Spain turns the corner, but the legacy from the crisis persists

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(1) Summary

The programme of reforms and austerity measures has set Spain on a path of accelerating growth, but the legacy from the crisis is such that unemployment will remain very high for several years yet. The budget deficit is gradually coming down, though not public debt in GDP terms; exports continue to grow, but less so than in the last couple of years; the banking system is more solvent; foreign direct investment in Spain is rising; net migration is outward and not inward and the political map is changing.

(2) Background to the crisis

Spain was hard hit by the bursting of its property bubble in 2008, whose creation was fuelled by very low interest rates and a staggering number of housing starts (762,214 in 2006 alone, reportedly more than Germany, France and Italy combined). The collapse of this sector, which forged a lopsided economy, followed the subprime mortgage crisis in the US and the downfall of Lehman Brothers, events that intensified the global credit squeeze and triggered the deepest downturn in the global economy since the Great Depression in the 1930s. Until its crash the Spanish economy had roared along at an annual average of 3.5% between 1995 and 2007, the highest and longest growth period since the 1970s. Between 2008 and 2013, the Spanish economy shrank by 6%.

When the bubble burst jobs, many of them temporary, were destroyed almost as quickly as they had been created and Spain was plunged into a five-year on-off recession. Between 2002 and 2007 the total number of jobholders rose by 4.1 million, a much steeper increase than in any other EU country and more than three times higher than the number created in the preceding 16 years. Since 2008, more than 3 million jobs have been lost, over half of them in the construction and related sectors, and the ranks of the unemployed have also been swelled by those coming onto the labour market and actively looking for work. The total number of unemployed, as measured by the latest quarterly labour force survey, stands at 5.6 million (a jobless rate of 25.9%).

The current account deficit ballooned to 10% of GDP in 2007, underscoring the extent to which the economy had become overheated and uncompetitive and the degree to which Spaniards, in general, and some companies, in particular, were living way beyond their means and on borrowed money.

Banks, particularly the 47 *cajas de ahorro* (regionally-based savings banks), were massively over exposed to the property sector and some of them had to be bailed out by the EU, most notably Bankia, Spain's fourth-largest bank, which was nationalised in 2012. The depth of the banking crisis was such that Miguel Ángel Fernández Ordóñez, the former Governor of the Bank of Spain, feared that it could force Spain out of the euro zone.

The rapid deterioration of the budget deficit (it reached 9.1% of GDP in 2011 as a result of plummeting tax revenues and rising spending) and the perception of the dangers inherent in a growing feedback loop between sovereign risk and banking risk pushed up Spain's sovereign debt yields to 7.5% on the 10-year bond at the end of July 2012. This was the level in Greece, Portugal and Ireland that triggered their sovereign bailouts by the EU. The risk premium on government bonds –the difference between Spain's 10-year bond yields and those of low-risk Germany– rose briefly to more than 650 basis points, from an average of 8 basis points in 2007. Public debt soared from 36% of GDP in 2007 to 70% to 94% in 2013 and continues to rise. The net international investment position reached almost 100% of GDP in 2013, one of the most negative in the euro zone.

The Popular Party swept the board in the November 2011 election, ejecting the Socialists from their eight years in office, and began a major programme of reforms and austerity measures that are beginning to bear fruit (see Figure 1).

Figure 1. A summary of Spain's structural reforms

What has been done	Work in progress
Strengthening the financial system Financial Sector Assistance Programme (2012-14) was successfully completed. Enhanced restructuring, resolution and supervision of banks. • Recapitalisation, transfer of assets to SAREB ('bad bank'), consolidation and restructuring. • Overhaul of savings bank framework.	**Strengthening the financial system** Reviewing insolvency regime (2014) to ease restructuring process. Some measures have already been adopted. Improve legal framework for venture capital (exp. 2014) to facilitate investment in SMEs. Law for the Promotion of Business Financing (exp. 2014): easier access to banking financing for SMEs and stronger foundation for non-corporate financing.
Ensuring the sustainability of public accounts Constitutional reform (2011) to ensure budgetary discipline and sustainability. Organic Law on Budgetary Stability and Financial Stability (2012). Pension Reform (2013) Creation of the Independent Fiscal Responsibility Authority (2013). Law of Rationalisation of Local Authorities (2013)	**Ensuring the sustainability of public accounts** Ongoing fiscal consolidation. • Further contain public spending. • Fight tax and social security fraud. Tax reform (approved in June 2014). Commission for the Reform of Public Administrations has been set up-ongoing efforts to modernise and rationalise public sector.
Increasing competitiveness Labour market (2012). Increased flexibility for firms, reduced dismissal costs. Entrepreneurship law (2013). Facilitated funding for entrepreneurs and new limited liability company. Creation of the National Commission for Markets and Competition (2013). Flexibility of retail hours and reduction of licences at municipal level. Electricity sector. Reforms to contain costs and eliminate the tariff deficit (2013). Further legislation to be approved in 2014.	**Increasing competitiveness** Implement law on the Guarantee of Market Unity and Plan for Regulatory Simplification. Active labour market policies. Results-oriented approach and focus on youth. Improve job placement via a single portal for job vacancies and public-private collaboration. Law on Professional Services (expected 2014), to reduce barriers to entry and exercise of services. Law on De-indexation (exp. 2014) to limit indexation in public sector.

Source: IMF Spain country report No. 14/192, July 2014.

The export-led economy began to grow again in the second half of 2013. The recovery is accelerating; growth this year is forecast at close to 1.5% and up to 2% in 2015. The better macroeconomic picture includes:

- The current account was in surplus last year (1% of GDP, a remarkable improvement since 2007) for the first time since 1986.
- Domestic demand is finally starting to rebound, as shown by the spurt in imports this year and a loss of steam in exports.

- Direct inward foreign investment has risen, and Spanish companies are investing abroad again.
- Sovereign yields are at pre-crisis lows. The interest rate on the 10-year bond fell below 2.5% in July for the first time ever.
- The government exited the bailout programme for banks in January.
- The budget deficit is coming down, albeit more slowly than desired.
- Modest net job creation is underway.

The legacy from the crisis, however, persists and will be with Spain for a long time.

(3) Unemployment: net job creation finally arrives

What stands out is the disproportionate rise in unemployment as compared to the degree of shrinkage of the economy. GDP declined by around 6% between 2008 and 2013, but the official jobless rate more than trebled to 26%. No other EU country except for Greece has seen its unemployment rate soar to such an extent as Spain's. The number of households with all adults unemployed has tripled since 2007 to 1.8 million.

