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Economic Outlook: 2011-2012

Canary Islands

Bouncing back on Tourism

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1. Statement of purpose.

This brief annual report aims to inform foreign investors about the evolution of Canary Islands' economy, focusing in changes in both the business climate and legislative environment that may affect their strategic plans for a territory which has a traditional and meaningful trade interest for European firms.

The report dwells mainly in official figures and tries to extract from them trends that may be of interest for future decisions. The unusual timing of the report (it is issued at mid-year) can be easily explained: the authors believe that the Canarian economic cycle is best understood when seen from July to July, for it is the touristic seasons (winter/summer) that govern the business climate in the Canaries.

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2. Still deep into recession.

Canary Islands economy's decline during 2009 and 2010 was one of the steepest in Spain, a troubled economy itself.

For a national average of -3,7% (2009) and -0,1% (2010), Canary Islands receded -4,2% and -0,9% in the same yearsⁱ. In a word, it went deeper into recession than most other Spanish regions.

A few factors may help understand why Canary Islands has suffered more than the rest of the already battered Spanish economy:

- It is comparatively more dependent on tourism, which accounted in 2009 for 27,4% of the whole Canary Islands economy, 30% of employment and 96, 1% of its Service Sector Exports. Since tourism decreased by 13,7% in 2009 (led by a staggering 22,7% descent in British touristsⁱⁱ), the economy faltered, for tourism affects not only direct economical activity, but also related services, investment and consumer behaviour.
- The building sector, another kernel of Canary Islands' economy, has kept pace with its Spanish peers, that is: it has collapsed. It endures, however, a

vicious twist in the Canaries: in order to avert environmental and aesthetical damages derived from over-building and to protect prices in the long run, hotel and touristic establishments licenses were frozen in 2001 by two subsequent Decrees, which affected not only new building licenses, but also the carrying-out of licensed projects, an effect that was called “*touristic moratorium*”. Though the Decrees’ logic was defied in the Courts, it somehow made into a Lawⁱⁱⁱ, also heavily contested. The recent blowing-off of the Spanish real estate bubble caught its Canarian chapter without an alternative resource it may have otherwise enjoyed: the pull derived from touristic projects and hotels.

- The Canaries ended up 2010 producing Spain’s highest unemployment rate at 28%, a figure deemed “*catastrophic*” by Financial Times^{iv}. Especially worrying is unemployment for youngsters (under 25), which is regarded, more or less accurately, to be at the vicinity of 50%. Reasons offered by specialists for these figures not to immediately spark street rioting are: a) they ignore the black economy’s hidden jobs; b) pleasant weather (*sic*) and strong family support tend to alleviate despair and help elicit civil unrest.

3. Signs of life.

Tourism is making a grand comeback in 2011.

The winter season, actually Canary Island’s high season, has witnessed a recovery of this industry, based on the strength of the Northern European markets and the by-effects of the *Arab spring*, a socio-political phenomenon that made Europeans trade their Maghreb and Near East vacations for a stay in the Canaries.

At 4,3 millions, official figures^v for January to May 2011 confirm an increase of 21% of visitors for the same period in 2010, compared with a 7,3% average increase for Spain. As for revenues, touristic expenditures in the Canaries increased a 15,7% to reach 4,3 bn Euros, for a round expenditure of 1.006 Euros per tourist per stay.

As the European economies are recovering faster than Spain, it is easier to forecast the industry’s behaviour for the last quarter of the year than for the summer season, for this is dependent on the much weaker internal Spanish market. A survey by PWC^{vi}, commissioned by the Spanish Confederation of Touristic Hoteliers, show that professional optimism about the summer 2011 campaign has improved by 35% the year 2010 results for the whole country, but obviously this is a perception study yet to be confirmed by data.

The expected good touristic balance for the year 2011 paradoxically leads to a much more cautious predictions for the Canarian economy as a whole.

According with Santa Cruz de Tenerife's Chamber of Commerce growth will be of a meagre 1%, roughly consistent with Spain's Central Bank (0,8%) estimation. But most forecasts were prepared before incoming data from the winter touristic campaign, when gloomy prospects were entirely justified.

The authors of this report consider that growth during the year 2011 will be **slightly** higher than predicted, as touristic revenues pump cash into a near-dead system and stimulate consumer demand. Not-yet official GNP growth rates for April and May 2011 already offer ground for a more benign prospect, making again the case for a tourism-centred recovery for the Canaries.

If confirmed by the summer season, then a more robust growth rate may be expected for the first semester 2012.

4. What to expect. Opportunities and threats.

a. Administrative pandemonium.

In elections held in June, all three levels of administrations have been renewed: Canarian Parliament & Government, Island Councils and City Councils.

If we add pre-polls campaign paralysis to post election ballroom dancing/ negotiations and then power transfer protocols, the political agenda makes it highly unlikely that any significant initiative or change will occur in any relevant area until September.

Presumably, after the summer the mood will quickly change, as new administrations fast-track their most notorious electoral plans and promises.

Here is an outline for the informed foreign investor.

b. Residential market.

