Economic Research:

The Motor Of Spain's Economic Recovery--Stronger Corporates

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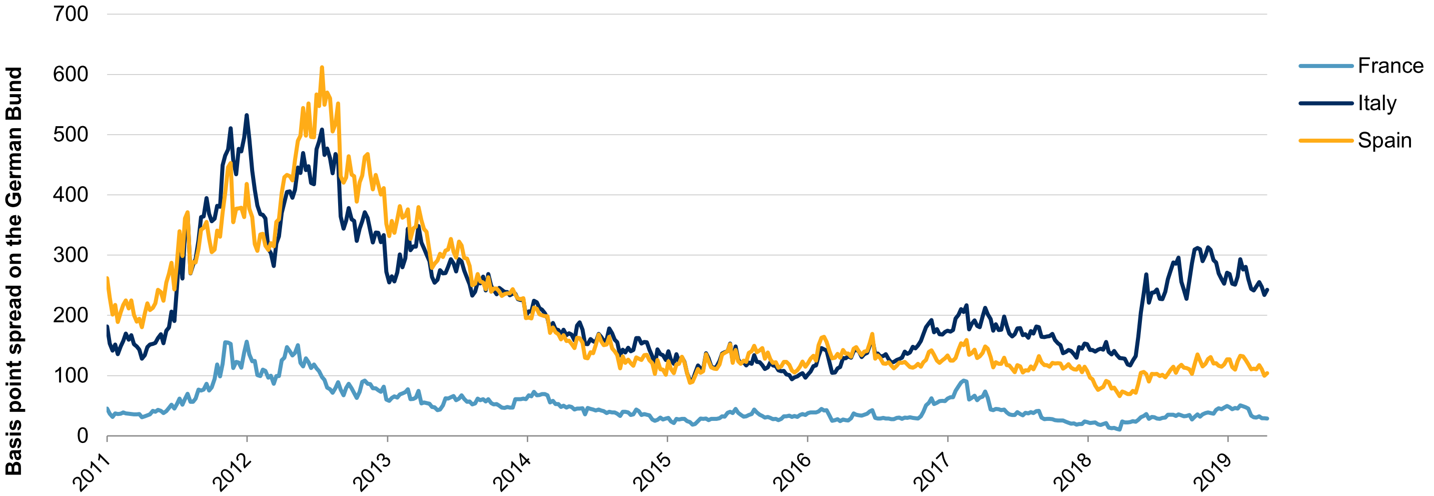
Key Takeaways

- The improved health of Spain's corporate sector is supporting the country's robust economic performance.
- Corporates have reduced debt by more than 40 percentage points of GDP in the past decade and raised profit margins to above the eurozone average.
- An export strategy shift toward higher value added and higher technological content makes Spain less vulnerable to external shocks than before the crisis.
- We expect that Spain's economy will outperform the eurozone average over the next two years, expanding at an average of about 2.0% compared with 1.25% for the eurozone.

The Spanish economy is looking more resilient to the economic slowdown in the eurozone than some of its peers. Stronger fundamentals suggest this will continue to be the case (see "European Economic Snapshots: Domestic Demand Still A Safety Net," published April 12, 2019). In the first quarter of 2019, the economy posted annual growth of 2.4% compared with 1.2% in the eurozone. Meanwhile, although Spain's persisting political fragmentation is unlikely to bring reform, yield spreads show that financial markets do not perceive the political uncertainties in Spain as a threat to its economic situation (see chart 1). Instead, they increasingly view Spain as a semi-core economy. Alongside the reforms Spain has undertaken since the financial crisis a decade ago, we think this is because of a stronger corporate sector.

Chart 1

In Contrast To Italy, Investors Are Not Demanding A Political Risk Premium In Spain
10-year yields spread with German Bund



Sources: Datastream, S&P Global Ratings.

