

**The European Union and Economic  
Reforms: The Case of Spain**

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## The European Union and Economic Reforms: The Case of Spain

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**Summary:** Since the 19th century, the obsession of Spanish reformists has been to bridge the gap between Spain and modernised countries. This paper examines Spain's integration experience in the European Union in order to study how integration has affected its economic structures and economic performance. It examines the relationship between regional integration, economic growth and economic reforms in this country, and draws some lessons based on its EU integration experience. In particular it looks at the impact of European Monetary Union (EMU) on the Spanish economy. While the overall benefits of EMU membership are undeniable, contrary to expectations it has not led to a process of deep economic structural reforms that would have fostered the development of an economic growth model based on value-added and productivity. The examination of the Spanish case will show that the process of economic reforms must be a domestic process led by domestic actors willing to carry them out.

### Introduction

In 2006 Spain commemorates 20 years of European Union membership.<sup>1</sup> EU integration was a catalyst for the final conversion of the Spanish economy into a modern Western-type economy. Indeed, one of the key consequences of its entry into Europe has been that membership has facilitated the modernisation of its economy.<sup>2</sup> This is not to say, however, that membership was the only reason for this development. The economic liberalisation, trade integration and modernisation of the Spanish economy started in the 1950s and 1960s and Spain became increasingly prosperous over the two decades prior to its accession to the EU.

Yet Spain's actual accession in 1986 forced the political and economic actors to adopt economic policies and business strategies consistent with membership and the *acquis communautaire* (which included the customs union, VAT, the Common Agriculture and Fisheries Policies and external trade agreements and, later, the Single Market, ERM and the European Monetary Union).

EU membership also facilitated the micro- and macroeconomic reforms that successive Spanish governments undertook throughout the 1980s and 1990s. In a context of strong support among Spanish citizens for integration, membership became a facilitating mechanism that allowed the government to prioritise economic rather than social modernisation and hence to pursue difficult economic and social policies (ie, to reform their labour and financial markets), with painful short-term effects. Moreover, the decision

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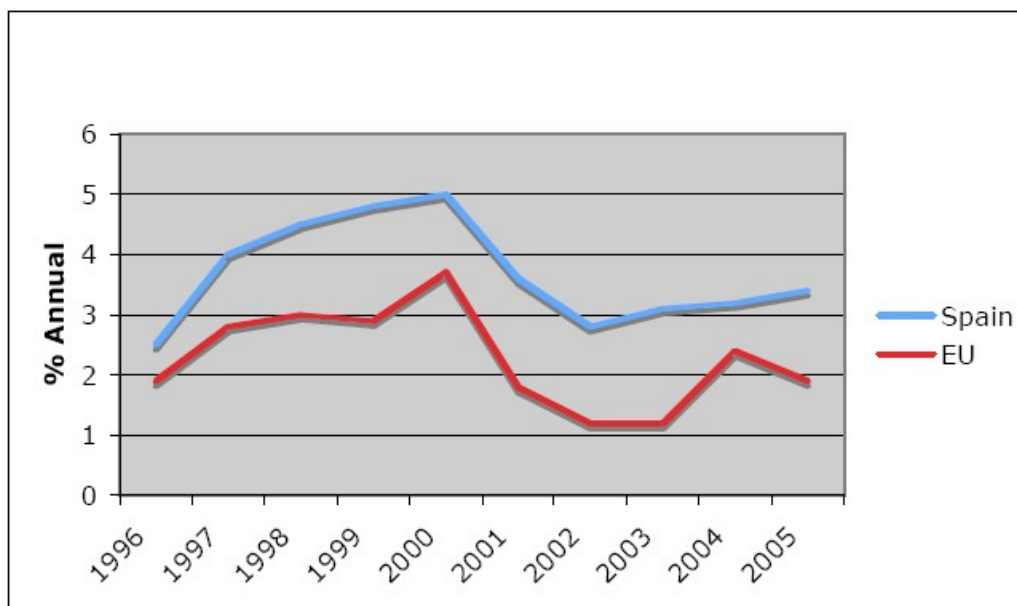
<sup>1</sup> For an exhaustive analysis of the impact of EU integration in Spain see Piedrafita, Steinberg and Torreblanca (2006).

<sup>2</sup> See Tovias (2002).

to comply with the EMU Maastricht Treaty criteria led to the implementation of macro- and microeconomic policies that resulted in fiscal consolidation, central bank independence and wage moderation.

The overall economic results have been very beneficial. Spain has closed the wealth gap with Europe's richest countries.<sup>3</sup> In 20 years per capita income has grown by 20 points, 1 point per year, to reach close to 90% of the EU-15 average. With the EU-25 Spain has already reached the average. It has grown on average by 1.4 percentage points more than the EU since 1996.

**Figure 1. GDP Growth**



Furthermore, the Spanish economy has led an extraordinary process of convergence and has integrated into the international economy. The integration with Europe has deepened: 90% of the FDI, 87% of the tourists, 74% of the exports and 66% of the imports come from the EU. EU integration has also allowed Spanish companies and people to access international markets, expand internationally and access capital abroad. One of the outcomes of this process has been the growing importance of Spanish multinational firms (like Telefonica, Banco Santander and ACS), which have become leaders in their markets.

Spain has also benefited extensively from European funds: approximately 150,000 million euros from agricultural, regional development, training and cohesion programmes. These funds have represented 24% of the country's annual agrarian income (80,000 million euros in 20 years). They have also contributed to the dramatic improvement of infrastructures (40,000 euros in 20 years): in 1986 Spain had 773km of highways and in 2006 6,267km, while 4km of every 10 have been financed with European funds; in 1986 it had no high-speed trains, while today it has three lines and for every 100 euros invested in trains, 38 have come from Europe. There are nine major ongoing infrastructure projects that will be partially funded with EU funds. Spain has also received 12,000 million euros from the cohesion funds that have helped fund projects such as the Madrid-Barcelona high-speed train (3,518 million in EU funds). While these funds represent 'only' 1% of GDP they have played a central role because they have generated opportunities that

<sup>3</sup> From 'Dos décadas de impulso a la economía', *El País*, 2 January 2006.

have led to initiatives and reforms that have been of key importance for the modernisation of the Spanish economy.

The integration process also faced difficulties. The process of industrial restructuring was very painful and destroyed thousands of jobs (unemployment reached 23% in the early 1990s). The elimination of corporate tax and the introduction of VAT in the 1980s were also traumatic. EU integration also brought more controls and accountability for public financial accounts. Moreover, the 1992 crisis of the European Monetary System was devastating for the Spanish economy: it led to three devaluations and the destruction of most of the jobs that had been created in the second half of the 1980s. Finally, the decision to join the European Monetary Union was also painful: it imposed fiscal consolidation.

