

## Inside Spain Nr 133

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### Summary

Spain back in the international arena, Merkel applauds Rajoy.  
New Popular Party (PP) minority government faces many challenges.  
European Commission downgrades growth forecast, making fiscal deficit reduction more difficult.  
Ferrovia wins €300m high-speed train contract in UK.

### Foreign Policy

#### Spain back in the international arena, Merkel applauds Rajoy

After almost a year when Spain almost disappeared from the international arena, Prime Minister Mariano Rajoy was invited to the mini summit in Berlin hosted by German Chancellor Angela Merkel for outgoing President Barack Obama.

Italy's Prime Minister, Matteo Renzi, France's President, François Hollande, and the British Prime Minister Theresa May also attended.

When acting Prime Minister, following two inconclusive elections, Rajoy was not invited to an informal summit on the Italian island of Ventotene in August with Renzi, Merkel and Hollande; and he did not attend a September summit of Mediterranean EU countries in Athens, where leaders informally discussed the EU's post-Brexit future.

In a reference to Rajoy's holding out for 10 months to form a minority government, Merkel congratulated him on returning to office and joked that he had 'the skin of an elephant'. She highlighted the strong bilateral relation by lunching with him in private and holding a press conference with him.

There is a feeling among independent observers that Spain has been punching below its weight over the last five years –and a weight that could very well increase because of the opportunity provided by Brexit if Spain seizes it–.

Merkel first meet Rajoy in 2004 when he was leader of the opposition and she attended the Popular Party's congress at which he was elected the party's president.

### Madrid signals softer approach towards Gibraltar

Disagreements over Gibraltar, the British Overseas Territory perched at the southern tip of the Iberian Peninsula and long claimed by Spain, should not be 'dramatised' in the Brexit negotiations, Íñigo Méndez de Vigo, the government's spokesman, said in Brussels in a move that suggested a softer approach towards the Rock away from the more hardline and vociferous stance adopted by the previous Popular Party government.

Under the former Foreign Minister, José Manuel García-Margallo, the government formally invited the UK to open negotiations on sharing the sovereignty of Gibraltar so that the mandates of EU treaties could keep being applied there after the UK leaves the EU. Gibraltarians voted overwhelmingly (96%) to stay in the EU. The idea, presented at the UN's Special Committee on Decolonisation last month, was swiftly and determinedly rejected by both London and Gibraltar.

García-Margallo, replaced by Alfonso Dastis, a career diplomat with deep experience of the EU, was adamant that Gibraltar could not be part of any agreement between the UK and the EU; once Article 50 was triggered Gibraltar would be a bilateral issue between London and Madrid.

Méndez de Vigo said Gibraltar 'will be part' of the Brexit negotiations. This was interpreted as meaning that Gibraltar could be part of the Brexit deal negotiated, which is what the territory is seeking for its special circumstances, but not part of the negotiating team.

The ruling Popular Party has made it clear that it would reject any attempt by Scotland to stay in the EU single market if the rest of the UK comes out. If Spain agreed a special deal for Scotland, it would have to negotiate a special position for Gibraltar, Esteban González Pons, who leads the Spanish delegation of MEPs in the European Parliament, told The Telegraph. Such a move, he said, would also encourage the separatist movements in Catalonia and the Basque Country. Any special deal would require the consent of all EU member states.

The Gibraltar government is feeding directly into the UK's process of preparing for the negotiations, ensuring London understands what Gibraltar needs from a Brexit deal and is able to represent that.

'At the end of the day, at the end of the process, I believe we should try to find the best solution', said Méndez de Vigo, who highlighted the fact that Prime Minister Mariano Rajoy had told Britain's Prime Minister Theresa May during their meeting earlier this year that Spain wanted to 'help in this process'.

It remained to be seen, however, whether the apparent policy change towards Gibraltar would turn out to be one of tone or substance.

