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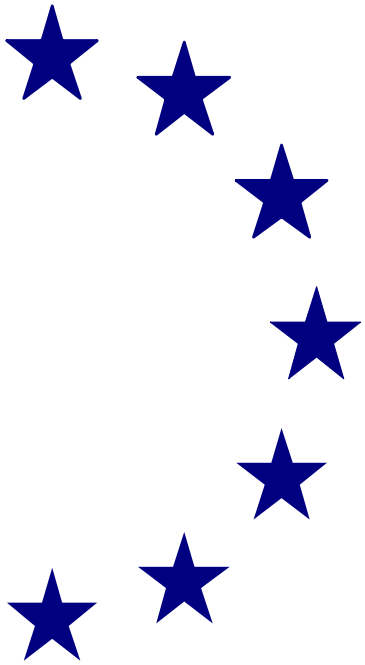

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Country Study: Spain in EMU: a virtuous long-lasting cycle?

by

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Executive summary

The story of the Spanish economy in EMU is a dazzling one, though its brilliance is dimming and clouds can be seen on the horizon. But Spanish private and public agents still have time to send the right messages and take the right action before the clouds close in.

Since the launch of the euro in 1995, Spain has enjoyed a virtuous economic cycle of high GDP growth, outstanding job creation, and relatively low inflation.

Between 1995 and 2003 real GDP grew in Spain at an annual average rate of 3.25%. This compares with a rate of below 2% in the euro area. Moreover, at 2.5% per year between 2001 and 2003, growth was much higher than in previous recessive phases of the cycle, 1980-1982 or 1992-1994, when GDP grew at a meagre 0.8% per year.

Employment has also registered a record performance since the mid-1990s. Between 1995 and 2003, civilian employment grew at an average rate of 3.5% (compared with 1.2% in the euro area as a whole). Strikingly, employment grew at 2.8% per year between 2001 and 2003, while jobs were lost at rates of 2% per year over 1980-1982 and 1992-1994. The unemployment rate declined in parallel from over 18% in the mid-nineties to just under 11% in 2003. The inflation rate also fell steadily, bottoming out at 1.8% in 1998.

At consequence of such a performance is that the real GDP per capita gap between Spain and the euro area narrowed by more than 7 percentage points in a decade (from 79% in the mid-1990s to more than 86% in 2003).

Looking at how demand and output have contributed to this positive record over recent years, the study shows that growth has come above all from dynamic domestic demand. Private consumption has been especially resilient over this cycle due to strong job creation and loose monetary conditions, which yielded positive expectations of higher permanent income. In parallel, the construction sector, particularly as a result of the strong demand for housing investment, seems to be enjoying a golden age with growth rates ranging from close to 4% to well beyond.

A note of caution must be sounded, however, since rapidly increasing housing prices and a massive acquisition of dwellings are fuelling household indebtedness, which now represents almost 100% of gross disposable income, twice as much as in the mid-1990s. This is becoming a major cause of concern, since any significant shock on interest rates might have a negative income effect on consumption. Moreover, investment in equipment has a poor record over the period, with growth rates not only entering negative territory in 2001 and 2002, but continuing rather flat afterwards. Thus, while investment in infrastructure

involves clear positive spillovers on other sectors' productivity, the current bias of capital formation in favour of residential construction is unlikely to provide an adequate foundation for sustained high growth in the long run.

Furthermore, the contribution of external demand has been negative on average over the whole 1995-2003 period, with the trade balance in the red by above 5% of GDP since 1999. This deficit, coupled with a historically declining surplus in services trade and a more negative balance of primary incomes, tipped the current account into the red already in 1998, and pushed it as low as -3.2 % of GDP in 2003.

An examination of macroeconomic policies shows that although fiscal policy has contributed to growth through dynamic public consumption and direct tax cuts, the fiscal stance has been tight, in contrast with the fiscal loosening observed in some large economies of the euro area, and would therefore not seem to be the most important factor behind high GDP and employment performance in Spain. Nevertheless, no doubt, sound fiscal policies, by delivering macroeconomic stability, have enhanced potential growth in Spain. On the other hand, once the conduct of monetary policy was taken over by the ECB, a single, relatively low interest rate, combined with a positive inflation differential with the euro area, induced a growth-supportive monetary loosening in Spain since 1999. Overall, therefore, the policy mix has been broadly neutral and does not seem per se to provide a complete explanation for the performance of the Spanish economy since the mid-nineties. Nevertheless, it should be born in mind that fiscal policy, through the consolidation efforts, may have contributed to macroeconomic stability and higher economic growth.

One particularly positive achievement was the successful expenditure-based fiscal consolidation in the second half of the nineties, supported by healthy growth rates, buoyant job creation and the sharp fall in interest rates which helped reduce the debt burden. Accordingly, between 1995 and 2003 the budget balance increased from a deficit of 6.6% of GDP to a surplus of 0.4%, while debt levels were reduced by 17 percentage points of GDP to below 51%. Moreover, personal income tax reforms in 1998 and 2002 aimed at lowering marginal taxes, reducing tax breaks, and providing incentives for higher participation in the labour market may indeed have triggered private agents' confidence and contributed to growth and job creation without jeopardising fiscal consolidation.

However, in the long term, it is of paramount importance to reinforce spending control mechanisms to ensure continued sound public finances without resorting to tax increases. In addition, while a number of measures have already been adopted to cushion the budgetary impact of the ageing of the Spanish population by increasing labour market participation, reducing public debt, and building up the pension fund reserve, further action on pensions and health care is also needed. Specifically, the relationship between contributions and benefits in the

public pension system should be strengthened, as recommended in the recently renewed Pacto de Toledo.

One way of ensuring the sustainability of public finances is to accompany job creation with high growth, which, in turn, depends on the productivity growth rate. The combination of high job creation and dynamic productivity growth is the foundation for a balanced real convergence. That real convergence has accelerated since the launching of the euro is simply a matter of fact. It is also a fact that the convergence process has come from outstanding job creation. However, not much capital, be it physical, human or knowledge, has been accumulated, and this has led to low productivity growth which, coupled with persistent inflation differentials, is a drag on the competitive position of the Spanish economy.

Since the mid-nineties the employment rate, which measures the percentage of the working-age population with a job, has increased by 13 percentage points in Spain, compared with only 4.5 percentage points in the euro area. However, productivity grew in Spain at only 0.6% between 1995 and 2003, while the figure for the euro area was almost 1%. Moreover, Spain's productivity growth has actually slowed down since 1995 compared with the period 1985-1995, when the annual average growth rate was almost 1.5%. Therefore, it seems that productivity is the issue, but this does not mean that labour market outcomes should be disregarded.

Specifically, although growing fast, the employment rate is still low by European standards and far from the Lisbon target of 70%. High job creation has reduced the unemployment rate by 7 percentage points, but at 11% the Spanish unemployment rate is still the highest within the euro area (8.4%), with certain geographical areas and women and young workers particularly badly affected.

One way of improving the labour market would be to significantly increase funding for active labour market policies, which is among the lowest in the euro area. The available funding for employment services and for training is also very limited. Efforts to increase female employability should also be stepped up, especially through greater use of part-time contracts, which now account for only 8% of total employment. In addition, there seems to be a broad consensus that the use of fixed-term contracts in Spain is excessive, at 30% of all jobs. Although fixed-term contracts have been instrumental in job creation and have made the workforce more flexible and adaptable to changing economic conditions, they have also led to a high degree of labour market segmentation between temporary and permanent workers. Too high a rate of use of fixed-term contracts reduces geographical mobility and has negative effects on human capital since these temporary workers may not receive enough on-the-job training. It might be possible to alleviate this by promoting the use of permanent contracts with lower firing costs, such as those introduced in 1997, and by closer monitoring of fixed-term contracts to ensure that they are not applied beyond the legal purpose of

covering temporary needs. Finally, unemployment disparities across regions could be mitigated if wage-setting institutions better reflected regional and other productivity differentials. In this respect, indexation clauses in wage agreements may still be a source of inflation tensions that introduces distortions in the functioning of the labour market and contributes to inflation persistence, especially in the current juncture of relatively high inflation due to external shocks. In this respect, the substitution of indexation by other bargaining mechanisms including a closer link between wage increases and productivity growth would lead to more efficient results.

