

Spain's external investment: Impact of the crisis

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Decreased new foreign investment flows, together with the falling value of past investments as a result of the crisis, is undermining Spain's external asset position, limiting the improvement in the international investment position, and constraining capital revenue received from the rest of the world.

Since the birth of the euro, Spain's economy has been boosted by a substantial increase in foreign asset purchases, mainly through foreign direct investment (FDI). As a result of the internationalization process, the value of Spain's financial assets abroad rose from 350 billion euros at the end of the nineties to above 1.3 trillion euros in 2007. The recent financial crisis substantially slowed down Spain's investment flows abroad during two clearly distinct phases: i) the first from 2009-2010; and, ii) the second, which began in early 2013 and continues at present, where divestment, coupled with the negative valuation effect, resulted in the largest downturn of the external investment position in the last two decades. Since 2012, FDI flows have begun to slow down, but the reduction of short term bank financing, affected by financial sector deleveraging, has led the decline. Capital revenues from external investments have also decreased, posing a risk to Spain's external surplus through a deteriorating income balance. Going forward, the need to rationalize investment decisions in the post-crisis environment will constrain the recovery of Spain's investment flows abroad. Nonetheless, Spanish corporates should take the lead in reviving external investment, as the domestic market now offers fewer growth opportunities.

The internationalization process before the onset of the crisis

As in most economies, the first phase of Spain's internationalization first manifested itself through a substantial opening up to trade upon the country's accession to the EU in 1986. The total volume of imports and exports of goods and services represented 36% of GDP in that year, but had climbed to 60% by the start of the 21st century.

The birth of the euro, with the resulting gains in the credibility of monetary policy, the convergence of

nominal interest rates of member countries of the euro area and the disappearance of exchange rate

Between 2000 and 2007, Spain purchased financial assets in the rest of the world amounting to an average of 134 billion euros a year.

risk in transactions between euro area countries, were the drivers for the financial internationalization of the Spanish economy.

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The fact that the euro area was founded in the midst of intensifying financial globalization at a worldwide level –characterized by the deregulation of financial transactions and an increase in cross-border capital flows– was a further incentive for export firms or firms with a competitive edge domestically to either stake out or expand their positions in the international market. They did so mainly through different forms of foreign direct investment.

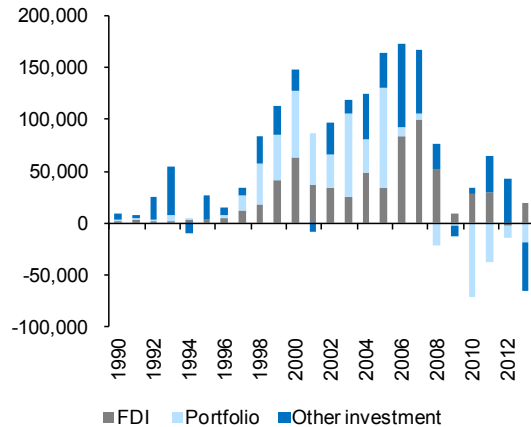
The net flows of asset acquisitions of Spain abroad reflect this process. According to data in the Financial Balance Sheet of the Bank of Spain, between the years 2000 and 2007, the Spanish economy purchased an average of 134 billion euros in financial assets a year in the rest of the world (i.e., about 16% of GDP), and these transactions show notable stability throughout the period. Some 40% of investment took the form of FDI decisions carried out mainly by non-financial companies, through the total or partial (yet targeted at gaining control) acquisition of foreign companies.

Portfolio investments also accounted for a good deal of Spain’s foreign investment flows in the expansion years, with some of these amounting to more than 60% of the total. Even where the financial sector has carried a larger relative weight than FDI in such investment decisions, the corporate sector again generated the bulk of portfolio investments through the purchase of minority shareholdings or stakes (the minority nature of these acquisitions explains why they are not considered an FDI decision).

Short-term bank financing granted to foreign counterparties in the form of either loans or deposits classified as “other investment” show a more volatile profile, but these became emblematic in the years immediately prior to the 2008 financial crisis. Such financing arose from the expansion of interbank lending that went along with the growth of private borrowing.

