Confluence Investment Management

Weekly Geopolitical Report

By Thomas Wash

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The New Spain

Plaza de Toros de Las Ventas is the largest bullfighting arena in Spain and the third largest in the world. Located east of Central Madrid, the arena, with its almost 100-year history, attracts tourists from around the world who want to experience authentic Spanish culture. However, the pandemic has put Plaza de Toros on life support. Not only have lockdown restrictions prevented the arena from opening during peak season, but strict travel bans and quarantine measures will likely halt foreign tourism for the foreseeable future.

Bullfighting is not alone as other tourist destinations were also forced to close due to lockdowns. When the pandemic struck in early March, restrictions limited flights, closed restaurants, suspended hotel reservations, and stopped sporting and theatrical events. The accommodation and food services sector, which makes up a fifth of the Spanish economy, contracted 10% from the prior year. Unemployment claims have risen 29% since February.

As the fourth largest economy in Europe, Spain's recovery will be critical for the European Union to get out of its economic slump. In this report, we will focus primarily on how the virus is affecting the Spanish economy. We will start our discussion with a broad overview of the economy. With this baseline, we will review the impact the virus has had on the country and possible changes going forward. We will conclude the report with potential market ramifications.

The Germanification of the Spanish Economy

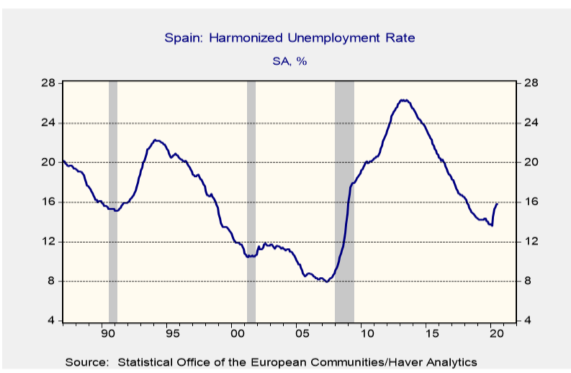
The Spanish economy has transformed drastically over the last 20 years. Following the Eurocrisis in 2012 and subsequent recession that saw the country seek a bailout from the IMF, European Commission, and the European Central Bank, the Spanish economy has become more export-driven as it seeks to mimic the success of Germany, its European counterpart.

Once viewed as "the sick man of Europe," Germany's growth over the past three decades is now considered to be an economic marvel. Economic reforms undertaken in the aught years led to a sharp rise in exports and a reversal in Germany's current account balance from deficit to surplus. Although the reforms succeeded in elevating the employment level, it did so at the expense of suppressed wage growth. Nonetheless, this model became the standard for countries looking to rebuild their economies throughout Europe, especially following the Global Financial Crisis.

In the following decade, several countries were also considered to be "sick." Spain, Portugal, Italy, Greece, and Ireland were forced to ask for bailouts. The conditions of the bailout agreements required these countries to adopt policies designed to promote exports.

Wrecked by a real-estate bubble that went bust, Spain needed a bailout to re-capitalize its ailing banks. In order to receive said funds, Spain had to commit to implementing economic reforms designed to make its exports more competitive. The reforms changed the economy in three ways: made it easier for firms to renegotiate unfavorable labor contracts, gave firms more flexibility to reduce their staff, and made it more difficult for people to receive government benefits. These changes allowed firms to efficiently adapt their business models in times of economic uncertainty. Additionally, firms had more leverage to negotiate wages for their workers, which resulted in suppressed wages and higher productivity.

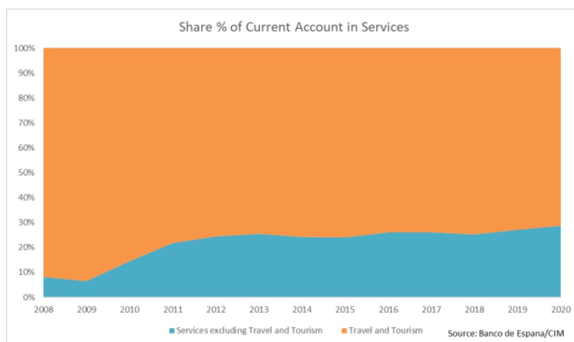
Although the reforms were largely viewed as successful in improving economic conditions, the burden of adjustment was largely felt by working-class households. As a result, unemployment rose and wage growth slowed, which led to growing political instability that the country has struggled to properly address.



The New Spain

Following the reforms, Spain became an exporting powerhouse much like Germany. In 2011, Spain ran its first surplus in 15 years and has been able to maintain one since. Despite the bulk of its exports being goods, Spain's large services surplus has bolstered the current account surplus.

Spain is now the 11th biggest exporter of services in the world. Additionally, service sector jobs account for nearly 65% of jobs created in the foreign sector; more than 50% of those service jobs are related to tourism. Despite tourism's overwhelming employment presence, the primary driver of growth in export services came from the non-tourism sector, primarily exports of intellectual property and business services.



