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Highlights in this issue:

External financial needs are increasing

Portfolio investment has replaced FDI as the external financing instrument

The financial system is the main channel for funding households and corporates

The solvency of domestic borrowers looks sound in the short term.

Spain's external deficit: how is it financed?

*By Alberto Cabrero, Luis Angel Maza and Javier Yaniz**

Summary

In 2006 the external net borrowing requirement of the Spanish economy was almost 8% of GDP, after having been in balance between 1993 and 1998. This increased borrowing requirement is the financial mirror image of a growth model, in which corporate and households' investments are generating an unprecedented private demand for credit. Although the solvency of Spanish borrowers does not seem to be at risk in the short term, in the medium and long run, any widening of the already extensive recourse to external saving might lead to additional pressure on the economy. An assessment of external imbalances should include scrutiny not only of the existing financial instruments and who issued them, but also of cumulated debt levels, i.e. an analysis of flows and stocks. According to the findings of this country focus, it is portfolio investment, rather than FDI, which is the main financial instrument, while the financial system - and not the corporate sector or general government - has become the main channel between domestic borrowers and private foreign lenders.

Analysing the recent trend in the external deficit

In the context of the monetary union, it is not only the size of the deficit that counts…

Spain's current account deficit was 8.5% of GDP in 2006. At €83 billion, it was the highest in nominal terms of all the OECD countries and second only to that of the USA. After adding the capital account, which consists mainly of EU transfers, Spain's net borrowing position is now close to 8% of GDP. The external deficit has been widening in parallel with Spain's long-lasting expansionary phase, during which annual GDP has grown in real terms at slightly over 3.5%. Starting from a broadly balanced position in 1998, the external financing needs increased steadily, reaching 3% of GDP in 2000. They remained broadly unchanged until 2003, but then resumed their upward path in 2004. According to Cabrero and Yaniz (2006), this upward trend stems mainly from the increasing trade deficit, which, in turn, is explained not only by cyclical factors, but also by structural determinants linked to persistent competitiveness losses.

... but also the quality of financial instruments and borrowers

In EMU, where there is no exchange rate risk, the financing of the external deficit becomes a microeconomic issue to be agreed between borrower and lender, and the key issue in terms of assessing the sustainability of external deficits and their potential impact on the economy is the solvency of borrowers. The scale of the annual financing needs is just one of a number of relevant factors. There are also other aspects that have to be taken into consideration. Specifically, three issues need to be discussed: (i) how are deficits financed (direct investment, bonds, etc),

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(ii) who owns and channels the financial inflows (breakdown by sector), and (iii) how big is the amount of cumulated debt (external liabilities)?

This Country Focus analyses these factors in order to present a complete picture, and then assesses the risks that external deficits might pose for short and medium-term growth prospects.

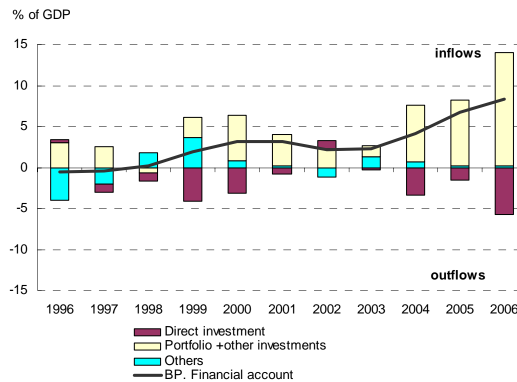
Financing the external deficit

External deficits reflect financial needs that cannot be met by domestic saving. These financial inflows are covered in the financial account. The external deficit is actually the reverse side of the imbalances of economic flows of the real economy, or the difference between domestic investments and savings.

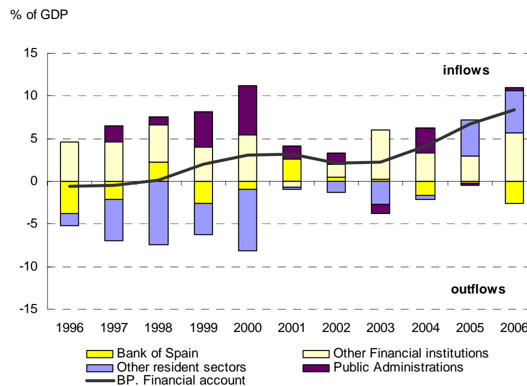
Portfolio investments shadow all the others, channelled by the private banking system…

External financing includes a variety of instruments, which can be put into three categories: direct, portfolio and other investments. The aim of foreign direct investment (FDI) is to participate in the decision-making process of the firm that has been created or acquired. FDI usually reflects an investment decision with long-term prospects. Portfolio investment, which includes mainly equity and debt securities, can encompass both short-term and long-term investment. However, compared to FDI, it is less well suited to long-term investment, as investors are usually looking for purely financial yields. Lastly, other investment is a category that includes non-marketable items, such as deposits and credits.