Despite these imbalances in the structure of employment and unemployment, the labour market performance has been remarkable compared with productivity growth which, as mentioned above, remains problematic. Although a sort of trade-off between employment and productivity seems to exist in Spain and, to a lesser extent, in the euro area, the reason productivity is growing slowly is not because job creation is high but rather because there is not enough capital accumulation or technical progress. The capital stock per person employed grew at similar rates in Spain and in the euro area at 1% per year between 1995 and 2003. This is unsatisfactory because it means that Spain, a low capital-labour-ratio country, is not catching up with the euro area. As a result, the ratio in Spain remains at only 67% that of the euro area, reflecting a relatively high share of labour-intensive activities in Spain, notably tourism and construction.

The euro area is also outpacing Spain in the field of technical progress. Although total factor productivity (TFP) growth has slowed down in both Spain and the euro area since the nineties, the growth rate remains twice as high in the euro area as in Spain (0.3%). Low TFP growth is in part a consequence of a low accumulation of both human capital and knowledge capital. Educational attainment (the percentage of the population aged 20 to 24 having completed at least upper secondary education) is below the euro-area average, and vocational training is also less developed in Spain than in other advanced economies. And at 1% of GDP, R&D and innovation expenditures in Spain are among the lowest in the euro area. Although the tax credit scheme for promoting R&D in Spain is among the most generous in the OECD, the development of innovative projects is held back by the insufficient expansion of risk capital funds. Moreover, the share of both gross value added and per capita expenditure on information and communication technologies is only 75% of the European average.

Spain's particular production structure mirrors its low productivity. Manufacturing is crucial for production and absorption of new technologies, but the share of manufactures in total gross value added in Spain is relatively low compared to other large EU countries. Although a downward trend in the relative weight of low-technology goods has been observed over the last few years, the gap between Spain and the EU in the production of high-technology goods has widened. Furthermore, the relatively low weight of high-tech activities in total

production is not compensated by imports, since the share of high-tech imports in total imports in Spain remains below the EU average.

Closely linked to the productivity slowdown, the traditional comparative advantages enjoyed by Spain, significantly based on low production costs, seem to be fading away. In the past, price-competitiveness advantages were also underpinned by currency devaluations. However, the nominal exchange rate is no longer an adjustment instrument in EMU, and inflation differentials result in losses in competitiveness unless they are offset by productivity differentials. This is not the case of Spain, where low productivity growth, mainly in tradables, coupled with malfunctioning product markets, is contributing to persistent higher inflation. This, combined with the appreciation of the euro in the last few years, is undermining the competitive position of the Spanish economy, not only in goods markets, but also in the tourism industry, where stronger competition from low-cost Mediterranean countries, a decline in price-competitiveness, and a certain obsolescence in tourist facilities in some areas is making it increasingly difficult for the Spanish tourism industry to hold on to its market share.

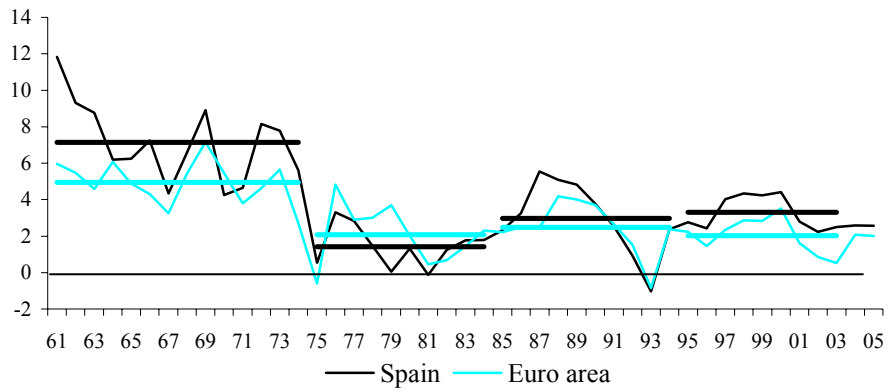
A sustainable improvement of the Spanish international competitiveness requires a radical shift by moving away from the current price-based model to a specialisation pattern based on product differentiation underpinned by higher productivity growth. Nowadays, when a broad consensus on the need to maintain stability-oriented macroeconomic policies has been reached within Spanish society, the productivity goal must be brought to the top of the economic policy agenda in order to promote the necessary structural changes. The adequate policies, many of them spelled out through this Country Study, are well-known, and would lead to a significant, efficient accumulation of physical, human and knowledge capital. Furthermore, this agenda should also look at the institutional setting. Specifically, measures should be taken to improve the functioning of labour, capital and product markets.

Spain in EMU: A virtuous long-lasting cycle?

1. The Spanish economy in EMU. A historical perspective

Since the launching of the euro in 1995, the Spanish economy is apparently immersed in a virtuous cycle in which high GDP growth comes hand in hand with outstanding job creation and relatively low inflation. Between 1995 and 2003, real GDP grew in Spain at an average rate of 3.3% per year, which compares with 2% in the euro area. This is somewhat higher than in the previous cycle, 1985-1994, when the Spanish GDP grew at less than 3% per year (2.5% in the euro area)[1]. Interestingly, the growth differential between 1995-2003 and 1985-1994 actually comes from a radically different performance during the corresponding recessions. Between 2001 and 2003 GDP grew in Spain at almost 2.5% per year, compared with 0.75% between 1992 and 1994 and 0.80% between 1980 and 1982. The growth rates for the euro area as a whole remained at around 1% in the three recessive periods here considered. According to the 2004 Autumn Commission Forecast, the growth differential, although still positive, is expected to narrow to around half a percentage point in 2004 and 2005.

Figure 1: Real GDP growth, 1960-2005



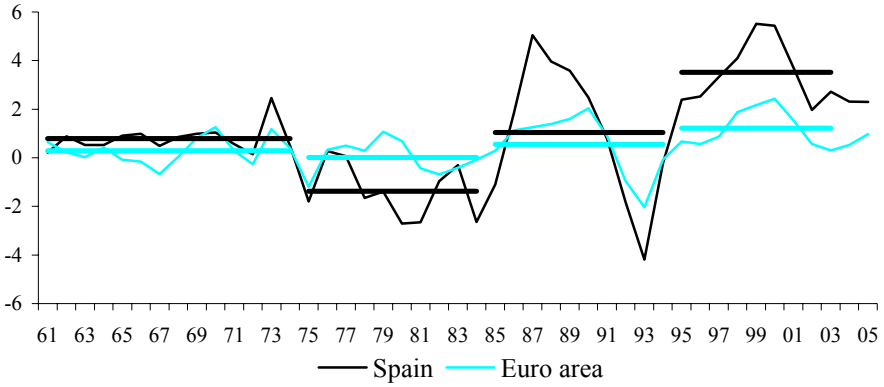
Source: AMECO

Employment also registered a record performance. Between 1995 and 2003, civilian employment, measured in persons grew at an average rate of 2.5% per year in Spain, more than the double of the 1.1% in the euro area. The annual average growth rate over 2001-2003 was 1.9%, compared with a rate of 0.7% in the euro area. This contrasts with the employment performance in the recessions of the eighties and nineties. Jobs were destroyed at rates of 2.1% and 1.6% during

[1] Indeed, these rates are well below the 7% recorded between 1961 and 1964 (5% in the euro area), when Spain was a low-income, fast-growing, catching up economy.

