The strength of Spain's external sector: Beyond tourism flows

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Spain's trade balance has notably improved since before the crisis. Even in the context of existing challenges, and a recent slowdown in line with the deterioration in global trade, the performance of Spanish exports remains remarkably solid.

The Spanish trade balance is holding up in the midst of a competitive environment characterised by increased flows of goods at notably lower prices, together with low oil prices. Aside from maintaining price competitiveness, the Spanish export sector faces various challenges in the short and medium term. These include Sterling depreciation and weaker growth in some key trading partners, especially the Euro Area. The increase in non-tourism exports may well represent the most significant structural change in the Spanish economy during the last decade, adding a strong boost to the services surplus.

Spanish external trade: Withstanding global deceleration

WTO international trade data for the first half of 2016 bears witness to the strong momentum enjoyed by the Spanish external sector. Whilst global exports contracted by 6.2% during the first half of the year in current value terms,

> *Spanish exports increased by 2.3% in value terms in the first half of the year, in contrast to a 6.2% decline in global exports.*

Spanish exports rose by 2.3%. Among developed economies, only Germany – with an increase of 1.6% – is able to boast of a similar performance (Exhibit 1).

According to the Ministry of Economy, the Spanish economy registered a trade deficit to August of 2.6 billion euros, down from 3.2 billion euros the year before. This adjustment took place following an 8.9% year-on-year increase in exports in August, outpacing a 4.2% rise in imports.

- *Momentum.* Spanish exports registered a modest decline during the last three months, contracting by 0.4% year-on-year – principally due to weak demand in the rest of the EU. Meanwhile, imports fell by 3.5%. Following negative growth in exports in June and July, it seems likely that exports will moderate in line with deteriorating global trade in Q316, rather than maintain the strong rates of growth seen during the first half of the year.

- *Deficit figures.* Over the last twelve months, exports have expanded by 1.9%, compared to a

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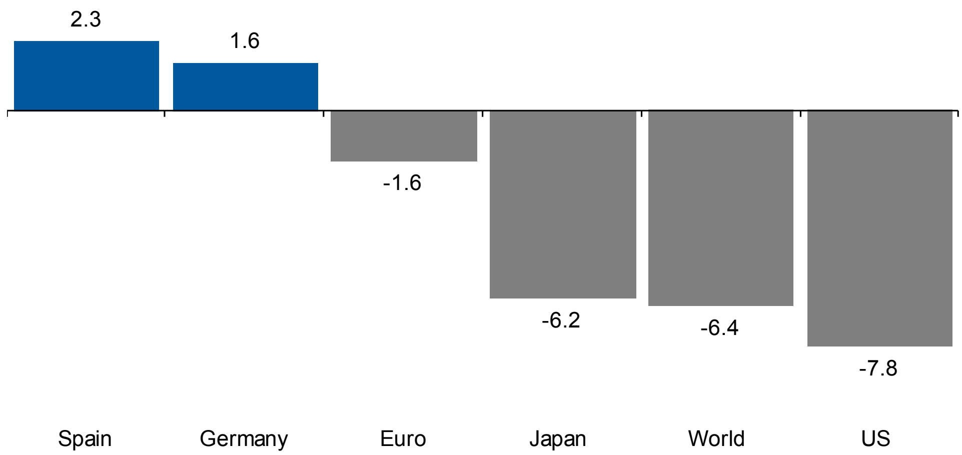
Exhibit 1

Growth in goods exports in the first six months of 2016 by country
(% YoY)



Source: WTO, AFI.

0.1% reduction in imports. The trade deficit now stands at 19.1 billion euros, its lowest level since the start of the recovery, and an improvement of about 5 billion euros relative to August last year. While the trade deficit still remains above the record low of 15.1 billion euros recorded in October 2013 (1.5% of GDP), it is a far cry from the heady deficits of over 104.2 billion euros registered in June 2008 (9.4% of GDP).

Changes in the export-import coverage and trade openness ratios

Overall, the trade deficit looks to have stabilised since the start of the recovery (Exhibit 2) at around 20 billion euros on an annual basis. This equates to 1.8 percentage points of current GDP, with an export-import coverage ratio of over 90% and a trade openness ratio of close to 50% of GDP.