It remained to be seen, however, whether the apparent policy change towards Gibraltar would turn out to be one of tone or substance. The shift in rhetoric has been overshadowed by recent incursions into British waters around Gibraltar by Spanish

vessels. Whether they are a return to business as usual now that there is a functioning government or whether this is a sign of a twin-track approach (softer rhetoric and upping the pressure on the ground) is the question British diplomats are asking themselves.

Gibraltar was ceded to Britain under the 1713 Treaty of Utrecht.

### Russia withdraws request to refuel Syria-bound warships in Ceuta

A Russian request to refuel warships headed for Syria at Spain's North African enclave of Ceuta angered Madrid's Nato allies and led Moscow to withdraw the request after Madrid intervened.

Spain had cleared the request for the stopovers by three ships but after reports on the possibility that these ships were to carry out supporting tasks for military attacks on the Syrian city of Aleppo the Foreign Ministry contacted the Russian Federation's Embassy in Madrid for clarification, and it withdrew the request.

Jens Stoltenberg, Nato's Secretary General, said the ships could be used to bomb civilians in Aleppo. 'It's for each nation to decide whether these ships can get supplies and be fuelled in different harbours along the route towards the eastern Mediterranean. But at the same time we are concerned, and I have expressed that very clearly, about the potential use of this battle group to increase Russia's ability and to be a platform for air strikes against Syria'.

The move by Madrid came just days after Spain signed a European Council statement saying it was 'appalled' at the escalating violence in Aleppo and called on the Syrian government and its Russian allies to stop its 'excessive and disproportionate' attacks on civilian areas.

Guy Verhofstadt, President of the Alliance of Liberals and Democrats in the European Parliament, called Spain's earlier decision 'scandalous'.

At least 60 Russian military craft have made technical stops at Ceuta since April 2010, when the naval base was opened up to serve ships from other nations.

## Domestic Scene

### New Popular Party minority government faces many challenges

The new minority Popular Party (PP) government, formed after 315 days of a caretaker administration, faces a tough time as it gets to grips with a host of challenges ranging from winning approval for next year's budget to dealing with the intensified push for independence in Catalonia.<sup>1</sup>

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<sup>1</sup> The issues facing the new government are discussed at much greater length in my Working Paper published on 3 November, available at

The government was formed after the Socialists relented, following two inconclusive elections, and abstained in the second investiture vote in parliament, thereby enabling the PP leader Mariano Rajoy to continue as Prime Minister. The PP only has 137 of the 350 MPs, meaning it will have to negotiate every bill with the opposition. The far-left Unidos Podemos and the centrist-liberal Ciudadanos upended the two-party system.

Soraya Sáenz de Santamaria continues as Deputy Prime Minister but with the added responsibility of the territorial administrations (most notably Catalonia); Luis de Guindos remains as Economy Minister and Cristóbal Montoro as Finance Minister. Alfonso Dastis, a career diplomat, replaces José Manuel García-Margallo as Foreign Minister.

Keeping the economic 'big guns' suggests that there will be no major changes in policy, now that Spain is out of a prolonged recession but with a still very high unemployment rate (18.9%), while the appointment of Dastis, formerly Spain's Ambassador to the EU and with a long experience in European affairs, signals Madrid's need to be more closely involved in the post-Brexit debate in Brussels from which it has been largely absent.

King Felipe set the tone for the new legislature when he opened parliament after 10 months of political paralysis. He called for political life to be regenerated and, for the first time, spoke openly of the corruption that has plagued the country. 'Corruption, that has angered public opinion throughout our country and which we must continue to fight against with force, must now become just a sad memory of a scourge that we must vanquish and overcome', the King said.

Close to 80% of Spaniards believe the previous PP government did not do enough to combat corruption, according to a survey by the Berlin-based Transparency International. Several mega trials are underway, particularly involving the PP.

Rita Barberá, a 68-year-old PP Senator and former Mayor of Valencia between 1995 and 2011, died of a heart attack in a Madrid hotel less than two days after testifying to the Supreme Court over claims of money-laundering. Reaction to her death was mixed: while the PP said she was the victim of a witch hunt, Unidos Podemos filed out of parliament when a minute's silence was held in the chamber. 'We regret the death of Barberá but cannot participate in a political tribute to someone whose career is marked by corruption', tweeted Pablo Iglesias, the party's leader.

