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Foreign Policy

Madrid Cancels Controversial Aircraft Deal with Venezuela
Spain will not sell 12 military planes to Venezuela. Washington's ban earlier this year on the re-export of US technology in the aircraft meant that EADS-CASA had to substitute these parts but it was not commercially viable to do so.

Miguel Ángel Moratinos, the Foreign Minister, said both sides had agreed to cancel the deal. 'The financial effort needed to adapt to the technological requirements of the United States was not worth it', he said.

Madrid initially defied the ban and pressed ahead with the €1.7 billion contract with the avowedly anti-American government of Hugo Chávez. Washington denied the request for licences to transfer the technology because 'in a region in need of political stability, the Venezuelan government's actions and frequent statements contribute to regional instability'.

Madrid's decision was the source of considerable friction with Washington and did nothing to improve relations between the two governments which plummeted after the Socialists won the March 2004 general elections and immediately withdrew Spain's 1,300 peacekeeping troops from Iraq.

José Vicente Rangel, Venezuela's First Deputy Prime Minister, said in Madrid that Caracas would still buy eight maritime surveillance boats from Spain. When the deal was signed José Luis Rodríguez Zapatero, the Prime Minister, insisted that the aircraft and boats were for peaceful purposes and would be used to combat drug trafficking.

EADS-CASA is an affiliate of the troubled pan-European aerospace company EADS, which also owns Airbus. The Spanish company Casa joined EADS in 1999 and is 5.5% owned by the Spanish state. The decision to cancel the sale of the aircraft is expected to enhance the prospects of EADS-CASA in the US where it is pursuing three mega contracts worth billions of euros. The company already participates in the US coastguard's Integrated Deepwater System programme.

Despite the government's friendly relations with Chávez, albeit less enthusiastic than a year ago, Spain voted for Guatemala to fill one of the rotating UN Security Council seats and not Venezuela. Washington lobbied hard against Venezuela's obtaining a seat. Nearly 50 rounds of voting failed to resolve the contest between Guatemala and Venezuela and both countries withdrew at the end of October, opening the way for Panama to take the seat.

In another development benefiting Spain's relations with the US, at least symbolically, the stars and stripes fluttered again at the Columbus Day military parade on 12 October for the first time since 2003 when Zapatero, then leader of the opposition, remained seated as the American flag passed by in protest at the war in Iraq. The following year George Argyros, the US ambassador in Madrid, boycotted the official commemorations. In 2005, the American flag was also absent from the parade. This year's parade, in the improved climate between Madrid and Washington, was attended by Eduardo Aguirre, who replaced Argyros in 2005.

Crown Prince Felipe, the heir to the Spanish throne, was one of the special guests at a reception given in the White House by George W. Bush as part of the celebrations during October to mark the Hispanic heritage. The official number of Hispanics in the US is now close to Spain's population of 44 million. Zapatero, however, is still one of the very few EU-25 leaders who has not been received in the Oval Office. He strongly condemned the US and UK-led invasion of Iraq at the summit of Latin American countries in Montevideo, Uruguay, calling it a 'serious error', but stopped short of calling for a withdrawal of all troops.

Curbs to be Placed on Romanian and Bulgarian Workers
Spain is to follow Britain and restrict access to its labour market to workers from Romania and Bulgaria when these countries join the EU in January. It did the same with the 10 new EU entrants in 2004 and lifted them earlier this year.

The move followed a call by the two main trade unions, the UGT and the Workers' Commissions (CCOO), who until now have barely raised their voices against the flood of immigrants into Spain, and amid growing public concern at the level of immigration. An estimated 400,000 Romanians and 160,000 Bulgarians already live in Spain, about half of them illegally.

Miguel Ángel Moratinos, the Foreign Minister, said access to the jobs market might be limited for two years.

In another move to stem the tide of illegal immigrants, Moratinos signed an agreement with Guinea-Conakry and Gambia which links development aid with meeting commitments on combating illegal immigration. Each country, modest providers of illegal immigrants to Spain, will receive €5 million and the government also said it would write off Guinea's debt of €8 million.

