program is the GDP growth outlook. Madrid expects GDP to accelerate swiftly, up to 3% yoy in 2017. With a fiscal multiplier of 1 (which is probably conservative), this means the Spanish authorities count on an "underlying" growth rate – i.e. before the effect of the fiscal contraction – of 3.5% by 2017. We think this is too ambitious, even considering the amount of slack that still needs to be plugged. In our long term trajectory we checked that over 2014/2030 average real GDP growth – 1.5% p.a. – does not exceed too much average potential GDP growth[8] (1.0%).

Figure 5: Public debt trajectory: it may take time....



Source:Spanish treasury, Deutsche Bank

In our trajectory, we stabilise the structural balance by 2020, at a time when the headline deficit is brought back to zero. In the following decade, the budget remains balanced, which calls for quite a lot of discipline. Even under these – we think – optimistic assumptions, by 2030 debt remains quite significantly above the EU's reference value of 60% of GDP. The purpose of this exercise is to remind our readers that the overall quantity of debt across sectors in Spain will likey remain high for a long time.

Total debt in the private non-financial sector (businesses and households) still stood at 206% of GDP in Q4 2013, from a peak at 230% of GDP at the beginning of 2010. The European Commission considers that the level below which private sector leverage is not a threat to economic growth and financial

[8] Note that both the Spanish finance ministry and the European Commission consider that potential GDP growth currently is negative.

stability is 160% of GDP. At the current pace of deleveraging – and we actually need deleveraging to slow down to see a continuation in the recovery in domestic demand – this threshold will not be reached before 2021.

Spain's aggregate balance sheet is in a much better shape now, but its capacity to withstand exogenous shocks should not be overstated.

Lesson # 2: Without European support, Spain would not have made it...

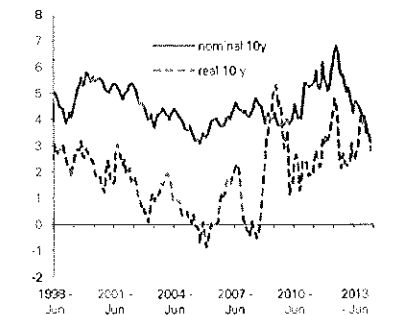
In retrospect, Rajoy was probably right not to request a full-blown support package from the ESM which would have been a condition for OMT intervention. Retaining full sovereignty – at least in appearance – was probably an asset for steering the country through the crisis. However, Spain would not have been able to re-capitalize its banking system without ESM support, and obviously the "potentiality" of OMT played a major role in restoring Spain's market access.

Warning # 2:...and today's interest rates should not be taken from granted

The current level of long term interest rates in Spain is hardly sustainable. We note yields will depend as much on euro-wide as on idiosyncratic Spanish developments. Assuming no downward shift in the inflation regime and a euro-wide potential GDP growth slightly south of 1.5%, the equilibrium rate in the euro area would normally stand between 3% and 3.5%. Given the still fragile balance sheet position of Spain, as discussed in section 1, we think it is reasonable to expect a sustained, significant risk premium for Spain. The government is already taking the normalization of monetary conditions into account in its Stability Program, with a 10 year rate at 4% by 2017. For our public trajectory, we used an average funding cost of 3.6% for the government over 2014/2030.

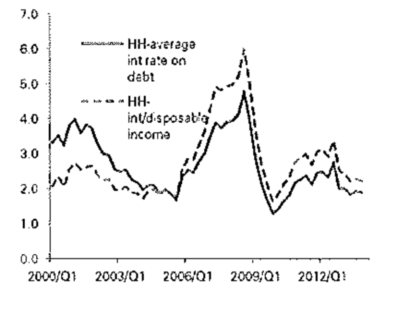
The relief brought by the ECB through a collapse in short term interest rates is less often discussed. True, the commentariat is right to focus on the lack of transmission of the monetary policy stimulus to *new* lending, but Spain still benefited from a significant relief on the stock of debt, in particular thanks to the automatic indexation of most mortgages on money market rates. At peak, in Q3 2008, the average interest rate on accumulated household debt – which we can calculate using the national accounts – stood at 4.8% against 1.9% in Q4 2013. At peak, this meant that interest payments absorbed 6% of household income, against 2% at the end of 2013, bringing an average relief of 0.8% per annum to purchasing power. No small number.

