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All Spanish Troops Back Home from Iraq

The Economy Moves Ahead

Spain closed the chapter on its military involvement in Iraq and opened a new page in its relations with Europe. All of Spain's 1,300 troops are back home, reversing the previous government's more pro-Atlanticist policy, and the new government spent its first month in office manning a diplomatic offensive in Europe. José Luis Rodríguez Zapatero, the Socialist prime minister, visited France, Germany, Italy and Portugal and his foreign minister, Miguel Ángel Moratinos, went to London for the first Anglo-Spanish talks. At the same time, the Socialists took a tough position on the voting system in the draft European Constitutional Treaty, ahead of the European Union (EU) summit on June 17.

Zapatero made a conspicuous point of making his first visit within Europe to Paris and Berlin in the hope of placing Spain beside the two countries that he calls the 'motor' of the EU. Jacques Chirac, the French president, formally announced the creation of a new axis of Berlin, Paris and Madrid to coordinate actions between the three countries. One specific proposal between France and Spain is to work closely to resolve the Sahara conflict this year.

However, the new rapprochement does not mean that Germany and France will necessarily give Spain a more sympathetic hearing over the contentious issue of the carve up of EU funds in the future (see *Inside Spain*, Newsletter 2, May 4, 2004). Germany and France are net contributors and Spain is still a net receiver.

Spain is also not happy with the compromise that seems to be taking shape among the EU-25 regarding the new double majority voting system based on a threshold of member states combined with a threshold of EU population. Talks on this issue collapsed last December when Spain's previous centre-right government, supported by Poland, insisted on keeping the system agreed at the 2000 Nice summit which was very favourable to Spain (see *Inside Spain*, Newsletter 1, April 1st, 2004). Spain flatly rejected the proposal in the draft constitution of taking decisions when backed by 50% of EU states representing 60% of the Union's population because it would mean that Europe's big three –the UK, France and Germany– could form a blocking majority on any decisions they did not like.

The most supported option now is 55% of countries and 65% of the population. Spain, however, is holding out for decisions to be taken by 55% of countries representing 66.6% of the population. These figures are very close to the position of the previous

government, although it never specified them. The extra 1.6 percentage points, in the Socialists' view, are very important because it would then be much easier for Spain, as a medium-sized country, to block a decision it did not want. The EU summit will be a defining moment for the new government's self-proclaimed desire for greater cooperation with Europe.

Spain will not take any decision until it sees the whole institutional package –the number of commissioners, the minimum number of seats in the European Parliament and the new voting system–. The Socialists are also pushing for Javier Solana, a former Socialist foreign minister in Spain and currently the 'high representative' for EU common foreign and security policy, to be the EU's first foreign minister. Solana also enjoys the support of London and Berlin.

The Socialists are also not insisting on including an explicit reference to Christianity in the new constitution, as the previous government did. 'Spain is a Catholic country, but in the European constitution our government is rather secular, and in this sense we want to respect the text as it currently stands' said Moratinos. This approach is consistent with the Socialists' decision to reverse the previous government's plan for Roman Catholic religion classes in state schools.

Zapatero will meet Tony Blair in the UK in June. Unlike the US administration, London, although Washington's main ally in the war with Iraq, did not take umbrage, at least publicly, when Spain decided to pull out its troops as quickly as possible. It took the view that Spain's decision was to be expected as it was a key part of the Socialists' electoral campaign and they had won a democratic election. The UK's approach smoothed the way for the first Anglo-Spanish talks. They were cordial, but Jack Straw, the UK Foreign Secretary, expressed his anger to Moratinos, his counterpart, at Spain's refusal to allow cruise ships that visited Gibraltar to subsequently dock in Spanish ports.

The row over the cruise ships began in late April when Madrid ordered several port authorities to ban non-EU registered cruise ships that had berthed at the colony. The ports invoked an EU freight regulation decreeing that non-EU vessels can stop at only one EU port. Spain insisted it had the right, while the UK said the regulation only applies to freight shipping. Whatever the rights and wrongs of the dispute the ban, last implemented in 2000, sent a negative signal to both the Rock (where cruise shipping is one of the pillars of its tiny economy) and to London, and only served to deepen Gibraltarians' mistrust of Spain.

