The impact of the slowdown in emerging markets on the Spanish economy

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Recent instability in some emerging markets threatens to undermine the recovery in major developed economies, in particular in Spain and other euro area countries, as strong external demand remains a key factor for economic growth.

In this article, we examine the main channels of contagion from the slowdown in emerging market for the Spanish economy. The most obvious channel is through trade exposure to the emerging block, a growing destination for Spanish exports in recent years. We also examine another important link between Spain and the emerging markets - the value of Spanish companies´ investments in emerging economies, as well as the revenue flows of internationalized companies abroad. The main conclusion is that growth prospects for Spain will remain intact even if the crisis in the emerging economies escalates further, primarily a consequence of the specific markets to which Spain is exposed. However, a major slowdown will significantly hurt growth. Domestic demand is not yet ready to substitute external demand, and is not expected to do so in the near-term, as the Spanish economy is still correcting the multiple disequilibria inherited from the boom years.

Introduction

The year has begun with outbreaks of instability in some major emerging countries. Emerging markets have been the main victim of the Federal Reserve´s (Fed´s) decision to reduce asset purchases. Between 2010 and 2012, coinciding with a two-trillion dollar expansion of the Fed balance sheet, emerging economies received private capital flows amounting to 6% of their GDP. Half of these flows took the form of foreign direct investment with a long-term view, but the other half (portfolio investment and bank lending) sought yields in a context of low interest rates in the major developed economies. The World Bank states that 60% of capital inflows to emerging markets were the result of the Federal Reserve's quantitative easing.

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Once accounting for the impact of the withdrawal of the Fed's monetary stimulus on the financing terms of emerging economies, the fact is that,

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unlike other episodes of external shocks, this time each country´s individual growth prospects, external vulnerability, and economic policy stance will determine the outlook for these markets in the future.

Based on these criteria, we can divide the emerging bloc into five groups of countries. One group would consist of economies like Argentina, Ukraine and Venezuela. Under a scenario of political and economic instability, they share an unorthodox management of internal politics that makes them particularly vulnerable to a scenario of increased volatility. A second group would be made up by countries with large current account deficits and/or high sensitivity of growth to the global commodity cycle that are currently seeing a slowdown in their growth. Turkey, South Africa, Chile and Peru, whose currencies have experienced deep depreciation so far this year, would be members of this group.

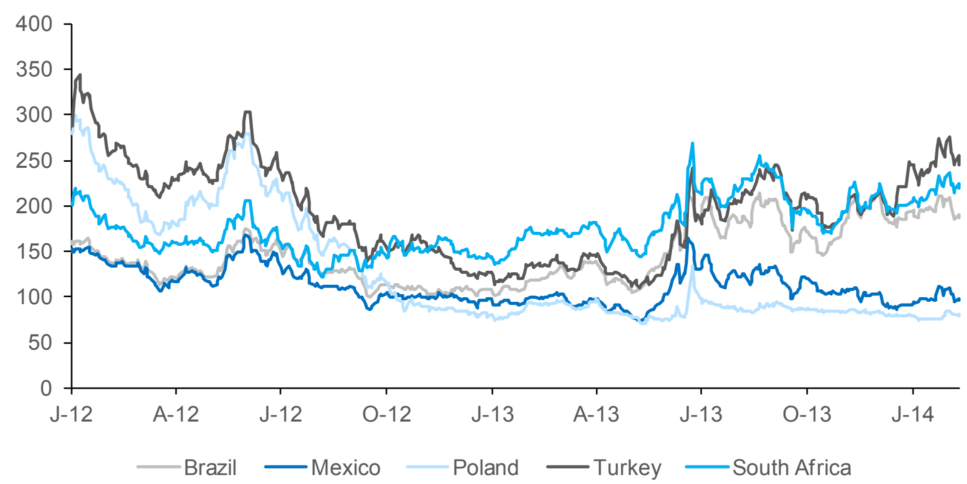
The third group would be formed by Eastern European countries, such as Hungary and Romania, which are sensitive to renewed instability in peripheral euro zone countries due to their strong financial ties to the euro area through their banking sectors and the fact that a significant part of their private funding is foreign currency-based.