Figure 6: Real long term rates remain historically high

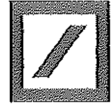


Source: Bloomberg Finance LP, Deutsche Bank

Figure 7: The ECB helped support Spanish household income



Source: EUdata, Deutsche Bank



Even if we expect the ECB to manage to reduce money market rates a bit further next week, the potential gains there are now by construction limited. The ECB will likely keep rates low for a long period of time, but the subsequent normalization in monetary conditions is another reason why, when taking a long term view of Spain, we remain prudent.

Lesson # 3: Cooperative unions matter as much as legislated structural reforms...

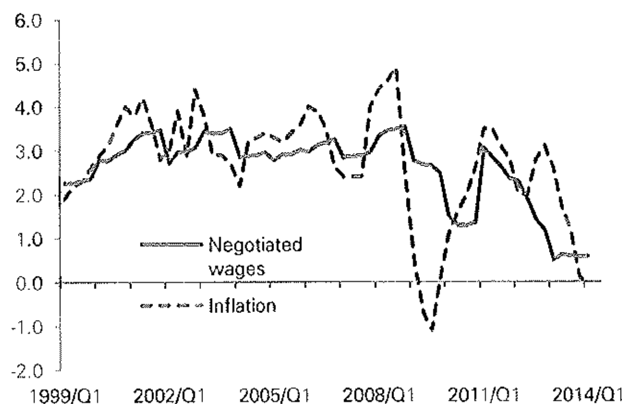
In the first section, we mentioned that compressed labour costs had been the main engine of the private sector adjustment in Spain. This obviously could take several forms: preserving wage growth at the cost of more lay-offs, pre-emptive layoffs keeping businesses alive or job destruction occurring mainly as the result of employers going out of business. In terms of long term cost to the economy – in particular maintaining as much physical and human capital intact – an efficient adjustment would focus on cost rather than headcounts, as well as on pre-emptive rather than reactive layoffs. For this, we note two conditions need to be met: a willingness and capacity of the government to pass the relevant legislation, and cooperative unions.

The commentariat – and we include ourselves – usually focuses on "structural reforms" in the form on new legislative provisions affecting market institutions as a marker of a country's progress. From this point of view, the Spanish government managed to enact important changes such as decline in severance payments, a broader definition of economically motivated layoffs and a possibility for individual companies to opt out of collective agreements at the branch level. All this allows Spanish businesses to reduce their headcounts without, or before, being put out of business.

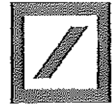
Still, Partido Popular, even if commanding an absolute majority in parliament, could not have steered the country through the adjustment without the implicit support of the unions. True, UGT and COO – the two dominant unions – staged the ritual general strikes, but they also accepted a deep change in wage setting in 2011, finally disposing with ex post indexation on inflation.

This was a crucial issue as inflation in Spain in 2011 and 2012 was artificially boosted by hikes in administrative prices and indirect taxes. This had created a negative supply shock which would have been exacerbated if wages had fully adjusted, thus reducing business margins. Engineering a drop in real wages was a transitorily painful, but necessary step in the adjustment of the Spanish economy.

Figure 8: Nominal wages and inflation converging



Source: INE, Deutsche Bank



Unions are also often accepting of deals with employers around ERTE – a new process through which businesses can temporarily accept a drop in working time and pay. In 2013 alone ERE (a forerunner of ERTE) had affected 370.000 workers.

We think that fairly cooperative unions are a key asset for Spain in attracting Foreign Direct Investment, a key avenue to prop up capital expenditure, at a time when domestic firms are likely still hesitant and maintain productivity gains on the strong post-2008 trend, this time not so much through a reduction in the denominator – labour – but more through the incorporation of technical and organizational innovation.

Warning #3: ...but a delicate balance needs to be found between sustained competitiveness and deflation risks

After a 2 year period of falling real wages – just after the conclusion of the new deal of wage bargaining – nominal wages growth is now roughly in line with inflation, remaining at a very subdued pace. The wage deal is expiring at the end of this year. The leader of UGT has already warned that his organization would seek a better deal than in 2011 and rejected any idea of a like-for-like prolongation of the current system (for 2014 wage growth is indexed on GDP rather than on inflation).

