THE VIEW

Economic Research

24 April 2019

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THE END OF THE SPANISH MIRACLE

Allianz

EULER HERMES

EXECUTIVE SUMMARY

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- Between 2014 and 2018, Spain experienced a second economic miracle: GDP grew by +2.8% on average p.a., exports grew by +4.2% on average p.a. and 2.6mn Spaniards were brought back to work. The 2010 and 2012 competitiveness reforms help explain this outperformance but the share of workers' compensations in national wealth dropped from 54.7% in 2010 to 51.8% in 2017.
- In January 2019, Prime Minister Pedro Sánchez increased the minimum wage (*Salario Mínimo Interprofesional* or SMI) by a whopping +22.3% to rebalance the economy, and partially offset growing social discontent. We estimate that this measure could have a net positive impact of +0.1pp on GDP growth in 2019, but a negative impact of -0.1pp in 2020 as competitiveness drops. Companies' margins are expected to be indented by -1pp to 42% of value-added, and the measure could also cause around 100 additional insolvencies in 2019, especially in the construction and service sectors, but also among some exporters.
- The elections on April 28 will plausibly yield a fragmented political landscape, making structural reforms harder to pass. Our forecasts for Spain point to a deceleration to +2% growth in 2019, and +1.8% in 2020 – from +2.6% in 2018. In 2019, the SMI boost barely compensates for: (i) the slowdown in foreign demand, which could reduce export growth from +2.3% in 2018 to +1.0% in 2019, subtracting -0.4pp from Spain's GDP growth, and (ii) the deceleration of domestic demand (consumption, investment and public expenditures) on the back of slowing employment gains. In 2020, as growth in major trade partners rebounds, Spanish exports would follow (+1.5%), this time with a drag from higher wage bills, marking the end of the Spanish miracle.


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+0.1pp in 2019, -0.1pp in 2020

The impact of the rise in the minimum wage on GDP growth

THE SPANISH MIRACLE
AN ECONOMIC *REMONTADA*

Between 2014 and 2018, Spain experienced a second economic miracle: GDP grew by +2.8% on average p.a., exports grew by +4.2% on average p.a. and 2.6mn Spaniards were brought back to work. One of the first and key drivers of the Spanish miracle was buoyant export growth, which lead to a rise in the share of exports in the overall economy (from 26% of GDP in 2008 to 33% in 2018). In the post-crisis years, Spain also increased its share of world goods exports at a faster pace than other EU countries, such as Germany and Italy. The IMF points out that as more firms began to internationalize, the number of regular exporters in Spain rose by nearly one-third between 2007 and 2017. Recent literature[1] shows that Spain's real export growth can mostly be explained by two drivers:

Cost competitiveness.

Spain's growth in exports is not attributable to higher export quality: The MIT Economic complexity index shows that Spain's export quality has not recovered from the crisis. In 2017, the knowledge-intensity of exports (a proxy for export quality) was still 23% lower than in 2008.

This export recovery is not because of productivity gains either: Looking at annual productivity growth in Spain, we see it did not outpace that of the Eurozone after the crisis except in 2012 and 2013 (see Figure 1). At the same time, the growth in the Unit Labor Cost or ULC (which is the ratio of total labor compensation per hour worked to output per hour worked, i.e. labor productivity) was systematically lower than that of the Eurozone starting from 2009.

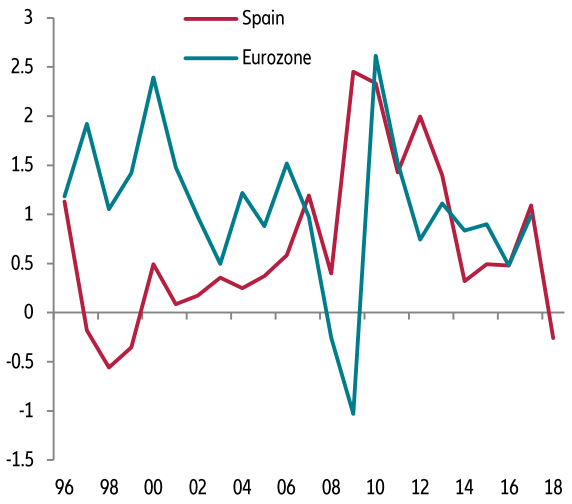
This shows that Spain's competitiveness gains were mainly due to adjustments in total labor compensation rather than productivity gains. In 2010 and 2012, Spain implemented labor market reforms to facilitate the adjustment of wages downwards in a high-unemployment context. According to estimates from the OECD (2014), these labor market reforms induced a drop in the growth of Spain's business sector ULC of between -1.2pp and -1.9pp from Q4 2011 to Q2 2013. Overall, between 2008 and 2017, the nominal unit labor cost index decreased by -6%. This competitive devaluation of labor costs helped facilitate the adjustments of company activity to economic shocks and boosted export performances.