The fourth group is composed of the BRICs (Brazil, Russia, India and China), with internal structural problems of a different nature, but with one common denominator: the risks of inaction on reform in key areas to ensure medium-term economic growth in line with the average of the last expansion phase. In the case of Brazil, the combination of an inflation rate close to 6% and reduced growth is calling into question the strategy of monetary tightening by the central bank. In China, the potential destabilization caused by “shadow banking” and the incomplete reorientation of growth towards domestic demand threaten to weigh on Chinese, as well as global recovery.

In the fifth and final group, we could include countries like Korea, Mexico and Poland, which have solid economic prospects, a lack of internal

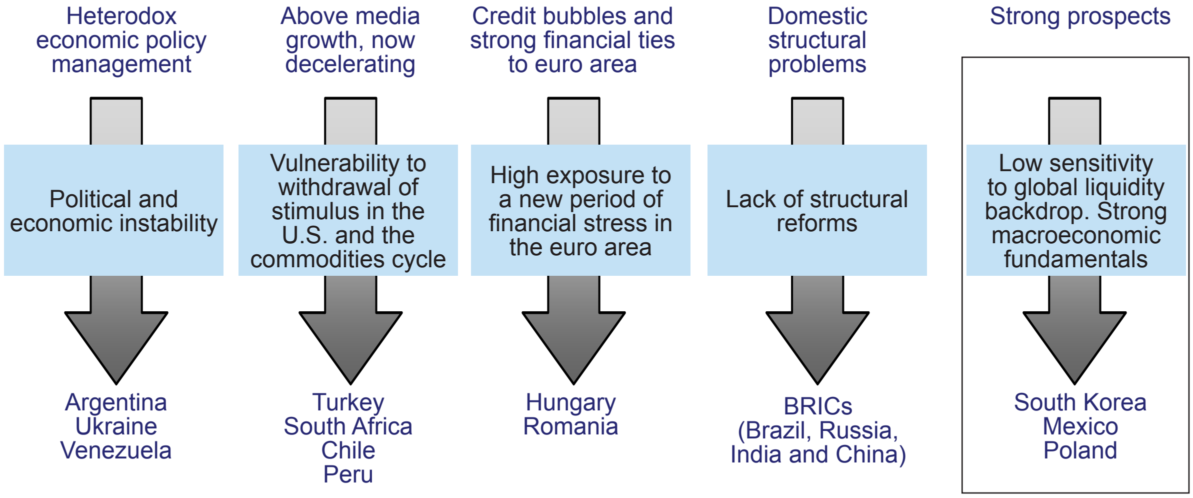
Exhibit 1

Sovereign CDS of emerging economies (5 years, bp)



Sources: AFI, Datastream.

Exhibit 2
Groups of emerging economies



Source: AFI.

imbalances and financing structures that are less dependent on global liquidity. Surely, they are the best positioned to deal with the effects of tapering.

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Markets are beginning to differentiate among emerging countries based on their sensitivity to global liquidity conditions. The positive aspect of the recent sell-off of emerging market assets over May 2013 was the decoupling of different markets, with investors penalizing those countries with a vulnerable financial position, as shown in CDS prices. The strategy of differentiating among emerging assets is key in an environment of uncertainty like the present. The intrinsic elements of the financing structure and the growth profile of each economy will drive emerging economies' risk premiums in 2014.

Economies with better economic fundamentals should soon overcome the recent financial stress and will surely be the first to benefit from the return of foreign capital.

The Spanish economy: Channels of contagion from the emerging market slowdown

The recent instability in some emerging markets is threatening to undermine the recovery of the core developed economies, and that of Spain and the rest of the euro area in particular, at a time when external demand still plays a key role in supporting growth.

The slowdown of Spanish goods exports in the second half of 2013 and, above all, those to non-EU destinations, poses a significant risk, to which we must add three others.

First, the falling value of investments made by Spanish companies in economies suffering sharp depreciation of their currencies.

Second, the impact of these economies' lower growth on the revenue flows of internationalized companies.

And third, the effect on the income and asset quality of the banking system, particularly of institutions with a high degree of internationalization.

The differential losses suffered by companies in the IBEX with a significant presence in Latin America (specifically, in Argentina, Brazil and Mexico) and Turkey (areas that are the focal point of financial and currency tensions), along with the indirect effect more limited growth of the emerging bloc may have on world trade, would warrant a review be conducted of Spain's aggregate exposure to these countries.