Chart 1. Financial account BoP
Chart 1a. Breakdown by category of investment (net flows)



1b. Breakdown by sector (net flows)



Source: Bank of Spain

The deterioration of the Spanish external account since 1998 has coincided with a marked increase of the importance of portfolio investment, relative to FDI, in the financial account (chart 1a). Specifically, during the second half of the 1990s, portfolio investments accounted for a fairly steady 3% of GDP per year, but in 2006 reached almost 15% of GDP; net FDI inflows, meanwhile, have become negative. Between 1999 and 2001, in parallel with growing financing needs which amounted

to 3% of GDP in 2001, outflows of direct investment have more than offset the inflows. This upward trend resumed in 2004, mirroring the proactive internationalization strategy of Spanish corporations, especially in Latin America. Consequently, portfolio and other investments have to finance both the net borrowing position of the country and the net FDI outflows. With the ever-widening borrowing needs, portfolio inflows have become practically the only instrument for financing additional needs.

... whereas net FDI is moving into negative territory and the public sector is becoming a net lender

This increase in borrowing needs has been driven by the steady worsening of the net financial position of both households and corporations, on the back of a strong fall in risk premiums and an easing of financial conditions. As far as households are concerned, while their net lending position reached 5% of GDP in 1996, ten years later the balance had shifted into the red, amounting to 1.5% of GDP. As a result, households have abandoned their traditional role as suppliers of funds to the rest of the economy. At the same time, corporations have seen their borrowing position, which accounted for 1% of GDP in 1996, worsen by 8 percentage points in only 10 years.

Given that Spanish households, as well as the bulk of non-financial corporations, are too small and cannot obtain funds directly from abroad, their borrowing positions are covered by funds from the domestic financial sector, which in turn gets its funds from the external markets. Chart 1b presents the sectoral breakdown of the financial account, which includes the Bank of Spain, other monetary financial institutions, other resident sectors and the public sector. "Other resident sectors" covers not only households and non-financial corporate business, but also other relevant financial market agents, such as investment and securitization funds. Since EMU membership, and in parallel with the sharp increase in portfolio investment, the Spanish financial system - together with securitization funds - has become the predominant net borrower over the past few years, channelling an increasing share of the financial needs of the country. This contrasts with the situation pre-1995, in which the public sector was instrumental in attracting external funding. However, largely on the back of the successful fiscal consolidation process that has gone on since the mid-nineties, the public sector's role as an external borrower has now become a marginal one. Essentially, the financial sector serves as an intermediary, distributing external funding to the private, non-financial sector of the economy.

According to Maza and Del Río (2006), around half of portfolio investment is directly related to the mortgage market, which means that this source of financing is linked to developments in the domestic housing market. Therefore, the indebtedness of the Spanish financial institutions through long term issues, particularly those backed by mortgage loans, has played a central role in channelling savings from the rest of the world

Spain's external debt

The widening external deficit of the Spanish economy has led to a significant increase in the cumulated stock of liabilities relative to the rest of the world; this has manifested itself in both capital (shares) and debt instruments (bonds and credits). The latter make up what is known as "external debt", and the analysis of this external debt is crucial to determining the exposure of Spanish borrowers to solvency problems. It is worth mentioning that this concept is expressed as a gross figure, which excludes financial assets owned by Spanish lenders.

Spain's cumulated gross external debt remains comparable to that of other European countries

The external debt position of Spain is comparable to that of other members of the Euro area. Table 1 shows that Spain's external debt levels are still relatively low. For example, while France's external debt reached 161% of GDP in 2006, Spain's was only 135% of GDP, and on a par with the levels recorded in Germany. However, the rapid increase in this figure is cause for concern. Spain's external debt levels rose by over 50 percentage points of GDP between 2001 and 2005, while debt in Germany has barely changed, increasing by a mere 3 percentage points.

