

External financial vulnerability after QE

Spain's borrowing position vis-à-vis the rest of the world stood at -77% of GDP at year-end 2018 – still high despite shrinking significantly during the recovery. The Bank of Spain's net liabilities with the Eurosystem, built up as a result of the decentralised implementation of monetary policy, distorts the picture. Even if it is stripped out, external debt still remains relatively high, in particular for the public sector, although there has been a notable reduction in vulnerability.

This week left us with...

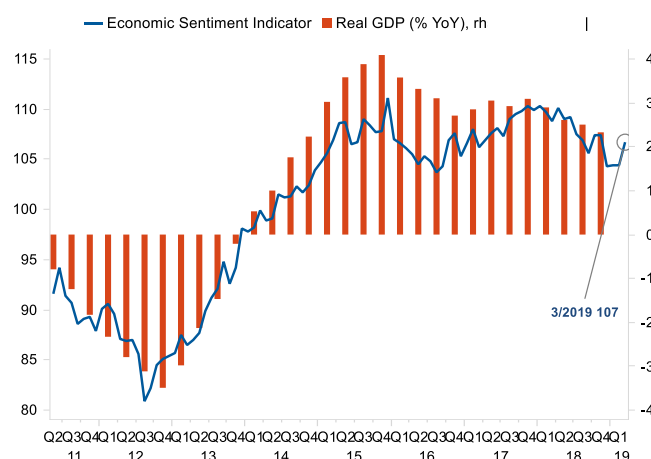
- **Mortgage loans:** the number of new mortgages continued to rise sharply, up 22% YOY in January, although the increase in the average loan amount has been smaller (+0.7%). The lion's share of new mortgages have been taken out for home purchases, while fixed-rate loans are becoming increasingly more appealing (making up 37.2% of new loans). The average floating interest rate is up slightly at 2.42%, but the average fixed rate has decreased to 3.04%.
- **CPI:** March saw the CPI increasing by 1.3% – two tenths higher than a month earlier. The rise primarily stems from higher electricity prices, which were above those reported in March 2018. Fuel prices have also contributed which – despite being below last summer's prices – are still up on March 2018.

EC confidence survey: the European Commission has published its confidence survey for March showing a fall across the eurozone. The Economic Sentiment Indicator (ESI) is down six tenths versus the previous month, dropping for the ninth month in a row. Industrial sector confidence was worst hit, while at the other end of the scale, sentiment improved in construction and the retail sector.

In Spain's case, the ESI was two points higher than in February at 106.7 compared to 104.4 the month before. The service sector is particularly upbeat, with its sentiment index continuing to rise albeit more slowly. The retail sector has also seen an increase of 5.9 points, with a slight improvement in industry.

The consumer survey also highlighted brighter expectations for consumption over the next 12 months, and the state of household finances, underpinning the stable forecasts.

ESI and GDP growth (index, %)



Source: Afi, BoS

... and next week focusing on...

Next week, Spanish and foreign tourist figures will hone into view, along with the export and import price, production and industrial indexes.

From 01 to 05 of April

01-abr	Tourist dwellings and hotels occupancy survey	February
02-abr	Tourist expenditure survey	February
	Foreign tourists entries	Febrero
04-abr	Domestic tourism survey	4Q18
	Price indices for exports, imports and manufactures	February
05-abr	Manufacturing output index	February

External financial vulnerability after QE

The correction in Spain's net international investment position (NIIP) continued throughout 2018, standing at -77% of GDP.

Having accumulated foreign liabilities since the start of the monetary union, the Spanish economy has been able to continuously post current account surpluses since 2013 (graph 1). **This has enabled the NIIP to be reduced by over 22 percentage points since 2015 to -77% of GDP at the end of 2018 (graph 2).** The NIIP continues to remain very high, especially compared to our neighbouring countries (Germany: +59%, France: -13% or Italy: -3%), and is above the indicative sustainability threshold set by the European Commission of -35%. Nevertheless, **the nature of monetary policy and the balance of payments in the monetary union alter a number of significant aspects of the information that can be drawn from the NIIP.** In this weekly report, we look at Spain's recent performance and its external debt vulnerability after the ECB's quantitative easing programme came to an end.

The current account surplus continues thanks to low oil prices and the reduction in interest rates, among others.