It is no secret that Spain is deflating its enormous real estate bubble at a pace not consistent with real market forces and realities. According with "Sociedad de Tasación"^{vii}, an independent property valuation firm, overall housing price had fallen a mere 15,5% from 2007 thru 2010 in Spain, 15,7% in the Canary Islands.

Even this seems to be out of touch with crude reality, having to do with more with resistance to declare asset devaluation in the books (mainly, by financial institutions) than with real demand. Thus, Bankinter is forecasting a further 7% price drop until mid-2012, where the minimum property price of the cycle will be reached^{viii}.

As we are approaching the nadir in property price, investors are resuming their interest in Spanish property.

All the more so in the Canaries, viewed by many Europeans as a the perfect place for ex-pat living or second residence due to warm weather, good quality of life and excellent transportation infrastructures^{ix}

Apart from prices reaching their lowest, there are other reasons to consider acquiring a property in the Canary Islands now, a reasonable option for the first time in the last four years:

- Most of the new administrations with competences on the matter are pushing plans to rehab touristic residential zones. Even the Spanish Parliament has passed a motion at the end of 2010 to enhance these local initiatives, pledging soft public loans to touristic rehabilitation plans (ICO) and fostering Canaries' Touristic Infrastructures Plan, where modernization/rehabilitation of residential areas is the gravity centre.
- Rents attached to touristic properties are beginning to recover as overall tourism does, as it is argued in this report.
- Main potential markets for these properties (Scandinavia, Germany, the Netherlands) are growing steadily and thus exerting their new buying power in a (perceived) cheap market. Less buoying British citizens will lose ground perhaps until end of 2012, where GNP growth will be of 2,1%, according with HM Treasury June 2011 poll of forecasts, but will no doubt adhere to the buying trend.

However, there are also reasons to be careful.

For example, an exit to the touristic licenses conundrum is unlikely. On one hand, the Spanish Supreme Court has ruled out reparation fines in favour of hoteliers^x that could have distressed public finances, since claims in Court by licensees affected by the moratorium amounted to no less than 1 bn Euros; on the other hand, the political consensus (*rectius*, unanimity) around the initial Law seems to be breaking, but the new Government CC/PSOE has not mentioned a possible reform of the "*Ley de Directrices de Ordenación General y de Ordenación del Turismo de Canarias*" in their working paper^{xi}.

For the time being and through the near future, investors should therefore seek legal advice before acquiring touristic properties recently developed or touristic plots to be developed.

Another caution: as this report is issued, the European debt crisis is gaining momentum. Spain is at the centre of hostilities: should the unthinkable (a bailout) become plain fact, any Spanish asset's value will be affected by uncertainty. Canary Islands may seem far from the eye of the storm, but actually it is not, neither politically or economically.

c. Taxation.

1. The new Canaries Law on Tobacco Works and Imports^{xii} came into effect on February the 1st 2011.

The tax calculation on imports introduced such a complicated formulae that the Law needed no less than 6 minor decrees in order to clarify and fix the tax concepts.

To put it bluntly, after the Law, tobacco imports to Canary Islands will be taxed at 40% to 50% of the recommended consumer price, compared with Spanish mainland's 80%. Canary Islands will thus continue to bear one of the most inexpensive tobacco in the European Union, but faintly less so. It is not a tiny market anyway, if we add the 10 million visitors to the 2 million residents.

The new Law renews a benign regime aimed at protecting Canarian produced tobacco works, and establishes a temporary exemption on dark tobacco imports.

2. Apart from the Tax on Tobacco Works, there are no known plans to raise local taxation in the temporary scope of this report (2011 to 2012), in spite of the European sovereign debt turmoil.

3. The new Government has stated its intention to reinforce the ZEC (www.zec.org), the Canarian Low Taxation Zone, purportedly one of the most benign tax regimes in the European Union. Operators are still unsure as to what can this statement mean.

d. Infrastructures.

Public works have come to a stand still, and the modest condition of available public finance needed for large infrastructure projects will continue through 2012.

However, there can be a few notable exceptions.

- Investment in main port and airports may offer contracting opportunities. The Central Spanish Administration is committing substantial resources to Las Palmas and Santa Cruz ports (Plans 2009-2013), whereas Gran Canaria airport (LPA) will be refurbished, receiving a third lane and a substantial reshuffle of its terminal, an initial 163 m Euros investment.
- Both Gran Canaria and Tenerife Councils are developing plans to build modern railway systems. Since these are large and costly projects (Gran Canaria valuing investment in 1,4 bn euros, for example), equally large international contractors will bid for them. However, only 10 millions Euros have so far been committed by each project, mainly for studies and schemes.
- Golf courses are reviving after some difficult years. A combination of political debate, ecological preoccupations and juridical uncertainty accounted for the freezing of extremely ambitious plans to exponentially widen Canary Islands' 22-strong golf courses offer. Then the crisis occurred, and it did not help the case for "*Canary Golf Paradise*". The public perception has somehow changed in the last 2 years, due to an evident swell of local golfers and the dynamicity of high-spending golf tourism during winter seasons, when most of Europe's clubs come to a standstill on weather conditions. Therefore, such plans may be resumed by the new administrations. Private investors and golf developers ought to be attentive, for after all the Canaries have a *de facto* winter season golf near-monopoly in Europe.

e. Energy industry.