Value of Spanish investments abroad: Analysis of exposure to Latin American countries

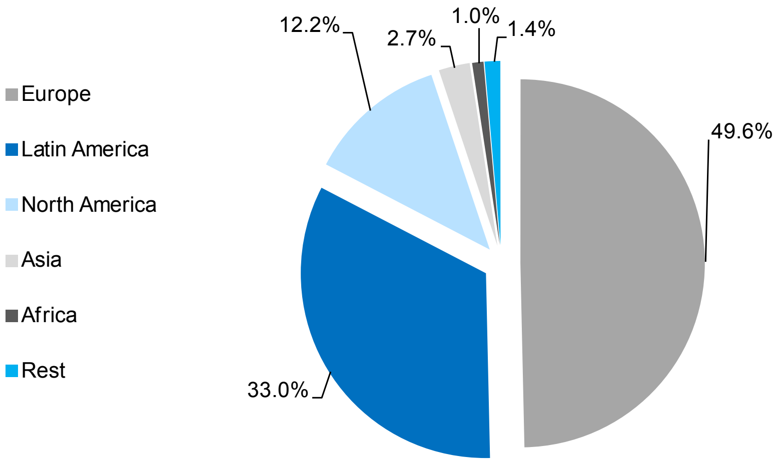
In 2011, Spain's Foreign Direct Investment (FDI) position abroad stood at 440 billion euros, more than 40% of GDP. In the final years of the nineties, Latin America (LatAm) accounted for the bulk of FDI decisions. As a result of Eastern Europe's entry in the euro area and economic expansion, the region has replaced LatAm as the main destination of Spanish FDI.

Despite the loss of relative weight in the total stock (near 30% of the total) and the significant reduction of the flow of new investment to the region, Spain's position in LatAm remains significant. Brazil, Mexico, Chile and Argentina account for 85% of Spain's FDI in the region.

The exposure of Spanish companies to LatAm economies is primarily concentrated in regulated

Exhibit 3

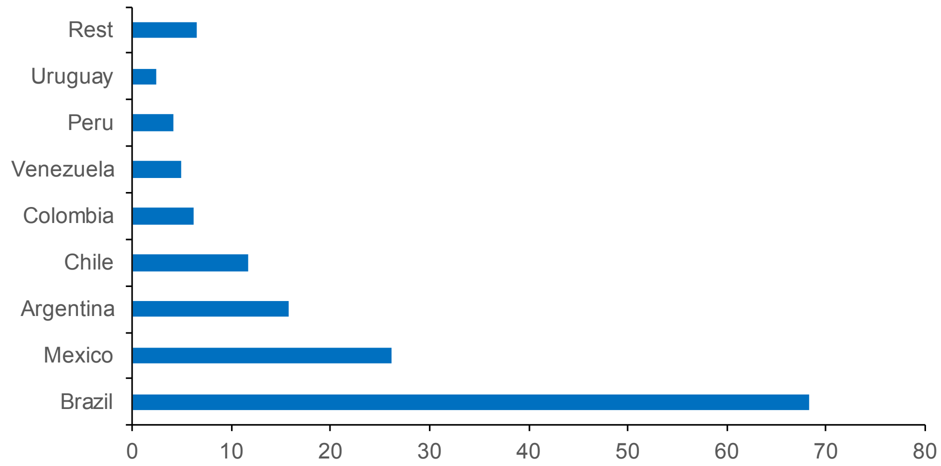
Stock of foreign direct investment (FDI) of Spain abroad (2011, latest available figure)



Sources: AFI, Datainvex.

Exhibit 4

Investment position of Spain in Latin America (2011, billions of EUR)



Sources: AFI, Datainvex.

sectors. On the basis of data up to 2011, financial services account for nearly 50% of FDI in countries like Brazil and Mexico, whereas oil and gas extraction and telecommunications represent close to 20% and 30% of FDI in Chile and Argentina, respectively.

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Economies that are leading the growth in the region have provided higher returns for the companies that have entered their markets. A stable institutional framework, which was an unresolved issue for these economies during the last decades, has also contributed to sustained earnings. Due to their macroeconomic and political stability, Chile, Peru and, to a lesser extent, Colombia have been successful choices for Spanish companies´ projects abroad.