Exhibit 1a

Investment flows from Spain by type of external financial asset
(millions of EUR)

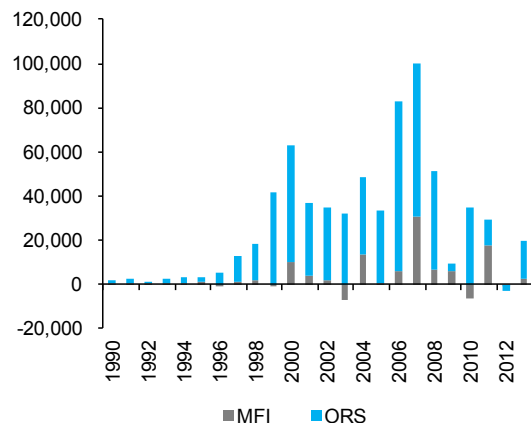


Sources: Bank of Spain, AFI.

As a result of the internationalization process, the value of Spain’s financial assets abroad rose from 350 billion euros at the end of the nineties to above 1.3 trillion euros in 2007, where changes

Exhibit 1b

FDI flows from Spain by sector
(millions of EUR)



Notes: MFI: Monetary financial institutions; ORS: other resident sectors (enterprises).

Sources: Bank of Spain, AFI.

in investments' valuations had a minimal impact. This valuation effect is revealed when comparing the net acquisitions of financial assets of the economy as a whole, according to the Financial Accounts, with the year-on-year change in the value of external assets, according to the International Investment Position.

Taking into account the high current account deficit in the decade of 2000 (nearly 10% of GDP), the external borrowing raised by Spain was allocated not only to financing domestic investment spending not covered by national savings, but also a sizable portion of the purchases of financial assets in the rest of the world.

Aside from the reliance on borrowing that often enabled the purchase of equity stakes abroad, in the context of abundant liquidity, easy access to credit and good business expectations, the increasing financial internationalization had the following consequences: (i) an expansion in the stock of FDI abroad; and (ii) capital revenue from these investments that fed the revenue side of the income balance.

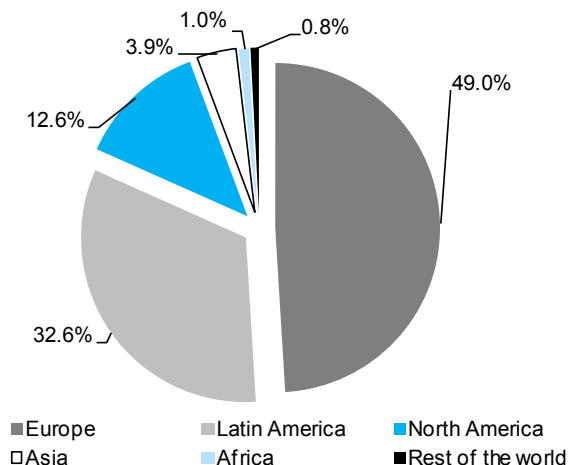
With regard to the former, the value of Spain's FDI amounted to nearly 400 billion euros in 2007 (37% of GDP) when it had been barely 52 billion euros in 1998, or less than 10% of GDP. Spain's stock of FDI in proportion to the size of its economy is similar to that of Germany, and larger than that of countries like the US or Italy.

Hence, it is useful to take note of the nature of the FDI flows from Spain in this period. In the first phase of Spanish companies' international expansion – from the late nineties until 2001-2002 – the majority of FDI was destined towards Latin America and, in particular, to the energy and telecommunications sectors (as in the acquisition of the Argentinean firm YPF by Repsol in 1999). Issues of shares and equity holdings, along with the contracting of bank loans, served as the funding basis of FDI in those years.

In the second phase between 2002 and 2007, the European Union replaced Latin America as the main destination of Spanish FDI, accounting for 64% of the total stock issued by Spain in 2007, according to Datainvox figures. The sector change was significant: industry and construction gained in relative weight, even though energy and telecommunications continued to account for a significant percentage of total investment. Telefónica's purchase of O2 and Iberdrola's acquisition of Scottish Power took place in those years. Reliance on borrowing, in the form of bond issues or the contracting of loans from the host banking sector, took the place of equity as the main funding source of FDI.

The reason for the persistent deficit in the income balance lies in the sizable amounts paid for the external borrowing undertaken, which nearly doubled the amount of such revenue in some years.