1980-1982 and 1992-1994, respectively. According to the Commission Autumn 2004 forecast, the positive gap of employment growth with the euro area is projected to narrow to one percentage point up to 2005.

Figure 2: Employment growth (LFS) and averages, 1960-2005



Source: AMECO

This Country Study analyses whether this high economic performance of the Spanish economy can be maintained in the medium to long term. The Study identifies the factors underpinning high growth and job creation and assesses the imbalances and risks that might jeopardise the ongoing real convergence with the euro area in the near future. But before, this introductory chapter summarises the salient features of the current cycle within a long-term historical framework.

The rest of the Country Study is structured around two parts. Part I, with two chapters, analyses the behaviour of the components of aggregate demand (chapter 2) and the role played by macroeconomic policies (chapter 3), putting a particular emphasis on the fiscal consolidation process that has taken place in Spain in the recent past. Part II is concerned with supply-side aspects of growth and competitiveness. Here the emphasis is put on the functioning and outcomes of the labour market (chapter 4), while chapter 5 analyses the causes of slow productivity growth. Finally, chapter 6 analyses inflation differentials between Spain and the euro area and assesses their implications for the external competitiveness of the Spanish economy.

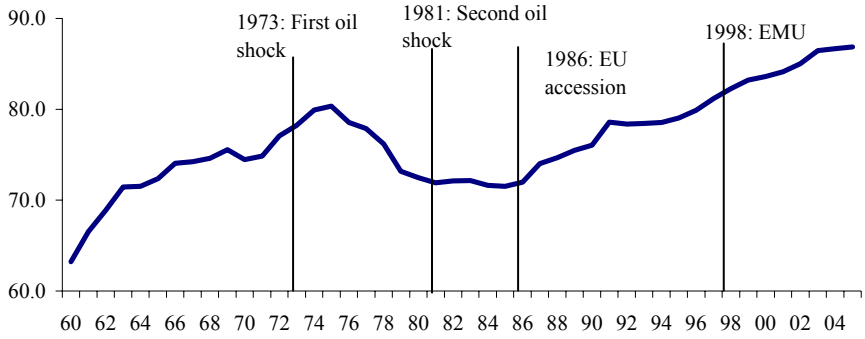
A catching-up economy

Growth and employment performance in Spain has gradually narrowed the per capita GDP gap vis-à-vis the euro area, well beyond the peak reached before the first oil shock, when the Spanish per capita GDP had attained 80% of the euro area average (Figure 3). Nowadays, the figure is above 86%. The outstanding performance recorded between 1960 and 1975 was the fruit of abandoning autarky and acceding to different international organisations in the late 1950s. In

parallel, a new economic policy was implemented, which aimed at integrating the Spanish economy in the international labour division, through less regulated markets and increasing openness. The latter was further enhanced by the 1970 trade agreement with the, at the time, European Economic Community.

This period of sustained economic growth was interrupted in the aftermath of the oil shocks in 1973 and 1981. This is the toll Spain paid for the wrong design of economic policies during the transition to democracy. Since the accession to the EU in 1986, the Spanish per capita GDP recovered gradually to reach again the level of 1975 at around the mid nineties. Against this background, the strong convergence process observed during the last eight to ten years might not have a clear distinguishing feature in historical standards. However, looking at the most recent developments, and the medium-term projections, the performance recorded since 2001 represents a change compared to previous business cycles. While in past recessions convergence slowed down or even reversed, the convergence process has actually accelerated during the last three or four years.

Figure 3: Real GDP per head in PPS (Euro area = 100), 1960-2005



Source: AMECO

Compared with its main European partners, Spain has followed an asymmetric evolution through the business cycles during the latest 30 years. While GDP grew sharply and above the largest EU economies in the upturns, which is a typical feature of an economy immersed in a strong catching-up process, the slowdowns were comparable or even deeper in Spain than in the most advanced of its European partners. For instance (Figure 1), while the GDP growth in Spain in 1981 went to red territory (-0.1%), the rate in the euro area was positive and close to 0.5%. Analogously, in 1993, GDP fell in Spain by 1%, compared to -0.8% in the euro area. However, since the mid 1990s this behaviour seems to have changed. The growth rate recorded in Spain in 2002 (above 2%) was more than double that in the euro area (slightly below 1%). The figures for 2003 indicate that the Spanish economy is growing 5 times faster than in the euro area (almost 2.5% compared with 0.5%). However, according to the Commission Autumn 2004 forecasts, this gap is expected to narrow in the medium term.

All in all, the Spanish economy has been growing much closer to its potential during the last 10 years or so than before. This might in principle be in line with theoretical and empirical findings in the economic literature. Output volatility is negatively correlated with the size of the public sector and with the size of the economy, while trade openness increases the exposure to external shocks and therefore output volatility (Galí, 1994, Fatás and Mihov, 2001 and Martinez-Mongay and Sekkat, 2003)**.** Therefore, in the Spanish case, and in spite of fast trade liberalisation, the simultaneous increase of the size of the economy, as a result of high GDP growth, and of the size of the public sector might be behind lower output volatility. In particular, the Spanish public sector, measured by the ratio of expenditures to GDP, has grown by 20 percentage points over the last 30 years, which, in turn, was driven by real convergence, demographic changes and rising trade openness (Rodrick, 1998, Martinez-Mongay, 2002). Although, all these factors have played an indisputable role in lowering volatility, they do not seem to explain the drastic increase in output stability observed in the late 1990s and early 2000s, when output volatility in Spain was below that of the euro area, a richer, older and more open economy. Beyond such long-trend factors, the structure of the demand, economic policies and, in particular the implementation of structural reforms and stability-oriented policies in Spain, seem to have played a paramount role. Such factors are analysed in different parts of this Country Study. The sustainability of the Spanish growth model from the demand side is analysed in chapter 2, while, for the supply side, chapter 5 looks at productivity developments.

Opening and restructuring

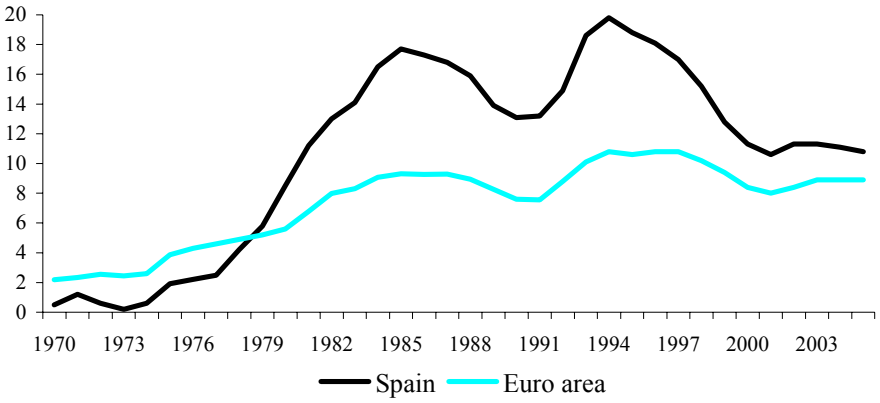
The Spanish accession to the EU in 1986 represented a major regime shift, which is paramount to understand its economic performance up to the present. The economic integration in the EU triggered the degree of openness, still relatively low despite the reforms adopted in the 1960s. Since the accession to the EU the average ratio of total imports and exports to GDP raised gradually by almost 10 percentage points to around 30% in 2003, which is comparable to other EU large economies. Economic integration has also changed the geographic structure of trade. Nearly 70% of the external trade of Spain is now carried out within the EU, which compares with around 50% before the accession. Integration has not only enhanced the commercial links of Spain vis-à-vis the largest EU economies, but also a higher exposure to shocks and spillovers from the EU.