Less attractive countries for investment are those that have followed heterodox economic policies in recent years, like Argentina and Venezuela. In the bulk of these economies, authorities have imposed capital controls and restrictions on repatriation of dividends. In some extreme cases, they have ordered nationalization processes that impair the value of investment projects for multinational companies and erode the confidence of developed firms in these markets.

Trade exposure of the Spanish economy to emerging markets

Spain's trade exposure to emerging markets is smaller in terms of GDP, as it just barely accounts for 5% of GDP. However, when we compare the exposure of other developed markets, we find that Spain´s interests in the emerging bloc are not so small. In fact, of the four main euro area

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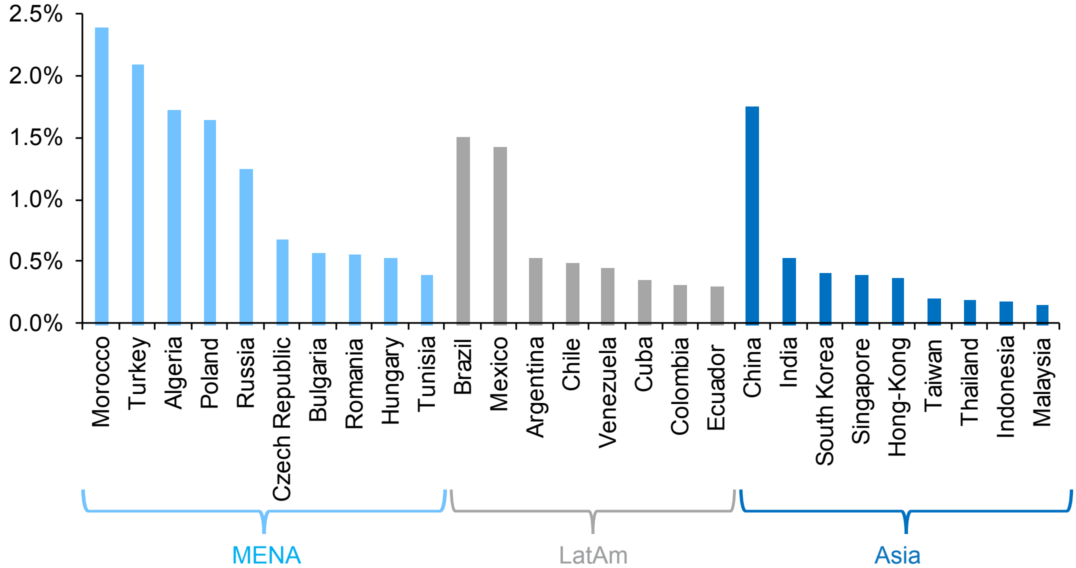
Exhibit 5

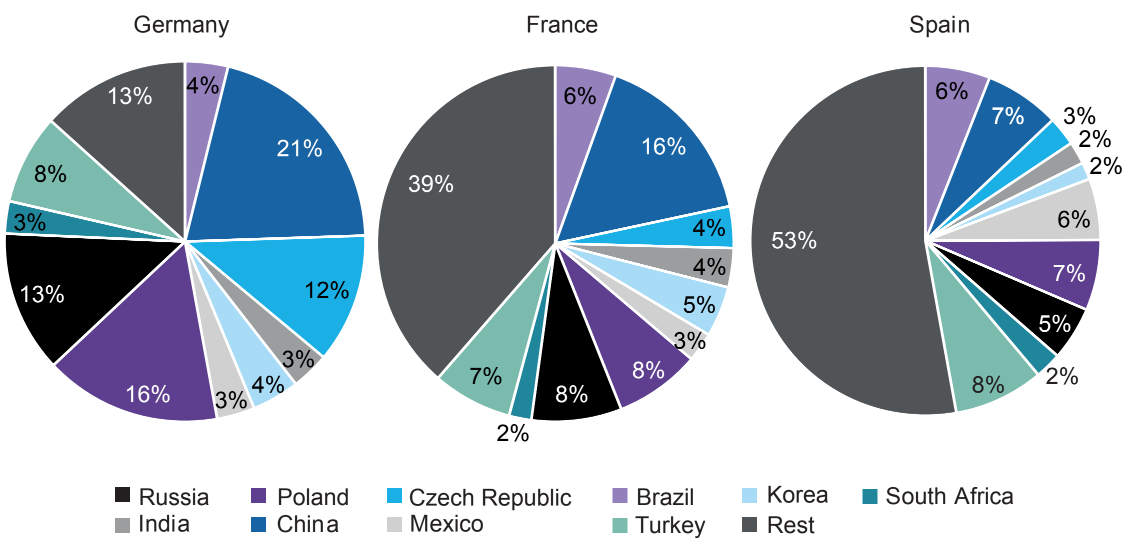
Goods exports of Spain to emerging economies (% of total)



Sources: Ministry of Economy, AFI.