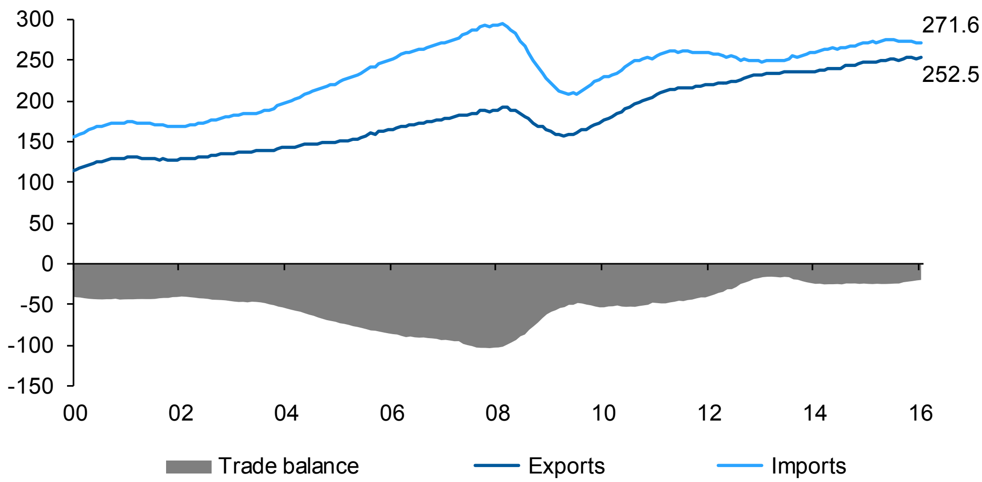
- *Export/import coverage ratio (X/M).* The export-import coverage ratio for goods has increased by around 30 percentage points from the 65% registered in the years immediately following the 2008 crisis. The improvement has occurred in phases (Exhibit 3), albeit with the bulk of the adjustment taking place from 2008 to 2014. During this period, dynamic export growth outpaced a more subdued recovery in imports, as the latter remained below pre-crisis levels. Since 2014, both exports and imports have grown at a similar rate in cumulative terms (Exhibit 2).

During the years immediately following the 2008 crisis, Spanish external trade declined precipitously. However, imports were more adversely affected than exports, as domestic consumption declined at a faster pace than demand in important neighbouring economies. This led to a rapid contraction of the trade deficit in the space of two years – from around 100 billion euros in mid-2008 to close to 50 billion euros in mid-2010. As a consequence, the coverage rate increased by 10 percentage points to over 75%.

This was then followed by a gradual recovery of trade flows with growth in exports outpacing

Exhibit 2

Evolution of annualised trade balance
(€ bn)

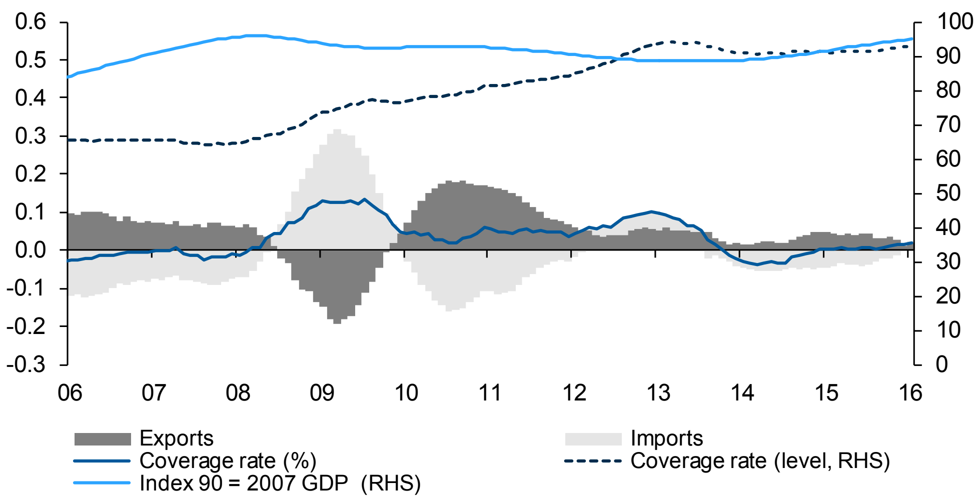


Source: MINECO, AFI.