Foreign demand.[2]

As a consequence of geographic diversification, foreign demand strongly contributed to the acceleration of real export growth. The EU's share in Spanish goods exports declined from 73.1% in 2000 to 70.9% in 2007, and even further to 66.3% in 2017. By targeting fast-growing emerging and developing markets Spanish companies boosted their exports.

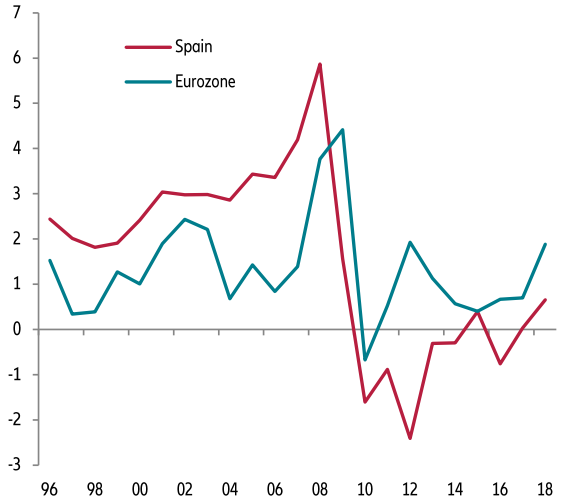
[1] Salas, Jorge. "Drivers of Spain's Export Performance and the Role of the Labor Market Reforms." *IMF Working Paper*, 2018
[2] We estimate foreign demand as GDP growth of trade partners weighted by their export share

Figure 1: Annual productivity growth (%)



Sources: OECD, Euler Hermes, Allianz Research

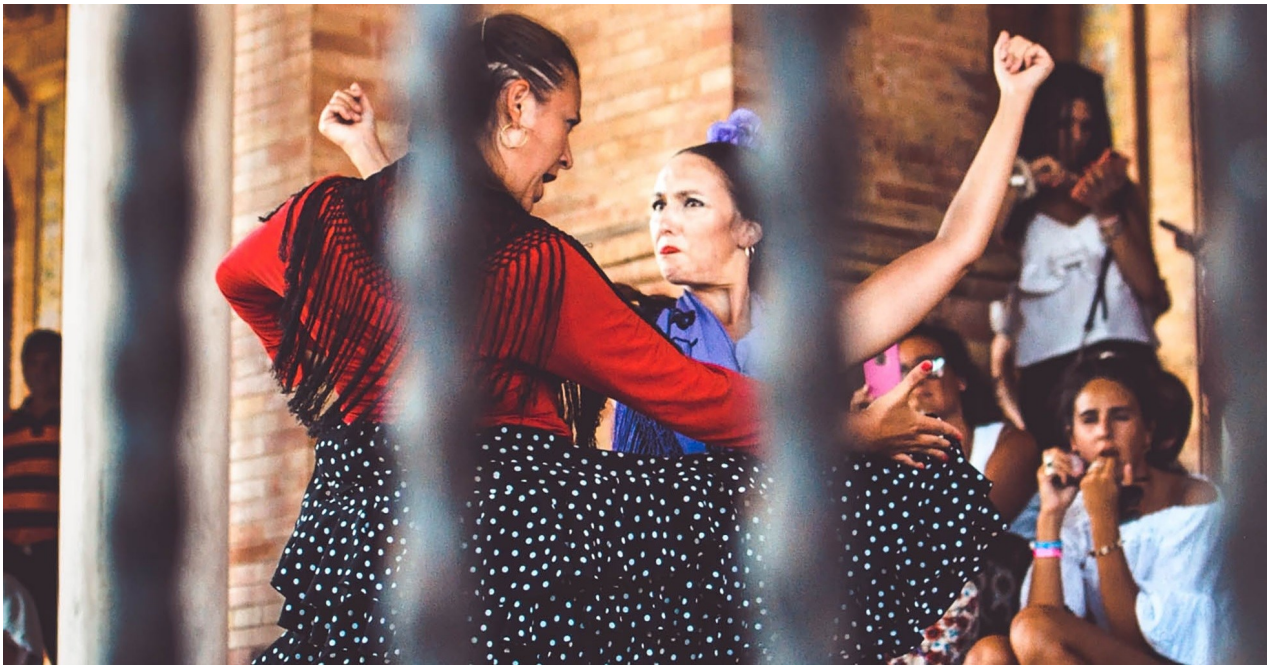
Figure 2: Annual unit labor cost growth (%)