The overall effects of EMU have also been positive: it has contributed to macroeconomic stability, it has imposed fiscal discipline and central bank independence, and it has dramatically lowered the cost of capital. As we shall see, without the euro the huge trade deficit would have already forced a devaluation and the implementation of more restrictive fiscal policies. Despite all these achievements the Spanish economy still faces serious competitive challenges. This paper will illustrate that EU and EMU membership have not led to the implementation of the structural reforms necessary to address these challenges. On the contrary, EMU has contributed to the economic boom fuelled by record-low interest rates, thus facilitating the postponement of necessary economic reforms. Spain faces a competitiveness challenge that requires significant structural reforms. This challenge, however, is not the problem of European institutions, but of national policies. I will conclude that the process of economic reforms has to be a domestic process led by domestic actors willing to carry them out.

The paper is divided into five sections. The first one examines the main economic consequences of European membership for the Spanish economy. The second analyses the economic convergence process and its challenges. The third section discusses the deterioration in the Spanish economy's competitiveness and its symptoms. The fourth explores the main shortcomings of the Spanish economy. The paper closes with some recommendations to address the competitive challenges.

### **Spain in the European Union**

Since 1986 the Spanish economy has undergone profound economic changes. EU membership has led to policy and institutional reforms in the following economic areas: monetary and exchange rate policies (first independent coordination, followed by accession to the ERM and finally EMU membership); reform of the tax system (eg, the introduction of VAT and the reduction of import duties); and a fiscal consolidation process. These changes have led to deep processes of structural reforms aimed at macroeconomic stability and the strengthening of the productive sector's competitiveness. On the supply side, these reforms sought the development of well-functioning capital markets, the promotion of efficiency in public services and the enhancement of flexibility in the labour market. As a result, markets and prices for a number of goods and services have been deregulated and liberalised; the labour market has been the subject of limited deregulatory reforms; a privatisation programme was started in the early 1980s to roll back the government's presence in the economy and to increase the system's overall efficiency; and competition policy was adapted to EU regulations. In sum, from an economic standpoint the combined impetus of European integration and economic modernisation have resulted in the following outcomes:

**Figure 2. Spain's Economic Transformation**



At the time of accession, it was considered that a critical factor to determine the final outcome of integration would depend upon the pattern of investment, which would bring about important dynamics effects. Spain had a number of attractions as a production base, including good infrastructure, an educated and cheap labour force and access to a market with a growing potential. In addition, EC entry would add the incentive of further access to the EC countries for non-EC investors in Iberia –ie, Japan and the US–. As expected, one of the key outcomes of integration has been a dramatic increase in foreign direct investment (FDI), from less than 2% to more than 6% of GDP over the last decade. This development has been the result of the following processes: economic integration, greater potential growth, lower exchange rate risk, lower economic uncertainty and institutional reforms. EU membership has also resulted in more tourism (which has become one of Spain's main sources of income).

Another significant dynamic effect has been the strengthening of the competitive position of Spanish firms. As a result of enlargement, Spanish producers gained access to the European market, which provided additional incentives for investment and allowed the development of economies of scale, resulting in increasing competitiveness. By the 1980s Spain was already facing increasing competition for its main exports –clothing, textiles and leather– from countries in the Far East and Latin America, which produced all these goods at a cheaper cost by exploiting their low wages. As a result of this development, the latter countries were attracting foreign investment in sectors in which Spain had traditionally been favoured. This situation convinced Spain's leaders that they had to shift towards more capital-intensive industries requiring greater skills in the labour force but relying on standard technology –eg, chemicals, vehicles and steel and metal manufacture–. In this regard, Spain's entry to the EC facilitated the shift. Indeed, the country gained access to the EC market, thus attracting investment that would help build these new industries. Finally, Spain also benefited from the EU's financial assistance programmes –ie, the European Regional Development Fund, the Social Fund, the

Agriculture Guidance and Guarantee Fund, the newly-created Integrated Mediterranean Programme for agriculture and, later on, from the Structural and Cohesion Funds.

EU integration has also allowed the Spanish economy to become integrated internationally and to modernise, thus securing convergence in nominal terms with Europe. As a result of these reforms, the process of financial liberalisation and the significant decline in real interest rates, Spain was successful in meeting the Maastricht convergence criteria. Indeed, on 1 January 1999 Spain became a founding member of the European Monetary Union. Finally, the country, which as late as 1997 was considered an outside candidate for joining the euro-zone, fulfilled the inflation, interest rates, debt, exchange rate and public deficit requirements established by the Maastricht Treaty. This development confirmed the country's nominal convergence with the rest of the EU.

**Table 1. Compliance with EMU Convergence Criteria for Spain, 1993-2004**

Year	Inflation (% growth)	Long-Term Interest Rate	Public Sector Deficit (as a % of GDP)	Government Debt (as a % of GDP)
1993	4.6	10.2	6.9	60.0
1994	4.7	10.0	6.3	62.6
1995	4.7	11.3	7.3	65.5
1996	3.6	8.7	4.6	70.1
1997	1.9	6.4	2.6	68.8
2004	3.3	3.64	0.3	62.6

Source: Commission and EMU Reports.

The EU contributed significantly to this development. Indeed, the structural and cohesion funds have been the instruments designed by the EU to develop social and cohesion policy within the European Union, in order to compensate for the efforts countries with the lowest per capita income relative to the EU (Ireland, Greece, Portugal and Spain) would need to make to comply with the nominal convergence criteria. These funds, which amount to just over one-third of the EU budget, have contributed significantly to reducing regional disparities and fostering convergence within the EU. As a result, major infrastructure shortcomings have been addressed and road and telecommunications networks have improved dramatically both in quantity and quality. In addition, increasing spending on education and training have contributed to the upgrading of the labour force. In sum, these funds have played a prominent role in developing the factors that improve competitiveness and determine the potential growth of the least developed regions of the country.<sup>4</sup>

During the 1994-99 period, EU aid accounted for 1.5% of GDP in Spain and, for instance, in 2001 Spain was allocated nearly 63% of the EU's structural funds budget (US\$27.8 billion). Overall, in absolute terms Spain is the country that has benefited the most from both structural and cohesion funds. Between 1989 and 2006 it will receive (excluding the funds from the CAP) more than 100,000 million euros (at 1999 prices). In 2005 Spain received 7.878 billion euros from the structural and cohesion funds (24% of the total or 50% of the cohesion funds –1.386 billion euros–). EU funding has allowed rates of public investment to remain relatively stable since the mid-1980s. Indeed, the percentage of public investment financed by EU funds has been rising since 1985, to reach average values of 15% for Spain. Moreover, the European Commission has estimated that the impact of EU structural funds on GDP growth and employment has been significant: Spain's GDP rose by 3.1% in 1999. Overall, these funds, given their impact on the demand side (eg, public works, etc) and on the supply side (increasing the Spanish economy's productive capacity), have contributed to economic growth. It is estimated that

<sup>4</sup> See Sebastian (2001).

on average the funds have added 0.4 percentage points to annual economic growth during the 1989-2006 period, or the equivalent of 600 euros per habitant and per year.<sup>5</sup> The 2007-13 EU budget agreement guarantees that Spain will be a net recipient until that date, although the bulk of the funds will be channelled to the new member states (representing 3%-4% of their GDP, which will allow them to create 2.5 million jobs).