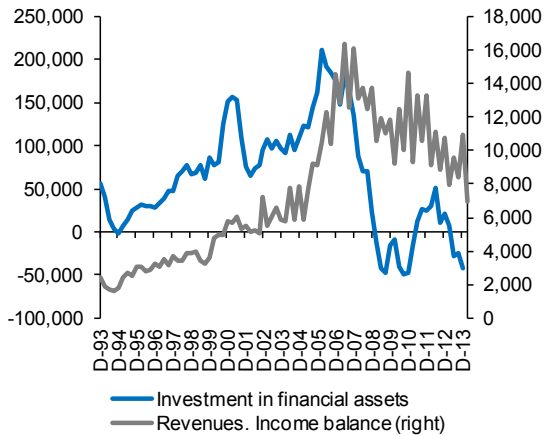
Exhibit 2
Spanish FDI stock in 2012 by geographic region
(% of total)



Sources: AFI, Datainvox.

Exhibit 3a

Net acquisition of financial assets by Spain abroad and revenue
(millions of EUR; quarter-on-quarter flows)



Sources: Bank of Spain, AFI.

increase in income received is reflected in capital returns. The reason for the persistent deficit in the income balance lies in the sizable amounts paid for the external borrowing undertaken, which nearly doubled the amount of such revenue in some years.

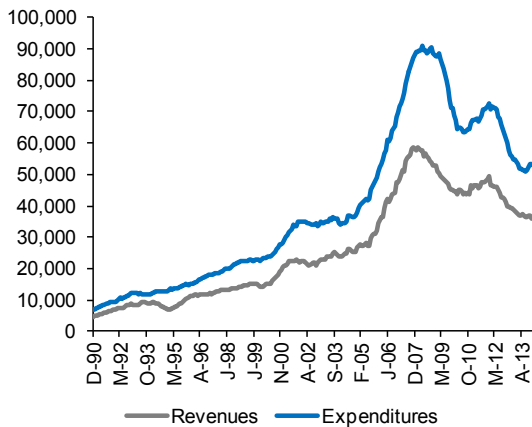
The impact of the recent crisis on Spain’s external investment decisions

The financial crisis that emerged in 2008 substantially altered the decision-making process of Spanish companies with regard to investments abroad. The systemic nature of the crisis and the fact that two of the crisis’ main symptoms were the closure of wholesale funding markets and the collapse of interbank liquidity channels explains the sharp slowdown in Spain’s investment flows. As in the expansion period, most economies were affected by this dynamic, but it was much more acute in economies that relied more heavily on bank financing, carried a high current account deficit and that sustained more significant private borrowing levels, as was the case of Spain.

48 With regard to the returns received by Spain on its foreign investments, the increase in capital revenues in parallel with the increase in net investment in financial assets is noteworthy. Given that wage income is minimal, the 42 billion euro

Exhibit 3b

Revenue balance of Spain
(millions of EUR; cumulative flows in last 12 months)



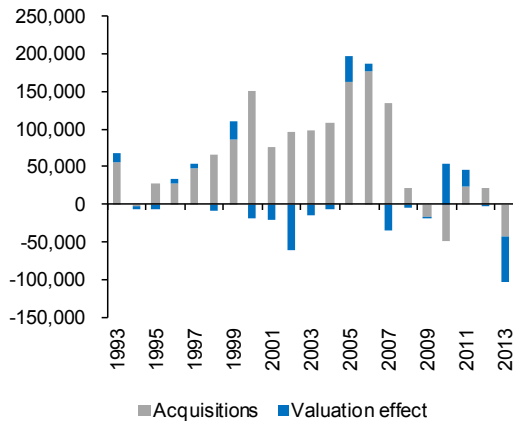
Sources: Bank of Spain, AFI.

In Spain, the process of declining investment abroad underwent two clearly distinct phases: the first was in 2009-2010, when the cumulative volume of divestments over the two year period amounted to 64.5 billion euros; and, the second which began in early 2013, and is on-going. One of the key differences between them is that, in the first, the rising valuation of assets abroad offset a good deal of the impact of divestment in the total asset position; whereas, in the second, net asset sales have combined with a fall in assets’ value (negative “valuation effect”). Indeed, Spain’s external investment position registered the largest downturn in the last two decades – 102 billion euros –, thus accounting for the 60% loss in value in the correction.