Even in 2007, at the height of its illusory economic boom, Spain's unemployment rate was 8%, a level regarded by some as full employment, as employers complained they could not fill posts. Clearly, Spain has a dysfunctional labour market. Why has unemployment risen so much? An important factor is Spain's lopsided economic model, excessively based on bricks and mortar, which is beginning to be rebalanced. The construction sector officially employed 2.7 million people in 2007 (more if those in the black economy are included), many of them on temporary contracts and the first to lose their jobs. This number was down to 970,000 in June 2014 (see Figure 2).

Figure 2. Employment in Spain by sectors, 2007-14 (1) (million jobs)

	2007	2008	2009	2010	2011	2012	2013	2014 (1)
Services	13.59	13.83	13.38	13.40	13.19	12.71	12.71	13.27
Industry	3.27	3.04	2.68	2.62	2.52	2.38	2.27	2.35
Construction	2.69	2.18	1.80	1.57	1.27	1.07	0.97	0.97
Agriculture	0.90	0.80	0.78	0.80	0.80	0.78	0.79	0.73
Total jobs	20.45	19.85	18.64	18.40	17.80	16.95	16.75	17.35

(1) June.

Source: INE, based on labour force survey.

The youth unemployment rate is put at a staggering 56%, and yet if one calculates it by the other method used by Eurostat, the EU's statistics agency, which is more realistic and known as the unemployment ratio, it is much lower. The youth unemployment ratio uses as its denominator all young people between the ages of 16 and 24 and gives a figure roughly in line with the national rate, while the denominator for the youth jobless rate are those in the labour force, ie, employed or actively seeking employment. The jobless rate formula makes sense among adults, but applying it to an age group where most people are still in education or training distorts its meaning.

A factor that tends to be overlooked when getting one's head around the scale of Spain's unemployment is the influx of immigrants. The foreign-born population has risen from 165,000 in 1974 to 4.6 million at the start of 2014 (excluding naturalised Spaniards). No other EU country has received such a large number of immigrants in a short time span (mostly between 2000 and 2010). Immigrants were particularly needed in the construction and agricultural sectors, as there were not enough Spaniards prepared to work in them. At the peak of the boom in 2007 more than half of the 3.3 million non-EU immigrants in Spain (mainly Latin Americans and North Africans) worked in the construction sector. When the economy went into recession, immigrants bore a large part of the surge in unemployment. The jobless rate among foreigners today (34%) is much higher than for Spaniards (23%). Only in the past two years have immigrants begun to return home (see the section on migration).

Spain is now beginning to create jobs in net terms. The government's labour market reforms, approved in 2012, have lowered the GDP growth threshold for net job creation from around 2% to 1.3% (the projected growth for this year), reduced dismissal costs and give companies the upper hand, depending on their financial health, in collective wage bargaining agreements.

The number of unemployed dropped from 5.9 million in March to 5.6 million in June, the lowest since the fourth quarter of 2011, according to the latest quarterly labour force survey. The jobless rate has inched down from 25.9% to 24.5%. Encouragingly, the drop occurred despite an increase in the labour force. This suggests that an upward trend in employment is taking hold and that the improvement is not just a statistical one. The great bulk of the rise in employment was due to the service sector –263,800 more jobs in the 12 months to June compared with a fall of 55,200 in construction and 13,800 in agriculture–. Most of the new jobs in services were in tourism and related sectors as Spain is enjoying another bumper year in foreign visitors. They are thus seasonal jobs and not permanent ones.

The labour market is still far too divided between well-protected 'insiders' on permanent contracts and precarious 'outsiders', who cycle between temporary jobs and unemployment. The proportion of jobholders on temporary contracts was 24% at the last count in June, down from 31.5% at the peak of the economic boom in 2007 but still some 10 percentage points well above the EU average.

In the IMF's view this division 'encourages rigidity in wage demands by insiders, since it places the burden of adjustment on outsiders (who have the same wages but lower firing costs). It also hurts productivity, as there is less investment in temporary workers and long spells in unemployment reduce human capital'.

No analyst, international institution or the government itself believes the jobless rate will drop below 20% before 2017 and there is a very long way to go before recovering the pre-crisis jobless rate of 8%. To do this, the number of unemployed has to be reduced by 4.5 million. In order to reach the structural unemployment rate of the last 30 years (14%), unemployment has to be cut by more than 3 million. Growth in itself not sufficient to reduce Spain's unemployment, due to its composition: 61% are long-term jobless; 42% over the age of 45; 55% have not completed their advanced secondary education; and 15% are under the age of 25 and have no work experience. The dire situation is highlighted by the sharp drop in Spain's employment rate –defined as those with a job as percentage of the working age population– from 64.5% in 2008 to 54.8% last year, compared to a fall of only 1.2 percentage points in the average for OECD countries (see Figure 3).

Figure 3. Employment rate, 2008 and 2013 (%)

	2013	2008
Germany	73.3	70.1
UK	70.8	71.5
OECD average	65.2	66.4
France	64.1	64.8
Italy	55.6	58.8
Spain	**54.8**	**64.5**

Source: OECD.

The education system continues to hold back the need to create a more sustainable and knowledge-based economic model. One in every four people in Spain between the ages of 18 and 24 are early school leavers, double the EU average but down from a peak of one-third during the economic boom when jobs were easy to find. Teenagers today have no option but to stay on at school. Even worse, almost one-quarter of 15-29 year-olds are not in education, training or employment, known as NEETs. The results in the OECD's Pisa international tests in reading, mathematics, scientific knowledge and financial literacy for 15-year-old students and for fourth-grade children in the TIMS and PIRLS tests are poor; no Spanish university is among the world's top 160 in the main rankings and R&D spending, at 1.3% of GDP, is way below that of other developed economies. Some of the brightest young scientists and engineers are emigrating. According to an OECD study, around 70,000 of the graduates hired last year were in jobs for which they were over qualified and many were in jobs for which they required hardly any studies at all.

(4) General government accounts: moving in the right direction

The headline budget deficit was reduced from a peak of 11.1% of GDP in 2009, under the last Socialist government, to 7.1% in 2013 (6.6% net of the one-off financial support for the recapitalisation of banks), in the second year of the Popular

Party government (see Figure 4). The structural primary balance was positive in 2013 for the first time since 2007 (surplus of 1.4% of GDP).[1]

Figure 4. General government balance, 2009 and 2013 (% of GDP, excessive deficit procedure)

	France	Germany	Italy	Spain
2009	-7.5	-3.1	-5.5	-11.1
2013	-4.3	0.0	-3.0	-7.1

Source: Eurostat.