Several factors have contributed to external surpluses being systematically generated:

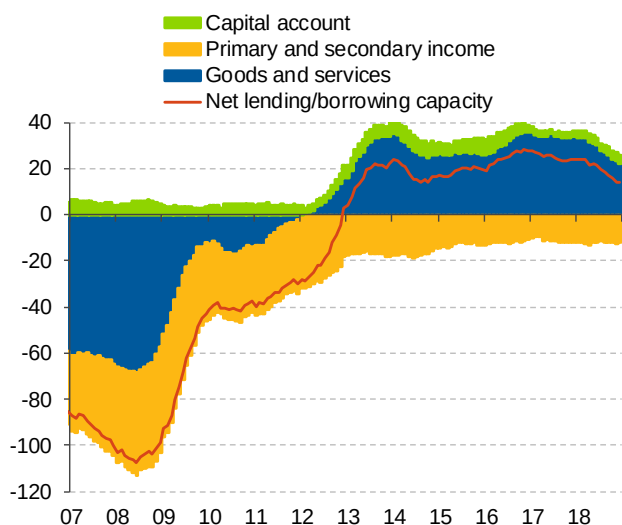
- **Balance of goods and services:** the deficit stood at 6% of GDP in 2007-08. **Since 2012, there has been a surplus, equating to 1.8% of GDP in 2018 (around EUR 22 billion).** Falling oil prices and a substantial surge in net non-energy exports lie behind this correction. Notably, last year the surplus fell below 2% for the first time since the start of the recovery and this moderation is expected to continue throughout 2019 given the strengthening global headwinds.
- **Primary and secondary income account balance:** the deficit equated to 4% when the crisis hit, falling to 1% since then. This represents an improvement of over EUR 34 billion:
 - **The net primary income account deficit has shrunk by more than EUR 29 billion, above all due to property income,** the balance of which has moved from EUR -35 billion in 2008 to EUR -6.4 billion last year. This saving primarily derives from a significant decrease in interest paid, specifically from EUR 66.7 billion in 2008 to just over EUR 25 billion now. Interest received, meanwhile, has also fallen, although to a lesser extent (from EUR 27.7 billion in 2008 to EUR 11 billion last year). In this regard, prevailing low interest rates have been especially favourable to the economy given that its private and public borrowing position is greater than its lending position.
 - Another important factor contributing to this improvement is the rise in net dividends received (this item comprises dividend pay-outs by companies, reinvested earnings from foreign direct investment and other investment income. The balance is currently above EUR 8 billion compared to around EUR 3.9 billion in 2008. The increase in dividends has added upwards of EUR 4 billion to the improvement in the balance of property income. These income items have increased for two reasons: higher foreign direct investment by the Spanish economy on the one hand, and the decrease in global business investment on recent years on the other.
 - **The secondary income account deficit has also narrowed by over EUR 5 billion.** It stood at close to EUR 15 billion in 2008 compared to EUR 10.3 billion today. The bulk of this change is due to the decrease in transfer flows containing international remittances.

The falling interest rates and paring back of debt account for more than 70% of the correction in the income balance deficit between 2008 and 2018...

... 13% is accounted for by the rise in dividends received...

... while 10% is due to the decrease in remittances.

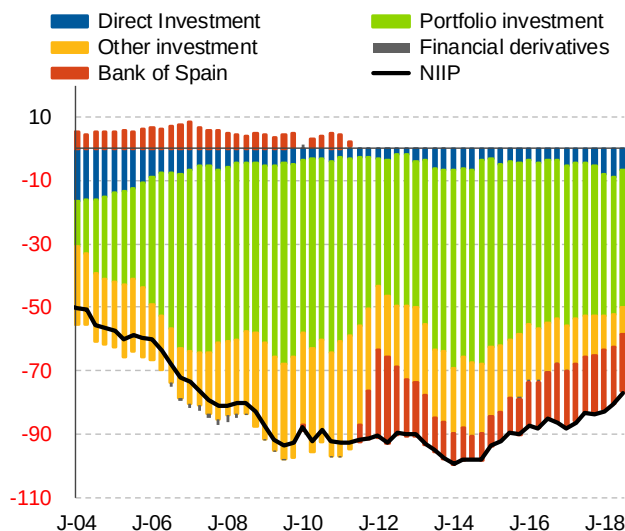
Graph 1. Net lending(+)/borrowing(-) position (12M cumulative, EUR billion)



Source: Afi, Bank of Spain

External debt has not decreased by as much as the NIIP...