Gradual trade opening accelerated the industrial restructuring initiated at the beginning of the 1980s in the aftermath of the second oil crisis. Restructuring was costly in terms of job losses. The unemployment rate jumped from below 9% at the end of the seventies to above 18% in the mid-eighties, and picked up at 20% in 1994. Unemployment persistence, which has been a distinctive feature of the Spanish economy until recently, was the result of several factors acting in the same direction: a sharp re-composition of the labour force and the productive

structure, which led to a marked decline in employment in the primary sector, as well as massive employment destruction in industrial activities, coupled with rigid labour market institutions, and thus with rising labour costs.

High and persistent unemployment prompted a labour market reform in 1984, which was instrumental to job creation. During the economic boom in the second half of the eighties, the unemployment rate went down to around 16% by 1991. Labour rigidities, which enhanced the persistence of adverse shocks (Dolado and Jimeno, 1997), coupled with the incorporation of the baby boom cohorts and women into the labour market in the late eighties and the early nineties, pushed the unemployment rate above 20% in the 1993 slowdown. Since the second half of the 1990s the unemployment rate fell significantly below 15% to nearly 11% in 2003 (Figure 4). According to the 2004 Autumn Commission Forecast, the unemployment rate in Spain should keep falling, while it is projected to stabilise in the euro area. Moreover, the resilience of employment growth has been particularly impressive during the last ten years. Since 1995, more than 25% of the total net job creation in the euro area was registered in Spain. Such (un)employment performance could point to a major structural change with respect to the past. Both employment performance and labour market reforms are analysed in chapter 4.

Figure 4: Unemployment rate in Spain and the euro-area, 1970-2005



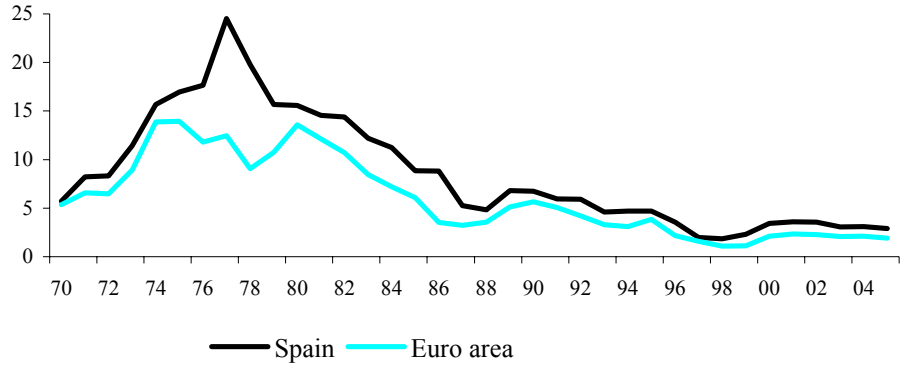
Source: AMECO

Persistent inflationary pressures

The two oil shocks led to double-digit inflation rates, which lasted until the mid eighties. Immediately after the accession to the EU, inflation was around 9% (Figure 5). The disinflation process turned out to be very slow and lacked continuity. Inflation rates situated between 6% and 7% at the end of the 1980s. Indeed, such inflation developments mirrored a lack of wage moderation and distorting labour and product market institutions. Price and wage developments moderated notably since the mid 1990s. As a result, real unit labour costs (RULC)

have been falling since then, in sharp contrast with the period 1987-1993, when they rose in Spain but fell in the euro area. Price-stability oriented monetary policies and wage moderation, underpinned by low import prices, allowed for a steady reduction of inflation rates, which bottomed out in 1998 with Consumer Price Index (CPI) inflation of 1.8%. Since then, the inflation differential between Spain and the euro-area has ranged between 0.5 and 1.5 percentage points. Although lower than in the past, the persistence of the inflation differential between Spain and the euro area may have a negative impact on the competitive position of the Spanish economy. This issue is discussed in chapter 6.

Figure 5: Consumer price developments, 1970-2005 (annual percentage change)



Source: AMECO, INE and New Cronos

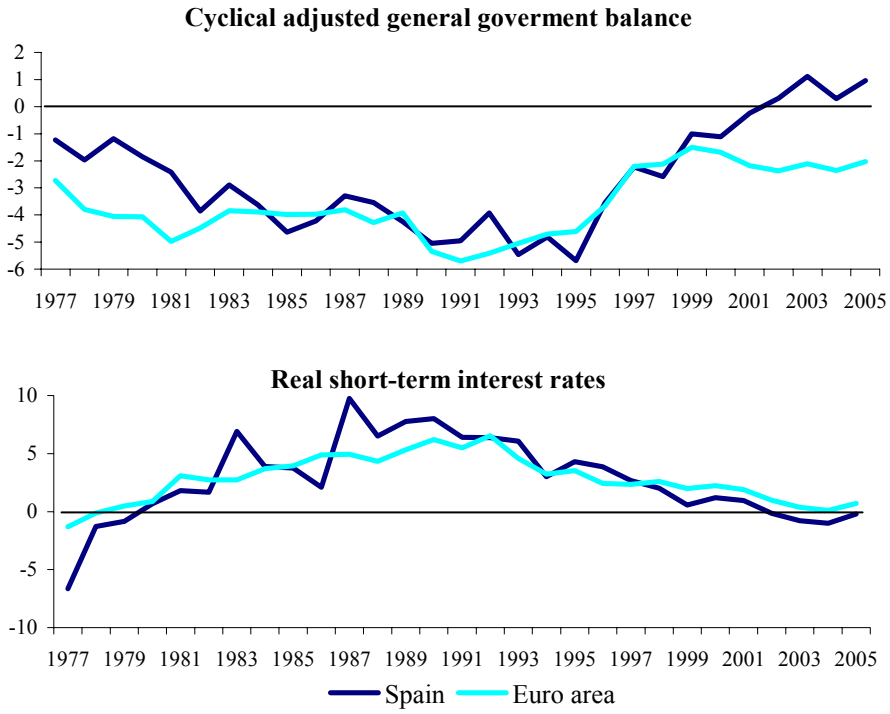
Re-balancing the policy mix

Between the seventies and the early eighties the policy mix was particularly unbalanced. Trying to compensate the effects of the two supply shocks (oil price hikes) on output and employment, fiscal policy was expansive in the seventies and part of the eighties, a policy mistake common to many EU countries at the time. This brought ramping public deficits (Figure 6), and further inflationary pressures. Such expansionary policies had also a more structural nature and tried to respond to social demands for building up the welfare state, little developed in Spain before 1975. Political difficulties to cut expenditures and the need to put in place a modern tax system resulted in a unsuccessful consolidation programme on the eve of the Spanish accession to the EU, where tax reforms aimed at increasing revenues in order to keep deficits under control. Unsurprisingly, the higher tax burden was unable to keep pace with expenditure needs, leading to persistent deficits and debt accumulation, which reached 4.3% and 44.3% of GDP respectively in 1991, on the eve of the recession of the early 1990s, thus unveiling serious sustainability risks (see e.g. De Castro and Hernández de Cos, 2002). This expansive budgetary policy contributed to higher long-term inflation expectations, and widened the current account deficit. As a consequence, macroeconomic

stabilization had to exclusively rely on tight monetary policies, entailing high interest rates between 1983 and 1993 and an over-appreciation of the real exchange rate since 1989, when Spain joined the ERM system until 1992.

The recession of 1992-1993 could only deteriorate further the budgetary position. The nominal deficit jumped to 6.7% of GDP in 1993, and the debt-to-GDP ratio rose to exceed 60%, while the interest burden increased above 5% of GDP, almost one point higher than in previous years. Such fiscal imbalances were the result of a vicious cycle going from deficits to debt levels, then to interest payments, to go back to the deficit again. In 1993, a policy shift put the foundations for a radical consolidation programme. However, such rising deficit path was only reversed after 1995, when it peaked at 6.6% of GDP.