More than halving it to the EU threshold of 3% of GDP in 2016, a commitment made by Madrid to Brussels after receiving a two-year extension in 2013, is going to be very difficult, particularly since a general election will be held by the end of 2015, making further spending cuts politically unpopular. Meanwhile, gross public debt is approaching 100% of GDP (see Figure 5).

Figure 5. General government consolidated gross debt, 2009 and 2013 (% of GDP, excessive deficit procedure)

	France	Germany	Italy	Spain
2009	79.2	74.5	116.4	54.0
2013	93.5	78.4	132.6	93.9

Source: Eurostat.

Also, the government's package of tax reforms, which comes into force in 2015, will reduce tax receipts. The top income tax rate will come down from 52% to 47% and the bottom rate from 27% to 24%. The corporate rate will fall from 30% to 28% and to 25% in 2016. These and other changes will deprive the state of revenues estimated at 0.9% of GDP. With the economy accelerating, the government is putting its faith in the elasticity of tax revenue to growth (the Laffer curve).

The government steered away from the unpopular measure of raising more revenue from VAT, one of the main recommendations of the non-binding report produced at its request by a committee of experts. The standard VAT rate of 21% (raised from 18% in September 2012) is in line with that of most other EU countries, but a wide range of goods and services pay a lower rate. Spain's VAT take in 2012 was 5.5% of GDP, the lowest level among the 28 EU countries (see Figure 6). The total tax burden in 2013 was 37% of GDP, also below the EU average.

1 This balance is a good indicator of the real progress made in fiscal consolidation as it is calculated by subtracting the cyclical component of revenues and spending from the actual balance. The structural balance shows what part of the actual balance is independent of the economic cycle.

Figure 6. VAT revenue (% of GDP), 2012 and 2007

	2012	2007
Denmark	10.0	10.4
UK	7.3	6.4
Germany	7.3	7.0
EU-28	7.1	7.0
France	7.0	7.2
Italy	6.1	6.2
Spain	**5.5**	**6.0**

Source: Eurostat.

While the tax reforms are questionable, fiscal consolidation is benefiting from a sensible and milestone pension reform that is designed to ensure the system's sustainability. With a greying population, a low fertility rate and fewer social security contributors per pensioner, because of the very high unemployment, Spain's pension system was not sustainable in its previous form. Rises in pension payments are no longer automatically indexed to annual inflation. As of this year, pension payments will rise by a minimum of 0.25% every year, well below inflation rates expected to be between 1% and 2%, while maximum increases will be capped at inflation rates plus a 0.25% percent top up.

Public pension spending is currently projected to decline from 10% of GDP in 2010 to 9.6% in 2060 (EU average estimated at 12.9% of GDP), compared with a forecast of 13.7% in 2060 before the reform.

More than one-third of Spain's population in 2050 will be over the age of 65, the third-highest proportion in the world, according to latest projections by the United Nations Population Division (see Figure 7). The fertility rate of 1.32 (see Figure 8) is below the replacement rate (the reproduction rate that keeps a population stable).

Figure 7. Population over the age of 65 in 2010 and 2050 (% of total)

	2010	2050
Japan	23.0	36.5
South Korea	11.1	34.9
Spain	**17.1**	**34.5**
Italy	20.3	33.0
Germany	20.8	32.7
France	16.8	25.5
UK	16.6	24.7

Source: United Nations Population Division.

Figure 8. Fertility rate in EU countries

	Children per woman
Ireland	2.01
France	2.01
UK	1.92
Italy	1.43
Germany	1.38
Spain	**1.32**
Portugal	1.28

Source: United Nations Population Division.

(5) Banking: a more solvent and resilient system

The banking crisis was concentrated in the 45 regionally-based and unlisted savings banks, which accounted for around half Spain's financial system and were closely connected to local politicians and their business associates. Their crony capitalism and spoils system exposed them massively to the real estate sector and necessitated a €41 billion bail-out (out of the available €100 billion) by the European Stability Mechanism (ESM) in 2012, mainly for nationalised Bankia, the fourth-largest bank headed by Rodrigo Rato, a former managing director of the IMF and economy supremo in the last Popular Party government, in return for sweeping reforms. The total losses of banking groups in 2012 year were €55.6 billion, compared with a loss of €1.5 million in 2011 and profits of €20.2 billion in 2009.

Probably no other European country had such a surge in 'bankarisation' as Spain: the number of savings bank branches almost doubled between 1990 and 2008 to a peak of 25,000, while the number of branches of the more prudent commercial banks reached 15,600. There was almost one bank branch (savings and commercial banks) for every 1,000 persons in 2008, almost twice the density of the euro-area average. The total number of bank branches is now down to around 33,500 from a high of more than 40,000 and the number of savings banks has been reduced to seven as a result of mergers, interventions and take-overs. Spain successfully exited the bail-out programme last January.

Non-performing loans (NPLs) shot up from a mere 0.7% of total lending in 2007 to 13.6% at the end of 2013 and began to inch down this year. Profitability is much improved on 2012 when both ROA and ROE were negative (see Figure 9). Bankia's net profit jumped 50% year-on-year in the first half of 2014 to €245 million and that of Santander, the euro zone's largest bank by market capitalisation, 22% to €2.76 billion. The government took advantage of the positive shift in sentiment toward Spain and sold 7.5% in Bankia in February. It has until 2017 to re-privatise the bank.

Figure 9. Selected financial soundness indicators (% or otherwise indicated), 2006 and 2012-14

	2006	2012	2013	2014 (latest)
Core Tier 1 capital ratio	7.5	10.0	11.8	–
Return on average assets	1.0	-1.4	0.4	–
Return on average equity	19.5	-21.0	5.3	–
Non-performing to total loans	0.7	10.4	13.6	13.4
Non-performing to construction loans	0.3	28.2	37.1	37.1
Non-performing to house purchase loans	0.4	4.0	6.0	6.0
Coverage ratio (provisions to NPLs)	43.6	42.6	46.9	47.4
Use of ECB refinancing (€ billion)	21.2	357.3	206.8	185.0
Loan-to-deposit ratio	165.0	137.3	123.0	124.3

Source: Source: IMF Spain country report No. 14/192, July 2014.