The UK Foreign Office regarded the move as a 'strange way' to kick-start a serious discussion on the Rock, which broke down last year after Britain had tried to foist on an unwilling Gibraltar an eventual joint sovereignty deal between Britain and Spain that would happen at some future date. The idea was so massively rejected by Gibraltarians in a referendum that it was dropped. Straw reiterated to Moratinos the longstanding UK position that there could be no change in the status of Gibraltar without the consent of its people in a referendum. London is caught between a rock and a hard place.

Lastly, Zapatero mended fences with two other US allies in the war with Iraq, Portugal and Italy. Silvio Berlusconi even apologized for the way some members of his government had criticized Zapatero's snap decision to withdraw Spanish troops. Zapatero offered to hold the signing ceremony for Europe's new constitution in Rome as opposed to Madrid, something proposed by the European parliament in honour of the victims of the train bombings in the Spanish capital. // *Cavaliere* was delighted with the offer.

Reforming the Senate

On the domestic political front, Zapatero kicked off the debate on reforming the Senate and converting it into a body representing Spain's 17 autonomous regions. He told the Senate, whose role in political life is marginal, that the only limits on the reforms were that they respected the basic framework of the constitution and were amply backed. The system of financing for the regions will also be reviewed. The Socialists, however, are as adamantly opposed as the previous PP government to the Basque government's plan for a referendum on an associated status with the Spanish state which, it is feared, would open the door to outright independence. They are hoping the Basque Nationalist Party (PNV), which governs the Basque country, will drop its plan but this is most unlikely to happen. The central and Basque governments are thus again on a collision course.

The government is also taking an equally hard line towards the political sympathisers of the Basque terrorist organization Eta. The director of public prosecutions challenged the legality of the Herritaren Zerrenda (HZ) party which has presented candidates for the June 13 European elections. Candido Conde-Pumpido said HZ was the same as the banned Herri Batasuna, the pro-independence party accused of being the political front of Eta, under a different name. HZ was barred from presenting candidates.

The government does not plan to announce any major economic or labour reform measures until after the European elections. The Socialists view these elections as a chance to show that their surprise victory in the March 14 general election was not just because of their anti-Iraq war stance and the sharp rise in voter turnout (in their favour) as a result of the Madrid terrorist blasts.

Royal Wedding

Crown Prince Felipe (36), heir to the Spanish throne, married Letizia Ortiz Rocasolano (31), a divorced commoner and former TV news reader, sealing the continuity of the line of succession. The prince is the last of the three children of King Juan Carlos and Queen Sofia to marry. The Socialists have announced that the constitution will be amended to remove the preference of male over female in the succession to the throne.

Spain's monarchy was reinstated in 1975 on the death of General Franco, following more than 40 years of republic and dictatorship (although a nominal kingdom from 1947). The monarchy has so far proved to be a popular institution, largely because of the huge respect that Juan Carlos commands for overseeing the very successful transition to democracy.

The wedding, attended by more than 30 heads of state and several monarchs and watched by more than 25 million people on Spanish television, provided an opportunity for Madrid to cast off the gloom following the terrorist attacks and recover a fiesta mood.

The Economy Moves Ahead

Spain's economy has hardly suffered from the terrorist attacks. It is forecast to grow 2.9% this year and 3.3% in 2005, according to the latest OECD Economic Outlook report. For the tenth straight year growth will be higher than the EU-15 average. As a result of this positive growth differential, Spain's per capita income has steadily advanced towards the EU-15 average (currently 86%).

The OECD advised the government to continue to run a general government budget surplus. This may be difficult to combine with fulfilling promises to increase spending in

various areas including education, R&D, the police, prisons (Spain now has the EU-15's second-largest prison population per 100,000 inhabitants) and giving every mother with children under the age of three €100 a month. At the moment only working mothers receive this subsidy via an allowance in their tax declaration. The minimum interprofessional wage will be increased by 6.6% as of July. This rise of more than twice the inflation rate will restore the purchasing power lost during the previous government. The wage, however, is still much lower than in other EU countries (see Figure 1). The Socialists are also promising to spend more on development assistance for poor countries and not to tie it, directly or indirectly, to commercial interests. The figures for 2003 were recently released and show that Spain is among the least generous of OECD donors (see Figure 2).