Spain also hopes to strike a similar deal, the first of its kind, with Senegal, the main African country sending illegal immigrants to the Canary Islands. Moratinos said a 'kind of window' would be created to give work in Spain to a significant number of Senegalese.

These moves were in response to the arrival of sub Saharans in flimsy fishing boats in the Canaries during the summer (see *Inside Spain*, Newsletter 28, 4 October 2006). The government has begun to get tougher with illegal immigrants: more than 76,000 have been repatriated so far this year and the inflow during October was well below that in September. Latin Americans arriving in Spain, however, are much more difficult to control as they come as tourists in much larger numbers and stay. During a trip to Argentina Moratinos said the EU might reintroduce visa requirements for all Latin Americans.

The government's efforts to crack down are hampered by the refusal of the Popular Party, the centre-right opposition, to agree changes to the Foreigners' Law and so present a united front to a problem that has become the main concern of Spaniards for the first time. In a survey published last week, 60% said immigration was their main worry, up from 28% in May last year, even though unemployment is at its lowest level in 27 years (see Figure 1 and separate item below).

Figure 1. The Three Main Concerns of Spaniards (% of Total Respondents)

	Immigration	Unemployment	Terrorism
May 2005	27.7	56.2	41.8
December 2005	29.4	49.0	27.9
April 2006	31.4	52.4	26.2
June 2006	38.0	43.1	22.8
October 2006	**59.2**	**42.1**	**18.0**

Source: CIS.

José Luis Rodríguez Zapatero, the Prime Minister, urged EU leaders at a meeting in Lahti, Finland, the current President of the Union, to review maritime law regarding the rescue of boats and ships in difficulties, something that has particularly affected Spain in recent months as thousands of sub-Saharans have made the treacherous crossing to the Canary Islands. At the moment, a ship that comes across another one in difficulties is obliged to take the passengers to the country of its origin. Zapatero said if the passengers were illegal immigrants, as was the case these days, the situation should be different. He also asked for the recently launched European Agency of Frontiers (Frontex) to be greatly strengthened.

The idea, shelved for the moment, of using the Spanish navy to intercept boats carrying immigrants was aired at a meeting of the cabinet and opposed by José Antonio Alonso, the Defence Minister.

Meanwhile, the debate continued on how many more immigrants Spain could continue to take or needed. According to a very detailed book published by the government of Catalonia, Spain will need a further 4 million immigrants by 2020 to meet labour market needs.[1] Immigrants is one of the new chapters in the substantially revised edition of John Hooper's widely admired *The New Spaniards* (Penguin). When it was first published in 1986, the subject was not even mentioned, and in the last revised edition (1995) it merited just a page.

Repsol YPF Agrees Nationalisation Deal with Bolivia

Repsol YPF, Spain's oil and natural gas conglomerate, agreed to continue operating in Bolivia. President Evo Morales nationalised the country's oil and gas industry on 1 May and gave foreign companies 180 days to sign new deals and cede control of commercialisation to the state or leave the country (see *Inside Spain*, Newsletter 25, 2 June 2006).

Repsol, and the other foreign companies in Bolivia including Brazil's Petrobras, will have to pay more taxes (up to 82% compared with the previous 52%). Repsol threatened to take Bolivia to international arbitration. In the end it did not walk away as it has invested €916 million in Bolivia since 1997 and believes its operations can still be profitable. As part of the new contracts, Repsol is expected to plough more than US$1 billion into exploration and production.

[1] Josep Oliver Alonso, *España 2020: un mestizaje ineludible*, Institut d'Estudis Autonòmics.

The importance attached to reaching a satisfactory solution, against a tense background which threatened to affect Spain's relations with Bolivia, was underscored by the incorporation of Bernardino León, the number two at the Foreign Ministry, to the negotiations during their final phase in La Paz. María Teresa Fernández de la Vega, the Deputy Prime Minister, was also involved in the negotiations.

Domestic Scene

Weapons Theft Threatens Government's Peace Process with Eta
The government's efforts to broker a peace deal with the Basque terrorist group Eta received a further setback when 350 firearms were stolen from a warehouse in France by suspected members of the group. José Luis Rodríguez Zapatero, the Prime Minister, said the robbery was 'serious and would have consequences' but he did not spell out what they would be.