In sum, the combined impetus of lowering trade barriers, the introduction of VAT, the suppression of import tariffs, the adoption of economic policy rules (such as quality standards and the harmonisation of indirect taxes) and the increasing mobility of goods and factors of production that comes with greater economic integration, have boosted trade and enhanced the openness of the Spanish economy. After 1999, this development has been fostered by the lower cost of transactions and greater exchange rate stability associated with the single currency. For instance, imports of goods and services in real terms as a proportion of GDP rose sharply in Spain (to 13.6% in 1987 from 9.6% in 1984), while the share of exports shrank slightly (to 15.8% of GDP from 16.6% in 1984, and from 17.1% of real GDP in 1992 to 27% in 1997). As a result, the degree of openness of the Spanish economy has increased sharply over the last twenty years. Changes to the production structure and the structure of exports, indicators of the Spanish economy's degree of competitiveness (ie, in terms of human capital skills, stock of capital and technological capital), show major improvements, although significant differences remain in comparison with the leading developed economies (which confirms the need to press ahead with structural reforms). These achievements verify that in terms of economic stability Spain is part of Europe's rich club.

This economic success however, has fostered a sense of complacency, which has caused a delay in the adoption of necessary structural reforms. Despite all the significant progress accomplished during the past two decades, Spain still has considerable ground to cover to catch up with the richer EU countries and to improve the competitiveness of its economy. Given the existing income and productivity differentials with the richer EU countries, Spain has to continue to intensify the reform process.

### Convergence with the EU

The above section highlights the benefits of EU and Euro membership on the Spanish economy. Yet the process of nominal convergence has advanced at a faster pace than real convergence. The country's income levels remain behind the EU average.

**Table 2. Divergence of GDP per Capita, 1980-2004**

(%)	1980	1985	1990	2000	2004
EU totals	100.0	100.0	100.0	100.0	100.0
Spain	74.2	72.5	77.8	81.0	97.2

Source: European Union.

Indeed, twenty years have not been enough. While there is significant controversy over the definition of real convergence, most scholars agree that per capita GDP is a valid reference to measure a country's living standards. This variable, however, has experienced a cyclical evolution in Spain with significant increases during periods of economic expansion and sharp decreases during economic recessions. Spain's European integration has revealed both convergence and divergence, nominal and real. As we shall see below, since 1997 inflation in Spain has exceeded the EU average every year.

Since the new EU member states that joined in 2004 are significantly poorer, enlargement has reduced the EU's average per capita GDP by between 10% and 20%. This is the so-called 'statistical effect'. Before enlargement (and the statistical effect) per capita income

<sup>5</sup> José A. Herce, 'La Política de Cohesión', *El País*, 15 November 2006, p. 4.

had increased by 'only' 16 percentage points in Spain since 1986. In Portugal the figure was 14.2%, and in Ireland, by contrast, it increased by 38%. Only Greece, with an increase of 6.8%, has had lower real convergence than Spain and Portugal. A possible explanation for this development has been the fact that while between 1990 and 1998 Spain grew by an average of 2.1%, Portugal grew 2.5% and Ireland 7.3% over the same period. This growth differential explains the divergences in real convergence. Other explanations include: the higher level of unemployment (on average 15% in Spain during the last decade); the low rate of labour participation (ie, active population over total population, which currently stands at 61%; expanding Spain's labour participation rate to the EU average would increase per capita income to 98.2% of the EU average); the inadequate education of the labour force (only 28% of Spain's potential labour force has at least a high school diploma, in contrast with the EU average of 56%); low investment in R&D and information technology (the lowest in the EU, with Spain ranked 61st in the World Economic Forum's *Global Report of Information Technologies 2002-2003* – spending even less proportionately than many developing countries including Vietnam–); and inadequate infrastructures (road miles per 1,000 inhabitants in Spain are 47% of the EU average and railways are at 73%). The inadequate structure of the labour market, with high dismissal costs, a relatively centralised collective bargaining system and a system of unemployment benefits that guarantees income instead of fostering job search, have also hindered the convergence process.<sup>6</sup>

An important factor in the convergence surge after 2000 was the substantive revision of Spain's GDP data as a result of changes in the National Accounts from 1995-2000. These changes represented an increase in per capita GDP of 4% in real terms (the equivalent of Slovakia's GDP). This dramatic change was the result of the significant growth of the Spanish population since 1998 as a result of the surge in immigration (in 2003 population grew 2.1%). The inclusion of the new population data in the 2001 census resulted in the revision of all the macroeconomic data. Spain's per capita income has got closer to the EU average, growing from 73.7% in 1986 (the year of accession) to 79.1% in 1992 (SEA) and 83.4% in 1999 (EMU). If we take into account the 25 member states, the growth differential has also been positive, increasing from 88.2% in 1996 to 97.2% in 2004 (or 89.7% in EU-15 terms). Between 2000 and 2004 the Spanish economy experienced a rapid process of convergence, increasing by 4 points and reaching 97.2%. This development was the consequence of three factors: demographic (the percentage of the working-age population over total population), the participation rate (the percentage of people employed over the working-age population) and labour productivity (GDP/number of people employed):

**Table 3. The Determinants of Real Convergence in Spain, 2000-04 (UE-25 = 100)**

	Per Capita Income	Labour Productivity	Participation Rate	Demographic Factor
2000	92.7	99.0	91.8	102.4
2004	97.2	96.8	98.5	102.8
Difference	+4.5	-2.2	+6.7	+ 0.4

Source: OEP 2005, p. 18.

The key factor in this acceleration of convergence, given the negative behaviour of productivity (if productivity had grown at the EU average, Spain would have surpassed the EU per capita average by 3 points), has been the important increase in the participation rate, which was the result of the reduction in unemployment and the increase in the activity rate (the proportion of people of working age that have a job or are actively seeking one) that followed the incorporation of female workers into the labour market and

<sup>6</sup> From 'La Convergencia real a paso lento', *El País*, 14 February 2000.



immigration growth. Indeed, between 2000 and 2004 the immigrant population has multiplied by three and has grown from 0.9 million to 2.8 million.<sup>7</sup>

### **The Loss of Competitiveness**

During the last decade Spain has accumulated intense disequilibria. While the economy continues to register robust growth (3.1% in 2004 and 3.4% in 2005, more than double the rate in the Euro-zone area as a whole), economic success is on shaky ground because it is being driven by the construction industry and by private consumption. Indeed, robust economic growth cannot mask worrying imbalances in the existing economic model, in which growth is largely driven by domestic demand: strength in consumption (domestic demand has increased at rates of 10% in 2005) and residential investment combined with high levels of indebtedness (110% of disposable income) and the negative contribution of the external sector to growth (in 2005 it detracted 2 points from growth). This pattern is not sustainable.