Capital has been bolstered: the core Tier 1 ratio rose from a pre-crisis level of 7.5% in 2006 to 11.8% at the end of 2013. The coverage ratio (specific reserves to NPLs) stands at around 47%, up from 36% at the start of the ESM programme, liquidity is stronger as measured by the loan-to-deposit ratio (124%, down from 165% in 2006) and reliance on European Central Bank funding has halved since 2012.

The bank restructuring fund FROB finally managed in July to sell Catalunya Banc, one of the last lenders in state hands, after two failed attempts. BBVA, Spain's second-largest bank, paid €1.2 billion for Catalunya, which was nationalised in 2011 and received a rescue injection of €12 billion. The sale represented a considerable loss to the taxpayer.

Total state aid to 12 banks between 2009 and 2013 amounted to €61.4 billion according to the Bank of Spain, only around 4% of which had been recovered by July 2014 (including the proceeds from Catalunya Banc). Including guarantees, the overall amount of public money used to shore up banks is put at more than €100 billion. Spain still has to divest one state-controlled bank, Banco Mare Nostrum, which is expected to happen through a public stock offering.

Lending has contracted rapidly due to various factors including still weak credit demand, over cautious banks fearful of more defaults (having previously fallen over themselves to make loans) and a heavily indebted private sector that is still deleveraging.

(6) Merchandise exports: a success story so far

Spain's gradual recovery has been driven by exports, which set new records every year between 2009 and 2013 (see Figure 10). But for this performance the recession would have been deeper and the recovery would have taken longer. Exports increased in these five years by €74.3 billion, equivalent to 7% of 2009's GDP (at current market prices) and a faster pace of growth than Germany, France and Italy, albeit from a much smaller base. Merchandise exports rose from 15.7% of

GDP in 2009 to 23.3% in 2013, although this increase was partly due to shrinking national output. The number of companies regularly exporting in 2013 (ie, for more than four consecutive years) was 41,163 out of a total of around 145,000, compared with 39,320 in 2007 out of a total of 100,000.

Figure 10. Main foreign trade magnitudes, 2009-14 (1)

	Goods exports (€ bn)	Goods imports (€ bn)	Balance (€ bn)	Coverage (%) (2)
2009	159.9	206.1	-46.2	77.6
2010	186.8	240.0	-53.2	77.8
2011	215.2	263.1	-47.9	81.8
2012	226.1	257.9	-31.8	87.7
2013	234.2	250.2	16.0	93.6
2014 (1)	98.6	109.0	10.4	90.5

(1) First five months.

(2) Percentage of imports covered by exports.

Source: Ministry of Economy and Competitiveness.

Traditionally, domestic and not external demand has been the engine of Spain's growth: between 1988 and 2013, the contribution of external demand to GDP growth was positive in only eight years, six of them since 2008 (see Figure 11). Domestic demand is forecast to be positive this year for the first time since 2007, the year that Spain's boom period ended, as exports are losing steam and imports are rising on the back of stronger domestic demand.

Figure 11. Total domestic demand (% change), net exports (contribution to growth) and GDP growth (% change), 2009-14 (1)

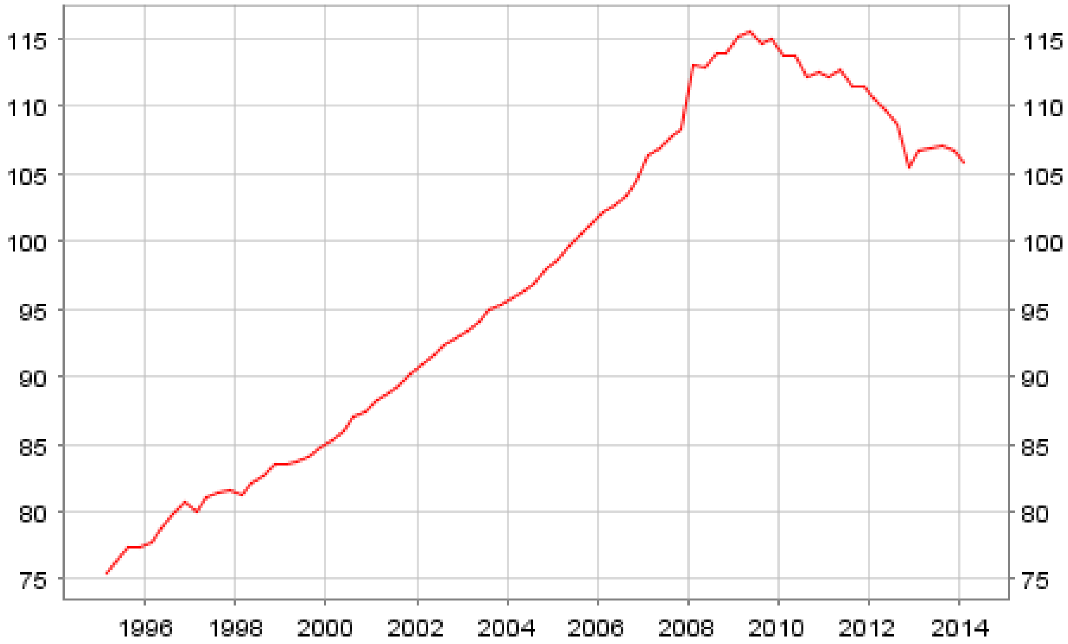
	2009	2010	2011	2012	2013	2014[1]
Dom. demand	-6.7	-0.6	-2.0	-4.1	-2.7	0.7
Net exports	2.9	0.4	2.1	2.5	1.5	0.5
GDP	-3.8	-0.2	0.1	-1.6	-1.2	1.2

Source: IMF.

The higher exports of goods and also of services (10.7% of GDP, up 8.5% in 2007), coupled with bumper tourism receipts (forecasted record of more than 63 million visitors in 2014), have helped to achieve a turnaround in the current account –from a deficit of 10% of GDP in 2010 to a 1% surplus in 2013–. According to the IMF, only one other advanced large non-commodity exporting country has had a similar current account improvement: South Korea in 1997-98. Germany had a similar current account improvement during the early 2000s, but it took seven years and it benefited, unlike Spain, from a vibrant global economy.

Spain has managed this without resorting to a currency depreciation, something that as a euro zone country it cannot do. It did it by becoming more competitive through improved unit labour costs as of the third quarter of 2009. This improvement largely reflects labour shedding and greater productivity (see Figure 12).

Figure 12. Unit labour costs, deflator, national currency, working day and seasonally adjusted, index (ESA95 National Accounts)



Source: Eurostat and European Central Bank.

Spain rose six places in the latest world competitiveness ranking of the IMD, the Swiss business school, to 39th spot out of 60 countries. Its rise was greater than that of any other European country (see Figure 13).