Figure 1. Minimum monthly interprofessional wage

	Euros
Belgium	1,163
France	1,154
Greece	605
Ireland	1,073
Luxembourg	1,369
Portugal	416
Spain	572*
United Kingdom	1,105

(*) Based on 14 payments over 12 months.

Source: Eurostat.

Figure 2. Net official development assistance, 2003

	% of GDP
Belgium	0.61
Denmark	0.84
Finland	0.34
France	0.41
Germany	0.28
Greece	0.21
Ireland	0.41
Italy	0.16
Luxembourg	0.80
Netherlands	0.81
Portugal	0.21
Spain	0.25
Sweden	0.70
United Kingdom	0.34

Source: OECD.

Pedro Solbes, the economy supremo, will broadly follow the macroeconomic policy of the previous government but the budget will be balanced over the life of an economic cycle rather than every year regardless of the state of the economy. Solbes said he would reform the fiscal stability law which came into effect in 2003 and commits the government to a balanced general government budget every year. The PP government achieved a small overall budget surplus of 0.3% of GDP in 2003 (thanks to the buoyant Social Security accounts), although the new team says it has discovered a 'hidden deficit' for last year and this year which has caused it to revise upward its figure for the central government deficit.

Solbes has a difficult task of maintaining fiscal discipline and meeting the Socialists' spending pledges. A decade ago he acted as a 'fireman' economy minister for the Socialists when he inherited an economy burned by three devaluations and a very

large budget deficit. That experience, it is hoped, should keep him on the straight and narrow.

It is becoming clear that the only way the government is going to achieve any significant increase in revenue in order to finance its spending is by getting to grips more strongly than the previous government did with tax evasion. The 2003 personal income tax reform, which reduces tax rates, will have some effect on receipts this year, and in the not too distant future Spain will feel the impact of reduced EU funds as a result of the Union's enlargement. The Fiscal Studies Institute puts tax evasion around €60bn a year, or about 10% of GDP. Tax returns for 2001, the latest available figures, show that fewer than 100,000 people declared gross incomes of more than €96,000.

The PP government, despite all its rhetoric, took a fairly benevolent approach towards tax evasion and did not make reducing it a priority objective. The emphasis in the Tax Agency was very much on checking tax returns rather than sending tax inspectors out to investigate areas of tax fraud and evasion. Miguel Ángel Fernández Ordóñez, the Secretary of State for Finance and an experienced hand (he held various senior positions in previous Socialist governments), called for more 'police work' and 'espionage' in the fight against tax fraud and evasion.

On the expenditure side, there are two areas where improvements could be made. One is RTVE, the state-run television, which has run up a debt of more than €6,600 million (largely during the eight years of the PP government), and the other is RENFE, the state railway company, with an even higher debt. Fernández-Ordóñez raised a predictable storm of protests from RTVE's employees when he floated the idea of privatizing one of RTVE's two channels. Other governments have also raised the ideas of privatizing RTVE but all of them have shied away from biting the bullet. This government, however, does seem to be more determined to make RTVE politically independent and less of a mouthpiece for the ruling party. To be fair to RTVE, however, its news coverage has not sunk to the partisan level of Italy's RAI. The government has commissioned a report from a team of experts on how to reform RTVE.

As well as these hot political potatoes, the government has also inherited a tense situation at the Izar state steel group. The European Commission, following a 4-year investigation, ordered Izar to return €308 million of aid 'illegally' granted by the previous government in 1999 and 2000. The final figure could be much higher. This could be the death of the ailing group which provides around 20,000 jobs directly and indirectly. Its order book is very low.

The Spanish authorities were not happy with the OECD's suggestion that there could be a 'sudden and sharp fall in the medium term' in house prices. There has been a lot of speculation recently about the risk of Spain's property bubble bursting. The average price per square metre rose from €674 in 1996 to €1,511 in 2003, roughly six times faster than the increase in wages, and they continue to climb. A property price crash would hit heavily indebted families hard as they might end up owing more to the banks than their homes are worth (the 'negative equity' phenomenon as it is called affected the UK in the early 1990s). Spain's gross household indebtedness reached a new record in 2003 of €507,585 million (double that of 1998), 82% of which is mortgages. Furthermore, interest rates (which are currently negative in real terms after taking inflation into account) are set to rise at some point this year in the euro zone which would increase the cost of repaying mortgages. The government has established a housing ministry, for the first time since the 1939-75 Franco regime, in an attempt to build a stock of homes at 'reasonable' prices.