The first victim of the new situation in parliament and a taste of what political life will be like during the course of Rajoy's second term in office was the vote by all the opposition parties to delay implementation of the PP's controversial education legislation, known as LOMCE.

The LOMCE became law in late 2013, but its contents are being applied gradually. One of its most controversial measures is the introduction of externally-assessed

standardised tests (known popularly as *reválidas*) that students will have to pass in order to receive their high-school and pre-university diplomas, regardless of how well they performed in school.

The opposition called for a national pact on education. One of the most serious failings is an early school-leaving rate of 20%, around double the EU average.

Consensus needs to be the new watchword, but a majority of Spaniards believe the government will not be able to attain with other parties the necessary agreements on the main issues facing it except on the 2017 budget, according to *Metroscopia*. *Ciudadanos* is seen as the party most open to consensus and *Unidos Podemos* the least (see Figure 1).

**Figure 1. Up to what point do you believe the following parties...? (1)**

	Popular Party	Socialists	Unidos Podemos	Ciudadanos
Know Spain's reality	4.9	5.0	4.4	5.2
Can be trusted in what they say and propose	3.9	4.0	3.4	4.4
Are open to dialogue and agreement	4.5	4.5	3.7	5.7

(1) Average score, from 0 (nothing) to 10 (a lot).

Source: *Metroscopia*.

As regards Catalonia, the Constitutional Court upheld new powers to act against public officials who do not comply with its decisions. The move is implicitly aimed at the Catalan independence movement, particularly the secessionist steps taken by the regional parliament, a majority of whose members are in favour of independence. The previous PP majority government approved legislation in 2015 that gave the court the right to fine or suspend officials if they defied its orders.

Carme Forcadell, President of the Catalan parliament, is under investigation on charges of disobedience and perversion of justice. Were she to be suspended, the already very fraught relationship between the regional government and Madrid would run the risk of reaching breaking point.

The latest opinion poll by the Catalan government shows the camp against independence gaining the edge over those in favour of secession: 45.1% against 44.9%.

In the Basque Country, the Basque Nationalist Party (PNV), which won the recent regional election but lost its absolute majority, and the Socialists agreed to form a government together. The two parties agreed to seek a great degree of autonomy for the region within the framework of the constitution, a marked difference from the route chosen in Catalonia.

The Basque Country has a degree of autonomy, particularly in financial matters, that is the envy of the Catalan independence movement.

Carles Puigdemont, the Prime Minister of Catalonia, rejected the pact in the Basque Country to reform the region's autonomy statute as a model for Catalonia. He said the region has already gone down this route to no avail

In 2010 the Constitutional Court in Madrid struck down some of the articles of the region's new self-government charter after the Popular Party (then in the opposition) referred it to the court. Three-quarters of Catalan voters had approved the charter in a referendum, following its approval by the Catalan and national parliaments, against 21% who rejected it. Ernest Benach, the then President of the Catalan parliament claimed the court's ruling opened a 'crisis of state' because it 'ignores the will of Catalan citizens'.

## The Economy

### European Commission downgrades growth forecast, making fiscal deficit reduction more difficult

The economy will slow down substantially next year, according to the latest forecast by the European Commission, making it more difficult for the Popular Party minority government to meet the budget deficit target agreed with Brussels.

GDP will grow 2.3% in 2017, down from the Commission's previous forecast of 2.5% and well below this year's robust 3.2% (see Figure 2). The government's forecast is 2.5%. The budget deficit is put at 3.8%, 0.7 points above the target, albeit below this year's target of 4.6% that the government is expected to meet.

**Figure 2. European Commission forecasts for Spain, 2016-18**

	2016	2017	2018
GDP (%)	3.2	2.3	2.1
Unemployment rate (%)	19.7	18.0	16.5
Current account balance (% of GDP)	1.7	1.5	1.5
General government balance (% of GDP)	-4.6	-3.8	-3.2
General government gross debt (% of GDP)	99.5	99.9	100.0

Source: European Commission.