imports. The coverage ratio increased by a further 10 percentage points from mid-2010 to mid-2012, reaching 85%. While imports once again lost ground during the second recession, exports were barely affected. The coverage ratio reached a maximum of 94%.

Exhibit 3

Changes in, and contributions to, export-import coverage rate
(% YoY)



Source: MINECO, AFI.

- *Trade openness ratio [(X+M)/GDP].* Goods trade openness also increased, from 42% at the start of the crisis to its current level of 47%. The rise is primarily associated with increased trade flows rather than declining GDP, which has only had a modest impact via the denominator (Exhibit 4).

  Spain's share of world goods exports has remained remarkably steady, slipping only slightly from 1.8% of global exports in 2007 to 1.7% in 2015. According to European Commission forecasts, this proportion is on track to rise to 1.8% in 2016 and 1.9% in 2017. In an environment of ever increasing globalisation, the Spanish economy's ability to maintain its overall export share is no small accomplishment. In fact, all major European economies have lost weight in global trade in recent years. The share for the Euro Area as a whole has shrunk from 30.4% in 2007 to 25.3% in 2015.

  Spain's trade openness ratio was initially very badly affected by the fallout from the collapse in global trade in 2008, falling to an all-time low of 34%, despite the compensating effect of declining GDP on the denominator. However, trade openness gradually recovered thereafter, managing to weather the 2010-2013 recession. More recently, the trade openness ratio has slowed and deteriorated modestly, as recent GDP growth has outpaced trade flows.

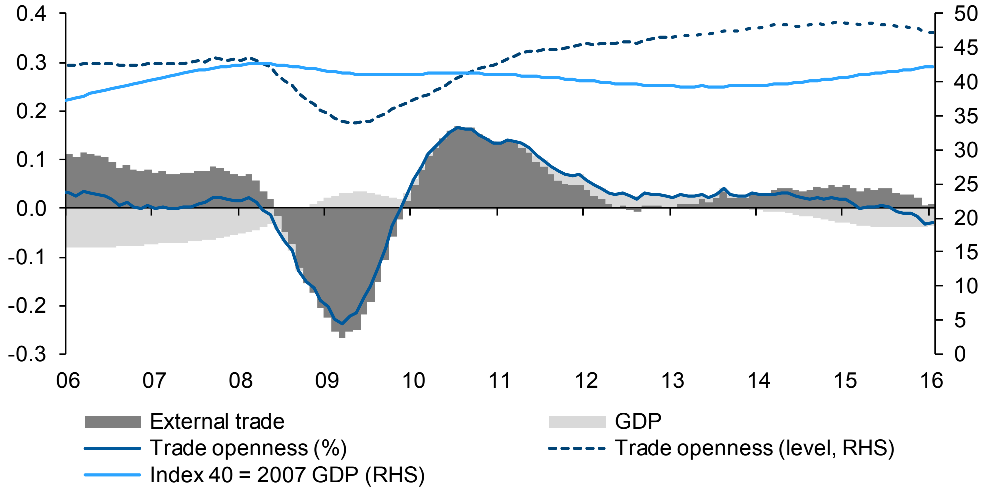
The impact of oil on the trade balance

Spain's trade balance is distorted by the burden of a high external dependence on hydrocarbons. Demand for hydrocarbons has oscillated between 30-35 billion euros in volume (2015) terms in recent years, reaching a maximum of 40 billion euros in 2008. As such, while the energy balance in volumes has remained broadly stable, the total trade balance has been primarily driven by movements in non-energy goods and oil price fluctuations (Exhibit 5).