One of the consequences of EMU membership for Spain was the convergence of interest rates, which declined more than 12 percentage points since 1996. This has led to record-low interest rates in the country (negative in real terms) and an explosion of credit and mortgages. Over the last decade and a half financial deregulation, rising incomes (linked to lower unemployment rates), immigration growth and strong demand from foreigners (which multiplied by six compared with the first half of the 1990s) –who have been purchasing properties in Spain– have all led to an upsurge of demand for real estate. Consequently prices have increased by 130% since 1997 (on average, nominal prices rose by 17% annually over the last few years) and the ratio of average house prices to average incomes is comparatively much higher than in other countries. According to some estimates, construction makes up almost 17% of GDP (in 1985-95 it represented an average of 13.5%) and residential construction reached 8.3% of GDP in 2004 (while in 1985-95 it represented an average of 13.5%).<sup>8</sup> The US market has grown moderately in comparison. This situation has led some observers to talk about a ‘real estate bubble’. While the empirical evidence is not conclusive, there is no question that this situation is risky. Since most mortgages have variable rates, the savings rate is very low and the rate of indebtedness of Spanish families has increased (before 1990 it represented 60% of disposable income and since then it has grown to 110%), while mortgage holders are very vulnerable to interest rate increases by the ECB.

The real estate bubble has masked the Spanish economy’s lack of competitiveness. The degree of competitiveness is a critical variable to establish the potential for growth and development of economies in the short and medium terms because it helps determine the share of domestic demand that is satisfied with products from abroad and the share of external demand that is satisfied with internal production. In this regard, the Spanish economy’s loss of competitiveness is a very worrying development. The current account deficit is a key symptom of Spain’s loss of competitiveness.

#### *The Trade Deficit*

Spain has a very open economy: exports represented 25.7% of GDP in 2004 and imports 29.3%. Inflation has contributed to Spain’s trade deficit, which has widened sharply and has caused a surge in the current account shortfall, which has reached 7% of GDP, the highest in the industrialised world. Indeed, Spain has developed a ‘dual economy’ in which the manufacturing/industrial sector, on the one hand, and the service/construction sector, on the other, have diverged in terms of performance. While the construction sector is booming (over 700,000 houses were built in Spain in 2004, more than the total in

<sup>7</sup> See Oficina Económica del Presidente (2005).

<sup>8</sup> See Gros (2005).

France, Germany, Belgium, Holland and Luxembourg combined), manufacturing production regressed by 0.4% in 2005 (the automobile sector declined almost 9% in 2005) and exports are experiencing almost no growth.

The pressure on the manufacturing sector has intensified in the last two decades. By the 1980s Spanish firms were already facing increasing competition for their main exports –clothing, textiles and leather– from countries in the Far East and Latin America, which produced all these goods at a cheaper cost by exploiting their low wages. As a result of this development, the latter countries were attracting foreign investment in sectors in which Spain had traditionally been favoured. These concerns intensified further due to increasing fears about new competition from central and eastern European countries after the enlargement of the European Union.<sup>9</sup> The major source of concern was the fact that these countries specialise in labour-intensive and low-to-medium technology products (such as machinery, electrical equipment, textile goods and automobiles), sectors that make up a large proportion of Spanish trade (7.4%, 7.3%, 4.5% and 20%, respectively, of total Spanish exports to the EU-15), and in which competitiveness via prices is of particular importance. At the same time, central and eastern European labour costs are between 20% and 60% lower than the EU's.

Furthermore, the increasing threat of outsourcing (companies such as Samsung, Philips, Panasonic and Levi's have closed their plants in Catalonia in the last few years) and the worrying pattern of decreasing FDI coming into Spain (having fallen by half during 2000-03, from 40,728 million euros in 2000 to 22,705 million in 2003), have intensified the pressure on manufacturing firms. In 2005, FDI started to recover with an increase of 71% or 17.3 billion euros.

The lack of competitiveness is reflected in the record trade deficit. Spain's current account deficit for the first 11 months of 2005 reached 7.35% of GDP (61 billion euros or US\$75 billion), increasing by almost 60% between January and November 2005 (with exports up 4.45% and imports up 11.4%). To place this figure in perspective, the US deficit stands at 5.8%. This imbalance has been affected by the soaring cost of energy imports, which have risen by 40% since 2004. The Commission has estimated that the current account deficit will reach 8.3% in 2005 and 9.1% in 2007. These levels are not sustainable.

Several reasons explain the evolution of the trade deficit:<sup>10</sup>

- (a) The decoupling between production and domestic demand: increasing internal demand has led to a growth in imports that has been hindered by the appreciation of the euro, the crisis in the larger European economies and the growing competition from other countries.
- (b) The savings rate is insufficient to cover investment projects. The current account deficit shows the disequilibria between savings and private investment. While the public sector no longer has a deficit, the private sector has a large deficit (particularly non-financial companies).
- (c) Spanish exports are concentrated in a few markets. 70% of Spanish exports go to the EU-15. Yet the average growth of Spanish markets in the last five years has been 4.5%, while global markets grew by 7%. The slow growth of the European economies has had a deleterious effect on Spanish exports.
- (d) The limited degree of technological sophistication of Spanish products. High-technology exports only represent 8% of the total (less than half of the EU-15 average). Most Spanish exports are labour intensive, which make them very vulnerable.

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<sup>9</sup> Sebastián (2001), p. 22.

<sup>10</sup> Oficina Económica del Presidente (2005), p. 27-28.

## Challenges

One of the main lessons from EMU is that countries should join only when their economies are sufficiently flexible. Indeed, in order to prosper in a monetary union countries need a sufficient degree of wage and price flexibility. Unfortunately, successive Spanish governments have failed to implement the necessary reforms to increase the economy's flexibility and consequently, as we have seen, Spain has gradually lost competitiveness against the rest of the EMU countries. At the root of this problem lie the following shortcomings:

### *Inflation*

Inflation remains one of the main economic challenges for the Spanish economy. The Spanish inflation rate has exceeded the Euro-zone's by an average of more than 1 percentage point each year and in 2004 the gap widened to 1.5 points. In 2005, once again, it ended the year with disappointing results. The Consumer Price Index (CPI) jumped to an annual 4.2%, almost doubling the government's estimates for the year, and 1.8 points higher than in the Euro-zone as a whole. This is the worst result since 2002, when it reached 4%. While this increase has been largely attributed to the oil and food (particularly olive oil) price increases, it further damages the Spanish economy's already deteriorated competitiveness. At the end of 2005 the price differential between Spain and the Euro-zone stood at 1.8 points (2.4% in the Euro-zone), the highest among all the Euro-zone members and the third largest of all the EU members (only ahead of Slovakia and Lithuania). This is the highest differential since 2003 and unfortunately there are no signs of it abating:

**Table 4. CPI Evolution in January**

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Variation	2.8	1.9	1.5	2.9	2.9	3.1	3.8	2.3	3.1	4.2

Source: INE

Most observers attribute the growing differential in Spain's inflation rate with the Euro-zone to the fact that there continue to be barriers to entry in the service sector, particularly in the gas and electricity sectors.<sup>11</sup>

Persistent high inflation also undermines Spain's economic growth and undercuts the ability of Spanish exporters to compete with other European countries. A continuation of this pattern for a few more years would wipe out Spanish exports.