Figure 13. IMD world competitiveness ranking, 2014 and 2013

	2014 ranking	2013 ranking
US	1	1
Germany	6	9
UK	16	18
France	27	28
Spain	**39**	**45**
Italy	46	44

Source: IMD World Competitiveness Yearbook 2014.

The global ranking is based on four categories: economic performance, government efficiency, business efficiency and infrastructure. Each of these categories, in turn, is based on five elements (see Figure 14).

Figure 14. Factors that comprise Spain's overall ranking, 2010-14

	2010	2011	2012	2013	2014
Economic performance	41	47	51	53	51
Government efficiency	45	38	40	50	46
Business efficiency	44	38	46	50	42
Infrastructure	28	26	27	27	27
Overall ranking	36	35	39	45	39

Source: IMD World Competitiveness Yearbook 2014.

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 15), according to the World Trade Organisation (WTO).

Figure 15. 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	3.7	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 structure of exports has also become more diversified, with food and drink overtaking those of vehicles, while sales outside of the euro zone have risen to some areas (see Figures 16 and 17).

Figure 16. Exports by sectors, first five months of 2014 (% of the total)

	% of total	Change 2014/13	Rep (1)
Capital goods	20.1	-3.4	-0.7
Food, drink and tobacco	16.1	6.2	1.0
Automotive	15.1	5.3	0.8
Chemical products	14.3	0.8	0.1
Non-chemical semi-manufactured goods	10.9	2.3	0.2
Consumer manufactures	9.0	6.0	0.5
Energy products	6.4	-4.3	-0.3
Other goods	4.2	-12.0	-0.6
Raw materials	2.5	-6.8	-0.2
Consumer durables	1.4	-0.7	0.0
Total	100.0	0.8	0.8

(1) Contribution in percentage points to the growth in exports.

Source: Ministry of Economy and Competitiveness.

Figure 17. Distribution of exports by geographical areas, first five months of 2014 (% of the total)

	% of total	Change 2014/13	Rep (1)
Europe	70.3	2.5	1.7
Euro zone	50.1	3.9	1.9
North America	4.7	10.2	0.4
Latin America	5.8	-4.7	-0.3
Asia	9.2	2.0	0.2
Middle East	3.1	-10.8	-0.4
Africa	6.9	-2.6	-0.2
Oceania	0.8	-27.5	-0.3
Total	100.0	0.8	0.8

(1) Contribution in percentage points to the growth in exports.

Source: Ministry of Economy and Competitiveness.

The challenge for Spain is to sustain the momentum of exports and not revert to an economy excessively driven by domestic demand which, given past experience, would create imbalances in the future.

(7) Inward and outward direct investment: on the rise

Foreign direct investment (FDI) in Spain, which has long played an important role in the economy, is on the rise, reflecting the greater confidence in the country and the attractive pricing of assets for sale, particularly in the depressed property and banking sectors. Meanwhile, the law on the guarantee of market unity adopted in December 2013 is improving the business environment and reducing administrative burdens: the domestic market has been fragmented by different layers of regulation in more than 30 sectors.

Net inward FDI rose 52.4% last year to US$39.16 billion, the highest level since 2010 and the largest in Europe, according to UNCTAD (see Figure 18), and it increased 10.2% in the first quarter of 2014 to €1.62 billion, according to the Spanish Registry of investments. The inward stock of FDI reached US$715.99 billion (52.7% of GDP) last year, up sharply from US$644.67 in 2012.

Figure 18. FDI inflows by EU countries, 2008-13 (US$ million)

	2008	2009	2010	2011	2012	2013
France	64,184	24,215	33,628	38,547	25,086	4,875
Germany	8,109	23,789	65,620	59,317	13,203	26,721
Ireland	-16,453	25,712	42,804	23,545	38,315	35,520
Italy	-10,835	20,077	9,178	34,324	93	16,508
Netherlands	4,549	38,610	-7,324	21,047	9,706	24,389
Spain	**76,993**	**10,407**	**39,873**	**28,379**	**25,696**	**39,167**
UK	89,026	76,301	49,617	51,137	45,796	37,101

Source: World Investment Report 2014, UNCTAD.

The largest investment so far this year is Vodafone's €7.2 billion acquisition in May of cable operator Ono.

Outward direct investment by Spanish companies was US$26.03 billion in 2013 (US$3.98 billion negative in 2012 after deducting disinvestments), according to UNCTAD (see Figure 19), and it almost doubled in the first quarter of 2014 to €3.83 billion, according to the Spanish Registry of Investments. The outward stock amounted to US$643.22 billion (47.3% of GDP) last year compared to US$636.73 billion in 2012.

Figure 19. FDI outflows by EU countries, 2008-2013 (US$ million)

	2008	2009	2010	2011	2012	2013
France	155,047	107,136	64,575	59,552	37,195	-2,555
Germany	72,758	69,639	126,310	80,971	79,607	57,550
Italy	67,000	21,275	32,655	53,629	7,980	31,663
Netherlands	68,334	34,471	68,341	39,502	267	37,432
Spain	**74,717**	**13,070**	**37,844**	**41,164**	**-3,982**	**26,035**
Sweden	30,363	26,202	20,349	29,861	28,951	33,281
UK	183,153	39,287	39,416	106,673	34,965	19,440

Source: World Investment Report 2014, UNCTAD.

Among the largest investments abroad are Santander's purchase of an 8% stake in China's Bank of Shanghai for €470 million and its €700 million acquisition of GE Capital's consumer finance unit in Sweden, Denmark and Norway. The bank is already the largest provider of auto finance in the Nordic region.

(8) Migration: a turnaround

The impact of the crisis on migration, both into and out of Spain, has been profound. The population fell in 2013 for the second year in a row, to 46.5 million from 46.8 million in 2011, as a result of an exodus of immigrants. Between 2001 and 2010, the population rose by close to 6 million, the largest rise in a decade in Spain's history and very largely due to an unprecedented influx of immigrants.

The crisis has sparked, on the one hand, a return of immigrants to their home countries and emigration of Spaniards and, on the other, a fall in immigration to Spain. Total net migration of foreigners and Spaniards (the difference between emigration and immigration) was 80.2% higher in 2013 at 256,849, up from 42,675 in 2010 and net immigration of 12,845 in 2009 (see Figure 20).

Figure 20. Net migration of foreigners and Spaniards, 2009-13

	Immigration	Emigration	Balance
2009	392,963	380,118	12,845
2010	360,704	403,379	-42,675
2011	371,335	409,034	-37,698
2012	304,054	446,606	-142,552
2013 (1)	291,041	547,890	-256,849

(1) Provisional figures.