The non-energy trade balance has benefitted from a form of automatic stabiliser effect thanks to the weakness of domestic demand during the last

Exhibit 4

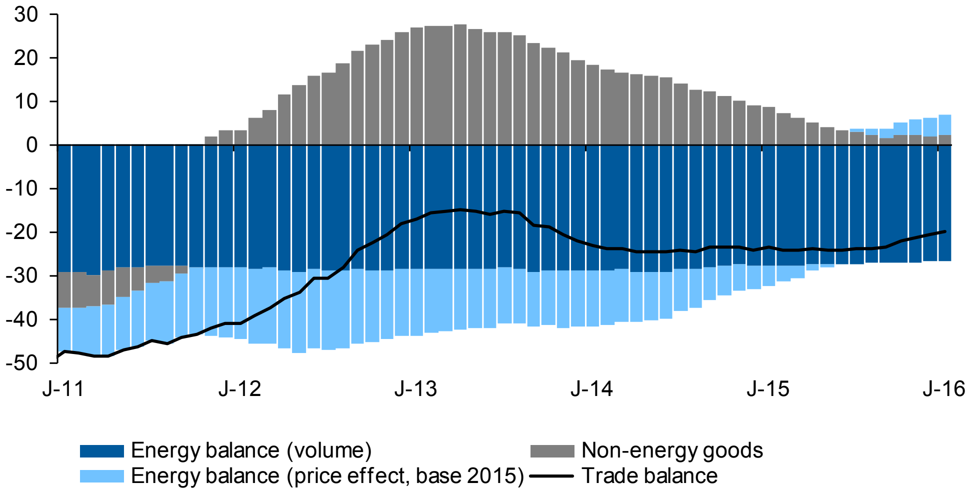
Changes in, and contributions to, trade openness ratio
(% YoY)



Source: MINECO, AFI.

Exhibit 5

Impact of oil prices on trade balance
(Billions)



Sources: MINECO, Bloomberg, AFI.

two recessions and the outstanding performance of some export sectors, such as automotives and food. In fact, the non-energy trade balance has adjusted exceedingly rapidly, swinging from an annual deficit of 65.2 billion euros in February 2008 to a surplus of 27.5 billion euros in October 2013. While the current domestic demand led recovery is now beginning to unwind the non-energy trade balance through increased imports, the economy continued to register a surplus of 2.2 billion euros in the twelve months to August 2016.

Exhibit 5 illustrates how fluctuations in oil prices have contributed both positively and negatively to movements in the overall trade balance during the last five years (taking as a reference point, average prices of Brent at the close of 2015).

Indeed, aside from the increase in exports of non-energy goods, the trade balance so far this year has clearly benefited from oil price developments. With average Brent prices to August of 48.6 dollars per barrel (39.6 euros factoring in currency movements), the Spanish economy has saved around 5 billion euros on its overall energy bill relative to the average price of Brent in 2015. This 5 billion euros broadly corresponds to the adjustment in the trade balance between the close of 2015 and August.

Current forecasts point to average oil prices of 45.5 dollars for 2016 as a whole and 54.7 dollars for 2017. On these estimates, the scope for further savings on the energy bill looks to be relatively limited.

The role of prices in exports

The overall trade balance figure – distorted by the significant dependence on hydrocarbons – should not distract from the strong performance of Spanish goods exports, which has been all the more remarkable given the current global environment.

- *Volume.* Growth in world trade has slowed significantly from rates that nearly doubled global GDP growth in the 1990s to broadly tracking growth in world GDP. In the face of this slowdown, Spanish exports have continued to hold up remarkably well. Since the end of the recession in 2010, Spanish exports have consistently outpaced average global export growth (Exhibit 6). In 2015, Spanish exports grew by 3.7%, compared to a 2.7% increase in global exports.

- *Prices.* Prices have played a particularly important role in recent trends in global trade. Global exports contracted by 14% last year in current price terms. Taking into account the 2.7% increase in global exports in volume terms, this implies that global export prices declined by 15% (Exhibit 6). By contrast, Spanish export prices fell by a more modest 2.4%, compared to a 4.9% decline in import prices.