The OECD also urged the government to carry out further reforms to its still rigid labour market. These, it said, 'should aim at increasing wage flexibility, which would also boost productivity performance'. Spain's ailing productivity is one of the weak points of the economy and a focus of the new government's economic policy. This problem, more acute now that the EU has expanded to the East and low cost countries, is highlighted by the latest IMD World Competitiveness Report. Spain declined from 27th position in 2003 to 31st this year (see Figure 3). The country's weakest factors included the unemployment rate, the number of days needed to start a business, employee training and technological cooperation between companies. The World Bank recently estimated that it took 115 days to set up a company in Spain with employees compared to two in Austria and 45 in Germany (see Figure 4).

The IMD report also covers Catalonia (the other non-countries included are Ile-de-France, Lombardy, Maharashtra, Rhone-Alps, São Paulo and Zhejiang). Catalonia, one of the motors of the Spanish economy, was ranked higher than Spain in 27th position. The IMD said that Spain was one of the countries that was most likely to be affected by the competition from the new EU members.

Figure 3. Decline of Competitiveness in Spain*

	2000	2001	2002	2003	2004
Economic performance	30	30	19	24	22
Government efficiency	19	20	22	24	22
Business efficiency	32	26	29	31	38
Infrastructure	25	23	25	28	31
Overall ranking	25	24	23	27	31

(1) Ranking out of 60 countries in 2004, 59 in 2003, 49 in 2002, 49 in 2001 and 47 in 2000.

Source: IMD Competitiveness Yearbook 2004.

Figure 4. Number of days to set up a company with employees

	Number of Days
Austria	2
US	4
Ireland	12
UK	18
Italy	23
Japan	31
Germany	45
France	53
Spain	115

Source: World Bank.

The loss of competitiveness is preventing Spanish exports from continuing to gain market share. Between 1993 and 1997, according to a Bank of Spain study released in May, the average annual real growth of Spanish exports was 13%, compared with 5.7% between 1997 and 2003. As a result, Spain's market share of world exports rose by 0.4 points (by 0.9 points in the EU) to around 2% and in the following six years it stood still.

On the brighter side, Spain's vital tourism industry, which generates 12% of Spain's GDP and supports more than 1.5 million jobs, has bounced back from the March bomb attacks. A study by Exceltur, a lobby group of 29 of Spain's main tourist groups and companies, showed the industry growing by between 3% and 4% in the first quarter. But for the attacks tourism would have been 'extraordinarily good'. The main damage to the industry was in Madrid. The report said it was 'business as usual' by April 8, just under a month after the attacks.

Telefónica, Spain's telecoms group, continued its acquisition of wireless operations in Latin America, with a US\$1 billion agreed bid for Chile's second-largest mobile phone operator. This purchase followed its agreement with BellSouth in March to buy 10 of its operators in Latin America, including one in Chile. Telefónica is now the dominant mobile phone operator in Chile, Argentina, Brazil, Venezuela, Panama and Nicaragua.

BBVA, Spain's second largest bank, acquired Valley Bank of California for US\$16.7 million. The purchase fits in with BBVA's strategy from Mexico, where it owns Bancomer, the country's second largest bank, of seeking greater business from Hispanics, particularly remittances.

Seeking to Control Islamic Radicals

The government has taken up the idea of the Association of Moroccan Immigrant Workers (ATIME) for a system similar to France's to supervise mosques and imams in order to try to ensure they are in moderate hands (see *Inside Spain*, Newsletter 2, May 4, 2004). Spain has an estimated 600,000 Muslims and more than 400 mosques or Muslim religious centres, some of them little more than converted garages or storefronts.