Figure 6: Fiscal stance and real interest rates in Spain and the euro area, 1977-2005



Source: AMECO

The need to fulfil the Maastricht criteria to participate in the euro in 1999 contributed positively to the fiscal consolidation process and a balanced budget in nominal terms was reached in 2002. Unlike in the eighties, the fiscal consolidation carried out in the nineties was based on expenditure restraint, significantly underpinned by falling interest payments brought about by the price stability-oriented common monetary policy. In particular, the budgetary position has improved further during the 2001-2003 recession. This departs significantly from previous recessions as well as from the path followed by several euro area

members, notable the largest ones in the early 2000s. Furthermore, the slightly tight fiscal stance is not foreseen to change significantly in the near future, while the loose monetary conditions are expected to remain. The role played by macroeconomic policies is the focus of chapter 3.

Part I: Overall macroeconomic performance and economic policies

The growth differential between Spain and the euro area has been steadily widening and reached 2 percentage points in 2003. Moreover, in sharp contrast with previous downturns, the slowdown starting in 2001 was much milder and shorter in Spain than in the largest economies of the euro area. Higher growth has largely relied on buoyant domestic demand, whereas the contribution of the external sector to GDP growth has been negative. On the basis of the most recent data available (2004), it appears that such an imbalance is becoming larger and larger. This raises serious concerns on the sustainability of the Spanish growth model in EMU.

Low interest rates brought about by EMU membership coupled with high inflation, have resulted in relatively loose monetary conditions in Spain. Specifically, real interest rates are actually negative for a number of maturities, which has triggered some components of domestic demand, namely investment in dwellings. However, the fiscal stance has been tight. The last decade has been characterised by an unprecedented consolidation process that reverted a deficit of 6.6% of GDP in 1995 to a surplus of 0.4% of GDP in 2003.

This part spells out the most salient features of the Spanish growth model. Special attention is paid in chapter 2 to the imbalances and risks on the demand side that may challenge real convergence. Chapter 3 analyses the extent to which macroeconomic policies help explain high economic performance.

2. Demand and output

High GDP growth and job creation in Spain has been underpinned by domestic demand, in particular consumption, both private and public, and construction. Although equipment investment grew strongly during the second part of the nineties, the 2001-2002 downturn reversed the trend, pushing growth of this category of investment into red territory. More than two years later, the recovery of investment in equipment is still uncertain. The contribution of the external sector to growth has been steadily worsening since the mid-nineties to become negative and attain -2 percentage points in 2004. Moreover, the huge increase in house prices and large household's indebtedness leave households highly exposed to negative shocks.

This chapter analyses the salient features of growth composition from the demand side and identifies main challenges. It appears of paramount importance to pursue efforts aiming at promoting competitiveness in order to restore external imbalances. Furthermore, attention needs to be drawn to the housing market. Specifically, measures should be implemented to contain housing prices and indebtedness in order to soften the landing of the sector and avoid painful adjustments in the future.

2.1. Demand at a glance

The resilience of domestic demand, especially consumption and construction, has been an outstanding characteristic of the Spanish economy since the mid 1990s (Table 1). Leaving aside 1996 and 1997, the external sector has contributed negatively to growth over the whole period. Its contribution has indeed been negative in 2003, and it is also expected to remain so in 2004. This represents a clear departure from past upturns, in which the external sector was the main driving force boosting economic activity. Between 1982 and 1984, the external sector was behind the recovery of activity after the second oil shock, contributing to growth with more than 1 percentage point on average per year, while the contribution of domestic demand was very low or even negative. In the upturn of the early nineties recession (1993-1995), the contribution of the external sector was also positive.

Within domestic demand, the positive contribution of equipment in the nineties contrasts with the important fall observed in 2001 and 2002. In 2003 the growth rate of this item was below a meagre 2% and it still remains relatively sluggish in 2004, suggesting that the recovery prospects are uncertain. In contrast, private consumption and dwellings, which gained momentum rapidly and peaked in 1999, have shown a remarkable dynamism also during the 2001-2002 slowdown, offsetting the poor performance of equipment and exports (see Figure 7).

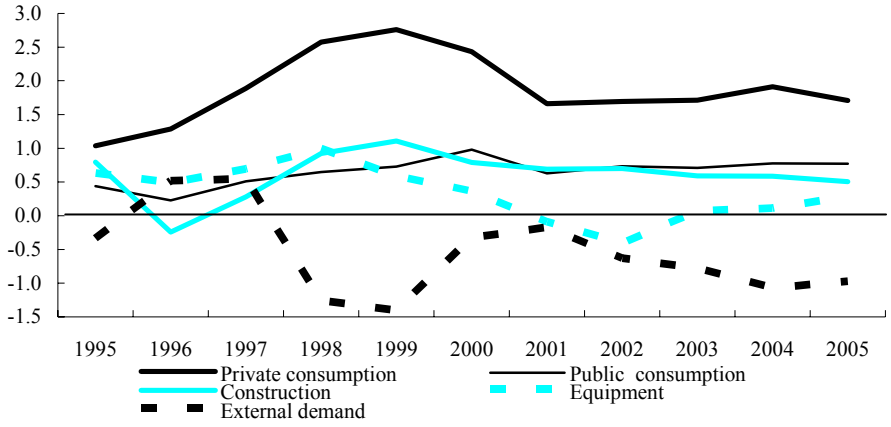
Table 1: Composition of growth in Spain, 1995-2005 (annual percentage change)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Private consumption	1.7	2.2	3.2	4.4	4.7	4.1	2.8	2.9	2.9	3.2	2.8
Public consumption	2.4	1.3	2.9	3.7	4.2	5.6	3.5	4.1	3.9	4.2	4.1
Gross fixed capital formation	7.7	2.1	5.0	10.0	8.8	5.7	3.0	1.7	3.2	3.3	3.7
of which construction	6.6	-1.9	2.3	7.8	9.0	6.2	5.3	5.2	4.3	4.2	3.6
of which equipment	11.3	8.1	10.8	14.5	7.8	4.7	-1.2	-5.4	1.0	1.7	4.2
of which other investment	6.1	6.1	3.3	8.7	10.3	6.1	3.7	3.0	3.0	3.0	3.6
Domestic demand (exc. inv.)	**3.1**	**2.0**	**3.5**	**5.5**	**5.6**	**4.7**	**3.0**	**2.8**	**3.1**	**3.4**	**3.3**
Change in inventories as % of GDP	0.3	0.3	0.3	0.4	0.5	0.4	0.3	0.3	0.4	0.5	0.7
Domestic demand	**3.1**	**1.9**	**3.5**	**5.7**	**5.6**	**4.6**	**2.9**	**2.8**	**3.2**	**3.5**	**3.4**
Exports of goods and services	9.4	10.4	15.3	8.2	7.7	10.1	3.6	1.2	2.6	4.5	5.2
Imports of goods and servicies	11.1	8.0	13.3	13.2	12.6	10.5	3.9	3.1	4.8	7.2	7.3
Gross Domestic Product	**2.8**	**2.4**	**4.0**	**4.3**	**4.2**	**4.4**	**2.8**	**2.2**	**2.5**	**2.6**	**2.6**
							Contributions to GDP growth				
Domestic demand (exc. inv.)	3.1	2.0	3.5	5.4	5.5	4.8	3.0	2.8	3.2	3.5	3.4
Change in inventories	0.0	-0.1	0.0	0.2	0.1	-0.1	-0.1	0.0	0.1	0.1	0.1
External balance	-0.3	0.5	0.6	-1.3	-1.4	-0.3	-0.2	-0.6	-0.8	-1.1	-1.0
Memorandum items:											
GDP Euro area	2.2	1.4	2.3	2.9	2.8	3.5	1.6	0.9	0.5	2.1	2.0

Note: 2004 and 2005 correspond to the 2004 Autumn Commission Forecast.
Source: AMECO

According to the Commission Autumn 2004 Forecast, these trends are expected to continue, leading to an even more unbalanced growth composition. The contribution of domestic demand is projected to strengthen, whereas the contribution of the net external demand would deteriorate further. Within this framework, the relative contribution to GDP growth of the different demand components is analysed in the rest of the chapter.