Graph 2. Net international investment position (% of GDP)



Source: Afi, Bank of Spain

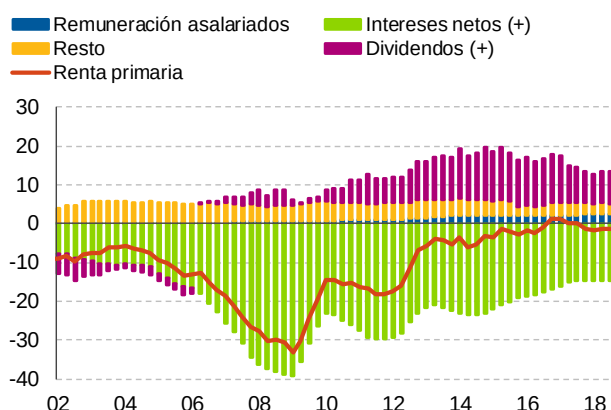
Unlike the NIIP, **the economy's external debt (callable portion of liabilities) has fallen hardly at all in recent years.** It stood at 167% of GDP in 2018, remaining at the same level as in 2013. In 2008, public debt was below 150% of GDP. The aggregate figure does hide differences at the institutional level:

- **Public sector:** the external debt ratio has risen by 28 pp over the last decade. There have been two clear phases: i) before 2012, external public sector debt remained relatively stable at around 22% of GDP; and ii) since 2012, this percentage has climbed to 50% today. This increase is partly to blame for the economy's total external debt position not shrinking.
- **Households and businesses:** the private sector has achieved quite significant deleveraging. The total debt ratio of households and non-financial corporations (NFCs) hit a high of around 220% of GDP in 2010, currently amounting to approximately 150% of GDP (accounting for both internal and external debt). Most of the reduction in debt has been among households given their lower direct exposure to global factors. Consequently, the external debt of households and NFCs has only fallen by 11 pp since 2010 to 23% of GDP.
- **Financial institutions (exc. Bank of Spain):** this sector's external debt rose continuously from 2010 when it equated to over 70% of GDP. Following the 2012 sovereign debt crisis, financial institutions pared back their external debt considerably to 35% in 2018.

... exposing the economy to external shocks.

As a result, in principal, **Spain's external debt remains high and exposes the economy to sudden changes in incoming investment flows.** Nonetheless, some of the components of this stock need to be analysed to qualify this conclusion. First, the direct investment component represents the net liabilities deriving from transactions between parents and their affiliates (graph 5). These finance flows tend to be for tax reasons or for the purposes of internal management of multinational groups and it is therefore not expected they would generate callable repayment obligations such as market debt transactions do.

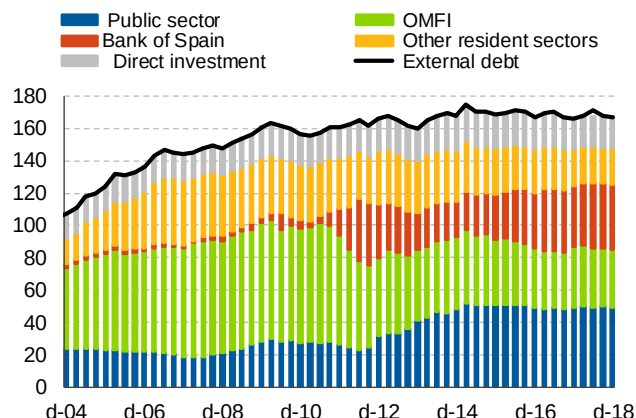
**Graph 3. Primary account balance: breakdown
(12M cumulative, EUR billion)**



Source: Afi, INE, Bank of Spain

The lending position with the Eurosystem reflects the ins and outs of the decentralised implementation of monetary policy.

Graph 4. External debt (% GDP)



Source: Afi, Bank of Spain

The other important qualification concerns the part of the NIIP corresponding to the Bank of Spain's so-called net lending position with the Eurosystem. This item came about with the creation of the monetary union to reflect the balancing item of all Spain's balance of payments transactions to replace the change in reserves that was traditionally used prior to the euro. The main components of this item are:

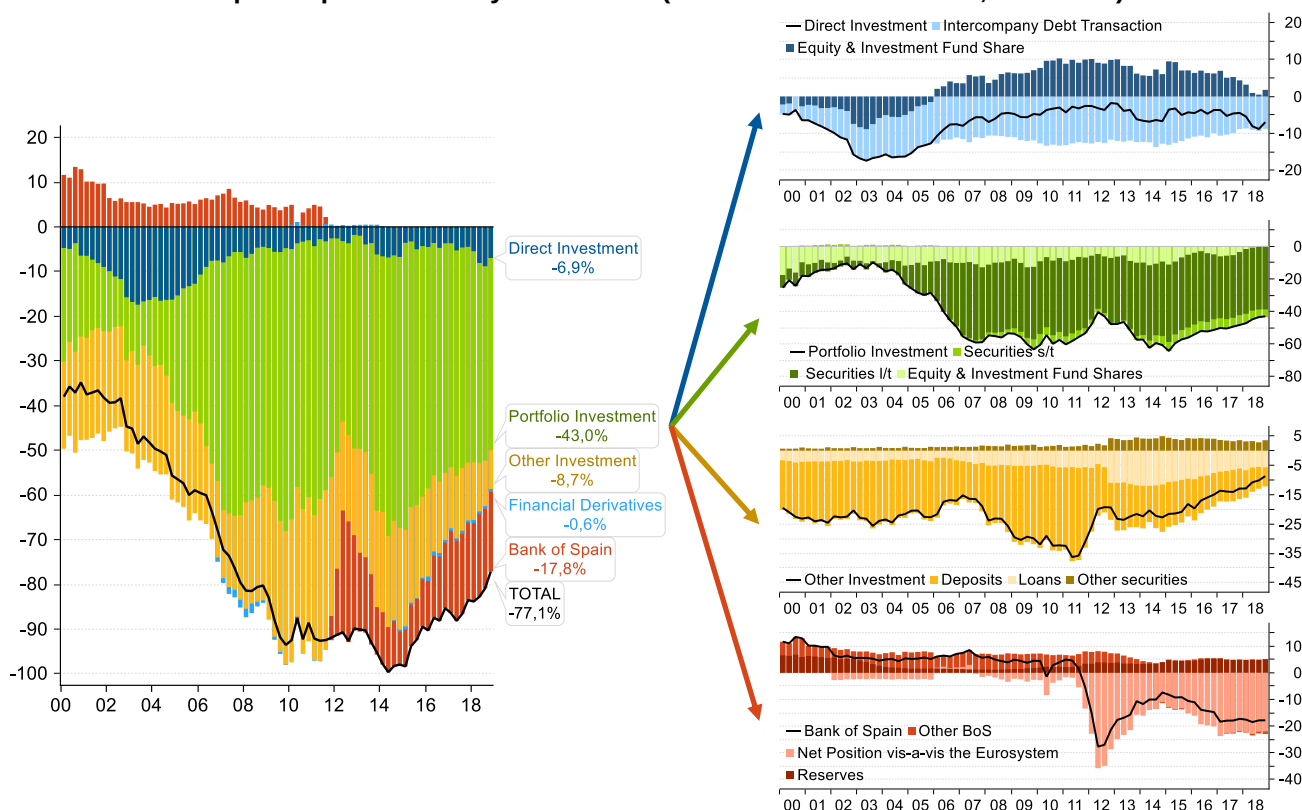
- On the **assets side**, the share of the ECB's capital held, the contribution to foreign currency reserves and, above all, the adjustment for the issuing of money. In short, countries such as Spain that print less money than their proportionate share of capital record the difference as a balance receivable from the Eurosystem. This balance has grown to EUR 124 billion.
- On the **liabilities side**, the main item is the TARGET 2 balance, which was also very small until the crisis hit. It grew exponentially during the worst phase of financial pressures, dropping in 2013-2014 before increasing again with the ECB's asset purchase programme. The large size of these intrasystem liabilities accumulated since the start of the crisis and that still remain, counterbalanced by the lending position with the Eurosystem, has been subject of debate. Some believe it is an obfuscated way of bailing out countries in Southern Europe, emphasising the high risks they create for core countries' central banks and even for their taxpayers. In reality, **the TARGET 2 balances are the accumulation of the balances of payments imbalances of monetary union member states**. They are not callable liabilities but adjustments reflecting the shifts of monetary base between National Central Banks and they bear interest at the same rate as the ECB's main lending facility.

The TARGET balance first widened under financial stress...

In the years before the crisis when money and debt markets achieved a high degree of integration and credit spreads remained very narrow, the TARGET balances were extremely small. Countries such as Spain with large current account deficits covered them easily through private finance in the form of net capital inflows (net debt purchases and bank finance in the form of other investments). **The fast growth in these balances during the crisis was a clearer sign of financial fragmentation because the pronounced capital flight from countries such as Spain. Italy, Greece and Portugal led to balance of payments deficits** (in Spain's case, net flows of payments from Spanish commercial banks' accounts with the Bank of Spain to the accounts of commercial banks in core eurozone countries with their respective national central banks).

The outflows in the balance of payments could be partially offset through an increase in the banking system's recourse to the Eurosystem financing. Higher borrowing from the central bank does not directly impinge on the TARGET 2 liability, as it is not a cross-border operation. Yet, under conditions of financial stress, there is a natural substitution of market financing for central bank financing.

Graph 5. Spanish NIIP by asset class (net balance of each item, % of GDP)



...and has again widened with QE in tranquil times.