The robbery, which raised questions of whether Eta was rearming or using the theft to pressure the government, occurred one day before the European Parliament narrowly backed Madrid's efforts to end the group's 38 years of separatist violence. However, the parliament's vote of 321 votes in favour and 311 against mirrored the divisions over the peace process in Spain where the centre-right Popular Party (PP) refuses to support the government as it believes it will make too many political concessions (see *Inside Spain*, Newsletter 26, 4 July 2006).

Mariano Rajoy, the PP leader, said the robbery was a provocation and he called on Zapatero to abandon the peace efforts. Eta has yet to show any willingness to lay down its arms, one of the conditions sought by the PP for supporting the government's initiative.

The parliament's move came seven months after Eta declared a ceasefire and against a background of continuing street violence in the Basque country, with the firebombing of buses, shops and banks.

The *Audiencia Nacional*, the court responsible for terrorism cases, confirmed that it would put Arnaldo Otegi, the leader of Batasuna, the political front of Eta, and 35 other members of the banned party on trial for their links with the group.

Catalan Election Result Quandary
Catalonia's conservative and nationalist Convergència (CiU) party won the region's elections but it did not win enough seats to govern on its own (see Figure 2). The most likely outcome looked to be a re-run of the three-way coalition, headed by the Socialists, which collapsed and triggered early elections.

Figure 2. Results of the Elections in Catalonia (1)

Party	Seats	% of Votes
Convergència I Unió (CiU)	48 (46)	31.5 (30.9)
Socialists (PSC)	37 (42)	26.8 (31.1)
Republican Left (ERC)	21 (23)	14.0 (16.4)
Popular Party (PP)	14 (15)	10.6 (11.9)
Greens-United Left (ICV-EUiA)	12 (9)	9.5 (7.3)
Ciutadans	3	3.0

(*) The results of the 2003 election are in brackets.
Source: Government of Catalonia.

The CiU increased the number of its seats from 46 to 48, but this was short of the 68 needed to govern alone. The Socialists suffered the most: they lost five seats and their share of the vote dropped from 31.1% to 26.8%. A new party, Ciutadans (Citizens) came from nowhere to take three seats.

The new government's main task will be to implement the new autonomy charter approved in a referendum in June after two years of wrangling which led to the collapse of the Catalan government (see *Inside Spain*, Newsletter 21, 7 February 2006).

European Commission gives Valencian Government Ultimatum over its Urban Development Law

Brussels threatened to take the government of Valencia, controlled by the centre-right Popular Party (PP), to the European Court of Justice if, within two months, it does not provide a satisfactory explanation as to why its new urban development law contravenes EU rules.

The government went ahead with its law in February despite a resolution by the European Parliament against it (see *Inside Spain*, Newsletter 20, 12 January 2006). The Commission's first warning, issued in April, went unheeded. The main objections concern procedures for public works tenders and the role of private real estate promoters. Valencia is one of the regions which has built the most homes in recent years.

In a separate development, the government has created a new unit of 200 civil guards which, as of next year, will investigate the rising corruption in the real estate sector. Newspapers of varying ideologies, ahead of next year's municipal elections, are awash with reports of corruption cases affecting the two main political parties. According to the civil guard, 12,832 denunciations of illegal building of homes were made between January 2005 and June 2006.

The central government is seeking to recover a greater role in urban development, particularly in the outskirts of cities and large towns. These powers were ceded to regional governments and town halls. Antonio Vercher, the recently appointed special prosecutor for the environment and urban development, said more than 100,000 homes had been built illegally and they should be demolished.

In the latest corruption perceptions index released this month, which seeks to measure the degree to which corruption is perceived to exist among public officials and politicians inside countries, Spain was ranked 23rd out of 163 countries (see Figure 3). This was the same position as in 2005, but Spain's score dropped from 7 to 6.8 –the closer to 10 the cleaner the country–. However, it remained much better placed than Italy (45th), which yet again was outflanked by Botswana (37th).