Sources: OECD, Euler Hermes, Allianz Research

Following the recovery of exports, private consumption started to grow again in 2014, lifted by a favorable investment cycle and employment gains. Data from the national statistics institute show that between 2007 and 2013, the domestic economy lost around 3.6 million jobs, then recovered, creating 2.6mn jobs between 2013 and 2018. The opportunities created by the export miracle allowed companies to restart their investment cycles, re-igniting their hiring cycles to support their growing activity, while benefiting from a high bargaining power: unemployment peaked at around 27% in 2013, while labor market reforms decentralized wage negotiations.

In addition, looking at the growth of compensation by sector between 2008 and 2013, we find that the construction sector (-60%), the manufacturing sector (-23%), the real estate sector (-23%) and the retail, accommodation, transport and food sector (-9.3%) have seen their wages adjust the most. Then, looking at the employment gains between 2013 and 2018, many of those same sectors hired relatively more than the rest: 260,000 new employees in construction, 800 000 in retail, accommodation transport and food, 200 000 in industry. Beyond the cyclical recovery, it is likely that the wage adjustment we described also contributed to the employment gains.



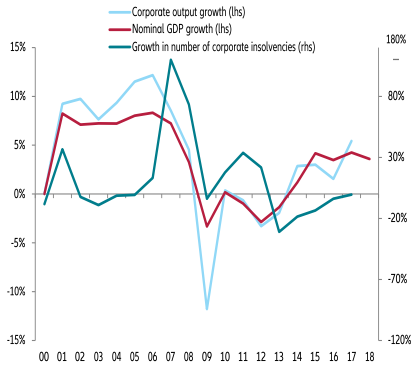
COMPANIES REAPED THE REWARDS OF THE SPANISH ECONOMIC MIRACLE

Insolvencies dropped for four years in a row before stabilizing in 2018, while turnovers kept pace with nominal GDP growth (see Figure 3). Besides, companies' profit share of private sector GVA reached a record high of 43.6% in early 2018 - higher than the Eurozone average high of 41% - and self-financing rates (the ratio of gross capital formation to gross savings) were also maintained at high levels (see Figure 4). This is not only attributable to the global cyclical recovery and accommodative monetary policy in the Eurozone but also to the business-friendly reforms adopted in Spain (labor market reforms and corporate tax rate cuts by 10pps, from 35% to 25%, between 2006 and 2016[3]). This coincided with a drop in the share of labor and tax costs over private sector GVA by respectively -7pps and -3pps (see Figure 5).

With the downward adjustment in labor cost, the share of the compensation of employees in the Gross Value Added of the economy dropped by -2.9pps from its peak of 54.7% in 2010 to 51.8% in 2017. As a result, after the recovery, workers captured a lower proportion of national wealth than before. At the same time, the share of companies' gross operation surplus increased by +2.1pps from its last trough of 45% in 2010 to 47.2% in 2017.

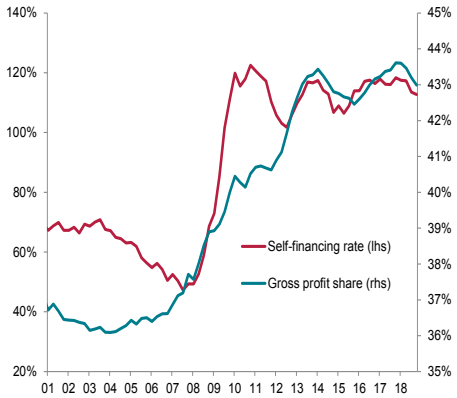
This growing imbalance created a demand for social policies in Spain.
In January 2019, in a politically strategic move ahead of mounting pressures for snap elections, Prime Minister Pedro Sánchez increased the minimum wage (Salario Mínimo Interprofesional or SMI) by a whopping +22.3% to rebalance the economy, and partially offset growing social discontent. This was the highest increase since Spain's return to democracy (+22.3%) after a +4% increase in 2018 and +8% in 2017.