A complementary analysis of debt maturity shows that around two thirds of the external debt in Spain is long-term liabilities, mostly issued by private agents (see chart 2 below). Over half of the external debt consists of long-term bonds, and another 10% of external debt is long-term loans. The rest consists of short-term instruments, especially deposits. This debt structure suggests that there is a

…liabilities, fuelled by growing external deficits, are growing faster.

relatively low risk associated with refinancing operations. However, the bulk of this long-term debt has been issued at variable interest rates, thus increasing the exposure of Spanish borrowers in a scenario of rising interest rates. While a substantial increase in repayment failures does not appear very likely in the short term, the combination of higher debt levels and higher interest rates might raise some doubts about long-term solvency of domestic borrowers. Needless to say, higher external debt means higher current income expenditure to non-residents, in the form of an increase in interest payments and a widening gap between GDP and GNP, which was 1.6% in 2006, compared to 0.8% in 2000, and is set to widen further.

Table 1. External debt in selected countries

	2001	2006
	% of GDP	
Germany	133.1	136.4
Greece	na.	128.3
Spain	83.8	135.6
France	127.2	160.8
Ireland	na.	699.6
Italy	91.4	103.8
Netherlands	na.	291.8
Portugal	na.	186.5
UK	299.3	360.7

Source: AMECO, IMF and Bank of Spain

Spanish assets abroad and the solvency ratio

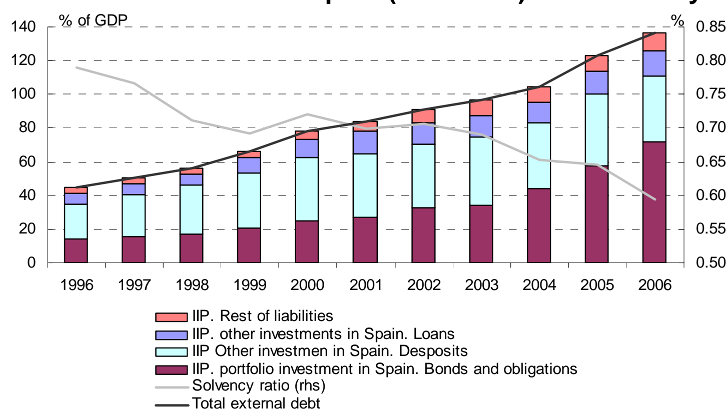
The external debt only takes account of receivable liabilities; it does not include domestic payable assets abroad. Obviously, as with private business firms, the analysis of the solvency of a country has to include these assets in order to compare them with liabilities. A representative ratio which shows both sides of the balance sheet is the so-called "ratio of external solvency" (RoES) or solvency ratio. The ratio can be defined as

(1) $$RoES = \frac{piabr + oiabr + bcnet}{piin + oiin}$$

Although Spanish assets abroad underpin the solvency of domestic borrowers…

where *piabr* and *oiabr* are the portfolio and other investments of Spain abroad, and *bcnet* denotes the net financial assets of the Central Bank. In the denominator, *piin* and *oiin* are, respectively, portfolio investments and other investments in Spain. The solvency ratio is supposed to measure a country's capacity to deal with a potential withdrawal of external capital. Consistent with some previous assessments (Requeijo, 2004), chart 2 shows that the external solvency ratio has fallen gradually from 0.8 at the beginning of the 1990s to around 0.6 in 2006. Given the latest projections for Spain's external deficit (Commission services forecast for spring 2007), the solvency ratio will continue to worsen in the next two years.