Another difference between the phases relates to the nature of the divestment flows. In 2009-2010, these mainly took the form of portfolio investment

Exhibit 4a

Change in value of Spain's financial assets abroad: Net acquisition of assets and valuation effect
(millions of EUR)



Sources: Bank of Spain, AFI.

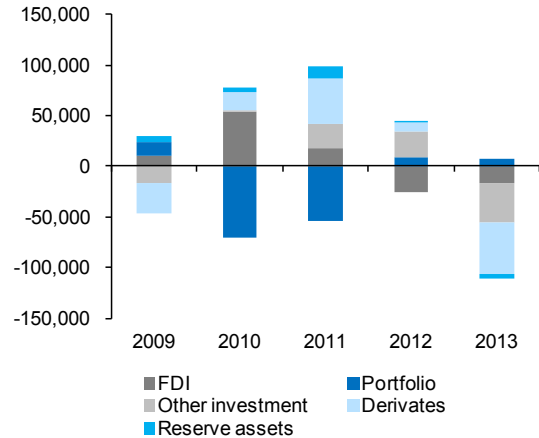
decisions. Since 2012, FDI flows have begun to slow down, although positions in derivatives and short-term bank financing (“other investment”) have led the retreat.

Since 2012, FDI flows have begun to slow down, although positions in derivatives and short-term bank financing have led the way in Spain's divestment abroad.

Again, we must distinguish between the causes of the downturn in Spain's investments in recent quarters. As shown in the exhibits below, the deepening process of deleveraging of the banking sector explains the unwinding of short-term financing positions reflected in “other investment” and that, in the final analysis, are related to deposit or repo operations. Sales of foreign debt portfolios (public or private) by financial institutions also account for a portion of Spain's net divestment abroad.

Exhibit 4b

Year-on-year change in value of Spain's financial assets abroad, by investment type
(millions of EUR)



Sources: Bank of Spain, AFI.

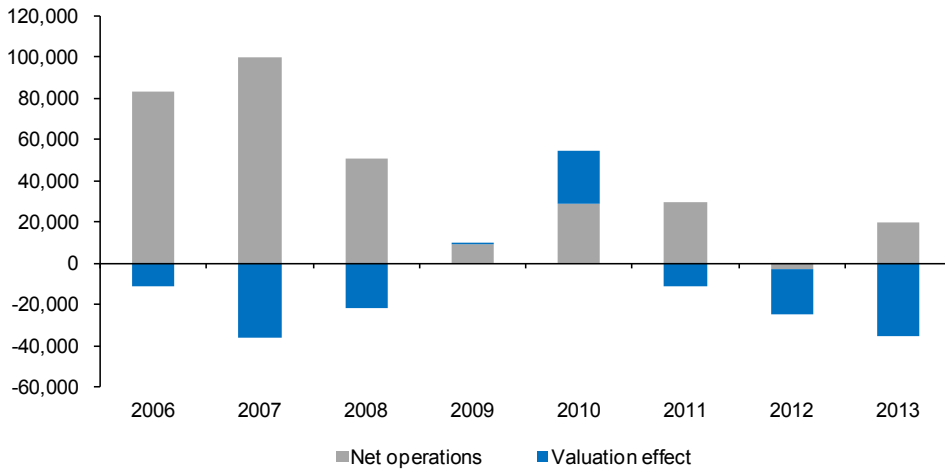
With regard to FDI, the negative valuation effect is determining the value of Spanish such assets: following the 2012 downturn, new flows – mainly non-share ownership interests and withheld profits – have managed to recover, although they remain far below the volumes of 2006-2008. FDI investment will be constrained by delays in decisions on international expansion owing to the duration of the recent crisis and the loss of momentum in some emerging economies receiving Spanish financial flows.

Income from capital revenue is suffering from the slowdown in external investments.

The counterpart to this dynamic is the slowdown in capital revenue received by Spain from its external investments that, at the same time, is affected by the downturn in returns in the bulk of fixed income assets. As against an average of 45 billion euros a year between 2009 and 2012, revenue amounted to 36.8 billion euros in 2013, a trend that is becoming stronger at the start of

Exhibit 5

Year-on-year change in FDI asset position of Spain abroad
(millions of EUR)



Sources: Bank of Spain, AFI.