Source: INE.

The foreign-born population (excluding naturalised Spaniards estimated at around 900,000) fell 7.8% last year to 4.67 million (10% of the total population, down from a peak of 12.2% in 2010). The largest outflow of immigrants was of Ecuadoreans, 56,466 of whom left Spain (see Figure 21). Britons are also leaving: pensioners are finding it increasingly difficult to make ends meet because of the rise in the cost of living since they retired to Spain.

Figure 21. Resident foreign population by main nationalities in 2012 and 2013

	1 January 2013	1 January 2014	Change
Rumania	769,608	730,340	-39,269
Morocco	759,273	714,221	-45,052
UK	316,362	311,774	-4,588
Ecuador	269,436	212,970	-56,466
Italy	181,046	182,249	+1,203
Colombia	223,140	172,368	-50,772
China	169,645	164,555	-5,091

Source: INE.

Of the 547,890 emigrants, 22.7% more than in 2012, 52,160 were native Spaniards and 27,146 naturalised Spaniards. Net migration of native and naturalised Spaniards has risen steadily since 2008 and last year was 45,913, up from a mere 1,804 in 2008 at the start of the crisis, but less than 20% of the total (see Figure 22).

Figure 22. Net migration of native and naturalised Spaniards, 2008-13

	Immigration	Emigration	Balance
2008	31,701	33,505	-1,804
2009	27,596	35,990	-8,394
2010	30,418	40,157	-9,739
2011	35,442	55,472	-20,030
2012	31,565	57,267	-25,702
2013	33,393	79,306	-45,913

Source: INE.

(9) Human development: income inequality more skewed

Spain has suffered its first sustained drop in per capita income since the late 1950s and the stabilisation plan that ended autarky and opened up the economy. Income dropped from US$31,369 in 2009 to around US$29,000 in 2013, but it was still double that in 1982. However, it had fallen to 95% of the average EU income, the same level as in 1997, from a peak of 105% in 2007 (see Figure 23). That year Spain overtook Italy on this basis and an exuberant José Luis Rodríguez Zapatero, the former Socialist Prime Minister, boasted that Spain would surpass Germany in these terms.

Figure 23. GDP per capita in purchasing power standards (EU = 100)

	2007	2010	2013
France	108	109	108
Germany	115	120	124
Italy	104	103	98
Spain	**105**	**99**	**95**
UK	118	108	106

Source: Eurostat.

Spain has also suffered one of the largest increases in income inequality. The Gini coefficient, the yardstick for measuring inequality rose from 0.313 in 2006 to 0.350 in 2012 (0 is perfect equality and 1 perfect inequality), making Spain the second most unequal country in the EU after Latvia. In 2011 (latest year), the income of the wealthiest 10% of the population was 13.8 times higher on average than the income of the 10% least wealthy, up from 8.4 times in 2007 and the third highest level among the 34 OECD countries after Greece and Mexico.

'Anchored' poverty –with the value of the threshold fixed in real terms at the 2005 level (when the Spanish economy was growing strongly)– increased by eight percentage points in Spain between 2007 and 2011 compared to a rise of two points in the whole OECD area.

Caritas, the Catholic relief and social service organisation, helped 81,300 people in 2013 in the form of clothing, food or accommodation, 13% more than in 2012 and 30% higher than in 2007. Of them 57% were Spanish and the rest immigrants, reversing the trend of a couple of years ago when immigrants were the main people helped.

At the other end of the social spectrum, the number of Spaniards with net assets of at least US$1 million, excluding their primary residence and consumables, rose 11.6% in 2013 to 161,000, according to the latest world wealth report of Capgemini and RBC Wealth Management. The number dropped sharply in 2008, when the economy slowed down before going into recession, and since then has recovered the level of 2007. One reason for the rise in wealth in 2013 was the rally in the Madrid stock market.

Spain slipped from 23rd position to 27th in 2013 out of 187 countries in the latest UN Human Development Index. Its overall index value (the maximum is one), calculated on the basis of several categories, dropped from a high of 0.955 in 2007 to 0.869 in 2013, close to the level in 1980 (see Figure 24). Spain's index value has steadily dropped since 2007, after rising continuously as of 1980 (see Figure 25).

Figure 24. UN Human Development Index (HDI) for selected countries

Ranking (1)	Human Development Index value 2013	Life expectancy at birth 2013 (years)	Mean years of schooling (2012)	GNI per capita (2011 PPP US$) 2013
1. Norway	0.944	81.5	12.6	63,909
5. US	0.914	78.9	12.9	52,308
6. Germany	0.911	80.7	12.9	43,049
14. UK	0.892	80.5	12.3	35,002
20. France	0.884	81.8	11.1	36,629
26. Italy	0.872	82.4	10.1	32,669
27. Spain	**0.869**	**82.1**	**9.6**	**30,561**
35. Poland	0.834	76.4	11.8	21,487

(1) Out of 187 countries.

(2) The maximum value is one.

Source: United Nations Human Development Report, 2014.

Figure 25. Change in UN Human Development Index for selected countries, 1980-2012 (1)

	1980	2007	2012	2013
Ireland	0.840	0.965	0.906	0.899
France	0.876	0.963	0.893	0.884
Spain	**0.855**	**0.955**	**0.885**	**0.869**
Italy	0.857	0.951	0.881	0.872
Germany	0.869	0.947	0.920	0.911
Greece	0.844	0.942	0.860	0.853
Portugal	0.768	0.909	0.816	0.822

(1) The maximum value is one.

Source: UN Human Development Reports.

Spending cuts led to a reduction of 28,500 in the number of public health workers between January 2012 and January 2014, and the average waiting time to see a specialist has risen from 58 days in 2007 to 67. The system to support the case of dependent people launched in 2007, which is supposed to guarantee state assistance for those who cannot look after themselves, is particularly under strain. There were 736,800 beneficiaries in May and 184,000 people with the right to assistance on a waiting list.

(10) Political scene: tremors shake the traditional two-party system

The impact of the economic, financial and banking crises that were superimposed on one another like Russian nesting dolls has been considerable on political life. Confidence in the monarchy, parliament, the government and political parties has plummeted to varying degrees. The political class is widely regarded as part of the problem: it has colonized state institutions, such as the *Consejo General de Poder Judicial* (the governing body of the judiciary system) and the *Tribunal de Cuentas* (National Audit Office) and consequently the rule of law and the separation of powers have been eroded.