The internal devaluation undertaken during the toughest years of the crisis has helped to sustain an inflation differential which continues to bear fruit in terms of the competitiveness of Spanish exports.

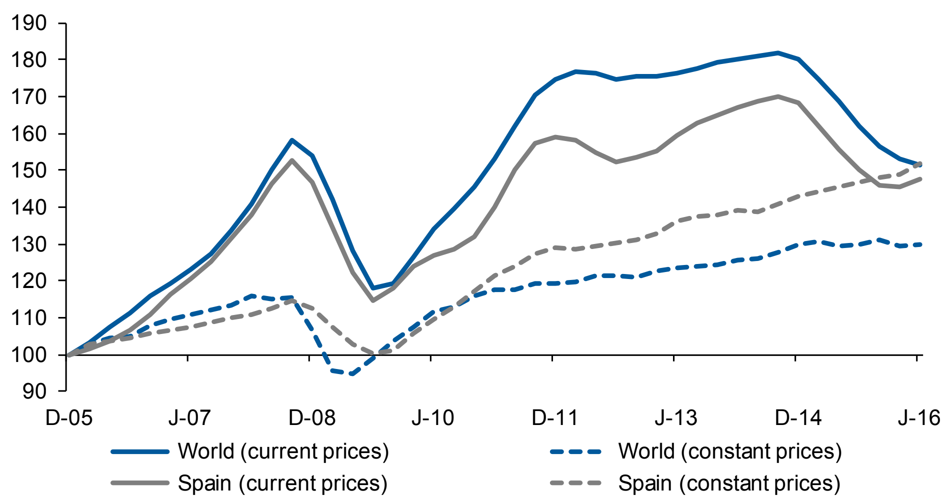
As a consequence, recent price movements are facilitating an increase in Spanish export volumes of a much greater magnitude than is reflected in the wider international context.

Going back further in time, Exhibit 6 shows that from around 2010, while Spanish exports significantly outpaced the global average in volume terms, the difference in performance was much less pronounced on a nominal basis. Indeed, the pattern of growth in Spanish and world exports on a nominal basis is broadly aligned, aside from the more noticeable decline in the former during the 2011-2013 recession. The clear implication is that export prices of Spanish goods have been significantly more contained than in the rest of the world. Seen from this perspective the internal devaluation undertaken during the toughest years of the crisis has helped to sustain an inflation differential which continues to bear fruit in terms of the competitiveness of Spanish exports.

Exhibit 6

Evolution of global goods exports

(Index 100 = 2005)



Sources: WTO, Bloomberg, AFI.

Services exports: It's not all tourism

Provisional balance of payments data for Q216 show a combined current and capital account balance of close to 26 billion euros, representing an all-time record. This improved financing capacity is primarily due to the stabilisation of the trade balance and an increase in the services surplus.

The latter reached 13.4 billion euros in Q216, compared to 12.2 billion euros in Q215. This significant improvement is not only due to the continued robust performance of tourism (9.6 billion euros of the service surplus) but has also been driven by strong growth in non-tourism services experts. The latter increased its overall surplus from 3.2 billion euros in Q215 to 3.8 billion euros in Q216.