Gone are the days of oil exploration by the coast of Lanzarote or Fuerteventura, the only souvenir of that period being an insistence by the Canarian Government to re-define inner territorial waters within the Archipelago as its own, sharing exclusivity with the Spanish State.

New big power stations will soon be built in Gran Canaria and Tenerife to cover the surge on electricity demand, but the real star of the Canarian Energy Plan (PECAN)^{xiii} is renewable energy.

Under the PECAN, renewable energies should account for no-less than 30% of all electricity demand in the Canaries by 2015.

The Plan, incepted in 2006, is in delay. For example, of the 1,000 plus MW of wind energy to be publicly procured and built, only 600 MW were already granted by the end of 2010. So, an 600 extra MW should be offered in the coming years, built and connected to the grid.

Three years to deadline, the new Government has sworn allegiance to the plan's timing, and thus a cascade of tender bids is to be expected in the next few years, as the rest of the Canaries aspire to mimic El Hierro, the Archipelago's less populated island and the only one that is 100% dependent on renewable energy.

f. R+D+i.

Given the relatively small size of Canary Islands' cluster of innovative and seminal R+D firms, it has suffered less from the (disputed) public capital and incentives draught resulting from Spain's austerity plan May 2010.

In fact, the agreement that gave birth to the new Canarian Government^{xiv} aims to mend an erring and somewhat disperse innovation policy by creating a Canarian Agency of R&D+I and IT to concentrate public aid, consolidate existing channels and serve as a one-stop innovation spot.

The Agency should come up with a plan to speed up connections between enterprises and researches in those fields where Canary Islands believes it has a strategic advantage: astronomy, oceanography, water technology, renewable energy, biotechnology and tourism.

g. Commerce & trade.

Canary Islands boasts a traditional and vigorous commercial life, as a walk through Las Palmas would attest.

The current weakness of internal demand has forced thousands of small business to close, a trend that has not affected malls, according with this industry's national association. Canary Islands now boasts 25% commercial per capita area than in 2007, a strange development in the midst of a cruel crisis.

More commercial zones are previewed for the big islands for the next 2 years, but now it seems less adventurous: tourism is not only providing direct revenues, but also planting jobs and, more important, changing the whole consumer élan. After years of survival economy, families are perhaps prepared to spend less fearsomely once cash is no longer a distant notion.

The crisis had also a positive outcome: it did to internationalization of Canarian big firms what decades of public programs could not. Beyond the so-called Platform America-Europe-Africa and much talks of opportunities across the ocean, it was the lack of opportunities in the domestic market that forced Canarian enterprises to invest in their natural hinterland, West Africa.

And they did it handsomely: Canary Islands firms investment abroad multiplied four-fold between 2008 and 2010, from 288 m euros to 1,228 m euros^{xv}. Most of this effort went to West Africa's infrastructural projects, including obviously touristic resorts.

Thus, firms with substantial interests in North & West Africa offer an interesting option for investors.

5. Conclusions.

Canary Islands is bouncing back on tourism.

The depth and sustainability of a tourism-led growth is yet to be acknowledged, but perhaps by the time it is already confirmed, most of the investment opportunities will no longer bear the price labels this worst of crisis has bestowed upon them.

But there are risks, too, as the European financial crisis could inhibit growth. So, a practical rule of thumb would be to follow the state of affairs in Canary Islands main markets (UK, Germany, Scandinavia and the Netherlands): if they fare well in the following months, Canary Islands will, too.

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ⁱ Source: INSTITUTO NACIONAL DE ESTADÍSTICA. (24 de MARCH de 2011). *CONTABILIDAD REGIONAL DE ESPAÑA BASE 2000*. Retrieved 28 de MAY de 2011 from INE: www.ine.es

ⁱⁱ All data from this paragraph: (EXCELTUR, 2010).

ⁱⁱⁱ “*Ley 19/2003, 14 abril, por la que se aprueban las Directrices de Ordenación General y las Directrices de Ordenación del Turismo de Canarias*”.

^{iv} Source: (Mallet, 2010)

^v Source: (MINISTERIO DE INDUSTRIA, TURISMO Y COMERCIO, 2011)

^{vi} (PWC, 2011)

^{vii} (SOCIEDAD DE TASACIÓN, 2011)

^{viii} Source: (BANKINTER, 2011)

^{ix} 8 airports, 6 of them International; a network of ports, 2 of them amongst Spain's most busiest.

^x Sentencias Tribunal Supremo Sala de lo Contencioso-Administrativo, 22 March 2011, 11 May 2010.

^{xi} (CANARIA/PSOE, COALICIÓN, 2011)

^{xii} Ley 1/2011, 21st January.

^{xiii} PECAN accesible at:

<http://www.gobiernodecanarias.org/cicnt/doc/industriayenergia/energia/pecan/pecan.pdf>.

^{xiv} (CANARIA/PSOE, COALICIÓN, 2011)

^{xv} (GUTIÉRREZ, 2011)

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