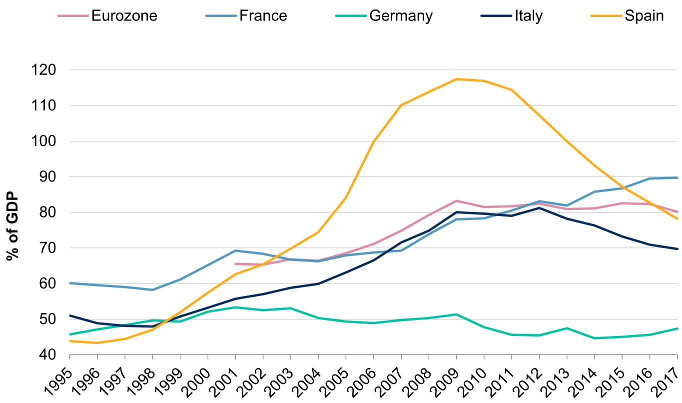
Higher Corporate Profit Margins And Lower Leverage Aid Economic Recovery

The current strength of the Spanish economy lies in Spanish corporates, which have undergone an impressive deleveraging process over the past decade. Spanish nonfinancial corporate debt was 78% of GDP at the end of 2018, well below its 2007 peak of 117% and lower than the eurozone average (see chart 2). This deleveraging, together with the European Central Bank's (ECB) low interest rates, has not only almost halved companies' interest burden since 2012, but also significantly reduced Spain's exposure to a rise in borrowing costs.

Key to this deleveraging has been an improvement in corporate profit margins, allowing firms to rely on internal financing to expand their business. The sector's profit margins averaged 43% of gross value added in 2018, five percentage points higher than in 2008, and the highest among the largest eurozone countries (see chart 3). The cut in corporate taxes from 35% in 2007 to 25% since 2016 has helped boost margins. Companies have also been able to improve their competitiveness through wage cuts between 2009 and 2014 (see chart 4) on the back of the labor market reform and also by diversifying their export markets and offering higher value-added goods.

Chart 2

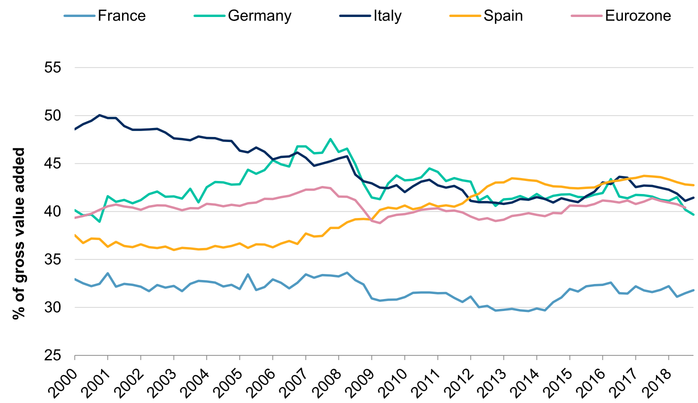
Spanish Corporates Have Cut Financial Leverage By 40 Percentage Points Of GDP In The Past 10 Years



Sources: Eurostat, S&P Global Ratings.