Figure 3: Growth insolvencies, turnovers and GDP



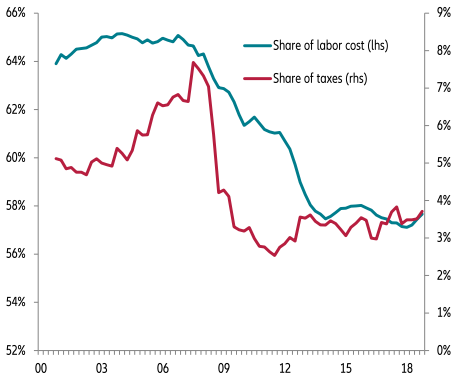
Sources: IHS Euler Hermes, Allianz Research

Figure 4: Margins and self-financing as a share



Sources: IHS Euler Hermes, Allianz Research

Figure 5: Labor and tax costs as a share of GVA

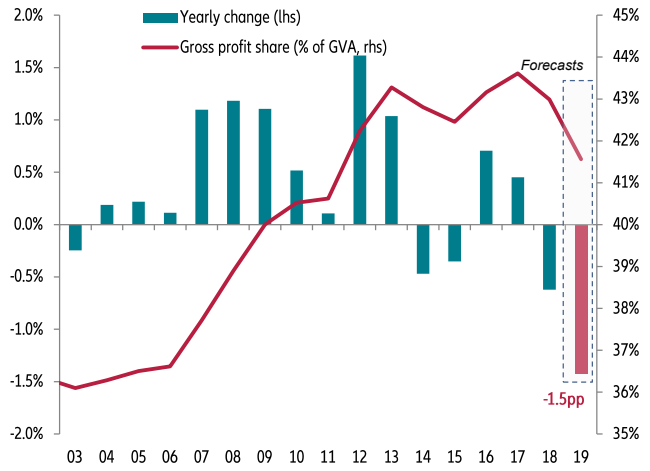


Sources: IHS Euler Hermes, Allianz Research

[3] In Portugal, it was decreased from 25% to 21% over the same period. In France, it stayed at 33.33%. In Italy, it decreased from 37.25% to 31.4% (then 24% in 2017). In Germany, the average corporate tax rate went from around 38% to around 30%.

INCREASE IN SMI: SHORT-TERM BOOST, MEDIUM-TERM DRAG

Figure 6: Profit margins in Spain and yearly change due to the SMI increase (y/y, pps)



Sources: IHS, Euler Hermes, Allianz Research

We estimate that this measure could have a net positive impact of +0.1pp on GDP growth in 2019, but a negative impact of a -0.1pp in 2020 as cost competitiveness drops. The increase to EUR900 from EUR736 a month (over 14 months) directly impacts about 8% of Spain's workforce, or 1.2 million employees. Due to spillover effects on the rest of the labor force, the measure should impact a total of 2.5mn workers, as per the government estimates. Hence, in both years, through the relatively high marginal propensity to consume[4] of lower-income households, additional consumption from the extra EUR2296 yearly could add +0.2pp to Spain's GDP growth. Yet, as Spaniards consume more, they also import more, which would subtract -0.1pp from GDP growth. Moreover, in 2020, the SMI increase should reduce the economy's cost competitiveness with a lag, which will impact exports, subtracting -0.2pp from GDP growth.

Impact on companies

We forecast that the SMI increase would be responsible for two thirds (-1pp) of the drop in company profit as a share of Gross Value Added (GVA), by the end of this year, all things remaining equal[5] (See Figure 6). The profit share could reach 41.5% of GVA, the lowest level since 2011.