Regular readers of the Spanish press can be forgiven for thinking that corruption has reached African proportions. Nearly all of the cases refer to the period before the crisis, and are now emerging in a steady stream. Spain's notoriously slow justice system, itself one of the most poorly regarded institutions, is finally cranking into action and cleaning out the Augean stables. The cases range from the salting away in a Swiss bank account of €48 million by Luis Bárcenas, a former senator and national treasurer of the Popular Party, to the fraudulent use of millions of euros of public funds for severance costs in the socialists' fiefdom of Andalusia by trade union and other officials, the charging of Iñaki Urdangarín, the brother-in-law of King Felipe VI, and his wife Cristina with various offences including tax fraud and money laundering, the jailing of a prominent PP politician in Valencia for appropriating millions of euros of public funds allocated for international development cooperation projects and the imprisonment of Jaume Matas, the former Popular Party (PP) president of the Balearic Islands, for trafficking of influences. Jordi Pujol, the Catalan president between 1980 and 2003 and the father of modern-day Catalan nationalism, is under investigation after admitting he had kept undisclosed bank accounts outside of Spain for the past 34 years. He was stripped of his honorary title of *Molt Honorable*. Several of Pujol's seven children are under investigation, one of whom has been indicted for bribery.

Spain was ranked 40th out of 177 countries in the latest corruption perceptions ranking by the Berlin-based Transparency International, down from 30th place in 2012. Its score of 59 was six points lower. The nearer to 100, the cleaner the country. Spain was the second-biggest loser of points, and only topped by war-torn Syria. The perceived level of Spain's corruption, however, is still a long way off Italy's (see Figure 26).

Figure 26. Ranking of perceived levels of public sector corruption, selected countries (1)

Country ranking out of 177 nations	Score out of 100
1. Denmark (1)	91 (90)
3. Finland (1)	89 (90)
12. Germany (13)	78 (79)
14. UK (17)	76 (74)
22. France (22)	71 (71)
40. Spain (30)	**59 (65)**
69. Italy (72)	43 (42)

(1) 2012 ranking and score in brackets.

Source: Transparency International.

For the first time in an election since the establishment of democracy after the death of General Franco in 1975, the PP and the Socialists captured between them less than 50% of the total votes. This occurred in May's European elections and stunned the political class. *Podemos* ('We Can'), a new party born out of the 2011 grass roots protest movement of *los indignados* ('the indignant ones'), came from nowhere to win five seats in the European Parliament and 1.2 million votes (8% of the total). Podemos had been predicted to win two seats at the very most.

It was no surprise that the PP, as the governing party that has implemented tough and unpopular austerity measures, did badly, though it still managed to win one more seat than the Socialists. It is a measure of the Socialists' meltdown that the party has so far failed to capitalise on the PP's reforms and spending cuts. Its result underscored the party's lack of credibility. Spaniards have yet not forgotten that the crisis happened on the Socialists' watch during their eight years in power, although the seeds of it were sown earlier. In a bid to renovate itself, Alfredo Pérez Rubalcaba, the party's 62-year-old leader and part of the 'old guard', stepped down and the unknown Pedro Sánchez, who is 20 years younger, won the primary election in July as the new Secretary-General.

Podemos is a fascinating populist phenomenon, typical of a country in a profound crisis. It is influenced by, among other things, the Bolivarian Revolution of Venezuela's Hugo Chavez, with whom several of *Podemos*' leaders worked. It has a 'boomerang discourse'. This consists of listening to the discourse of the street and the slogans in protests, repackaging them, and sending them back. It is an effective strategy of empathy and connection with a segment of the population.

Podemos took votes from all the main parties including 100,000 from the PP, according to a post-election survey by the government-run Centre for Sociological Investigations. Based on the voters in the 2011 general election, *Podemos*' voters in May comprised:

- 26% of those who voted for United Left in 2011.
- 16% of those who voted for the Socialists.
- 11% of those who voted for Union, Progress and Democracy.
- 5% of those who voted for the PP.

Podemos also won the votes of people who abstained or cast blank votes as a protest in 2011, and it was the most popular party for new voters –those too young to vote in the last general election–. These figures show that *Podemos* has a wide support base that cuts across traditional party lines.

It is too early yet to say whether *Podemos* will repeat its European success in next year's general election. This depends on many factors, not the least whether *Podemos* can field candidates around the country. One should not underestimate its potential: its leaders are smart and media savvy and both the Socialists and the PP are worried.

The monarchy is also going through a rough time. The abdication of Juan Carlos in June in favour of his son Felipe, brought on by the corruption scandal in the royal family, his poor health, rising republican sentiment, including in the Socialist party, traditionally republican but where the issue has been dormant, and the crisis in Catalonia over the region's push for an illegal referendum on independence in November, has revived the debate on monarchy or republic.

Spain has far more important problems to resolve than the form of its state. Furthermore, parliamentary monarchies are generally cheaper to maintain than republics and have provided a higher standard of living.[2] Spain's royal's household receives €7.9 million from the national budget, compared with more than €100 million for France's Élysée presidential palace. A Felipe González or a José María Aznar, respectively former Socialist and PP prime ministers, would not be above the political fray in very partisan Spain as much as a Juan Carlos was or Felipe VI is proving to be.

The new King began his reign in a more inclusive style. He became the first Spanish head of state to receive a delegation of lesbian, gay, bisexual and transsexual groups (LGBT) and no longer are new members of state institutions and ministers sworn into their posts in the monarch's presence with the bible and a crucifix before them. This change seeks to comply belatedly with the principle of a non-confessional state set out in Spain's 1978 constitution, although the Roman Catholic Church is still given a special recognition in it. The King has also gone further than his father in opening the monarchy's affairs to more public scrutiny: palace accounts will be subject to external audit.

[2] This is well explained by Emilio Lamo de Espinosa in his article published by *El País* on 16 July, 2014. See http://elpais.com/elpais/2014/07/14/opinion/1405358062_448651.html

The government is promising long overdue measures in the autumn to 'regenerate democracy', including incorporating the illegal financing of a political party into the Penal Code, tougher sentences for trafficking of influences and bribery, a ban on anonymous donations to political parties by companies and greater transparency on the salaries of those in public office. These reforms follow the Transparency Law adopted last December, the first since the end of the Franco regime in 1975.