Chart 3

With Higher Profit Margins, Spanish Firms Can Rely On Internal Financing To Grow

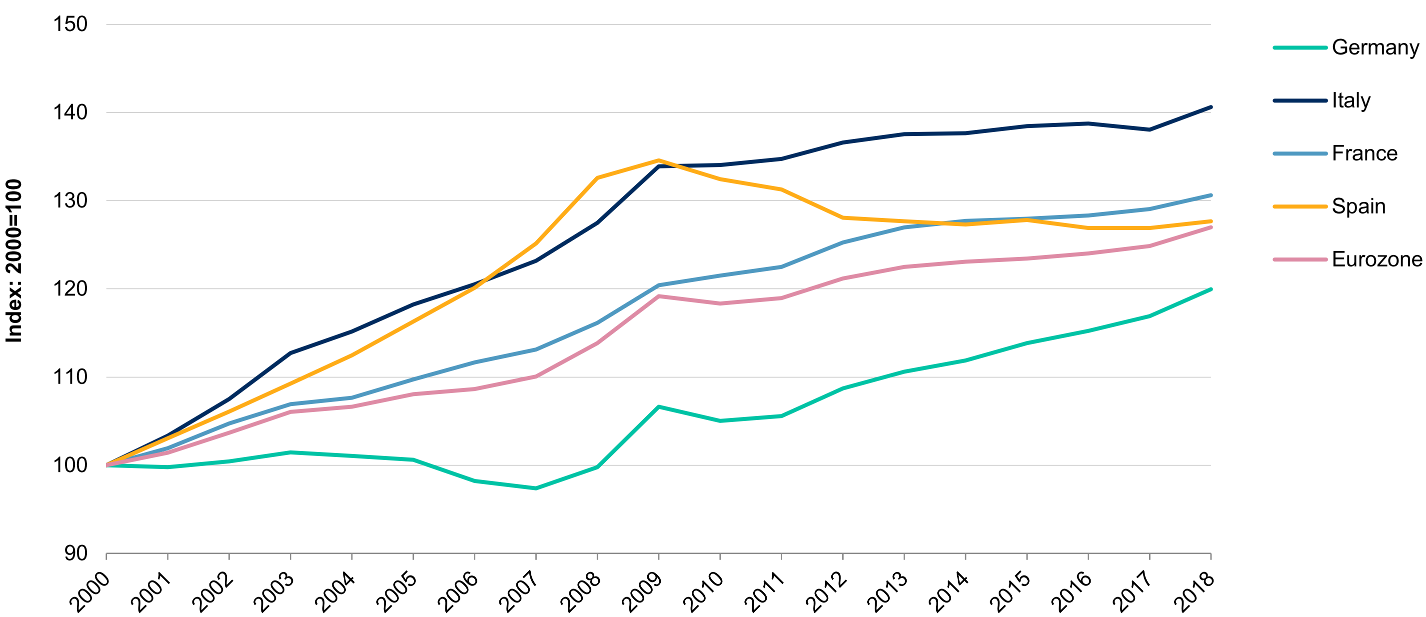


Sources: Eurostat, S&P Global Ratings.

Chart 4

Wage Moderation Has Helped Profit Margins Recover In Spain

Nominal unit labour costs



Sources: Eurostat, S&P Global Ratings.

A New Business Model Improves Competitiveness

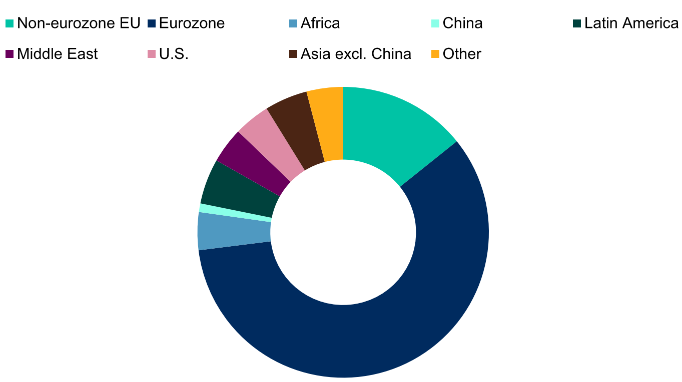
To combat faltering internal demand following the crisis in 2008, many Spanish corporates increased their focus on export markets. They also made efforts to increase their share of products with higher value added and technological content. This had a meaningfully positive effect on Spain's current account balance. The four main drivers of this increase in competitiveness are as follows:

Companies have increased their business investment, despite deleveraging. Having dropped sharply in the global financial crisis, business investment as a share of GDP rose above 10% in 2018. This is well above pre-crisis level and is comparable with Germany, albeit below that of France (13%). We therefore see room for further increases in Spanish corporate business investment. That said, low domestic savings constrain much higher investment in Spain. In this respect, improvements to capital mobility in the eurozone are needed to lift this constraint.