Actually, we think that there may be a case for a prudent acceleration in wages in the next few years in Spain. Indeed, the improvement in Spanish performance on export markets (exports have increased 12% faster than world demand since 2008) together with the current account surplus suggests that the "labour cost purge" may have fulfilled its goal. At the same time, counting solely on an export-led model would be dangerous, in our view. Actually, the contribution from net trade has diminished in 2013 as Spain was exiting from recession, and world demand to Spain is far from stellar (+2.7% yoy in Q4 2013 according to the OECD) as some key markets for Spain (France, the non-European Mediterranean basin, Latin America) are no longer performing very well.

In addition, as we suggested in last week's Focus Europe ("The limits of the export-led strategy"), exporters may have to live with a structurally strong euro now that the region seems to have settled for a substantial current account surplus, while developing the export-oriented tradable sector (manufacturing) may not yield significant results in absorbing mass unemployment. Indeed, even in countries such as Germany, which managed to maintain the share of manufacturing in total output, this sector has not been a net supplier of jobs, which actually came from the services.

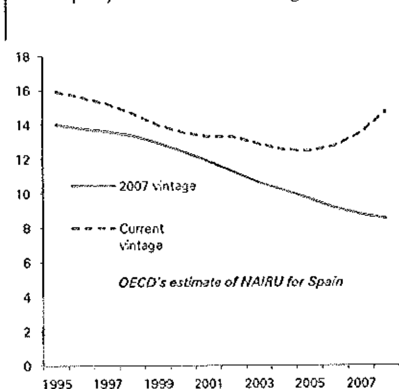
For now, deflation does not seem to rank high in Spanish preoccupations. The very subdued pace of inflation is generally seen as a natural reflection of the country's adjustment and as supportive of purchasing power. While we note this is true, if that becomes entrenched, absorption of accumulated debt would be impaired. The magnitude of slack, though, remains problematic, and engineering some wage growth – and hence supporting demand – would be welcome.

Lesson # 4: Strong social fabric helps to withstand mass unemployment...

The magnitude of Spanish unemployment was often seen as "proof" of the inanity of structural adjustment in the Euro area context. This failed, in our view, to recognize the structural nature of a large share of Spanish unemployment.

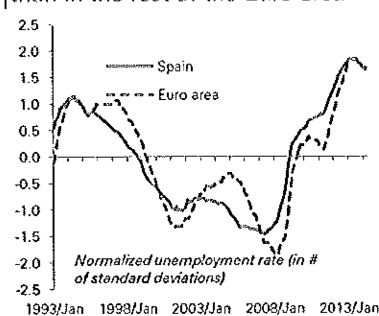
At the cyclical peak, in 2007, the OECD estimated that structural unemployment (proxied here by the NAIRU) for that year stood at 8.8%. In the current vintage, it is now estimated at 13.5% for 2007. First, this shows how fickle this kind of measure can be and second that most observers at the time had failed to recognize how unsustainable Spanish GDP growth was, confusing what was a credit-fuelled overheating – generating a lot of jobs – with genuine potential GDP growth.

Figure 9: Estimating structural unemployment can be tough...



Source: OECD, Deutsche Bank

Figure 10: By historical standards, Spanish unemployment is not higher than in the rest of the Euro area



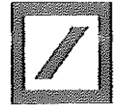
Source: Eudata, Deutsche Bank

Rather than embarking on another estimation of structural unemployment, we simply look at the normalized value of the harmonized unemployment rate, i.e. the distance from the 1993-2014 average expressed in a number of standard deviation. Using this metric, Spain does not appear to be that different from the Euro area aggregate, with an unemployment rate standing now at two standard deviations from average. During the – much milder and shorter – recession of the early 1990s, the unemployment rate had shot up to 20%. The high level of structural unemployment suggests that more reforms are needed, but also that the social fabric of the country is geared towards managing mass unemployment.

Immigration as an "adjustment valve" has also played an important role. Since the beginning of the crisis, the foreign working age population residing in Spain has diminished by 732k. Between Q1 2013 and Q1 2014, using our own seasonal adjustment, the number of unemployed persons fell by 331K, while employment had barely stabilized. The solution to the equation is the drop in the number of working age foreigners by 390k.