Chart 2 External debt of Spain (% of GDP) and solvency rate

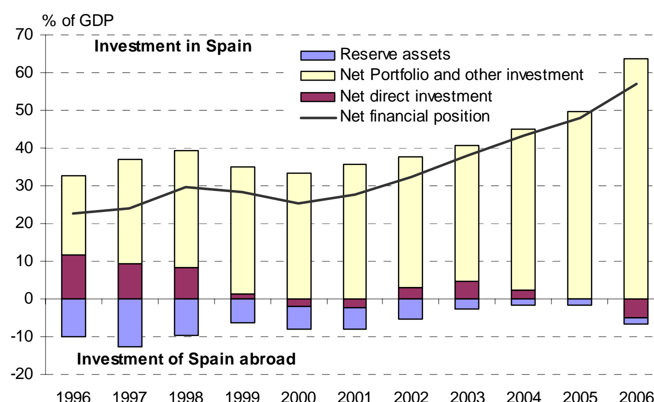


Source: Bank of Spain and own calculations

The RoES does not include capital instruments such as shares because they do not generate debt rights and therefore have no direct adverse impact on solvency. By contrast, most portfolio instruments, such as bonds and obligations, do require regular payments from the borrowers. As a result, capital instruments have to be included in order to give the full picture of what Spain owns in relation to what it owes, in much the same way as a corporate balance sheet does. This represents the so-called *net international investment position* of Spain and, according to the IMF definition, is the balance sheet of the stock of external financial assets and liabilities. It encompasses the sum of net cumulated FDI, portfolio and other investment. Specifically, Spain's net international position has worsened, with net liabilities increasing from 25% of GDP in 2000 to around 55% in 2006 (see chart 3)

The international investment position, slightly above 50% of GDP, does not look worrying yet.

Chart 3 International Investment Position (net position)



Source: Bank of Spain

Although it does not look like a worrying level, it marks a significant departure from the position of other European countries, which show a lower net indebtedness due to higher asset holdings abroad. Comparing average investment positions over the periods 1995-2000 and 2001-2005, table 2 shows that countries with higher gross external debt than Spain, such as the Netherlands, Germany, France, Ireland and the UK (see table 1), are in a healthier position in net terms. Specifically, France, Germany and Italy show a small net creditor position, which is largely explained by the strong presence of their multinational firms abroad. The UK and Ireland, with large gross debt levels, present a small net debt position due to their role as world financial centres. Greece and Portugal show a worse net investment position. It is worth noting that, as expected, the worsening of the intentional investment position goes hand in hand with a sustained external deficit.

Table 2. International Investment Position (IIP) of selected countries

	Net International Investment Position		memorandum item: Net lending/borrowing of the Nation	
	1995-2000	2001-2005	1995-2000	2001-2005
	% of GDP			
Germany	4.0	7.9	-0.9	2.4
Greece	-35.9	-61.6	-2.2	-8.1
Spain	-25.8	-34.8	-0.1	-4.1
France	5.0	10.5	1.7	-0.2
Ireland	na.	-17.4	2.7	-0.4
Italy	-0.1	4.3	2.0	-0.4
Netherlands	0.9	-11.9	4.7	5.9
Portugal	-21.5	-52.9	-4.3	-6.5
UK	-7.7	-7.2	-1.1	-1.6

Source: AMECO, IMF and Bank of Spain

Unlimited external credit? Short and medium-long term prospects

Before Spain joined the EMU, the rebalancing and financing of Spain's external deficits had involved exchange rate devaluations. Rising current account deficits triggered devaluations as a way of restoring the external equilibrium. However, the adoption of the euro has broken the direct link between nominal exchange rate and national macroeconomic imbalances. In the context of EMU, deficits do not put

pressure on domestic currencies - which no longer exist - and both credit limits and financial sustainability have become microeconomic issues. In the case of Spain, domestic saving has been persistently lower than domestic investment, leading to growing current account deficits which have been sustained by external financing in a context of easy monetary conditions within EMU (Laborda, 2005).

According to the findings of this country focus, both the external debt and the net investment position of Spain are still at relatively low levels. This would suggest that there are relatively low risks for the banking system in the short term as shown by the low rates of mortgage repayment failures (or delinquency rates), which are currently being kept at historically low levels of around 0.8%, compared to the average rates of well above 6% which were characteristic of the 1990-1995 period. In the context of monetary union, credit limits are defined by both the perceived solvency of borrowers and the attractiveness of the liabilities they have issued. The perceived solvency of the Spanish financial system seems to be currently at its height, as reflected by the demand from foreign investors for Spanish financial products. According to Banco de España (2005), Spain's financial system is currently sound, as it is one of the most efficient and competitive financial systems in the European Union. One indicator of financial stability, despite the outstanding deterioration of the external balance, is the negligible spread between the Spanish and the German 10-year bond.

Although risks in the short term should not give any cause for alarm, growing recourse to external saving in the medium term might put additional pressure on the capacity of the financial institutions. The major increase in external saving via portfolio investment might require additional premiums, ultimately bringing higher returns for foreign lenders. These could fuel a rise in interest rates and would cool down domestic demand, particularly private consumption and investment in dwellings. Depending on the scale of the adjustment, the final result could still be positive by gently rebalancing the economy or, on the contrary, might worsen medium and long-term growth prospects in the event of an excessive slowdown of domestic demand.

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