A focus on new and more diversified export markets has reduced corporate reliance on domestic demand and made them less vulnerable to external shocks. Spanish firms now sell a greater variety of products abroad and their exports are also geographically more diversified. The share of Spanish exports to other eurozone countries decreased from 59% in 2005 to 52% in 2018, but exports to Asia, Africa, and the Middle East increased (see chart 5). Spain's export market share has remained stable since 2010, as has Germany's, while those for France and Italy declined. This underlines the improved competitiveness of Spanish exports, a development that can be traced back to lower unit labor costs and higher quality products.

Chart 5a

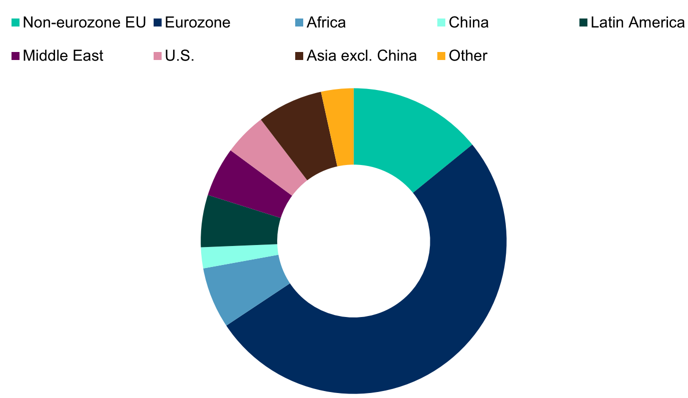
Spain's Exports Are More Geographically Diversified, Reducing Vulnerability To External Shocks
Spanish export breakdown by destination in 2005



Sources: Banco de Espana, S&P Global Ratings.

Chart 5b

Spain's Exports Are More Geographically Diversified, Reducing Vulnerability To External Shocks
Spanish exports breakdown by destination in 2018



Sources: Banco de Espana, S&P Global Ratings.

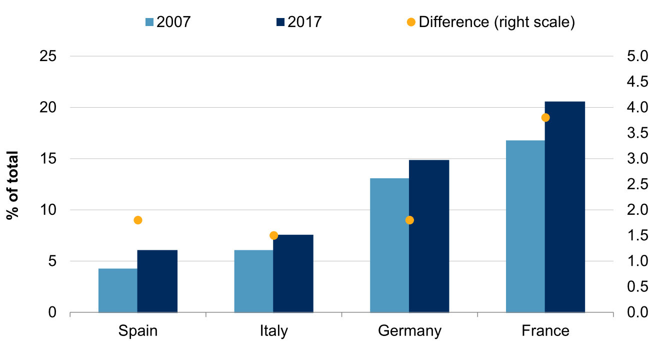
Technological content in Spanish exports has increased. The share of high-tech products in total exports increased to 6% in 2017 from 4.2% in 2007 (see chart 6). Although it is still far behind the other large eurozone countries, the rate of the increase for Spain has been second-highest over this period. This is in a context of faster-rising exports when compared with France, which has seen the highest increase in technological content. The higher degree of technological content underlines Spain's progressive move from competing on price toward competing on quality in international markets. As such, we find that a variation of the real effective exchange rate has no significant impact on Spanish export growth, a change from 10 years ago.

Spanish corporates now produce more value added domestically. Spain's domestic value added as a share of total gross exports had increased to 78% in 2016, from 75% in 2007 (see chart 7). It is the only one of the four latest eurozone countries to have posted such a significant increase. With more value added generated domestically, exports are also generating more profits.