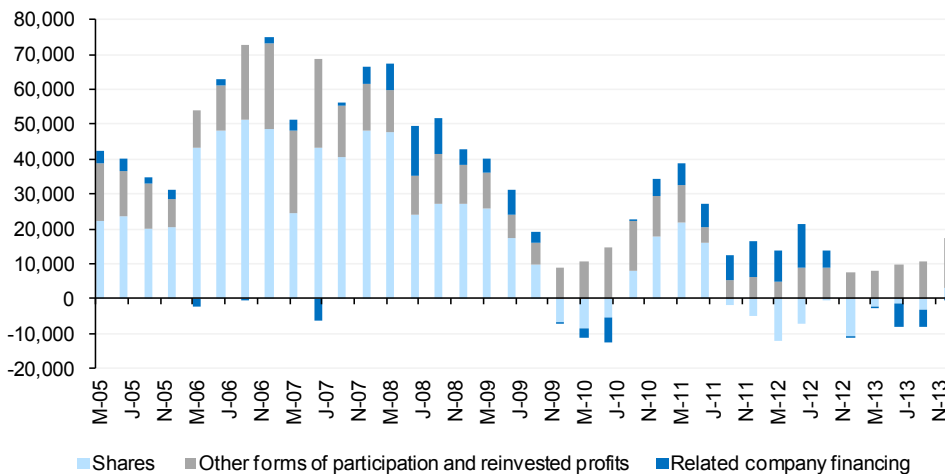
2014. In the first quarter of this year, revenues amounted to 6.9 billion euros, which is one billion less than in the same period of 2013. Taking into account that revenue payments abroad are not declining at the same pace, the deficit in the income balance has been increasing since late

2013, and it now stands at about 17 billion euros (1.7% of GDP).

A good performance of the income balance is a key factor in achieving sustainable improvements in Spain's external surplus. The reversal of the

Exhibit 6

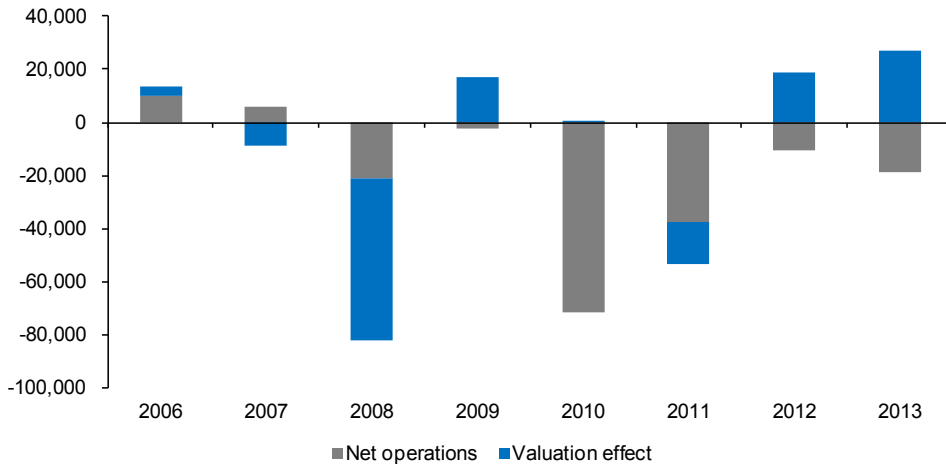
FDI flows of Spain abroad by instrument type
(millions of EUR; cumulative flows in last 12 months)



Sources: Bank of Spain, AFI.

Exhibit 7

Year-on-year change in asset position in Spain's portfolio investment abroad (millions of EUR)



Sources: Bank of Spain, AFI.