Figure 7: Domestic demand components (contributions to growth), 1995-2005



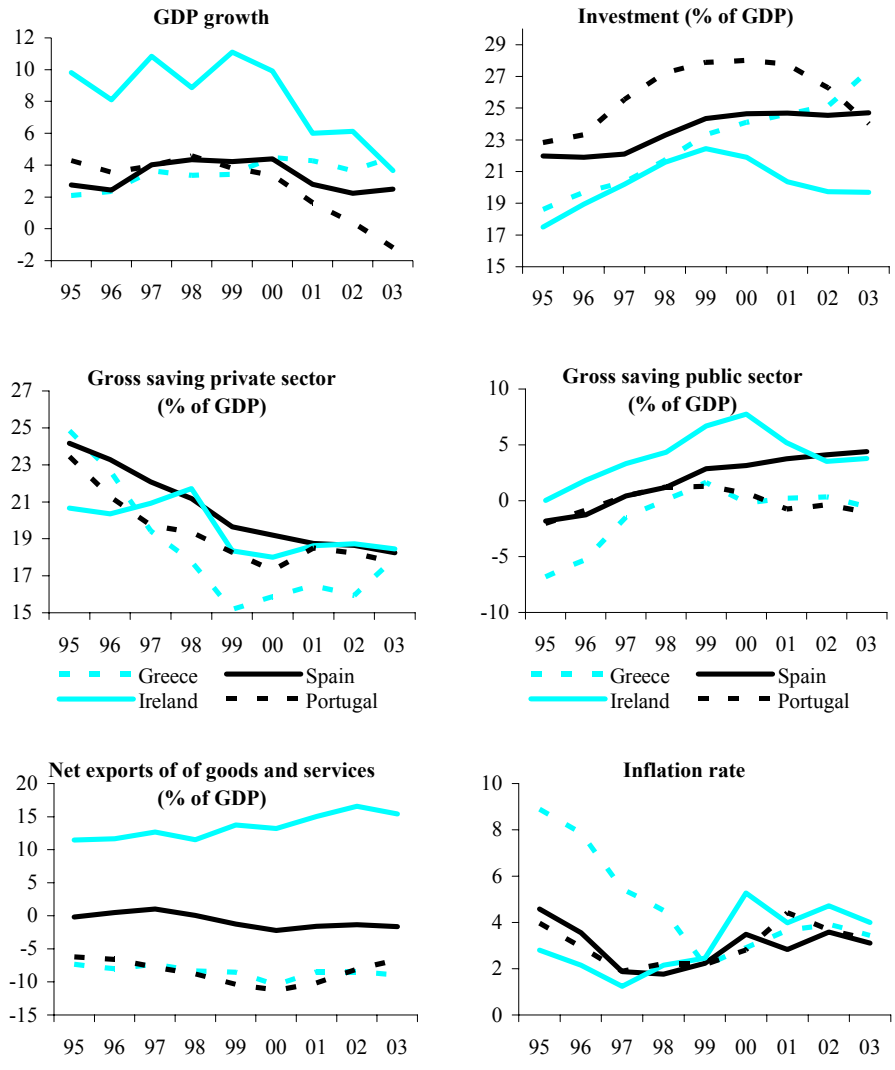
Source: AMECO

Box 1: What do Portugal, Ireland, Greece and Spain have in common?

Overall, similar developments observed in key economic variables in these four are difficult to attribute in full to their common nature of catching-up economies.

Although in the four economies, traditionally known as cohesion countries, average growth has been higher than in the euro area since the mid-nineties, only Ireland grew at rates high enough as to surpass the average income per capita of the EU. During most of the period, Portugal, Greece and Spain grew at comparable rates, but well below those of Ireland. However, after the slowdown of 2001, Portugal entered into a deep recession, while the other three cohesion countries kept growing at more than 3%. A large part of such growth developments can be associated with mirroring developments in the investment ratio.

Economic developments in non-core economies



Source: AMECO

The four peripheral economies are also characterised by high, albeit decreasing, saving ratios, which are converging below 20%, while, ten years ago, private savings were close to 25%. The exception is Ireland, where large FDI inflows largely compensated a lower savings ratio. All in all, it appears that EMU membership has induced positive wealth effects, according to which, agents have considered lower interest rates as a permanent characteristic of their economies. Reflecting the fiscal efforts to qualify for EMU, public savings recorded an unambiguous upwards path until 2000. After the last slowdown only the Spanish and, to a lesser extent, the Irish governments kept improving public balances. In Greece and Portugal, the trend was partially reversed and public savings are now negative. Net exports of goods and services do not show many common features. While high net exports in Ireland are a direct consequence of foreign investments with a clear export vocation, a steady deterioration of the commercial balance is recorded in Spain. In Greece and Portugal, total trade deficits, seem to be permanent and stable at 5%. Therefore, where the external sector is concerned, no clear common paths are detected in the four economies. On the one hand, large FDI flows to export-oriented activities in Ireland have resulted in a very high and almost permanent trade surplus, while in Portugal and Greece capital inflows are financing the deficits in these small and open economies. On the other hand, in Spain, a relatively large economy, and thus less open, increasing trade deficits are meeting more and more difficulties to be financed by the currently diminishing capital inflows.

The EMU effects are evident in the evolution of prices. Falling inflation rates is a characteristic of the first part of the period not only in the four peripheral economies but also in many other Member States. However, in the second part of the period, has and in spite the price-stability oriented monetary policy conducted by the ECB, inflation actually rose in the four cohesion countries. Although higher inflation in peripheral economies is usually associated to their nature of catching-up economies, as shown in the particular case of Spain, higher inflation may not be a result of higher potential growth but of pervasive structural factors.

2.2. Consumption

From a mere 1% in 1995, private consumption grew in real terms by more than 4% per year on average between 1998 and 2000 (peaking at 4.7% in 1999). After decelerating to slightly below 3% between 2001 and 2003, private consumption is expected to keep momentum in the short term. Loose monetary conditions and positive agents' expectations linked to higher macroeconomic stability provided by EMU have supported buoyant private consumption between 1997 and 2000, and contributed to its resilience in 2001 and beyond. Moreover, the personal income tax reforms implemented in 1998 and 2003[2], by reducing tax rates, provided additional stimulus through their positive effect on permanent income. Last but not least, the dynamism of the labour market, coupled with high immigrant flows, which have led employment to grow above 3.5% until 2000, and around 2% on average in the period 2001-2003, are paramount to explain the strength of consumption during the past slowdown.