Tourism related activity

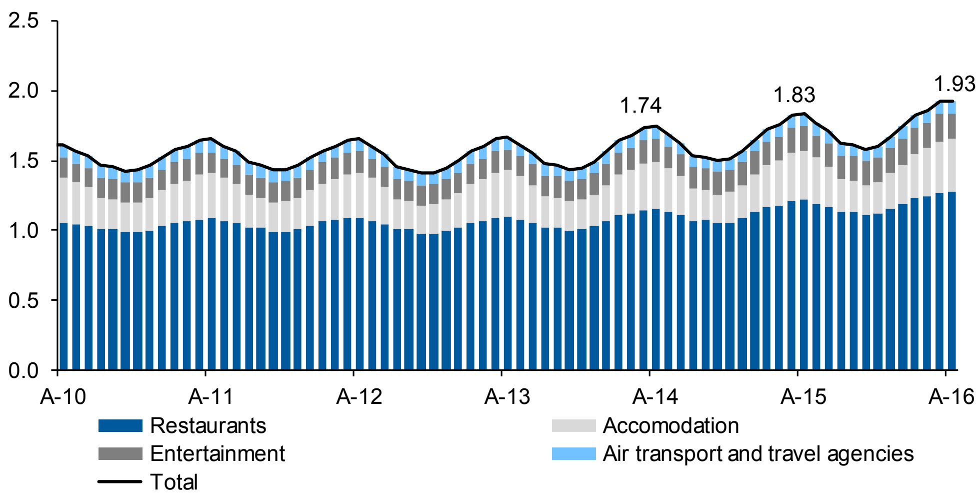
Social Security registrations associated with activity directly related to tourism (air transport, travel agencies, accommodation, catering and entertainment) accounted for around 100,000 of the year-on-year increase in employment in the last three Augusts. Approximately 60% of tourism activity is related to catering and a further 25% to accommodation (Exhibit 7). All-in-all tourism related employment explains around 20% of all employment generated during the last twelve months.

During recent quarters, attention has shifted towards the gradual deterioration in the political stability of competitor Mediterranean countries (Turkey, France, Egypt, Tunisia) and, to a lesser degree, Brexit related uncertainty.

- *Political instability in the Mediterranean.* Turkey is Spain's main competitor for tourism in the Mediterranean. In 2015, Turkey received 36 million tourist visits. However, as a result of political uncertainty, it is estimated that Turkey, Tunisia and Egypt together lost between 4 and 5 million tourist visits during the first five months of the year, compared to the same period last year (EXCELTUR, 2016).

Exhibit 7

Evolution of social security affiliations in tourism related activities
(Millions)



Source: WTO, Bloomberg, AFI.

Meanwhile, during the same period, foreign tourist arrivals into Spain have risen by 2.7 million with respect to the previous year (INE, 2016). A significant proportion of this is likely to reflect straight substitution effects between competitors.

- *Brexit impact.* Tourists from Britain account for 23% of all tourist visits to Spain, making the UK the number one market for Spanish tourism.

  Given that reservations are typically made two to three months in advance, the possible reduction in inflows of British tourists due to Sterling depreciation has so far been limited. Nonetheless, Brexit related uncertainty represents a potential threat to the Spanish tourism sector for future tourist seasons.

In additional, while demand for overnight stays has increased significantly, revenues have not grown as quickly. Latest data suggest that a decline in average length of stay is the main factor behind the fall in average revenue per tourist. Reduced spending per person and per day – a source of concern for the industry since 2012 – may also have played a small part.

Social Security registrations directly related to tourism account for an annual increase in employment of around 100,000 or 20% of total employment generated in the Spanish economy.

Afi's tourism forecasts use a combination of Social Security registrations, foreign tourist arrivals from Frontur, the index of Tourism Business Confidence (ICTUR) and other sources to project tourism flows in the coming quarters. These forecasts foreshadow a gradual deceleration in year-on-year growth in tourism related GVA from peak levels registered this summer. Even so, tourism is forecast to continue to grow at year-on-year rates significantly in excess of the wider economy. Specifically, the tourist sector could expand by 4.5% in 2016 and 3.8% in 2017, compared to projected GDP growth of 3.2% and 2.3% respectively.

Other sources, such as EXCELTUR (2016), put growth in tourism GVA at 4.4% in 2016. Two-thirds of this is explained by forecasted consumption by Spanish and European households, with the remaining third attributable to substitution effects related to instability in competitor countries.