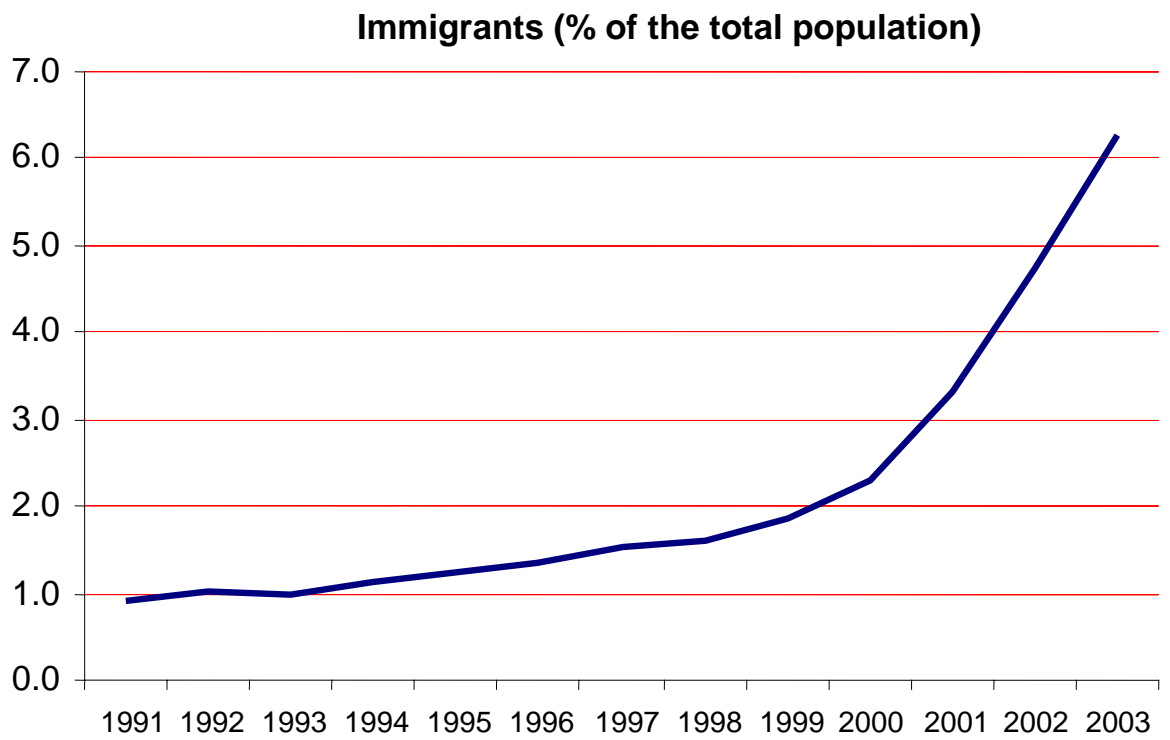
José Antonio Alonso, the Interior Minister, said ways were being studied to tighten the laws to control Islamic radicals. 'We need to have a legal situation in which we can control the imams in small mosques', he said. 'That is where the Islamic fundamentalism which leads to certain actions is disseminated'. Miguel Angel Moratinos, the foreign minister, said mosques had sprung up in Spain in a completely uncontrolled fashion. One idea is to establish a register which would clearly state who is responsible for leading worship. It would be very difficult, however, to censor the content of sermons, not least because they tend to be improvised and in Arabic, and the authorities do not know where many of the mosques are located other than those that are conspicuous by their minarets.

The government's proposals were criticised by some but not all Islamic groups in Spain. Carlos Amigo, the Roman Catholic cardinal of Seville, said the plan reminded him of the Franco regime's censorship of sermons in churches.

Meanwhile, in a move of political correctness, the cathedral of Santiago de Compostela in Galicia announced it would remove a statue of Spain's patron saint, St. James the Moor Slayer, because it could be construed insulting to Muslims. The statue depicts the heads of decapitated Moors at the saint's feet. The saint is a symbol of the fight between Christianity and Islam and the reconquest of Spain from eight centuries of Moorish rule before 1492.

There is already a mechanism in place to exercise some control on the Muslim community, but it was never properly developed. The Socialist government in 1992 created an Islamic Council, the maximum body for relations between the state and Muslims. At that time the number of Muslims in Spain was very small. Since then there has been a more than fivefold surge in immigrants to 2.7 million in 2003 (6% of the total population), a large proportion of whom are Moroccans (see Figure 5).

Figure 5.



Source: INE and Interior Ministry.