### *The Labour Market*

Employment figures have been very good: in 2005 employment grew over 3% (0.4% more than in 2004) and the participation rate increased from 56.3% in 2000 to 61.1% in 2004, closing the gap with the EU average of 65%. In 2005 the Spanish economy created 894,000 jobs (4.9% more than in 2004), the total number of employed people reached 19,314,300 and unemployment declined to 8.7% –the lowest figure in decades–. These impressive results, however, cannot mask the weakness of this development: the temporary rate has grown from 30.8% in 2004 to 33.7% in 2005, the highest by far in Europe; productivity rates have been negative (having declined by 1.3% in 2005); and there are wide disparities in the quality of work between men and women. Indeed, according to the OECD women's wages are almost 20% lower than men's (in Europe the average is 16%, female unemployment is at 11.6% –twice as much as the male rate–, the 'glass ceiling' is hard to break (more than two-thirds of Spain's top 35 listed companies

<sup>11</sup> 'Almunia Says Inflation Dampens Spain's Potential Growth Level', *El País, English edition with International Herald Tribune*, 18 February 2006.

have no female board directors and only 6% of directorships are held by women), and female workers are more likely to be stuck in low-paid short-term work.<sup>12</sup>

The lack of competitiveness has been further hastened by the spectacular growth of temporary employment, which has helped to more than halve Spain's official unemployment rate since the 1993 recession to 8.7%, and has contributed to a 60% increase in the number of people in work during the last decade. From 1984 to 1997 the number of temporary contracts increased from 7.5% to 39% of the total. Hence, the level of temporary work among new workers in Spain rose from 61% in 1987 to 81.5% in 1990, doubling the proportion of the active population on temporary contracts during that period from 15% to 30% (and accounting for 90% of all employment contracts). In addition, almost 50% of the staff in small firms is temporary (see Bentolila, Segura, and Toharia, 1991, p. 237-38, and Richards and Polavieja, 1997, p. 13-23).<sup>13</sup> In 2006 the temporary rate stands at 33.7% of the labour force, a level twice as large as the EU's 13.6%. With only 10% of Europe's active working population, Spain accumulates 31% of the temporary workers in the Euro-zone, and there are more temporary workers in Spain than in Italy, the UK, Belgium and Sweden combined. The problem is not abating; on the contrary, the current level of temporality is the highest ever with the exception of 1994-95.<sup>14</sup> Of the 900,000 new jobs created in Spain in the year to June 2005, two-thirds had contracts of six months or less.

In addition, the industrial relations framework does not provide the necessary flexibility (either internal or external) to firms to deploy and organise their labour forces.<sup>15</sup> A central challenge for Spanish firms and employers is to find a balance between the reduction of temporary contract levels and the rigidity of certain contracts. In a context of relatively high dismissal costs (generally entitled to 45 days' pay for every year worked) and a high employers' share of social security contributions as a percentage of wages (among the highest in Europe) employers have been using these contracts as instruments to introduce flexibility in their labour force in order to be able to adapt it to market conditions, technological change and demand. They are often accused of abusing temporary contracts by hiring people until the end of July, the start of the holiday season in Spain, and then renewing them in September to avoid paying for holidays. Temporary work, however, limits the incentives of employers to invest in their workers, reduces the commitment of employees to their firms and hinders the development and implementation of training programmes, with negative consequences on productivity. These contracts pay as little as 4 euros an hour and offer little, if any, training. Furthermore, the trend towards temporary work is stifling innovation and worker mobility, and job insecurity leads to a lack of enterprise among young people with university degrees.<sup>16</sup> Employers are starting to recognise the perverse consequences of these developments (Jiménez Aguilar, 1997, p. 12-13) and to demand a reduction in the costs of dismissals and social security

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<sup>12</sup> 'Spain Plans to Ban Sex Discrimination at Work', *Financial Times*, 4-5 March 2006, p. 2. In response to this challenge the Socialist government has proposed a new law that will oblige companies with more than 250 workers to introduce 'equality plans' to eliminate discrimination against women in pay, benefits and promotion.

<sup>13</sup> Despite the efforts from the trade unions, fixed-term employment has remained persistently high, and it is increasing in the public sector where it represented over 20% of all employment in 2003. One of the reasons is the high rate of turnover experienced by temporary workers (in abuse of the law): in 1994 each temporary worker had signed an average of two contracts per year, but in recent years the figure was three. Half of the temporary contracts have a duration of less than a month. See EIRO, *2003 Annual Review for Spain*.

<sup>14</sup> This development is also partly a consequence of the country's productive structure, highly dependent on seasonal activities like tourism, agriculture and construction. See 'España tiene más eventuales que Italia, Reino Unido, Bélgica y Suecia juntos', *El País*, 10 August 2005.

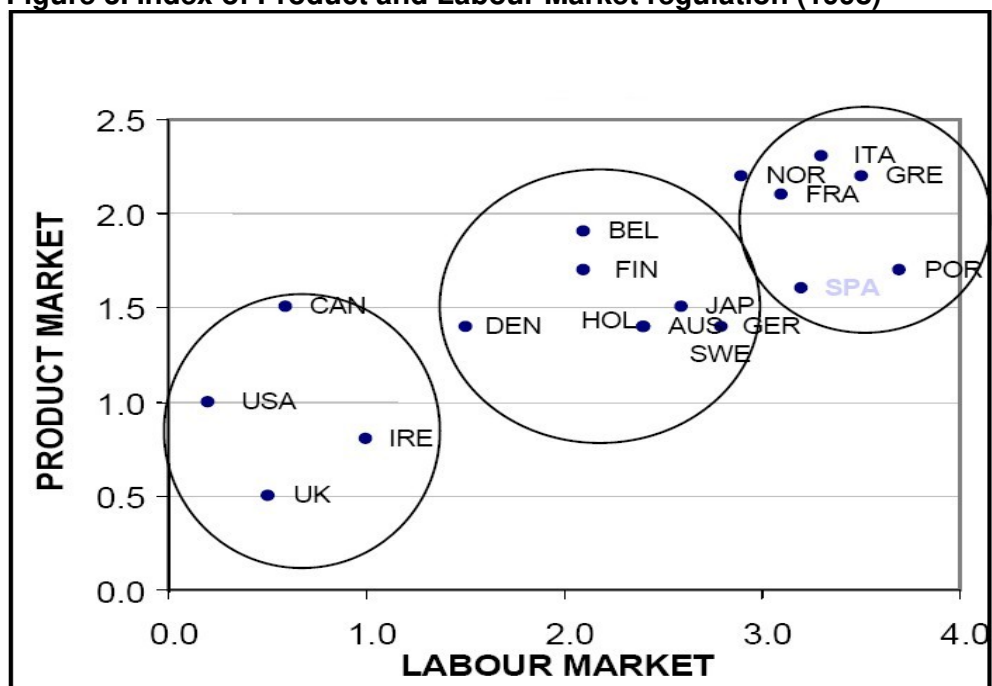
<sup>15</sup> See Jesús Benegas Nuñez, 'Innovación, Productividad y Empleo', *El País*, 10 July 2005.

<sup>16</sup> "Garbage Jobs" Stifle Spanish Innovation', *Financial Times*, 21 October 2005, p. 3.

contributions.<sup>17</sup> The generalisation of this practice has led to the establishment and institutionalisation of a model based on low costs that is no longer competitive.<sup>18</sup>

Rigidities in the labour market further hinder economic adjustment in the case of shocks and make it more difficult to adopt new technologies. Yet according to the OECD (1999) Spain remains among the least flexible economies.