Non-tourism related services

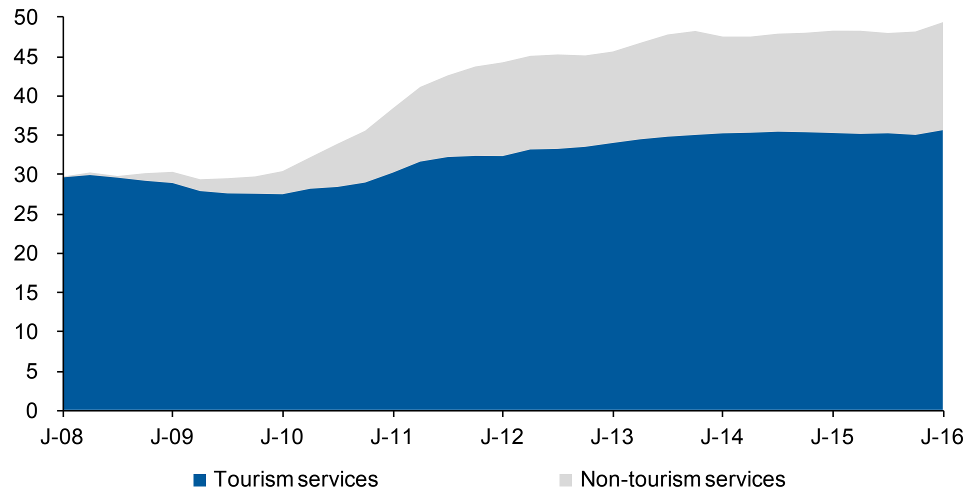
The growing importance of non-tourism services represents one of the most important structural changes in the Spanish economy since the 2008 crisis. In Q208, non-tourism services barely made a dent in the overall external sector balance. However, during the last twelve months, non-tourism services contributed 13.7 billion euros (Exhibit 8), representing around 27% of the total services surplus.

Indeed, non-tourism services alone are now able to offset around 70% of the trade balance deficit (Exhibit 9). What is more, growth in non-tourism services has been sustained since 2008 and is showing few signs of abating. Together with the adjustment in the construction sector, the increase in exports of non-tourism services probably represents the biggest structural change in the Spanish economy during the last decade.

INE's *International Trade in Services Survey* (ITSS), available from Q114 and consistent with Bank of Spain Balance of Payments data, provides information on the destinations and type of activities incorporated in non-tourism exports.

Exhibit 8

Annual change in services balance
(Billions)

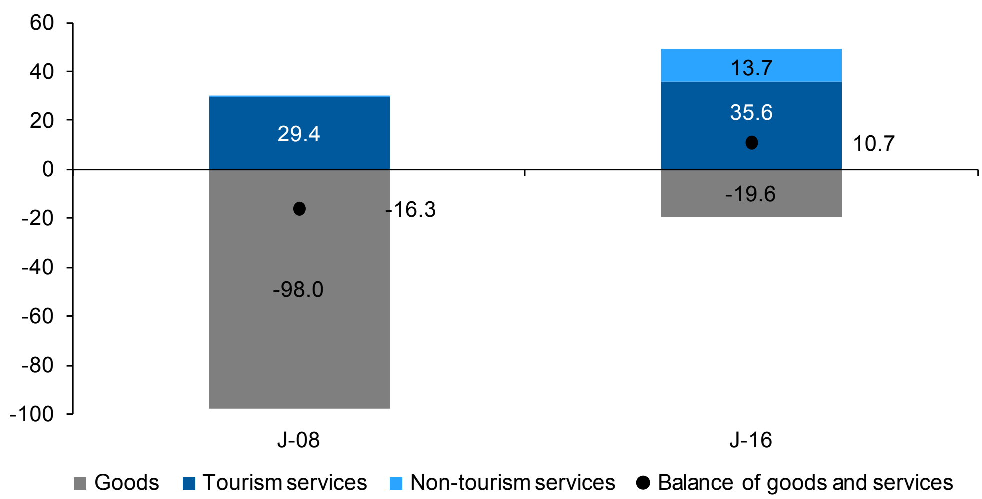


Source: Bank of Spain, AFI.

- *By destination.* The Euro Area is the main destination for Spanish non-tourism services exports, accounting for 38% of demand. Europe as a whole represents more than 60% of demand, while America accounts for 23% and Asia a further 11%. On a country basis, Europe's three

Exhibit 9

Annual change in trade and services balance
(Billions)



Source: Bank of Spain, AFI.

heavyweights – Germany, France and the UK – each amount to 9% of demand (Exhibit 10).