The PP was supposed to finally comply with EU fiscal guidelines this year and attain a deficit of 3% of GDP, but that proved impossible after its last government missed the targets in 2014 and 2015. The deficits in those years were 5.8% and 5%, 0.3 and 0.8 pp above target respectively. Under a new deal with the European Commission, the deficit

(revised target for 2016 of 4.6% compared with an initial objective of 2.8%, a difference of some €20 billion) has to be below 3% in 2018 or Spain will face a financial punishment (a maximum of 0.2% of GDP), which it narrowly missed this year. The PP needs to find €5.5 billion of extra revenues or spending cuts in 2017.

Approving the budget for next year is the first major challenge facing the new government and one when its ability to strike a deal with other parties in order for it to be approved will be tested.

Luis de Guindos, the Economy Minister, said VAT and personal income-tax rates would not be touched. The extra revenues would come from closing some of the loopholes and deductions in corporate taxes. In 2007, the last year of a long boom period, Spain collected about €40 billion in corporate taxes compared with around €20 billion this year. Many companies during the intervening years accumulated a negative tax base that they are allowed to deduct. This will probably change.

Spain's overall tax-to-GDP ratio of 34.6% in 2015 is well below the EU-28 average of 40.0% (see Figure 3). Its standard VAT rate of 21% is at the top end among EU countries, but the amount it collects measured in GDP terms is along the lowest, suggesting that fraud and evasion remain high in this area. According to the European Commission, Spain failed to collect €6.2 billion of VAT revenue in 2014 (latest year available), 8.8% of the total amount that should have been received.

**Figure 3. Total revenue from taxes and social security contributions, 2007 and 2015 (% of GDP)**

	2007	2015
France	44.3	47.9
Italy	41.7	43.5
EU-28	39.1	40.0
Germany	38.8	40.0
UK	35.1	34.9
<b>Spain</b>	<b>37.1</b>	<b>34.6</b>

Source: Eurostat.

Tax reforms in 2014 and 2015 have not produced any significant advances in terms of the revenue collected –during the period of high growth progress relied heavily on transitory factors linked to the real estate boom– and the competitiveness of the tax system. Spain was ranked 27th out of 35 countries in the 2016 International Tax Competitiveness Index, only three positions higher than in 2014.

There was better news on unemployment. The jobless rate came down to below 20% (18.9%) for the first time in six years. The rate peaked at 27% in 2013. Youth

unemployment (those under the age of 25) was 42%. Spain's growth in job creation will be the fastest in the EU this year, according to the European Commission, albeit from a still dire situation (see Figure 4).

**Figure 4. Forecasted growth in job creation, 2016 and 2015 (%)**

	2016	2015
<b>Spain</b>	<b>2.8</b>	<b>3.0</b>
EU-28	1.4	1.2
UK	1.2	1.8
Germany	1.2	0.9
Italy	1.2	0.8
France	1.1	0.4

Source: European Commission.

Over 1.4 million households have no breadwinners, according to INE. This is one factor behind the alarmingly high share of children living in poverty (see Figure 5) and the rise in income inequality.

**Figure 5. Share of children living in poverty (1)**

	%
Turkey	25.3
<b>Spain</b>	<b>23.4</b>
US	22.5
Italy	17.7
France	11.3
UK	9.9
Germany	9.8
Denmark	2.7

Share (%) of children (0-to-17) living in a household in poverty. Poverty is defined as living with an equivalised post-tax-and-transfer income of less than 50% of the national median equivalised post-tax and transfer income.

Source: OECD Family Database.

Spain's Gini coefficient of disposable household income, a standard measure of inequality, which takes the value of 0 when everybody has the same income and 1 when



one person has all the income, increased from 0.324 in 2007 to 0.343 in 2014, one of the biggest rises among developed countries, according to the OECD (see Figure 6).