Exhibit 6

Exports distribution from Germany, France and Spain to emerging countries*



*Note: *The chart shows the weight of emerging countries in total exports to the emerging bloc of each country. The weight of the emerging bloc exports of each country is as follows: Germany (25.8%), France (20.5%) and Spain (25.1%). In the case of France and Spain, the "rest" consists mainly of the economies of North Africa.*

Sources: AFI, Datastream.

economies (Germany, France, Italy and Spain), Spain ranks second in exports to emerging economies. Exports to these countries represent 25% of Spain's total exports, a percentage that is similar to Germany's (near 26%), and slightly higher than France or Italy (near 20%).

An important issue to take into account at this point is that the external sector has been the main driver of growth for the Spanish economy during the crisis. The weight of exports in GDP has risen from 26% in Q108 to 35% in Q413. And export growth has averaged an astonishing 6.6% since 2010, thanks partly to emerging market growth. In the first half of 2013, emerging bloc exports accounted for up to 25% of export growth, and LatAm accounted for 6.5%.

Just as important as emerging bloc exposure, however, is specific country exposure. We have seen that the emerging bloc cannot be treated uniformly, and that different country groups can be easily distinguished by their macroeconomic and financial fundamentals. Some groups are better prepared to deal with the withdrawal of monetary stimulus in the United States, and others might struggle to maintain financial stability.

Fortunately, Spain's trade exposure is weighted towards emerging economies that are not likely to be the focal point of renewed financial stress in the emerging bloc. Central and Eastern Europe and MENA (Middle East and North Africa) countries are still at the top in the ranking of trade partners, and potentially "problematic" partners (Brazil, India, Turkey) account for a very small portion of exports to the emerging bloc.

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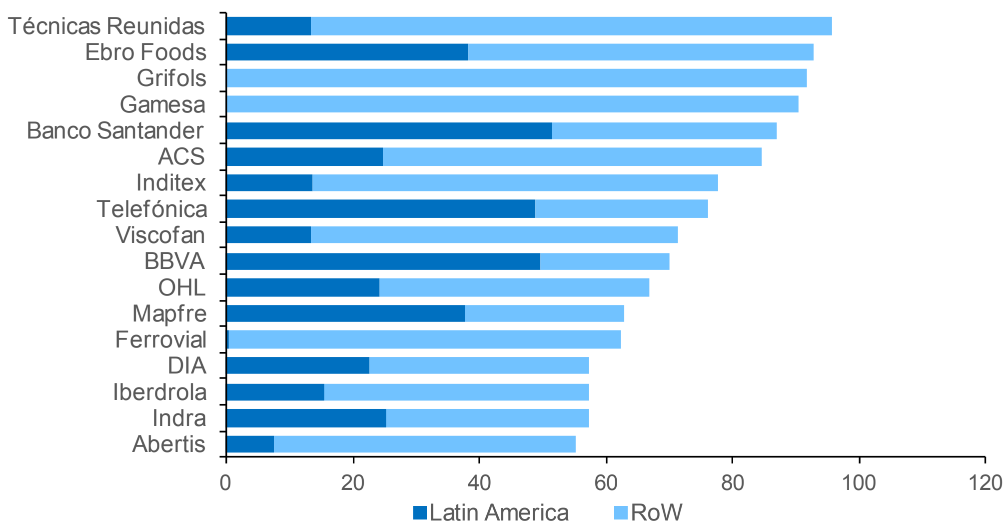
A brief review of earnings generated by main Spanish corporations (IBEX 35) in emerging markets

Business and earnings generated outside Spain and, specifically, in LatAm, are significant for some of the leading companies of the IBEX, particularly

Exhibit 7

Revenue from rest of world (2012, % of total)



Sources: AFI, FacSet.

for the banks BBVA and Santander. In the case of Santander, assets in LatAm represent 22% of the balance sheet, with a greater presence in Brazil (12%), followed by Mexico (4%) and Chile (3%). For BBVA, 34% of its assets are in Mexico (13%), other Latin American countries (13%) and Eurasia (8%), which includes Turkey and China. In both cases, these countries' contribution to income exceeds 50%.