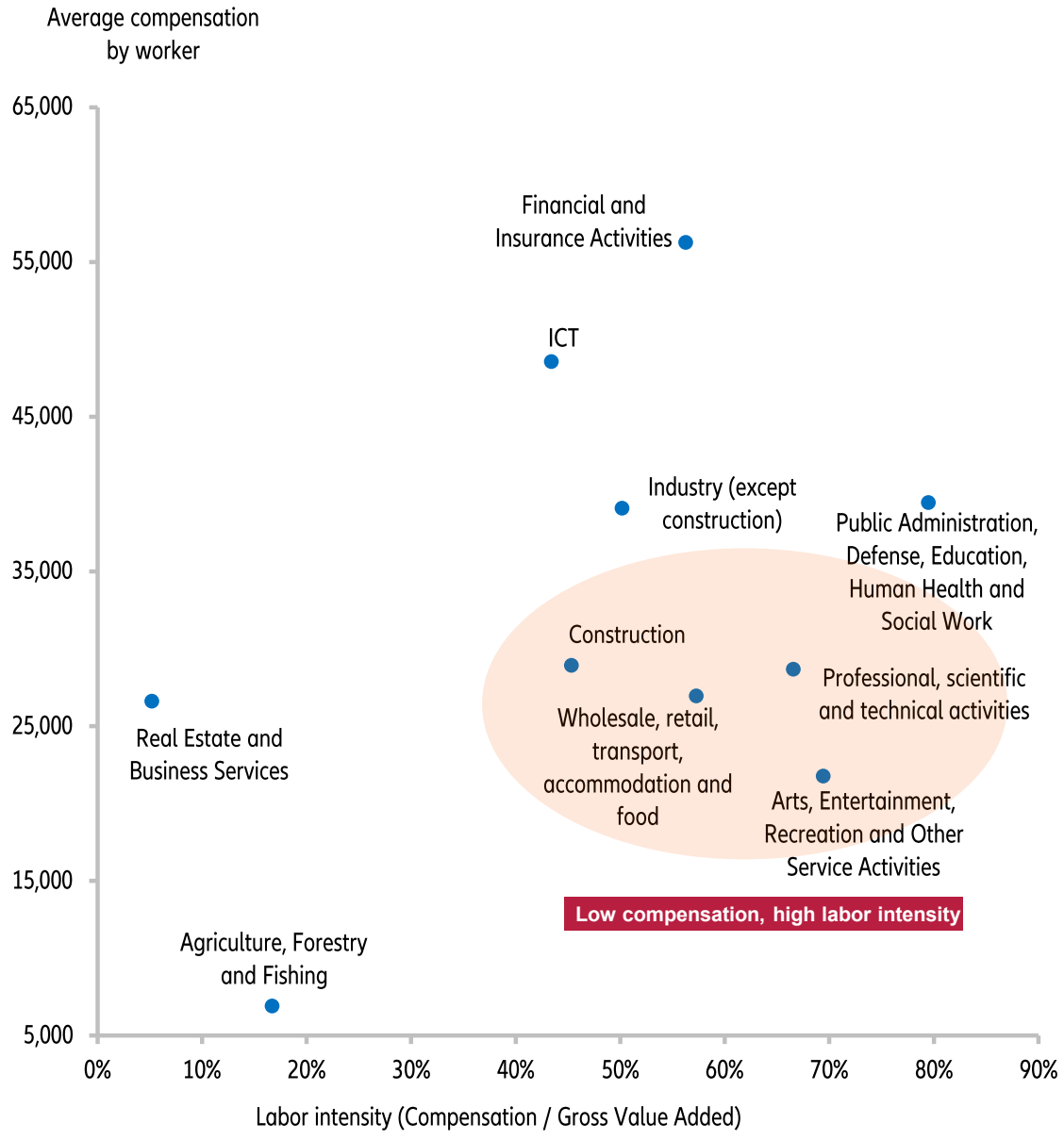
Higher salaries and lower margins also mean higher insolvencies. From the correlation between insolvencies and compensation of employees (controlling for GDP growth), we find that higher wages (partly due to the SMI rise) could add around +2pps to the growth of insolvencies compared to 2018 (i.e. around 100 insolvencies). We see insolvencies growing in total by +5% in 2019 (after stabilizing in 2018). The continued global economic slowdown will also contribute to the increase in insolvencies.

[4] The Marginal Propensity to Consume or MPC is the share of 1 additional unit of income used for consumption

[5] Here we consider the direct effect of the automatic wage increase of a private-sector worker earning the SMI. We estimate the new profit share of GVA through an analysis of Non-Financial Corporations National Accounts. We assume a growth of ~3.5% in GVA and ~4.5% in non-minimum wage compensation. Other unrelated items of the NFCs balance sheet are maintained constant from 2018.