Figure 3. Transparency International Corruption Perceptions Index, 2006, Selected Rankings (1)

Country	Score (2)
1. Finland	9.6
11. United Kingdom	8.6
16. Germany	8.0
18. France	7.4
20. United States	7.3
23 Spain	**6.8**
45 Italy	4.9

(1) Out of 163 countries.
(2) The CPI score relates to perceptions of the degree of corruption as seen by business people, academics and risk analysts, and ranges between 10 (squeaky clean) and 0 (highly corrupt).
Source: Transparency International.

The Economy

Government Bows to EU Pressure on Endesa Bid and Removes Barriers
The government lifted most of the 19 restrictions imposed on the €37 billion take-over bid by Germany's E.on for Endesa, Spain's largest power company, holding out the prospect of an end to the long-running saga.

The conditions, announced in July, would have forced E.on to sell 32% of Endesa's domestic generating capacity. The government's stance should be seen in the context of the first bid for Endesa by the Barcelona-based Gas Natural more than a year ago which it favoured in order to create a national champion. Eon's chairman, Wulf Bernotat, said the company was prepared to cooperate with Gas Natural if it dropped its bid for Endesa.

Madrid's decision came after the European Commission launched a formal infringement case against the government for ignoring a ruling by Brussels regarding the take-over. The Commission said Madrid had no right to impose its own conditions on the deal, after it had given the green light to the bid in April and that 18 of the 19 conditions contravened its rules (see *Inside Spain*, Newsletter 28, 4 October 2006).

The government, however, is still going to argue the case for increasing the remit of its national energy commission (CNE) which it did in response to E.on's bid. Brussels has called for this law to be repealed.

E.on, before the government's decision, took its battle for Endesa to New York where it filed a suit last month alleging that the Spanish construction firm Acciona misled the US Securities and Exchange commission when it snapped up 10% of Endesa in an after-hours raid. E.on believes Acciona is working to block its tender offer. The court sought clarification from E.on and called for a new hearing on 16 November.

The CNE, meanwhile, authorised Acciona to own up to 24.9% of Endesa. Santander, Spain's largest bank, has agreed to sell Acciona its 9.6% stake in Endesa.

Iberdrola Wins Contracts in the Middle East
Iberdrola, Spain's second-largest power company, has won two major contracts in the Middle East. It will build a combined cycle plant in Qatar for €1.3 billion and another one in the United Arab Emirates for €112 million.

The two projects were won by Iberdrola's engineering unit which has business in more than 20 countries. The plant in Qatar will be the largest one based on natural gas in the Middle East and Iberdrola's contract is the largest won by a Spanish company in that part of the world.

Outward Stock of Direct Investment Surpasses Inward Stock

The stock of Spain's outward direct investment in 2005 surpassed the inward stock for the first time (see Figure 4). The outward stock of US$381.3 billion (33.8% of GDP) was US$13.7 billion more than the inward stock, according to UNCTAD's latest World Investment Report.

Figure 4. Spain's Inward and Outward FDI Flows and Stocks, 2003-05 (US$ billion)

	1990-2000 Average	2003	2004	2005
Inward investment	14.3	25.9	24.7	22.9
Stock (1)	–	65.9	156.3	367.6
Outward investment	15.1	27.5	60.5	38.7
Stock (1)	–	15.6	167.7	381.3

(1) FDI stocks are presented at book value or historical cost, reflecting prices at the time when the investment was made.
Source: UNCTAD, World Investment Report 2006.

Outward investment flows in 2005 amounted to US$38.7 billion, down from US$60.5 billion in 2004 (revised up from US$54.2 billion), and inward of US$22.9 billion were not far from 2004's figure of US$24.7 billion (revised up from US$18.3 billion). UNCTAD revises its figures in each year's report.

The outward stock rose 25 times between 1990 and 2005 and the inward stock fivefold. Spanish companies have invested heavily in Latin America and increasingly, as of 2004, in Europe and the US. Spain's outward stock, however, is still well below that of Germany (US$967.2 billion) and France (US$853.1 billion), but much higher than Italy's (US$293.4 billion).