- *By activity type.* Business services account for nearly a third of total non-tourism services exports, led by technical services – related to engineering activity – but also retail (22%), management and professional consultancy (9%) and R&D (2%).

  Transport services, maintenance and repair represent 29% of non-tourism service exports; telecommunications and ICT 17%, financial services, insurance and pensions 11%. Various other services, including those related to construction, account for the remaining 10% (Exhibit 11).

Conclusions

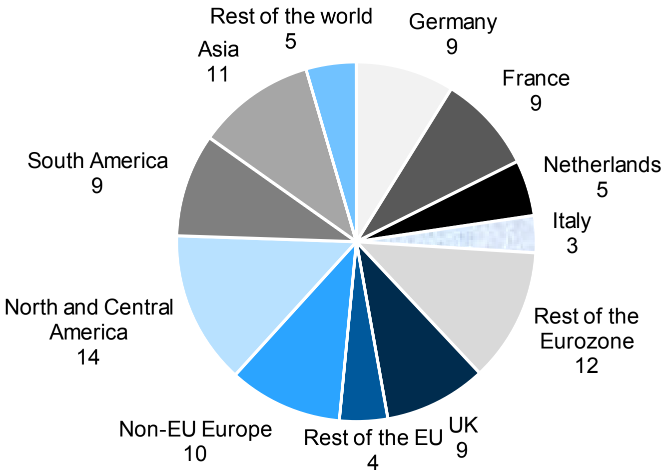
WTO international trade data for the first half of 2016 provides evidence of the strong momentum enjoyed by the Spanish external sector. Whilst global exports contracted by 6.2% during the first half of the year in current value terms, Spanish exports rose by 2.3%.

The trade balance looks to have stabilised since the start of the crisis at around 20 billion euros p.a., equivalent to 1.8 percentage points of current GDP and consistent with an export-import coverage rate of over 90% and a trade openness ratio of close to 50% of GDP.

Since around 2010, while Spanish exports significantly outpaced the global average in volume terms, the difference in performance was much less pronounced on a nominal basis. Indeed, the pattern of growth in Spanish and world exports on a nominal basis is broadly similar, aside from the more noticeable decline in the former during the 2011-2013 recession. The clear implication is that export prices of Spanish goods have been significantly more contained than in the rest of the world. Seen from this perspective the internal devaluation undertaken during the toughest years of the crisis has helped to sustain an inflation differential which continues to bear fruit in terms of the competitiveness of Spanish exports.

Exhibit 10

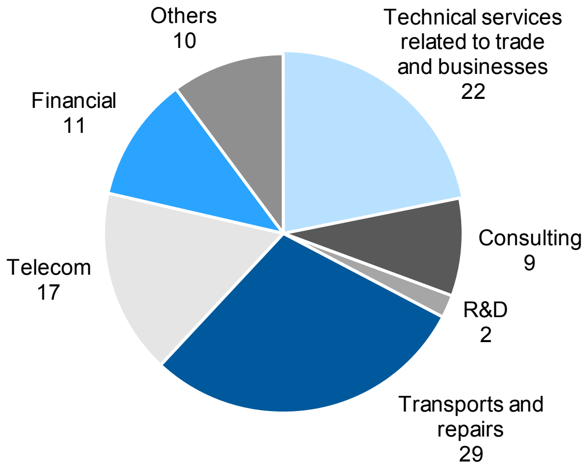
Annual exports of non-tourism services by destination
(% total, Q216)



Source: INE, AFI.

Exhibit 11

Annual exports of non-tourism services by activity type
(% total, Q216)



Source: INE, AFI.

The growing importance of non-tourism services represents one of the most important structural changes in the Spanish economy since the 2008 crisis. In Q208, non-tourism services barely made a dent in the overall external sector balance. However, during the last twelve months, non-tourism services contributed 13.7 billion euros, representing around 27% of the total services surplus and equivalent to 70% of the trade balance deficit.

Business services (technical, engineering, consultancy) account for nearly one third of total non-tourism services exports, followed by exports of transport, telecommunications, insurance and construction services.

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