The sectors that will be the most impacted by the government's measure are those with the lowest average compensation by worker (where the SMI hike has the highest likelihood of incurring costs) and the highest labor intensity (ratio of compensation of employees to GVA). Those are construction and selected services (wholesale, retail, transport, accommodation and food; arts, entertainment, recreation, and professional scientific and technical activities (see Figure 7). Special attention should be given to the transportation sector, which saw its Day Sales Outstanding (DSO) increase in 2018 by +6 days, and the food sector (+2 days). The service sector only saw an increase (+1 day). The minimum wage increase represents a double-whammy blow for those sectors: higher costs of production and longer payment terms. But export-oriented sectors are also expected to be at risk starting in 2020 as Spain's cost competitiveness erodes further.

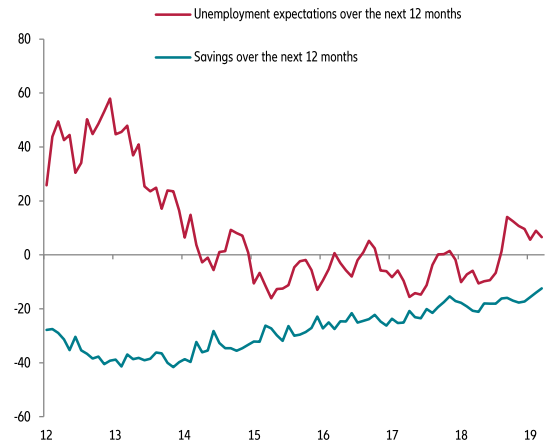
Figure 7: Sectors that are the most vulnerable to the SMI increase



Sources: IHS, Euler Hermes, Allianz Research

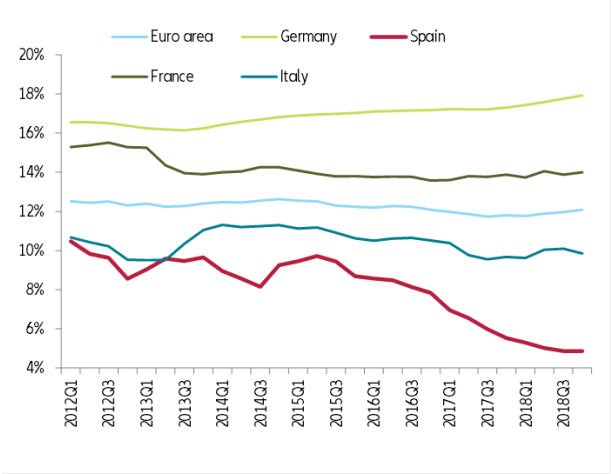
ALONG WITH POLITICAL FRAGMENTATION IN A WEAKENING EXTERNAL ENVIRONMENT, THIS COULD MARK THE END OF THE SPANISH MIRACLE

Figure 8: Surveys, consumer expectations for savings and unemployment



Sources: Eurostat, Euler Hermes, Allianz Research

Figure 9: Savings ratios in the Euro Area



Sources: Eurostat, Euler Hermes, Allianz Research

The April 28 elections should result in the victory of the Socialist party but could lead to a hung parliament as political fragmentation is historically high in the country and the winning party would gather only around 30% of the votes. Spanish sovereignty issues, especially regarding Catalonia, as well as the stigma of the corruption trials of many members of the right-wing Popular Party, should make coalition-building a more difficult task. This will in turn make it much harder to pass structural reforms to compensate for the loss of cost competitiveness, such as reforms to prioritize Spain's export quality (still 23% lower than in 2008) and productivity (which dropped -0.3% in 2018, for the first time in almost 20 years).

This political fragmentation comes at a time when the Spanish economy might, contrary to previous years, no longer be in auto-pilot mode. Our forecasts for Spain point to a deceleration to +2% growth in 2019, and +1.8% in 2020 – from +2.6% in 2018.