Warning # 4: ....but beware of the long term effect on productivity

Still, and that is a point we made several times in FE, mass youth unemployment – a striking feature of Spain, with a labour market operating to



a large extent as a "waiting room" - entails a long term cost, even if in the short run it probably reduces the risk to financial stability (the cost of the adjustment disproportionately rests on those who have a low level of debt), since there is a negative correlation between labour productivity and an ageing workforce. Earlier, we estimated the long term impact of the increase in Spanish youth unemployment since 2008 on productivity at 0.3% p.a, offsetting the near-entirety of the boost received from the structural reforms.

Lesson# 5: incumbent governments can still win elections....

The "Jean-Claude Juncker paradox", according to which governments in Europe know very well what to do, but do not know how to get re-elected afterwards, may not hold in Spain. Indeed, there the incumbent Popular Party came out first in the European elections last week, with 26% of the votes. Actually, what we find remarkable in Spain is that 6 years into the crisis the two traditionally dominant political forces, PP and PSOE, topped the polls. The political landscape in Spain is not dislocated by the emergence of populist parties, contrary to what happened to its Northern neighbor.

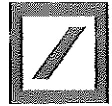
Warning #5: ...but the capacity to form an effective coalition in 2015 is unclear

PP and PSOE together controlled 73.4% during the general elections in 2011; however, this time they gathered only 49%. While there is no serious competition to PP on the right, support for the centre-right collapsed from 44% in 2011 to 26%. The most striking shift, though, was on the left, with (i) significant progress for IU, the traditional radical left party with roots in the communist movement (9.7% against 6.9%) and (ii) the emergence of a grass-root, leftist protest party ("podemos") which gathered 8% of the votes. The socialist party – which leader resigned – lost further ground from the general elections with 23% of the votes (against 28.8%). This may mean two things.

First, at this stage, assuming last week's results were replicated in the general elections next year, there is no credible government alternative on the left. While IU, Podemos and the socialists, to which regional leftist parties would need to be added, totaled more than 40% (the usual majority threshold in parliament), we think the ideological distance between these organizations are too wide to build a workable platform.

Second, PP is isolated. It is the largest Spanish party, but does not have any natural partner. Given its staunchly centralist stance, forming alliances with regional centre-right parties will be difficult. The progressive-centrist UPyD, which shares PP's distaste for devolution, improved its score at 6.5% from 4.7%, but remains small and radically disagrees with PP on social issues.

We do not want to draw too much from the European elections, which offer the ideal platform for protests groups which may face more difficulties to attract the same share of the electorate when choosing the next national government will be on the agenda. Still, while Madrid continues to face the independentist push from Catalonia, the capacity to build a majority that would be as forceful as the current administration in continuing the adjustment after next year is now in question. This is another reason to praise Spain for the progress made so far, but also to warn against excessive euphoria.



Appendix 1

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Risks to Fixed Income Positions

Macroeconomic fluctuations often account for most of the risks associated with exposures to instruments that promise to pay fixed or variable interest rates. For an investor that is long fixed rate instruments (thus receiving these cash flows), increases in interest rates naturally lift the discount factors applied to the expected cash flows and thus cause a

loss. The longer the maturity of a certain cash flow and the higher the move in the discount factor, the higher will be the loss. Upside surprises in inflation, fiscal funding needs, and FX depreciation rates are among the most common adverse macroeconomic shocks to receivers. But counterparty exposure, issuer creditworthiness, client segmentation, regulation (including changes in assets holding limits for different types of investors), changes in tax policies, currency convertibility (which may constrain currency conversion, repatriation of profits and/or the liquidation of positions), and settlement issues related to local clearing houses are also important risk factors to be considered. The sensitivity of fixed income instruments to macroeconomic shocks may be mitigated by indexing the contracted cash flows to inflation, to FX depreciation, or to specified interest rates - these are common in emerging markets. It is important to note that the index fixings may -- by construction -- lag or mis-measure the actual move in the underlying variables they are intended to track. The choice of the proper fixing (or metric) is particularly important in swaps markets, where floating coupon rates (i.e., coupons indexed to a typically short-dated interest rate reference index) are exchanged for fixed coupons. It is also important to acknowledge that funding in a currency that differs from the currency in which the coupons to be received are denominated carries FX risk. Naturally, options on swaps (swaptions) also bear the risks typical to options in addition to the risks related to rates movements.

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