Chart 6

Increasing Technological Content Allows Spanish Corporates To Compete More On Quality

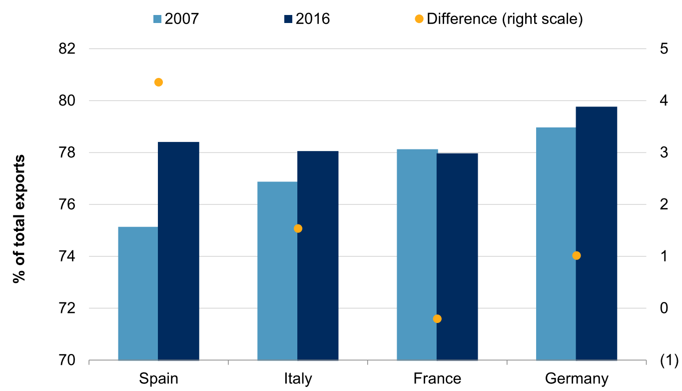
High tech trade as a percentage of total exports



High-tech products include: aerospace, computers/office machines, electronic telecommunications, pharmaceuticals, scientific instruments, electrical machinery, chemicals, nonelectrical machinery, and armaments. Sources: Eurostat, S&P Global Ratings.

Chart 7

Spain Saw The Largest Increase In Its Share Of Domestic Value Added In Exports Among Large Eurozone Countries

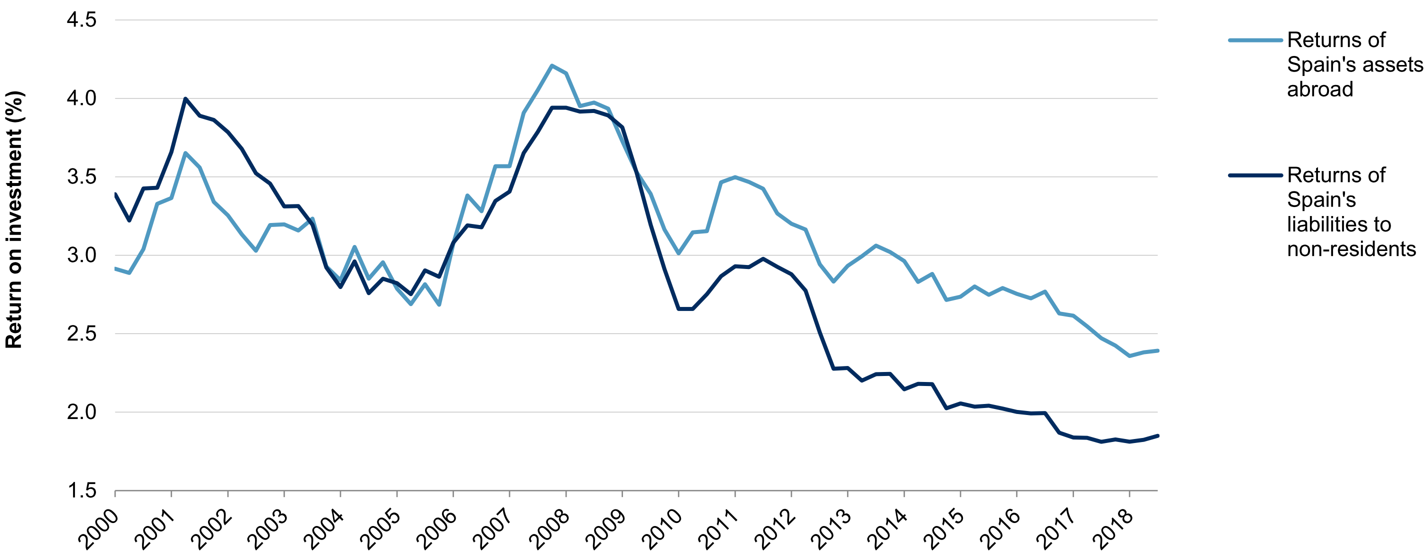


Sources: OECD, S&P Global Ratings.

Spanish corporates' new business model has helped the current account balance turn positive since 2012. In 2018, the current account balance stood at 0.9% of GDP, a much stronger position than the deficit of 9.6% in 2007. One other reason for this turnaround is that imports have been subdued, linked to weak internal demand. Still, the rise in Spanish exports to 33% of GDP in 2018 from 26% in 2007 also shows that Spanish companies' new business model has been a key driver of this structural shift. Another indicator that corporates' internationalization strategy has been successful is that Spanish investments abroad have yielded much higher returns than nonresident investments in Spain over the past decade (see chart 8).