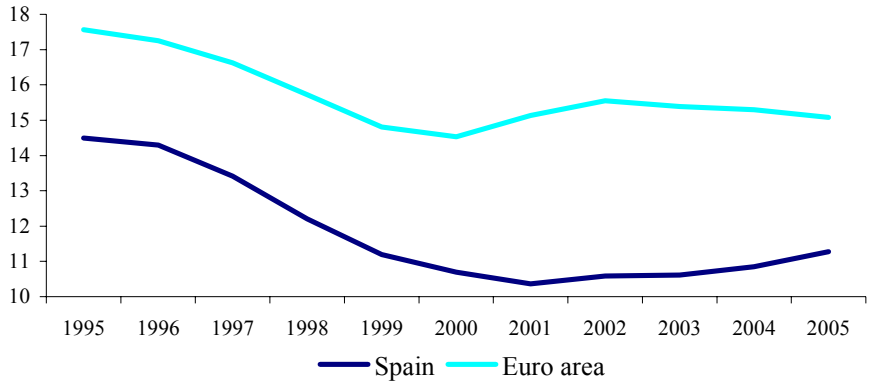
Strong private consumption growth was supported by shrinking savings, which reached historical lows: The households' saving ratio went down below 11% of Gross Disposable Income (GDI) in 2002. This represents a fall of nearly 5 percentage points since 1995. It would seem that the sharp decline in interest rates

[2] Next chapter analyses in detail these tax reforms.

brought about by EMU in the second half of the nineties was perceived by private agents as an increase in permanent income, which boosted borrowing and favoured a rapid increase of indebtedness by households and non-financial corporations. Therefore, a significant part of the reduction of the saving ratio might be permanent because EMU is expected to ensure a sounder macroeconomic framework, with low and stable interest rates, which would reduce the needs for precautionary saving. In this vein, a more stable framework should promote faster growth and higher permanent income, leading to higher present consumption. Accordingly, although the reduction of the households' saving ratio has been a common phenomenon in Europe, the ratio in Spain has not only been lower than in the euro area but the gap has widened since 2000 (see Figure 8). This seems consistent with an increase of the expected permanent income in Spain higher than in the euro area average.

The public sector has also contributed to keep total consumption on a sustained growth path. Public consumption has been growing above GDP since 2000. As a result, its contribution to real GDP growth has been close to one percentage point in some years (Figure 7). As discussed in the next chapter, the expansion of public consumption was more than offset by the buoyant tax proceeds stemming from robust GDP, high employment growth and lower interest burden of government debt, thus leading to a concomitant increase of public saving.

Figure 8: Households' saving ratio (% of gross disposable income)



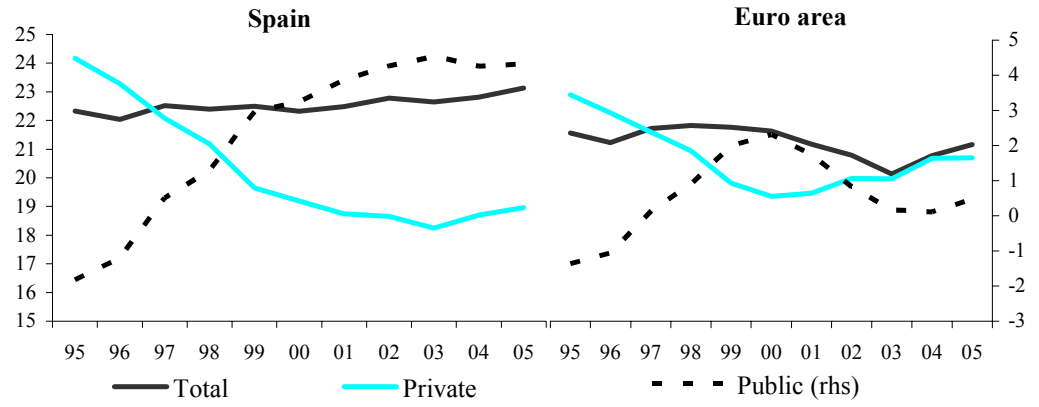
Source: AMECO

The steady fall of the private saving ratio has been offset by growing public saving, leaving the total saving ratio barely changed[3]. This redistribution of national savings in Spain since the mid nineties differs sharply from that observed in most Member States. Growing public deficits in the euro area were only

[3] According to figure 9, the total saving ratio in Spain does not seem to be a matter of concern, but only for the moment. Additional cuts in the private saving ratio would further deteriorate the current account balance, which should be compensated by higher public surpluses. However, this would conflict with other objectives, given the current necessity of structural policies (see Part II).

partially offset by a recovery of private saving (Figure 9), entailing a gradual deterioration of the total saving ratio since 1998.

Figure 9: Private and public saving as percentage of GDP. Spain and the euro area, 1995-2005



Source: AMECO

2.3. Construction and the housing market

Construction activity fell in 1996 by 1.9% in real terms and remained subdued in 1997 to clearly recover in 1998 (Table 1). Since then, this sector seems to be experiencing a sort of golden age, with growth rates close to or well beyond 4%. With contributions to output growth ranging between 0.5 and 1 percentage points, construction is, together with consumption, the main factor behind the resilience of economic activity during the past slowdown (Figure 7). Construction accounts for more than 8% of total gross value added in Spain, which compares with 6% in the euro area. Moreover, between 2000 and 2003, 40% of new housing in the EU was built up in Spain.

Developments in this sector largely depend on public investment in infrastructures, which in turn, are very much determined by the electoral cycle and usually instrumental to facilitate fiscal adjustment in recessions without incurring in significant political costs. Spain, where public works account for nearly 30% of total construction, is not an exception to such rules (see Argimón et. al., 1999). Public investment was to a certain extent behind the relatively poor performance of the construction sector during the early phases of fiscal consolidation in Spain over 1996-1997. However, the roots of the recovery of dwellings from 1998 onwards have to be found in residential construction, rather than in public infrastructure expenditure, the share of which in GDP has remained relative stable since that year.

The spectacular expansion of residential construction has its roots in strong demand. Since 1999, new housing supply has been growing by more than 500,000

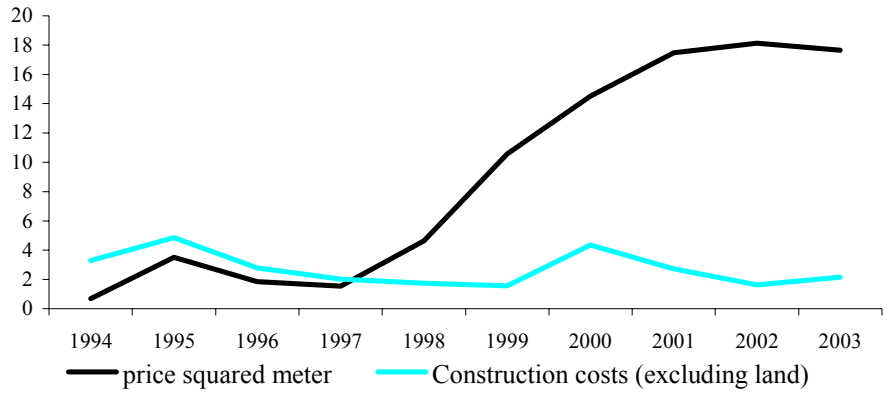
housing starts per year, compared with 250,000 to 300,000 starts in the previous period. Additionally, more than 50% of the recent increase in the housing stock corresponds to first residences.

The dynamism exhibited by housing demand stems from the concurrence of several factors, including historically low interest rates following EMU membership, strong job creation and the sharp increase in female employment, the favourable fiscal treatment of housing acquisition, which contrasts with the scant development of the renting market[4], high migration flows, adding to the baby boom generation participating in the labour market, and the poor performance of the stock-market since 2000 that made of dwellings an attractive investment. In addition, EMU membership has eliminated exchange rate uncertainties, which has boosted acquisitions by foreigners, mainly from the EU (see section 2.5).

As a result, housing prices multiplied by more than 2 since the mid 1990s, much more than construction costs (Figure 10). Households' indebtedness also more than doubled and now represents around 100% of GDI. However, although lower interest rates and longer maturity of mortgages led the financial charge, as a percentage of GDI, to increase only moderately, the current situation is not free of risks. Growing indebtedness leaves households exposed to less favourable economic developments. In particular, unexpected upward interest rate movements may have a sizeable impact on the financial burden of mortgages and thus on consumption through a negative income effect.