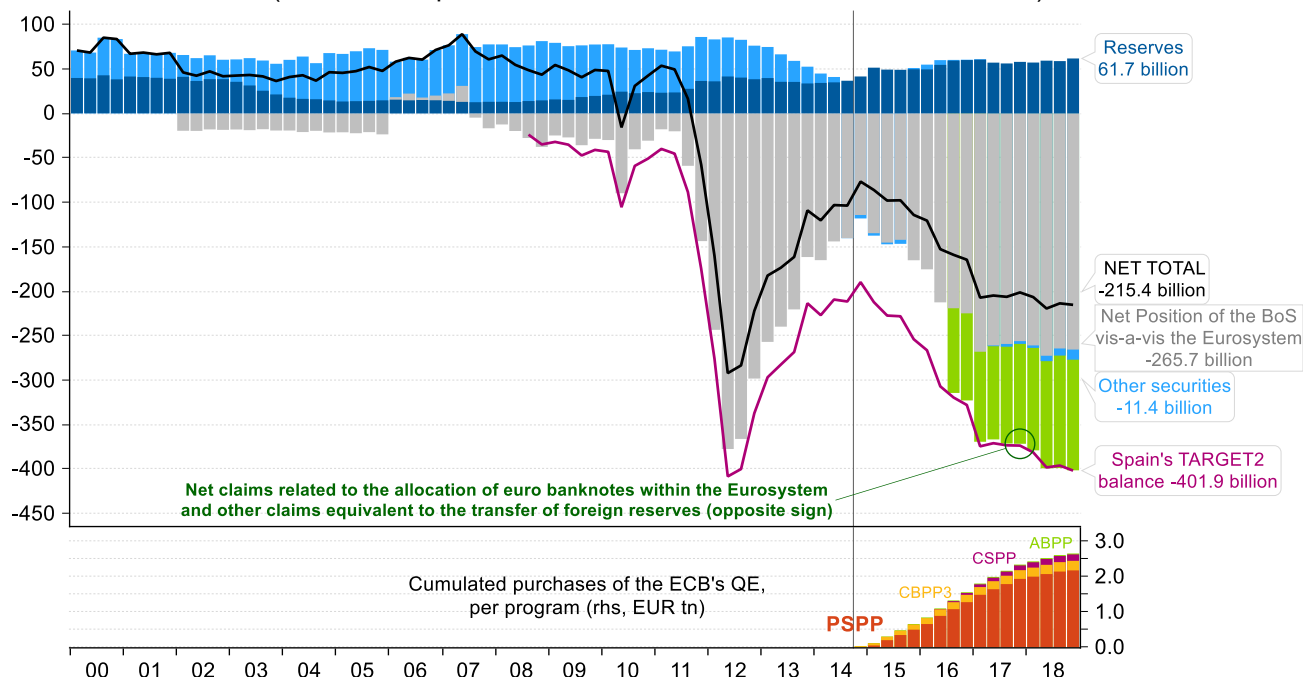
This process began to wane in 2013 and 2014 as capital outflows decreased and current account deficits were pared back (reducing the need for external debt). However, the ECB's asset purchase programme drove up Spain's TARGET 2 borrowing position once more. The reason for this is that the Bank of Spain has been the primary purchaser of Spanish public debt, with part of these purchases been settled in accounts with the holders of the debt in the national central banks of other eurozone countries. Thus, a borrowing position with a non-resident has been replaced by a borrowing position with the Bank of Spain, which does not feature as external debt. On this occasion, for Spain this does not involve a balance of payments deficit due to capital flight, rather it is a reflection of the decentralised implementation of the purchase programme, along with the continued servicing of debt by Spanish agents with their creditors in the eurozone. Against this background, the round of TLTRO III should not have a critical impact on the TARGET 2 balance, taking into account that their features are not expected to favour using the funds for deleveraging.

The large TARGET 2 borrowing position should not be a concern, although the level of public external debt should be.

In summary, the lending position with the Eurosystem does not represent a callable liability that results in future refinancing risks or generates costs and interest. It is an accounting adjustment deriving from the decentralised structure of the Eurosystem, the aim of which is to facilitate distributing the seigniorage generated by monetary policy (difference between the return on central bank assets and cost-free liabilities such as cash). Spain's foreign net debtor position remains high but, as with other structural vulnerabilities, the situation has improved considerably. Stripping out the Bank of Spain component, Spain's NIIP would equate to 50% of GDP, painting a better picture of progress and what is still left to be achieved.



Graph 6. Effect of asset purchase programmes of the ECB's QE on Spain's NIIP
(€bn on the top chart, lhs; €tn on the bottom chart for the QE, rhs)



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