Spain was placed 19th out of 141 countries in the outward FDI Performance Index ranking, based on the country's share in global FDI outward stocks and GDP.

Three Spanish companies –Telefónica, Repsol YPF and Endesa– remained among the world's largest 100 non-financial transnational corporations (TNCs) ranked by foreign assets. Telefónica was 33rd with US$43.2 billion, Repsol YPF 49th with US$29.8 billion and Endesa 52nd with US$28.7 billion. The ranking is based on foreign assets in 2004. The banks, Grupo Santander and Grupo BBVA, were ranked 15th and 26th, respectively, among the world's 50 largest financial TNCs, with foreign assets of US$774.4 billion and US$416.2 billion.

Unemployment at Lowest Level since 1979

The registered unemployment rate was 8.1% in September, the lowest level since 1979, but the proportion of the employed with temporary contracts (34.6%) was the highest figure since 1995. The government's labour market reforms, introduced in July, to reduce the European Union's highest level of short-term contracts have so far had no effect (see *Inside Spain,* Newsletter 25, 2 June 2006).

There was also good news on the inflation front. Consumer prices increased 2.6% year-on-year in October, the lowest rise since March 2004, according to the preliminary estimate of the National Statistics Institute (INE). Housing prices are slowing down and international oil prices are lower.

The year-on-year pace of growth in housing prices in the third quarter dipped below 10% for the first time in five years. The average price of a square metre was €1,956, 9.8% more than in the third quarter of 2005. Spain's housing prices have been among the fastest growing in Europe in the last decade.

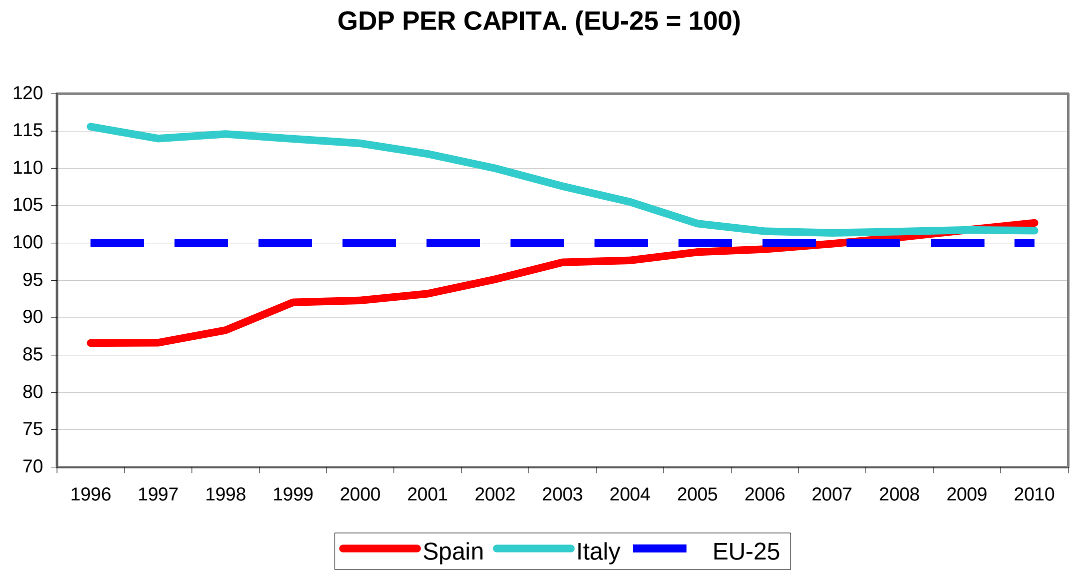
The current account deficit for the first seven months was 71% higher at €7,906 billion, because of the larger trade and transfer deficits and the smaller services surplus (tourism and other elements). The rising current account deficit is symptomatic of Spain's declining competitiveness, among other factors.

Meanwhile, the Madrid stock market hit yet another high at the end of October, rising 6.3% in the month and 28.1% so far this year. As well as economic fundamentals, the market is being driven by a handful of cash-rich construction, infrastructure and real estate companies –Acciona, Ferrovial, Sacyr and Metrovacesa– which are the new movers and shakers in corporate Spain.