Chart 8

Spanish Investment Abroad Has Yielded Higher Returns On Investments Over The Past 10 Years



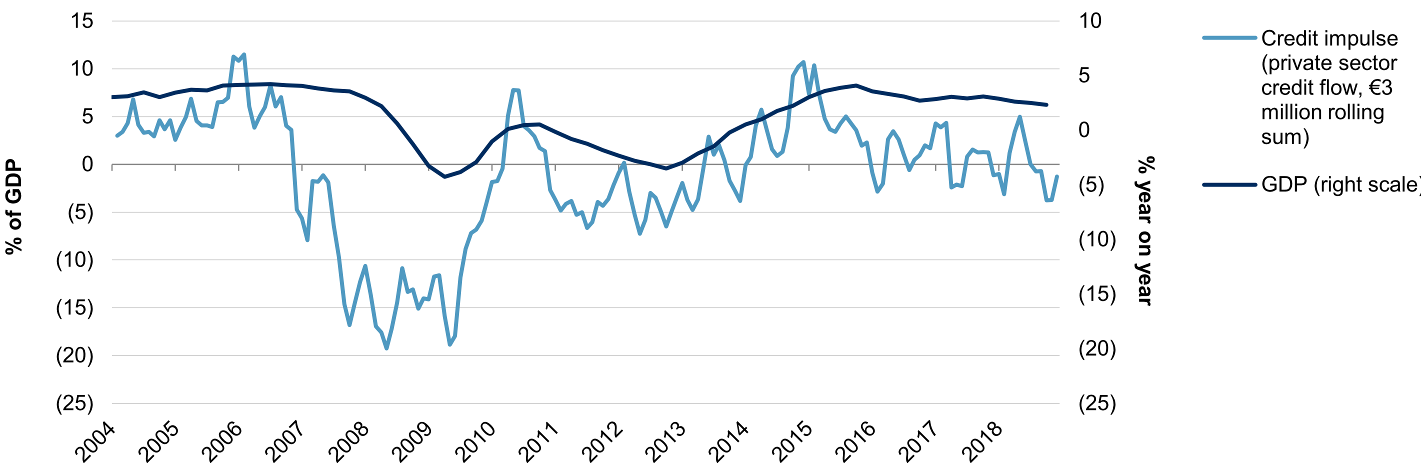
We calculate return on investment as the investment income from the current account balance, divided by the stock of assets / liabilities from the financial account of the balance of payments. Sources: Eurostat, S&P Global Ratings.

A Sustainable Growth Model Given Lower Indebtedness

With lower leverage and higher profit margins, Spanish corporates' growth strategy appears sustainable, even in a lower growth environment, and thus puts Spain's economy in a good position to expand further. Overall credit growth in Spain has yet to move into positive territory (see chart 9). This suggests that companies are continuing to use cash from high profit margins to invest rather than bank or market finance. According to the European Central Bank's (ECB's) Bank Lending Survey, Spanish corporates' demand for loans remains muted.

Chart 9

The Credit Impulse Remains Negative In Spain, But Deleveraging Is Slowing



Sources: ECB, Eurostat, S&P Global Ratings.

However, corporate deleveraging has started to slow and is likely to continue to decelerate as monetary policy remains accommodative. The ECB will not raise interest rates before 2020, and only very gradually thereafter, thus keeping corporate borrowing costs low. Borrowing rates are currently at a historical low: the average interest rate on new business loans for nonfinancial corporates is 1.7%.

Spanish corporates should remain in good health on the back of healthy profits and loose financing conditions. As their new, more export-oriented business model has proven successful, we also expect corporates to continue to achieve higher growth rates abroad. As a result, they should continue to create jobs at home and underpin Spain's robust economic expansion.

This report does not constitute a rating action.