Conclusions

After the reduction of financial fragmentation in the euro area, the main risk faced by the region is a worsening of the slowdown in emerging markets.

The emerging bloc has been the main source of global growth since 2008, and it is expected to increase its share of world GDP in the coming years. However, growth since 2008 has not been as resilient as before, and the evolution of some financial variables, like credit to GDP, points to increasing financial vulnerability in some countries.

Easier liquidity conditions prompted by monetary policy decisions in the United States in the aftermath of the crisis have masked structural problems in vulnerable economies. These structural problems are likely to arise now in the form of slower growth and financial instability. While we think that a major crash is not imminent, and that financial resilience is now higher than in other episodes of emerging markets crises, global activity is likely to be hampered.

Not all the emerging countries can be categorized into a single group. Differences among emerging countries are too wide to consider them a unique and homogenous bloc. South Korea, for instance, has gained the status of a developed market in the last decades, but is often classified as an emerging country, together with very different economies like Nigeria, Brazil or Indonesia. Also, vulnerabilities in one country have nothing to do with vulnerabilities in other nations. Eastern Europe has suffered the impact of the euro crisis and many economies in this area have been under extreme financial stress in recent years. Some of them have even requested financial aid from institutions like the International Monetary Fund, and have undertaken ambitious programs of fiscal consolidation and enacted reforms to boost potential GDP. The results of this economic policy strategy are still unclear.

Asia and LatAm economies have enjoyed a very favourable environment for attracting capital flows from developed markets. Lower yields in developed financial assets explain the attractiveness of these emerging markets to foreign investors, together with these regions' growth potential. But the change of monetary policy in the United States has threatened financial stability, and the first signs of "capital flight" are eroding market confidence in the ability of the emerging block to overcome the current crisis.

The slowdown in emerging areas is of the utmost importance to developed economies and particularly to the euro area and Spain. The reason is that, unlike economies like the United States or the United Kingdom, the euro area is only now starting to recover from its second recession since 2008. Moreover, the drivers of the recovery are rooted in the ability of the euro block to export, at least while domestic demand remains muted due to the combination of fiscal consolidation and weakness of domestic demand in the peripheral economies.

We have considered herein various channels of contagion to developed economies and Spain from the crisis in the emerging markets. The most obvious channel is through trade relationships, but other elements can hurt growth, such as the investment position of Spain in the emerging bloc (risk of impairments in external assets) or the weight of revenues collected abroad on the income statements of a good proportion of national companies, especially the biggest ones.

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With regard to the investment position, it is noteworthy that the bulk of FDI is concentrated in Europe and LatAm. In order to assess the risk of potential losses arising from a major slowdown in these markets, it is necessary to take a country-by-country approach in the analysis instead of examining big trends in a region as a whole.

"Trade exposure" to emerging areas has increased notably in recent years as export growth rates to the emerging markets have systematically surpassed growth rates of exports to other developed markets. Currently, Spanish goods exports to these countries amount to 25% of the total, one of the biggest shares in the euro area. However, emerging "Europe" and MENA countries represent the bulk of the exposure in trade terms to the emerging block. Presumably, these countries are not likely to suffer the effects of monetary policy developments in the United States, or not to the same extent as the group of potentially "problematic" countries.

Overall, we think that growth prospects for Spain will remain intact even if the crisis in the emerging economies escalates further. Two assumptions are implicit in this statement. First, that the emerging block crisis does not significantly hamper the global growth outlook. Avoidance of economic policy mistakes in countries like China (which is managing a liquidity squeeze in some segments of the interbank market) and a solid recovery in the United States are necessary conditions in this sense. Second, that activity in the euro area gains momentum, allowing countries like Spain to maintain acceptable growth rates in exports even if growth in emerging markets falters.

In the absence of more growth in the euro area, or if growth disappoints in economies like China or the United States, the Spanish economy will suffer from the emerging market slowdown. Domestic demand is not yet ready to replace the external sector as a source of growth, and will not be ready to do so in the short term as the economy is still correcting the multiple disequilibria inherited from the boom years.