Spain's Per Capita GDP to Overtake Italy's in 2009
Spain, which only 10 years ago lagged well behind Italy in terms of GDP her head, will overtake the country in 2009, according to a government forecast. Spain's per capita GDP, measured in purchasing power parity terms, is currently 98.2% of the EU-25 average and Italy's 100.5%. Thanks to a decade of strong growth well above that of the EU average, Spain will overtake Italy (see Figure 5). If Spain's black economy is included which, unlike Italy's, it isn't, then the *adelantamiento* has probably already occurred.

Italy's growth has been very sluggish over the past five years and last month Italian government debt (106% of GDP compared with Spain's 43.1%) was downgraded.

Figure 5. GDP Per Capita



Source: Economic Office of the Prime Minister.

As part of the Lisbon strategy, designed to make the EU a much more competitive and technologically advanced economy, Madrid issued its annual assessment of the progress made in its National Programme of Reforms (PNR). Real per capita convergence with the EU continued apace. Spain will reach the EU average in 2008, two years ahead of the date set in the PNR. Spain's nominal GDP exceeded US$1 billion for the first time in 2004, when the size of its economy overtook Canada's (a G8 member, unlike Spain), and next year it will be more than €1 billion.

Productivity, however, declined from 98.4% of the EU average in 2004 to 97.4% in 2005. Another problem area is the school drop-out rate. In 2005 it was 30.8%, far from the target of 15% by 2010 and double the EU-25 average.

Progress was made in the employment rate (those employed and aged between 15 and 64 as a percentage of the total number in this age group), which reached 63.3% in 2005 and was just below the EU average. The target for 2010 is 66%.

Spain's Labour Costs Not Far Behind Italy's

Spain's hourly labour costs in manufacturing are close to Italy's, according to the latest comparative figures by the German Economics Institute (IWD).

In 2005, the average cost was €17.25 in Spain compared with €17.71 in Italy (see Figure 6). And while Italy's costs dropped, Spain's rose. The growth in Spain's labour costs is one factor behind the shift of some multinationals from the country to Hungary, Poland and other eastern and central European countries that joined the EU in 2004.

Figure 6. International Labour Costs

Country	€
West Germany	27.87 (27.60)
Finland	25.98 (24.88)
France	21.38 (20.74)
UK	20.47 (19.89)
Ireland	19.47 (18.11)
United States	19.27 (18.76)
Italy	17.71 (18.79)
Spain	**17.25 (16.59)**
Portugal	7.37 (7.21)
Hungary	4.88 (4.53)
Poland	3.80 (3.29

Note: cost per hour in 2005 in the manufacturing sector including salaries and other expenses such as the employer's social security contribution. 2004 figures in brackets.
Source: German Economics Institute (IWD), Cologne.

Spain Ranked 13th Out of 30 in Bribe Payers Index

Spanish companies are not too prone to bribe when doing business abroad, according to Transparency International's (TI) latest bribe payers index which ranks the country 13th out of 30. The cleanest country is Switzerland and the most corrupt India (see Figure 7).

Figure 7. Transparency International Bribe Payers Index 2006: Selected Rankings (1)

Country (2)	Average Score (0-10)	% of Global Exports (2005)
1. Switzerland	7.81	1.2
2. Sweden	7.62	1.3
6. UK	7.39	3.6
7. Germany	7.34	9.5
9. US	7.22	8.9
13. Spain	**6.63**	**1.9**
15. France	6.50	4.3
20. Italy	5.94	3.6
30. India	4.62	0.9

(1) Out of 30.
(2) The Index is based on the responses of 11,232 business executives from companies in 125 countries to two questions about the business practices of foreign firms operating in their country, as part of the World Economic Forum's Executive Opinion Survey 2006. Respondents are asked to answer on a scale of 1 (bribes are common) to 7 (bribes never occur). In calculating the BPI, the answers are converted to a score between 0 and 10, and the ranking reflects the average score.
Source: Transparency International.