**Figure 6. Gini coefficient of disposable income inequality, 2007, 2010 and 2014**

	2007	2010	2014 or latest year
Norway	0.250	0.249	0.252
Germany	0.285	0.283	0.292
France	0.295	0.305	0.294
Italy	0.313	0.323	0.325
Greece	0.330	0.337	0.343
<b>Spain</b>	<b>0.324</b>	<b>0.340</b>	<b>0.346</b>
UK	0.373	0.351	0.358
US	0.374	0.376	0.394
OECD	0.317	0.315	0.318

Source: OECD.

The hardship was dramatically exposed this month when an 81-year-old woman died in her flat in Reus after her electricity was cut off for non-payment of bills and she choked on fumes from a fire started by one of the candles she lit.

Thanks to still strong growth in exports and weakening imports, the external sector's contribution to growth is expected to remain positive next year. Exports of goods in the first nine months were 1.2% higher at €188.4 billion, a record for the period. The trade deficit was 29% lower at €13.2 billion, the second lowest figure for the period since 1997.

Spain has gained competitive advantage with regard to Germany, France and Italy since 2007, as a result of the drop in its unit labour costs. Spain's exports of goods and services are forecast to register the second highest growth among EU countries this year and next (see Figure 7).

**Figure 7. Forecasted growth in exports of goods and services, 2016 and 2017 (%)**

	2016	2017
Slovenia	6.2	4.0
<b>Spain</b>	<b>6.1</b>	<b>4.5</b>
Euro zone	2.7	3.3
Germany	2.6	2.8
Italy	1.7	2.8
France	1.0	3.1

Source: European Commission.

Between 2008 and 2004, salaries fell 9.2% in real terms, according to the index created this year for the first time by the National Statistics Office (INE). Salaries declined 0.7% during this period and inflation was 8.5%.

Inflation accelerated in October at its fastest rate since 2013, as the country consolidated its move out of deflation, begun in September when prices inched up 0.1%. Harmonised consumer prices rose 0.5% compared with the same month last year, driven up by higher transport and housing costs.

### Foreign direct investment in Spain and Spanish investment abroad fall

Productive gross foreign direct investment (FDI) in Spain in the first six months was €6.7 billion, 28.7% lower than in the same period of 2015, and gross Spanish investment abroad was down 73% at €5.6 billion (see Figures 8 and 9).

**Figure 8. Productive gross foreign direct investment in Spain excluding special purpose entities (€ billion) (1)**

First half 2014	First half 2015	First half 2016
5.27	9.41	6.71

(1) See the definition at <http://glossary.reuters.com/index.php?title=SPV>.

Source: Foreign Investment Registry.

**Figure 9. Productive gross Spanish investment abroad excluding special purpose entities (€ billion) (1)**

First half 2014	First half 2015	First half 2016
9.28	20.81	5.65

(1) See the definition at <http://glossary.reuters.com/index.php?title=SPV>.

Source: Foreign Investment Registry.

Net FDI in Spain (gross investment less disposals and excluding special purpose entities) fell 28.7% to €4.97 billion and net Spanish investment abroad declined 63.1% to €5.12 billion.

Greenfield investment in Spain, where a company builds its operations from the ground up as opposed to acquiring companies already created, declined 52% to €3.3 billion. Luxembourg was the main investor (see Figure 10).

**Figure 10. Gross foreign direct investment in Spain by main ultimate investing countries, first half 2016 (€ million) (1)**

Country	Investment	%of total	Change 2016/15
Luxembourg	1,392	20.7	-27.0
Germany	1,101	16.4	204.6
Netherlands	707	10.5	-43.0
UK	640	9.5	-19.7
Canada	514	7.7	NC
France	499	7.4	-59.8
China	223	3.3	-58.9

(1) Excluding special purpose entities.

Source: Foreign Investment Register of the Secretary of State for Commerce.

The country that received the most Spanish investment was the US (see Figure 11).

