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Is Spain Becoming Semi-Core?

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The semi-core bloc is growing as countries reap the benefits of past structural reform and maintain growth momentum. We argue that spain may indeed be transitioning to a more semi-core status in line with market pricing.

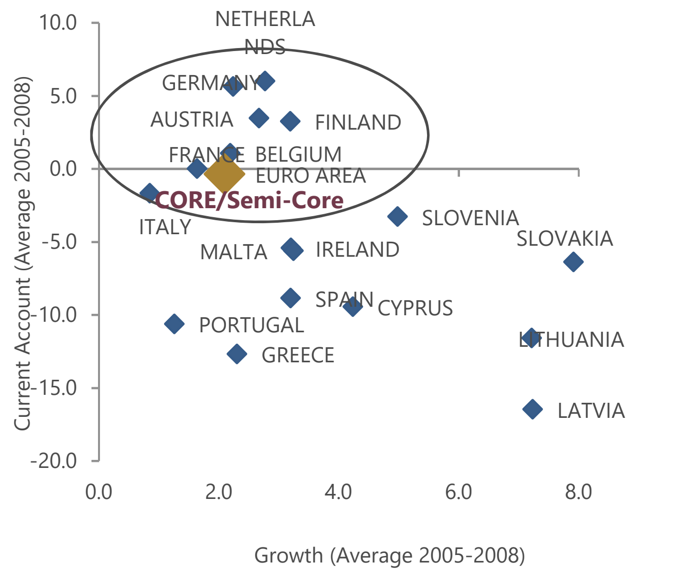
Previous to the crisis, and with some distinct exceptions, a map of the euro area divided the core in the North (Netherlands, Germany, for example), the periphery in the south (Spain, Portugal, Italy) with the semi-core riddled throughout the region (France, Belgium). The reality, however, was an economic landscape:

- The core: super competitive with sustainable current account surpluses
- The semi-core: somewhat competitive with roughly balanced current accounts
- The periphery: strongly non-competitive with large current account deficits

As seen in Chart 1, spanning the four years before the Global Financial Crisis, the periphery countries generated growth in line with the core/semi-core by running large current account deficits. Spain was notable in this degree, with 3.2% average annual growth driven by -8.8% average annual current account deficits. Likewise, other typical periphery economies – Cyprus, Portugal, Greece, Latvia – all had similar pre-crisis economic circumstances to Spain.

However, since the culmination of the European Sovereign Debt Crisis (2013) the regional situation has changed dramatically. As seen in Chart 2, the OLD bloc of core/semi-core countries has been losing competitiveness (all except Germany of course) with the OLD periphery countries gaining competitiveness. Spain is no exception to this rule.

Chart 1: Competitiveness Defines the Core and Semi-Core of Europe



Source: IMF World Economic Outlook, October 2017; BNYM AMNA Calculations

Since the European Sovereign Debt Crisis, Spain saw a 10.4% surge in its average annual current account with just a slight drop in average annual growth (-0.5%) in the last four years since the euro area resumed positive growth.

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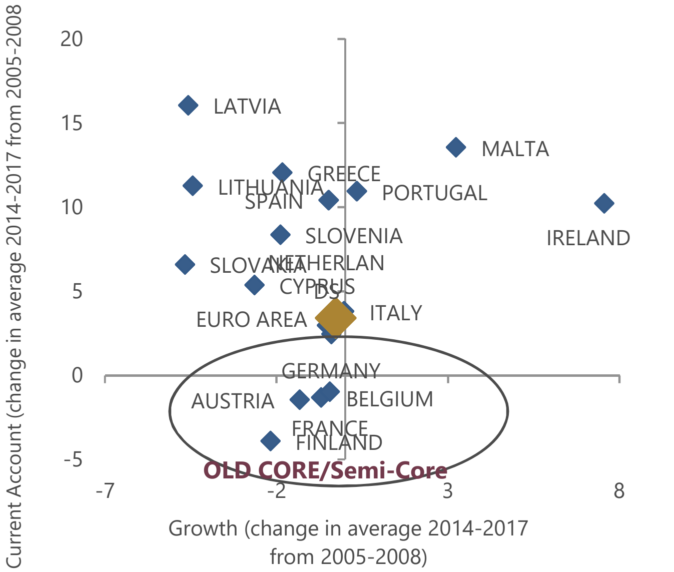
Chart 2: The Semi-Core Bloc is Growing



Source: IMF World Economic Outlook, October 2017; BNYM AMNA Calculations

This reshaping of the competitiveness landscape is quite remarkable – an achievement seen by other OLD periphery countries in the region, such as Slovakia, Slovenia, or Latvia. Therefore, the wedge between the OLD periphery and OLD core is closing resulting in a larger semi-core bloc as countries gain competitiveness following progress on the structural reform front.

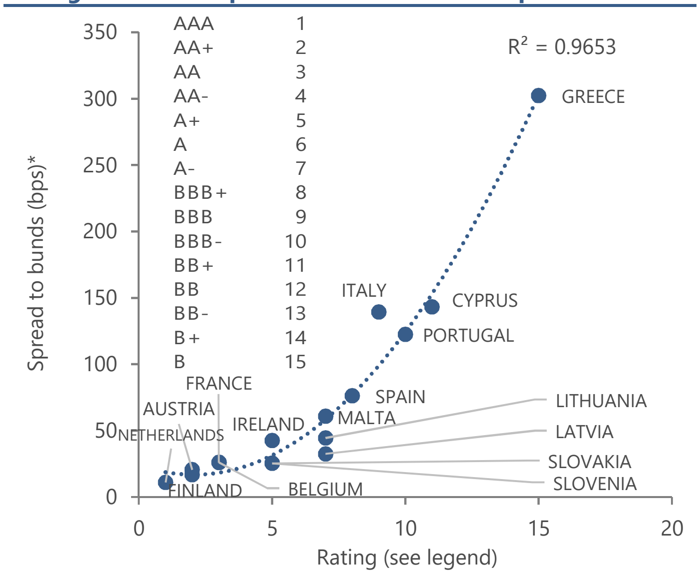
Is Spain becoming semi-core?

From a pure economic perspective, we argue that yes, Spain is semi-core. The IMF estimates Spain's potential growth to have improved from 0% in 2014 to 1.5% this year. Therefore, with a 2.5% pace of growth expected, some of the growth is purely cyclical but the structural reforms put in place starting in 2009 have contributed to a fair degree of competitiveness gains and higher potential growth.

More importantly, the market is likely to trade Spain favorably in the coming year. A potential catalyst is likely to be S&P's review of spain, currently BBB+ with positive outlook, on March 23 2018. With the growth outlook remaining robust and the Catalonia-Madrid tensions dwindling, we do believe that the macro risks stemming from the regional dispute have receded sufficiently for the agency to upgrade Spain to A-.

The upgrade to A- will take two rating agencies into A-range (Fitch upgraded Spain to A- on January 19) with the market likely to price it as an A credit. There exists a robust polynomial relationship (96% R^2) of euro area ratings to government spreads that implies 10yr Spain should trade at a spread of +58 bps spread to 10yr bunds.

Ratings versus European Government Bond Spreads



Source is BNYM AMNA Calcs; Bloomberg; and S&P Ratings as of February 8, 2018
*We use spread to bunds instead of spreads to swaps because we feel the level of risk-free rate is better incorporated into the rating analysis.

In conclusion, as Spain sees further recognition from the rating agencies that this country is sustaining robust growth and current account surprluses, the market will continue to reprice the country through peers such as Italy and Portugal. More on the Italy and Portugal legs in another piece.

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