**Figure 3. Index of Product and Labour Market regulation (1998)**



This problem has been compounded by the fact that Spain entered the euro at an undervalued exchange rate and subsequently lost competitiveness against the Euro-zone because of above-average wage increases and inflation. Unit labour costs have continued to rise, not so much because of higher nominal wages (which have grown moderately), but because of a fall in productivity.<sup>19</sup>

**Table 5. Wage Increases Negotiated in Collective Agreements in Spain, 2000-04**

Year	Wage Increase	CPI Real Year Average	Purchasing Capacity
2000	3.6	3.4	0.2
2001	3.7	3.6	0.1
2002	3.8	3.5	0.3
2003	3.5	3.5	0.7
2004	4.0	4.4	0.4

Sources: MTAS: Estadísticas de Convenios Colectivos.

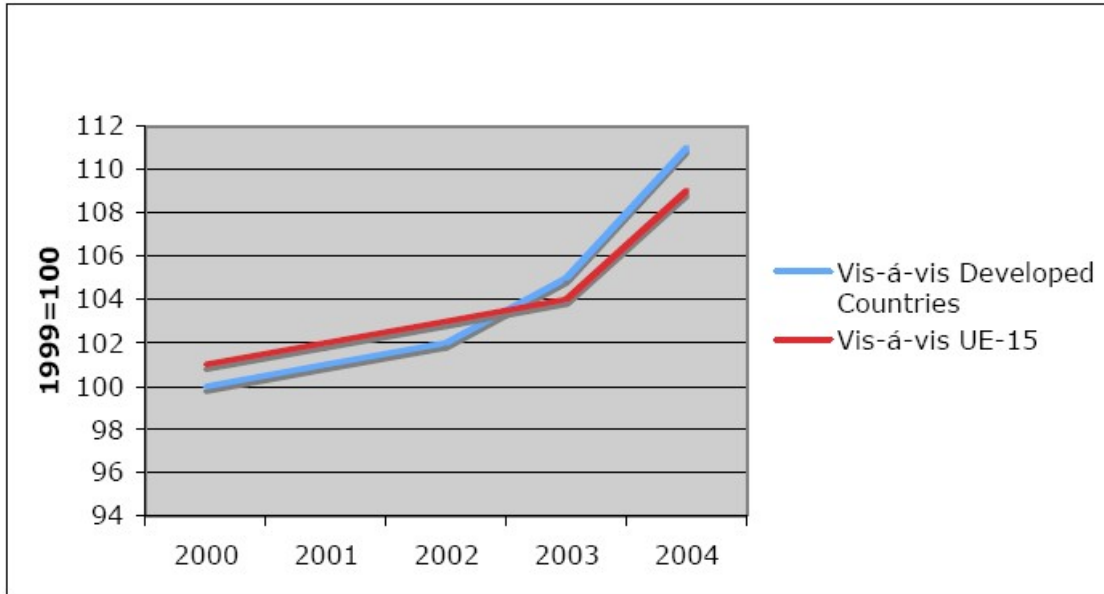
<sup>17</sup> Although employers' associations frequently express their antagonism towards trade unions, criticise an environment that they consider hostile to them and demand greater labour market flexibility, in private, during the course of the interviews that I conducted with their leaders they recognised the need for greater cooperation and stressed the benefits of concertation. One of the leaders of the CEOE, Jiménez Aguilar, has recognised that the increasing segmentation of the labour market between permanent and temporary workers 'hinders workers' professional training, their motivation and in sum the competitiveness of the firm and the quality of its products'.

<sup>18</sup> In Valencia, for example, many companies that used to produce textiles or shoes have seen their low-cost competitive advantage eroded as a result of competition from Asia and have been forced to close their plants and import products from China. They are now focusing on design and distribution, activities that require little labour.

<sup>19</sup> The surge of immigration, which resulted in a sharp increase in the participation rate, has led to a decrease in the average remuneration per worker (around 3.7% between 2002 and 2004).

The following graph shows that since 2000 unit labour costs have increased over the EU-15's causing an important loss of competitiveness:

**Figure 4. Competitiveness: Unit Labour Cost**

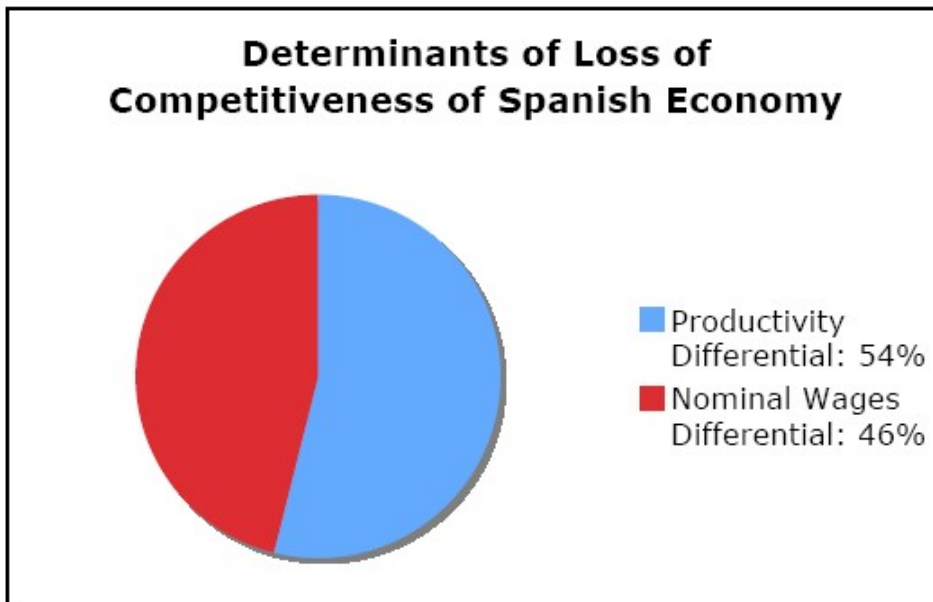


Source: OEP (2005), p. 30.

#### *Productivity*

The unfavourable evolution of unit labour costs is closely associated to the insufficient growth of productivity.

**Figure 5.**



Source: OEP (2005), p. 31.

According to the *Conference Board*, Spanish labour productivity suffered the biggest fall in 2005 of all the countries in the OECD, with a drop of 1.3% (in the EU it was up 1.1%), and OECD data show that during 1994-2003 Spain was placed next to last among 30 developed countries. While we know little about what determines productivity growth in advanced economies, some of the reasons for the lacklustre productivity performance of

the Spanish economy may include: heavy regulation, public spending (ie, public sector productivity shows a decline), low rates of investment, low skill levels in human capital, poor infrastructure (eg, road congestion or problems in retail and wholesale distribution), mediocre performance in innovation and expenditure on R&D, poor intellectual property protection, poor science base (ie, the reduced number of scientific publications) and a weak presence in high-technology industries. Finally, this drop can also be explained by the massive wave of immigration, which has increased the working population and reduced the average worker's contribution to GDP.<sup>20</sup>

#### *The Economic Structure*

An economic structure based on small and medium enterprises (SMEs), with companies that have the capacity to adapt to changing environments, has produced benefits such as flexibility, openness to innovation, fluid communication channels and employment creation. However, the small dimension of these firms generates deficiencies that hinder their competitiveness. For instance, they have difficulties exporting and competing in international markets, they generally fail to use new technologies and managerial tools, they have problems raising capital and accessing public funds for research and development, they have little purchasing power and a tendency to underutilise their productive capacity and they lack resources to train their workforce. More importantly, their size limits the possibility of exploiting the economies of scale necessary to compete and improve productivity.