The advent of patent boxes[1] allowed companies to receive tax subsidies on patents related to research and development. By registering the intellectual property in Spain, companies could potentially lower their corporate tax rates from 34% to 10%. Accordingly, Spain's intellectual property exports rose from $717 million in 2009 to $3.53 billion in 2018.[2]

[1] A patent box is a low corporate tax regime that taxes patent revenues at a preferential rate.
[2] https://comtrade.un.org/Data/

In addition to boosting its intellectual property exports, Spain was able to boost its presence in global value chains. Due to the internal wage deflation that was caused by economic reforms, Spain became an attractive place for firms looking to have goods assembled at a relatively low cost. As a result, manufacturing services exports rose nearly 50% from 2013 to 2018.[3]

Despite its improvement in recent years, some of the changes to the current account may be inflated. Intellectual property exports can be misleading as it is difficult to discern the place of origin of the research and development that led to its creation. For example, a company looking to take advantage of the tax benefits could register its IP in Spain instead of its actual place of origin. Additionally, the exports in manufacturing services can also be misleading as intermediate goods can cross borders more than once, resulting in double counting in the exports. Therefore, growth in Spain's non-tourism sector may not be enough to ween the country off its reliance on tourism for its exports.

Export-promotion drove Spain's economic rise, with GDP outpacing most of its Eurozone peers since 2013. However, integration into the global economy made Spain more susceptible to global supply shocks. This integration is likely the reason that the global slowdown caused Spain's economy to contract more than any of its Eurozone peers.

Different Systems, Different Results

Prior to the pandemic, the Spanish economy was expected to gradually slow from 2019 to 2022, according to Banco de Espana, Spain's central bank.[4] However, the pandemic likely accelerated this slowdown. An unprecedented surge in cases and deaths forced the country to impose harsh lockdown restrictions. The country's capacity to rise out of recession will hinge on its ability to contain outbreaks and for businesses to adjust to the new normal.

Although the central government has complete authority to rule the country as it pleases, Spain allows its states (or regions) to maintain a certain level of autonomy. This autonomy has allowed the heads of government of each of its 17 regions to decide how to respond to the pandemic. The lack of cohesion between these states made virus containment difficult as regions have struggled to track and report cases.

Following the lifting of restrictions in late June, Spain has had mixed results in containing the virus, with states in the north faring worse. The economic toll of the lockdown has made regions skittish to reimpose new restrictions. Accordingly, there has been an increase in outbreaks in isolated areas within the country. The situation was likely made worse following the reopening of schools.

The recent surge in cases has highlighted the problems with regional autonomy. Due to inconsistent protocols and varying hospital capacities, regions have struggled to track

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[3] https://www.trademap.org/tradestat/Country_SelService_TS.aspx

[4] https://www.reuters.com/article/spain-economy/update-1-spanish-economy-to-gradually-slow-down-through-2022-as-consumer-demand-wanes-idUSL8N28Q24R

the number of cases and deaths. Data collection has often been sporadic and inconsistent, with reports being revised frequently. Additionally, responses to outbreaks have been erratic. Catalonia, Spain's most populous region, saw a relatively low rise in cases in the last week after it banned social gatherings of more than 10 people. However, Madrid, which has a smaller population, has been hesitant to follow suit and saw the highest rise in cases in the last week. This lack of coordination likely contributed to Spain's reemergence as Europe's leader in number of cases.

As citizens grow tired of restrictions, a second wave of the virus will likely weigh on consumer sentiment. Thus, it is unlikely that the Spanish economy will return to normal anytime soon. Nevertheless, all the news in Spain isn't necessarily bad. The pandemic allowed the country to further modernize its economy. These changes, along with receiving stimulus from the EU, will likely make the Spanish economy better than ever once it does recover.

A Spanish New World

Among Eurozone countries, Spain's economy was the most negatively impacted by the pandemic. In an effort to rebuild the economy, the country is using the pandemic to implement much-needed changes. The hope is that these changes will make the economy more efficient and dynamic. Higher margins have become a priority for businesses looking to adapt to the post-pandemic world. In order to save its struggling tourism industry, the country has begun exploring "safe tourism" or "turismo seguro."[5] Because rural areas are least susceptible to the virus, the country has explored ways to offer high-end tourism in those areas. Therefore, some of the poorest areas will likely receive a boost in investment as firms seek to relocate their operations to those areas.

The pandemic has also allowed large enterprises to acquire small and mid-sized firms. These mergers should create efficiencies and make labor markets less susceptible to shocks. Research shows that small and mid-sized firms suffer disproportionately during a recession when compared to large firms, which is likely the result of smaller firms lacking access to credit during times of economic uncertainty. Consequently, these acquisitions could make the Spanish economy more resilient when conditions begin to deteriorate.

Lastly, firms have used the slowdown to make upgrades to their businesses. Hotels have invested in building more one-capacity rooms and hospitals have embraced artificial intelligence to improve capacity utilization, while the government is using the opportunity to invest in expanding its trade surplus in renewable energies.

Ramifications

In conclusion, the Spanish economy will likely be negatively impacted by the pandemic until the virus is successfully and reliably contained or until a vaccine becomes widely available. Spanish equities could be attractive following the pandemic as the country will likely be better positioned than it was pre-pandemic. If our expectations for a stronger euro come to fruition, equities in periphery countries could be attractive to dollar investors.

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[5] https://www.expansion.com/economia/politica/2020/09/13/5f5de09d468aebf83b8b4587.html

This report was prepared by Thomas Wash of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

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