**Figure 11. Gross Spanish investment abroad by main countries, first half of 2016 (€ million) (1)**

Country	Investment	% of total	Change 2016/15
US	1,259	22.3	93.2
Luxembourg	1,166	20.6	NC
Netherlands	1,095	19.4	964.3
Venezuela	448	7.9	NC
South Korea	198	3.5	NC
Portugal	163	2.9	-26.9
Italy	143	2.5	-85.2

(1) Excluding special purpose entities.

Source: Foreign Investment Register of the Secretary of State for Commerce.

UK investment in Spain in the first half was not affected by the uncertainty created over the referendum in June on whether to leave the EU. However, 30% of companies surveyed in a report commissioned by the British Chamber of Commerce and prepared by the consultancy Afi said Brexit would affect their future investments.

The UK accounted in 2014 (latest year available) for 11% (€37.7 billion) of Spain's total stock of FDI, most of it in telecoms, tobacco and wholesale trade sectors.

### Barcelona city hall fines Airbnb and HomeAway €600,000 each for unlicensed accommodation

The city hall of Barcelona is to fine Airbnb and HomeAway €600,000 each for offering flats and rooms in the Catalan capital that were not included in a tourism registry and licensed.

Ada Colau, the city's left-wing Mayor, said it was 'unacceptable that there are thousands of apartments operating illegally without a permit, not paying taxes and causing a nuisance to neighbours'.

The two holiday rental website were fined €30,000 each last year for the same offence.

As well the nuisance caused, the city's officials blame such companies for driving up rental prices and pushing local residents out into the suburbs.

The move followed fines of more than a million euros on three banks for keeping flats on their books empty for more than two years, and which they refused to hand over to the authorities to be used as social housing.

Barcelona is suffering a tourism saturation: the number of visitors increased from 3.1 million in 2000 to around 8 million in 2015. A large part of the rise is due to cruise-liners that dock in the city.

## Spain rises in Doing Business ranking

**Figure 12. Ease of doing business (DB) ranking**

Ranking in DB 2017	Distance to frontier in 2017 DB (1)	Distance to frontier in 2010 DB (1)
1. New Zealand	87.01	88.84
7. UK	82.74	83.58
8. US	82.45	85.72
17. Germany	79.87	79.49
29. France	76.27	69.79
<b>32. Spain</b>	<b>75.73</b>	<b>68.18</b>
50. Italy	72.75	66.12

(1) An economy's distance to frontier is reflected on a scale from 0 to 100, where 0 represents the lowest performance and 100 represents the frontier. For example, a score of 75 means an economy was 25 percentage points away from the frontier constructed from the best performances across all economies and across time. A score of 80 would indicate the economy is improving.

Source: Doing Business 2017, World Bank.

## Corporate scene

### Ferrovial wins €300 million high-speed train contract in UK

Ferrovial Agroman, a subsidiary of Ferrovial, won a €300 million contract to complete enabling works on the 100km central section of the high-speed rail linking Birmingham and London.

The work will be carried out in a joint venture with Morgan Sindall and BAM Nutall and includes ecology and environmental surveys, archaeology, site clearance, demolition, ground remediation and watercourse activities.

Earlier this year, Ferrovial was awarded contracts to build a stretch of California's high-speed rail.

### Forbes puts wealth of richest 100 Spaniards at close to €200bn

The total wealth of the richest 100 Spaniards increased by 4.8% to €198.4 billion, according to the magazine Forbes, 36% of which is in the hands of Amancio Ortega, the founder of the clothing empire Inditex (see Figure 13).

**Figure 13. The 10 richest Spaniards in the Forbes list of billionaires**

Ranking	Company	€ bn
1. Amancio Ortega	Inditex	71.0
2. Juan Roig	Mercadona	8.0
3. Rafael del Pino	Ferrovial	7.6
4. Sandra Ortega	–	7.6
5. Isak Andic	Mango	4.2
6. Sol Daurella	Coca-Cola Iberian	3.7
7. Francisco and Jon Riberas	Gestamp	3.0
8. Herraiz Mahou y Gervás families	Mahou San Miguel	2.7
9. Juan Miguel Villar Mir	OHL	2.6
10. Victor Grifols Roura	Grifols	2.5

Source: Forbes.