Furthermore, the small dimension of Spanish companies also makes it difficult for them to generate the collective goods that these firms need in order to compete successfully. Most firms employ production strategies that rely on a relatively skilled labour force. Yet they do not have strong incentives to invest in their workers because they are vulnerable to 'hold ups' by their employees and to the 'poaching' of skilled workers by other firms. Employees, for their part, do not have strong incentives to share with the management the information they gain at work, because they would then be open to exploitation. Finally, the dimension of Spanish firms reduces their options to raise capital to innovate and their ability to invest in new technologies. These shortcomings should lead economic actors to support institutional mechanisms to help coordinate their activities and provide the necessary collective goods to succeed in the global economy.

#### *Other Indicators*

Spain lags well behind in critical areas: since most employment is in sectors based on intensive and not very qualified labour; only 36% of Spanish employees work with new technologies; the percentage of the population that participates in professional training programmes is merely 5.8%, well below the 9% EU average; Spain is listed 20<sup>th</sup> in the GCI on the innovation capacity and technological development of Spanish firms; and while investment in R&D has increased over the past five years (1998-2003) at an average of 7.6%, the percentage of investment in R&D (at 1.1% of GDP) is still lagging behind the 1.93% EU average.

Productivity is also affected by capital stock deficiencies. Despite the spectacular improvement in infrastructures, Spain still lags behind the EU, and public investment, which had experienced rates of over 9% in the 1990s, decelerated markedly between 2000 and 2003. This development is particularly worrying in the context of the spectacular population growth of the past five years.

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<sup>20</sup> 'Almunia Says Inflation Dampens Spain's Potential Growth Level', *El País, English edition with International Herald Tribune*, 18 February 2006. See also Martin Wolf, 'Britain Must Get to Grips with Lacklustre Productivity Growth', *Financial Times*, 8 November 2005.

**Table 6. The Spanish Economy's Infrastructure Stock**

	2000	2001	2002	2003	2004
Public investment growth	-8.9	9.2	9.0	1.2	6.7
Infrastructure growth	3.3	3.6	3.4	3.6	3.6
Infrastructure growth per capita	2.5	2.0	1.7	1.4	2.5
Infrastructures per capita (EU-15 = 100)	84.2	84.1	82.3	79.4	80.0

Source: OEP (2005), p.36.

This deficit in capital stock requires that the government continues investing in infrastructures to close the gap.

The quality of human capital is also deficient. While the quality of labour has improved, according to the International Programme for Student Evaluations Spanish students are below OECD averages in reading and comprehension, math and sciences.

**Table 7. The Education of the Spanish Labour Force**

	2000	2001	2002	2003	2004
Illiterate	0.5	0.5	0.4	0.4	0.4
Primary education	25.2	23.5	22.2	20.4	18.9
Secondary education	46.5	47.4	48.1	49.5	49.9
University education	27.8	28.7	29.3	29.7	30.8

Sources: OEP (2005), p. 37.

In addition, while changes to the production structure and the structure of exports –which are indicators of the Spanish economy's degree of competitiveness (in terms of human capital skills, stock of capital and technological capital)– have shown some improvements, significant differences remain in comparison with the leading developed economies. The European Commission has reported that the EU is 'losing the battle on competitiveness' in a list of 44 indicators, including economic performance, reform, employment and research. Spain (along with Portugal, and Greece) is among the worst-performing countries in most areas.<sup>21</sup> According to the *Global Competitiveness Index* (GCI), Spain is placed 23rd in the world, and in some of the categories computed in the ranking (eg, the quality of public institutions) Spain is even performing worse than in previous years.

The country's poor record on innovation is also deteriorating even further. Although Spanish scientists account for 4% of the world's published research, the country lags behind other European countries in innovation league tables based on patent filing.<sup>22</sup> Data from the European Office of Patents indicates that Spanish patents are only 19% of the European average and 11% of the US average. Furthermore, according to the European Commission's latest *Innovation Scoreboard*, Spain is 'losing ground' and is placed 16th among UE countries. One of the central problems, according to the report, is the 'very weak performance of entrepreneurial spirit'. The rate of enterprise creation in Spain is merely 10% (compared with 11.2% in Europe) and 70% of newly-created companies do not have paid employees. This can be partly explained because of the precariousness of the job market, which leads youngsters to look for security above everything else, with many seeking jobs as civil servants. Other problems include: the very low level of cooperation on innovation among small and medium enterprises, which is only 38% of the

<sup>21</sup> See 'The EU is Losing Battle on Competitiveness', *Financial Times*, 13 January 2003, p. 3. Spain has lost three positions (and is listed at number 20) in the Globalisation Index published by *Foreign Policy* (January/February 2003, nr 134, p. 60). In addition, the *World Economic Forum* has placed Spain and Portugal among the least competitive countries in the European Union (with only Greece behind) in its *Report on Global Competitiveness*. This report examines economic conditions in 80 countries focusing on two main indexes: the MICI (Microeconomic Competitiveness Index), which measures the quality of business development, and the GCI (Growth Competitiveness Index), which examines growth perspectives in 5-8 years based on macroeconomic stability.

<sup>22</sup> "Garbage Jobs" Stifle Spanish Innovation', *Financial Times*, 21 October 2005, p. 3.



European average; backward steps on key indicators that measure the resources devoted to information technologies and telecommunications, which have decreased from 85% to 83% of the EU average; and, finally, while there has been significant progress on R&D expenditure in the public and private sectors, Spain is still lagging far behind the EU average (expenditure in the public sector has increased from 64% to 70% of the EU average and from 45% to 49% in the private sector). Spain invests 1.05% of GDP in R&D, less than half the EU average. At the current pace it would take 20 years to get to the EU average. Finally, Spain also shows a significant deficit in relation to the information society and the use of electronic trade (the percentage of Spanish companies that buy and sell over the Internet is the lowest in Europe). High-technology exports are only 33% of the European average and have only increased 2 points (from 31%) since 2001.<sup>23</sup>

## Conclusions

The idea of Europe became a driving force that pushed reforms forward and was a fundamental factor for bringing about political stabilisation, economic recovery and democratic consolidation. Indeed, the European integration process has facilitated the reincorporation of Spain to the international arena, contributed to the legitimacy of the new democratic regime, acted as a buffer in controversial issues (such as decentralisation and the implementation of economic reforms) and has facilitated and accelerated the process of convergence and modernisation of financial, commercial and manufacturing structures. Overall, the impact of membership has been very beneficial. While there have been painful changes (such as the process of industrial restructuring and fiscal reforms) with traumatic effects (unemployment levels reached over 20% in the early 1990s), the changes would have been necessary anyway. European integration accelerated the reforms but at the same time allowed an orderly implementation that benefited from the experiences and support of other European countries (and funds). The impressive rates of economic growth experienced by the country during the last 20 years are closely connected with EU membership. The sharp decline in interest rates that resulted from EMU integration, the transfer of European funds to Spain, the implementation of more orthodox fiscal policies and the opening of the Spanish economy are all examples of outcomes associated with European membership. Finally, without the euro, the huge trade deficit would have already forced a devaluation and the implementation of more restrictive fiscal policies.