The transparency law is very much a move in the right direction but it is lacking in number of areas; for example, it is ranked 72nd out of 96 countries as regards access to information laws, according to the RTI ranking of the Centre for Law and Democracy. In spite of the pressing need to tackle corruption and secrecy, this law will not be in force at the national level until December 2014, and not fully in force at the regional and local levels until December 2015. The scope of the access to information law is narrow and does not enshrine access to information as a fundamental right: information regarding national security, defence, foreign relations, public security or the prevention, investigation and sanction of illegal actions is not public, and one article limits the right of access to information that harms economic and monetary policy or the environment in such a general way that if interpreted widely reduces the access to a minimum. Furthermore, the access is only to public documents and not to information in general: for example, there is no access to reports and internal communications used to take decisions. Lastly, the agency responsible for guaranteeing the right of access is not independent as its head is appointed and dismissed by the government of the day. It is to be hoped that the regulations for implementing the law improve this situation.

(11) Conclusion: the battle is won but not the war

Spain has turned the corner and is now set on a path of accelerating growth and modest job creation, as a result of:

- The successful completion of the financial sector programme.
- The lower budget deficit.
- Progress made in private sector deleveraging.
- The greater flexibility in the labour market, allowing companies to better adapt to their real needs.

These factors have improved Spain's boom-bust dynamics, but there is no room for complacency or easing up. Spain paid a high price for the mistakes of the past and living beyond its means, and will do so again in the future if the lessons have not been learned.

Appendix

Table 1. Main economic indicators (percent change unless otherwise indicated), 2010 and 2013-15

	2010	2013	2014 (1)	2015 (1)
GDP growth	-0.2	-1.2	1.2	1.6
Total domestic demand	-0.6	-2.7	0.7	1.0
Net exports (contribution to growth)	0.4	1.5	0.5	0.5
Exports of goods and services	11.7	4.9	4.7	5.1
Imports of goods and services	9.3	0.4	3.6	3.9
Household saving rate (% of gross disp. income	13.9	10.4	10.3	10.1
Private sector debt (% of GDP)	295.0	255.0	243.0	238.0
Harmonised index of consumer prices (aver.)	2.0	1.5	0.1	0.8
Unemployment rate (%)	19.9	26.1	24.9	23.8
Labour costs, private sector	0.8	0.3	0.4	0.4
Trade balance of goods (% of GDP)	-4.6	-1.1	-1.3	-1.0
Exports of goods (% of GDP)	18.6	23.3	23.9	24.9
Imports of goods (% of GDP)	-23.2	-24.5	-25.3	-25.8
Current account balance (% of GDP)	-4.5	0.8	0.6	0.7
Net international investment position	-89.0	-98.0	-96.0	-92.0
General government balance (% of GDP) (2)	-9.6	-6.6	-5.7	-4.7
Primary balance	-8.0	-4.1	-2.7	-1.6
Structural balance	-8.1	-4.0	-3.5	-2.9
General government debt (% of GDP)	62.0	94.0	99.0	101.0

(1) Forecasts.

(2) Excludes financial sector support measures equal to 0.5% of GDP in 2013.

Source: Source: IMF Spain country report No. 14/192, July 2014.

Table 2. Spain today: some economic and socioeconomic realities

Global ranking	Description
Top 5	Longest life expectancy in the EU
Top 5	Largest installed capacity of solar energy
Top 5	Largest international manager of infrastructure
Top 5	Biggest producer of olive oil
Top 5	Biggest producer of sparkling wine (cava)
Top 5	2nd largest high-speed rail network after China
Top 5	2nd largest number of sites (44) in UNESCO's World Heritage List
Top 5	3rd largest tourist destination in terms of visitors
Top 10	9th largest stock of inward foreign direct investment
Top 10	9th largest stock of outward direct investment
Top 15	11th in the Elcano Global Presence Index (out of 70 countries)
Top 15	12th largest producer of vehicles
Top 15	14th largest economy in purchasing power parity terms
Top 25	27th in the United Nations' Human Development Index (out of 187 countries)
Top 25	25th in the Democracy Index of the Economist Intelligence Unit (out of 165 independent states and two territories)
Top 30	40th least corrupt country out of 176 nations in Transparency International's ranking of perceived levels of public sector corruption

Note: The figures are the latest available at the beginning of August 2014.

Source: The Lancet, IMF, Economist Intelligence Unit, UN Human Development Report 2014, World Investment Report 2014 (UNCTAD), ANFAC, the World Tourism Organisation, Transparency International and Elcano Royal Institute.

Table 3. Spanish multinationals with the largest global market positions (1)

Company	Industry	Global market position
Ebro Foods	Food processing	#1 trader/miller of rice, and 2nd producer of pasta
Grupo SOS	Food processing	#1 producer of olive oil
Viscofán	Food processing	#1 producer of artificial casings for the meat industry
Freixenet	Sparkling wine	#1 producer of sparkling wine
Tavex	Textiles	#1 producer of denim
Inditex	Clothing	#1 fashion retailer by sales
Pronovias	Clothing	#1 maker of bridal wear
Acerinox	Steel	#1 producer of stainless steel
Repsol	Energy	#3 privately-owned shipper of liquefied gas
Roca	Sanitary equipment	#1 maker of sanitary equipment
Grupo Antolín	Automobile components	#1 producer of interior linings
Zanini	Automobile components	#1 producer of wheel trims
Gamesa	Machinery	#4 manufacturer of wind turbines
Indo	Optical equipment	#3 manufacturer of lenses
Mondragón	Diversified	#1 worker-owned cooperative group
Iberdrola	Electricity	#1 wind farm operator
Ferrovial/Cintra	Infrastructure	#7 developer & manager of transport infrastructure (2)
ACS/Hochtief	Infrastructure	#1 developer & manager of transport infrastructure (2)
Globalvia-FCC-Bankia	Infrastructure	#2 developer and manager of transport infrastructure (2)
Abertis	Infrastructure	#4 developer & manager of transport infrastructure (2)
Telefónica	Telecom	#5 telecom operator by total customers (3)
Santander	Banking	largest bank by market capitalisation in the euro zone, and #1 franchise in Latin America
Prosegur	Security	#3 company by sales
Sol Meliá	Hotels	#1 holiday hotel chain by number of beds
Real Madrid	Sports	#1 football club by revenue

(1) Latest available.

(2) Ranked by number of road, bridge, tunnel, rail, port and airport concessions over US$50 million investment value put under construction or operation as of 1 October 2013.

(3) This takes into account approval of Telefónica's acquisition of the Dutch KPN's E-Plus German mobile unit.

Source: Interbrand, Public Works Financing, BrandFinance and company reports.

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