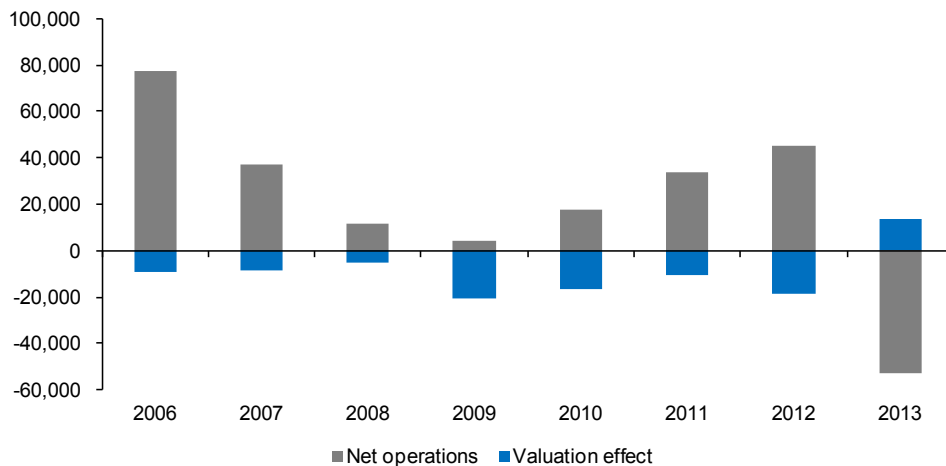
current account balance from negative to positive from mid-2013 was the result of strict containment of the trade deficit and an increase in the services surplus brought about by a strong recovery in foreign tourism and the momentum of non-tourist service exports – business, financial and transport

services, etc., but it may be hurt by the worsening income balance.

A breakdown of the current account balance into its structural and cyclical components reveals that a good deal of the relative improvement

Exhibit 8

Year-on-year change in asset position in Spain's "other investment" abroad (millions of EUR)

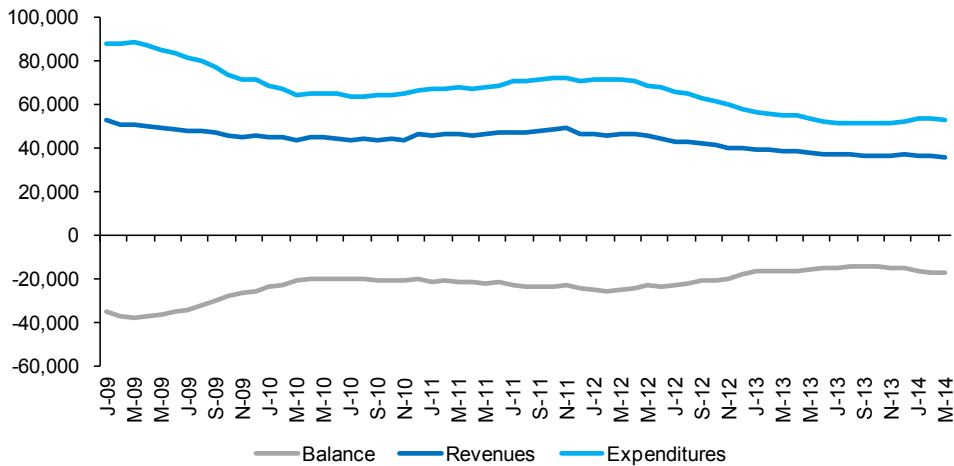


Sources: Bank of Spain, AFI.

Exhibit 9

Income balance of Spain

(millions of EUR; accumulated flows in last 12 months)



Sources: Bank of Spain, AFI.

seen during the crisis was structural, or long-term in nature; that is, it was driven by an ongoing convergence of the investment rate in fixed assets and the bank credit-to-GDP ratio at more sustainable levels. However, the severity of the economic recession also gives the cyclical component a key role in altering Spain's external position. As the upturn in activity that began in late 2013 further consolidates, the trade deficit will tend to deteriorate from current levels owing to the high degree of sensitivity still shown by goods exports to the stabilization of domestic demand and to the growth of exports. The margin for further increases in the services surplus is also limited. Consequently, a steeper downturn in income would tend to undermine the consolidation of the Spanish external surplus.

Conclusions

The need to streamline new investment decisions, in some cases, and – in many others - to reduce the size of the balance sheet, will continue to constrain the recovery in Spain's financial investment flows to the rest of the world, particularly in investments

that entail a permanent presence in the destination country. At the same time, the reorientation of banking business strategies at a European-wide level – and especially in Spain – more towards traditional financing and with a lower relative weight of wholesale funding, will continue to determine the performance of investments in the near term. It is foreseeable, moving forward, that the bulk of net acquisitions of financial assets in the rest of the world will rely on the generation of domestic savings, and make less use of external financing as a source of funding for international expansion. In any event, companies in sectors whose presence abroad has already been consolidated and that present a positive business outlook should end up taking the lead in reviving external investment, given that the domestic market will offer fewer growth opportunities than in the recent past.