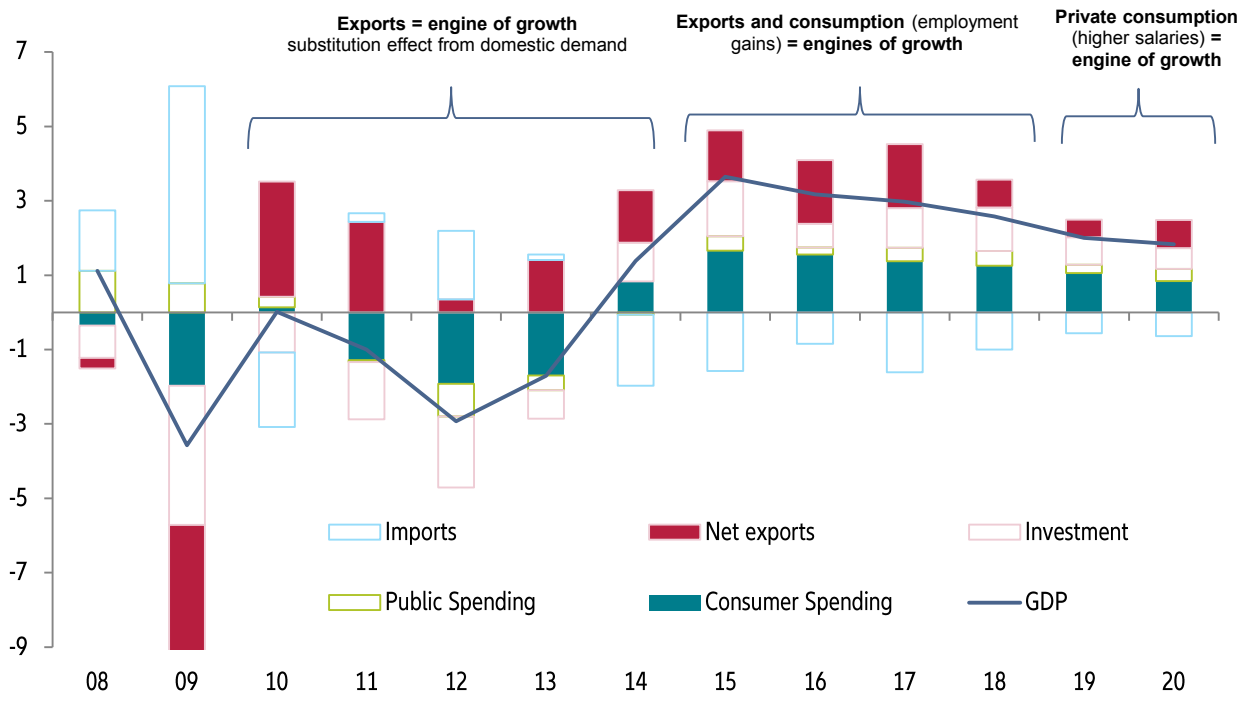
This year, the SMI boost to GDP growth (+0.1pp) barely compensates for:

- The slowdown in foreign demand, which could reduce export growth from +2.3% in 2018 to +1.0% in 2019, subtracting -0.4pp from Spain's GDP growth, and
- The deceleration of domestic demand (consumption, investment and public expenditures) on the back of slowing employment gains, which could cut -0.3pp from Spain's GDP growth. Employment gains should slow as the unemployment rate reached 14.5%, its lowest level since mid-2008. The latest surveys and savings data also signal a downward shift in consumer confidence. First, as shown in Figure 8, fewer people are confident they will not need to save in the future. This is coherent with the savings ratio data, which show that Spain not only has a historically low savings ratio, but that it this is also much lower than its Euro area peers (Figure 9). Second, expectations about unemployment have shifted from predicting a decline in unemployment for nearly four years without interruption to predicting a rise over the next 12 months. Besides, as the fiscal deficit is expected at around -2% this year (after -2.7% in 2018), fiscal room for maneuvering to further support households is limited.

In 2020, the boost from the rebounding growth in major trade partners should lift Spanish exports (+1.5%), hence adding +0.2pp to GDP growth compared to 2019. Yet this will barely compensate for:

- The deceleration of domestic demand, which should again subtract -0.3pp from Spain's GDP growth, and
- The competitiveness drag on exports from higher wage bills (notably from the SMI increase), which should decrease GDP growth by -0.1pp. This could mark the end of the Spanish miracle.

Figure 10: Spain GDP growth and contributions



Sources: IHS Euler Hermes, Allianz Research

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