However, despite all the significant progress accomplished during the past two decades, the Spanish economy confronts difficult challenges in the new millennium. Compared with other European countries the Spanish economy is experiencing faster rates of growth. Yet it has not reached the development levels, particularly in technology, of the richest European countries. Furthermore, the competitive position of the Spanish economy has deteriorated lately and this is a very worrying development that must be addressed. Failure to do so may have dire consequences. Some observers have argued that Spain is about to experience a German-style economic stagnation or worse<sup>24</sup> while others are raising the possibility that Spain might have to leave the euro.<sup>25</sup>

From a standpoint of economic convergence, given the existing income and productivity differentials with the richer countries, Spain will have to continue raising its living standards to bring them closer to the current EU average. For this to happen, it is necessary for the Spanish economy to grow faster than the other rich European countries. This will require further liberalisation of its labour structures (both internal and external),

<sup>23</sup> 'España pierde terreno en innovación y baja al puesto 16 de la Unión Europea', *El País*, 13 January 2006, p. 45.

<sup>24</sup> Gros (2005).

<sup>25</sup> See Wolfgang Munchau, 'Spain has More Reason to Quit the Euro than Italy', *Financial Times*, 20 February 2006, and 'Monetary Union is Not for the poor', *Financial Times*, 30 January 2006.

as well as increasing competition within its service markets and improving the utilisation of their productive resources. Convergence will also demand institutional reforms in R&D policies, in education, improvement of civil infrastructures, as well as further innovation, an increase in business capabilities, more investment in information technology and better and more efficient training systems. Moreover, Spain needs to find the right balance of labour flexibility and worker incentives to promote productivity. A successful convergence policy will also require a debate about the role of public investment and welfare programmes. In Spain increases in public expenditure to develop the welfare states have caused imbalances in the national accounts. Yet it still spends significantly less in this area than its European neighbours (Spain spends 6.3 points less in welfare policies than the EMU average). Effective real convergence would demand not only effective strategies and policies, but also a strong commitment on the part of Spanish citizens to achieve this objective.

Moreover, the Spanish economy still has considerable ground to cover to improve its competitiveness. Since the country is part of EMU and any adjustment through a devaluation of its currency is no longer feasible, the only way for Spain to regain lost competitiveness is through a long period of wage moderation and increasing productivity. This will demand improvements in the working of markets and the elimination of distortions, as well as further liberalisation of the economy, particularly in the gas and electricity sectors, and enhanced energy efficiency to reduce the country's continuing dependence on imported energy, which contributes to inflation. Furthermore, it will require the use of new technologies and increasing spending on research and development.

A competitiveness agenda will have to focus on productivity growth, which is even more important in Spain than nominal wage growth. To address this shortcoming will demand actions to improve policies across a wide front: higher investment in infrastructure, improvements in land-use planning, efforts to increase the quality of education, rigorous promotion of competition in all areas of the economy, tax simplification and the rationalisation of existing regulations.<sup>26</sup> Furthermore, such an agenda will demand a shift from a low-cost, low-skill manufacturing base that relies on technical design and marketing skills from elsewhere towards more capital-intensive industries that require greater skills in the labour force and rely on standard technology –eg, chemicals, vehicles, steel and metal manufacturing– as well as a change in the existing growth model (based on relatively low production costs) in order to build a new framework based on innovation, quality, value-added and productivity.<sup>27</sup> Small companies have to carve out market niches in the global market and develop the technical capacity for short production runs to be able to respond to shifting demand. They have to develop their own brands and distribution networks and create their own customer bases. This will require the development of a technological know-how and marketing techniques.

The goal must be to increase productivity by increasing the capital intensity of production. Innovation and higher productivity will require four main conditions:

- (a) Investment in capital technology (eg, information systems and telecommunications).
- (b) A new culture of entrepreneurship, innovation and risk.

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<sup>26</sup> See Martin Wolf, 'Britain Must Get to Grips with Lacklustre Productivity Growth', *op. cit.*

<sup>27</sup> There are some positive indicators: General Motors has recently decided to manufacture its new *Meriva* in its plant in Fegueruela (Zaragoza), which was in competition with Gliwice (Poland). This decision has taken place in a context of outsourcing and delocalisation in the Spanish automobile sector, burdened by high relative labour costs and pensions. The reason for the decision was based on the higher productivity of Fegueruela's workers, facilitated by concessions from the GM workers' council, which will allow the assembly of cars in 16 hours (instead of the current 21). As a result, production costs would be similar to those offered by Poland (Polish workers' salaries are one-third of Feguerela's).

- (c) Human capital with strong skills and the flexibility to adapt to new technologies and processes, based on a model of continuous training.
- (d) A flexible and adaptable industrial relations framework.

Do the Spanish people want to continue building houses or do they want to increase salaries and develop a model based on value-added? There are other European countries that have developed knowledge-based economies with very strong results and which can serve as references (eg, the Scandinavian countries). Yet these challenges no longer depend as much on Europe as they do on Spain itself. The wide scope of these reforms reflects the daunting challenge facing Spanish governments. They will face growing resistance from the people likely to be hit hardest by the reforms. However, the lack of political willingness to implement the reforms will hinder the convergence process and further erode the competitiveness of the Spanish economy. It will not be easy. Globalisation is forcing economies to open up markets and embrace reforms, but the current stalemate in Europe after the rejection of the constitutional treaty by Dutch and French voters, growing protectionism (manifested by the opposition of national governments to cross-border mergers and acquisitions in sectors such as energy), and the increasing backlash against 'Anglo-Saxon' free-market capitalism will make the reform process even more difficult.

The main economic lesson from Spain's integration in Europe is that both the EU and the EMU have limited direct powers to enforce outcomes. Spain's experience shows that the effects of the influence of indirect EU recommendations on policy have been greater than direct action. It demonstrates the limits of peer pressure and the ability of the *acquis communautaire* to force change. The challenges facing Spain are not a problem of European institutions, but of national policies. While EU membership will facilitate (and in many cases ameliorate) adjustment costs and will provide the impetus for reforms, Spain's experience shows that this is no substitute for the domestic implementation of reforms, which should proceed further in areas such as labour, product and capital markets. Successful convergence and increasing competitiveness will hinge to a considerable degree on the ability of Spain's leaders to implement reforms in the face of domestic resistance. Lack of progress will bring economic stagnation or worse.

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