However, such upside risks are unlikely to lead to a sharp correction of housing prices since, on the one hand, even if interest rates rise in the short term, they are expected to remain moderate by historical standards, and, on the other hand, the elements sustaining housing demand are not expected to fade away in the near future (Box 2).

Figure 10: Housing prices and construction costs (annual % change)



Source: Ministerio de la Vivienda[5]

[4] García-Montalvo (2003).
[5] http://www.igsap.map.es/cia/agenda/mviv.htm

Box 2: Housing prices in Spain

The evolution of housing prices in Spain has raised concerns on the possible existence of a speculative bubble in the housing market and on the consequences on consumption and financial stability stemming from an abrupt price correction (useful references for housing bubbles are Hendershott, 2000, and Bourassa, 2001). Some international economic institutions (OECD, 2004 and ECB, 2004) and analysts (The Economist, 2004) have warned about the increasing risk of a sudden price adjustment given that current prices would be above equilibrium levels. Empirical research in this respect is, however, not conclusive. Ayuso and Restoy (2003) point out that price-to-rent ratios are at around 20% above the equilibrium values as a result of both supply constraints and demand shocks stemming from interest rate movements and higher labour market participation. Similarly, Balmaseda, San Martín and Sebastián (2002) estimate that housing prices in the period 1999-2002 are 28% overvalued.

On the other hand, Martínez-Pagés and Maza (2003) find that loosening credit constraints and falling nominal interest rates are the key explanatory factors for the boom of housing. They obtain evidence of overvaluation under two alternative models, and conclude that, although a correction in real terms can be expected, it should not be necessarily sharper than in previous episodes. Finally, Béranger (2004) does not find evidence of speculative bubbles but stresses the risks linked to the high households' indebtedness and the likely adverse wealth effects through higher interest rates.

Some structural elements from the supply side seem to be also partially responsible for the developments observed in the housing market (see Martínez Pagés and Maza, 2003). The scarcity of land in some urban areas along with land regulations implemented by local authorities in order to collect revenues from taxation on land may have contributed to boost prices since the mid 1990s. For instance, in Madrid the cost of land as a percentage of final housing prices is above 60% compared to nearly 40% in 1995. In this respect, García Montalvo (2003) stresses that land prices are a consequence of housing prices rather than a cause (land prices are set depending on expected housing prices). Therefore, a greater flexibility of current regulations allowing for higher supply of land can not represent in itself a "miracle" damping down housing price increases.

Consequently, there seems to be some room for public action to lower housing price pressures, without provoking a hard landing in the housing market. Among the proposals put forward by different commentators, three appear particularly interesting: *first*, a more neutral fiscal treatment between housing acquisition and letting[6]; *second*, a better and more flexible regulation of the rental market aiming at ensuring higher protection to owners' rights, and, *third* a greater transparency and flexibility in land regulations, which by enhancing housing supply would also ease price tensions in the medium-term.

Leaving aside the risks associated with imbalances in the housing sector (see Box 2), an excessive development of the housing sector may also have structural implications for the Spanish economy. While investment in infrastructures involves clear positive spillovers on productivity in other sectors, residential

[6] However, tax incentives on housing acquisition cannot be blamed for such increase in housing prices. In fact, these incentives were already in place well before the housing boom started. It would rather seem that the fall of interest rates triggered demand for housing.

construction is unlikely to provide the adequate foundations to maintain growth in the long run. Real convergence and sustainable long-term growth require re-conducting financial resources to other activities with higher impact on productivity growth, for which a recovery of investment in equipment appears essential.

It might be argued that a financial crisis would be one risks associated with an excessive indebtedness. Unfavourable events leading to interest rate rises could bring about difficulties in debt servicing, which, the argument would go on, might result in a deterioration of balance sheets of banks. However, this does not seem a likely outcome in the case of Spain, where financial corporations enjoy a healthy position due to exigent reserve requirements. Nevertheless, credit contention associated with deteriorating balance sheets of financial institutions could affect consumption and investment.

2.4. Equipment

After falling markedly by nearly 20% in 1993, investment in equipment recovered strength in the second half of the 1990s and peaked in 1998, when it grew by 14%. Since then, equipment growth slipped into a decelerating path and became negative in 2001 and 2002, declining by almost 5.5%. In 2003, it grew by 1% pointing to a very limited recovery. As a result, investment in equipment as a percentage of GDP declined from close to 8% in 1999 to below 7% in 2003, which contrasts with the growing share registered by construction in the same period (from around 13% to nearly 14%).

Unlike construction, equipment in Spain follows a cycle in synchrony with that observed in other euro area partners and appears more linked to developments in the external sector rather than to domestic demand conditions (see Figure 11).

Figure 11: Equipment, exports of goods and domestic demand, 1991-2005. (real annual % change)

Source: AMECO

Fluctuations in equipment investment over the cycle are closely related to capacity utilisation and profitability, especially in capital-intensive sectors such as manufacturing. In particular, Spanish companies in the last years have shown healthy profitability sustained by falling financial charges, while unit labour costs have been growing below the GDP deflator. These elements along with a higher capacity utilisation stemming from the current economic recovery should boost investment in equipment, which seems paramount in order to improve the poor developments recorded by labour productivity growth, in particular total factor productivity.

However, such prospects might turn out too optimistic because of the close link between investment in equipment and the exporting manufacturing sector. Specifically, cost competitiveness losses registered in the last decade have resulted in narrowing margins for Spanish manufacturing firms so as to preserve their external market shares. Persistent margin shrinkage may end up by affecting profit rates in manufacturing relative to other less capital intensive sectors. As a matter of fact, price moderation in manufacturing has come hand in hand with growing real unit labour costs, which is in sharp contrast with the continuous drop in RULC for the rest of the economy and departs from euro area trends (see chapter 6 for the details)[7]. In the medium term, these elements might constitute a weak incentive for investment in manufacturing, which is the activity branch more inclined to innovation.

2.5. The external sector

Trade deficits, which have been a constant of the Spanish economy since the end of the autarky, have gained momentum to reach 5-6% of GDP since 1999, and net imports growth has remained buoyant in the slowdown (see Table 2). In contrast, the surpluses recorded by the balance of services, which, mainly through tourist revenues traditionally finances the external balance, have not kept pace. Only during the period 1996-1998 the service surplus made up for the trade deficit.

The primary incomes balance, which basically records the remuneration of foreign capitals, is also negative, as would be expected in a country that has been receiving large foreign capital inflows and has widespread presence of multinational companies. This deficit, historically accounting for around 1% of GDP, seems to be gaining pace in the latest years, although a moderation underpinned by the remuneration of increasing Spanish direct investment abroad should not be excluded in the future.

From a historical perspective, current transfers balance has also contributed to reduce the external deficit, although much less than services. The main source of

[7] While real unit labour costs for manufacturing in Spain grew by 1.1% in the period 1996-2003 (a fall of 0.5% in the euro area), they dropped by 0.5% for the whole economy in the same period (-0.4% in the euro area).

this item was income inflows sent by Spanish emigrant workers. However, since the mid eighties such inflows have been fading out, although compensated by EU funds, notably European Agricultural Guarantee Fund (EAGGF section guarantee). However, in the most recent past, Spain has become a net receptor of immigrants, the financial outflows of whom, along with the progressive reduction of EU funds, are expected to worsen this balance in the coming years.

The resulting current account balance has worsened systematically since 1998, while the capital balance, which is positive and mainly comes from EU capital transfers[8], only amounts to 1% of GDP, clearly insufficient to offset such figures. As a result, the previous net lending position of the Spanish economy has turned into a net borrowing vis-à-vis the rest of the world since 1999.

Table 2: Balance of Payments as % of GDP, 1995-2005

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Exports of goods	16.0	16.8	19.0	19.1	18.8	20.7	20.2	19.5	18.9	18.9	19.1
Imports of goods	19.1	19.5	21.5	22.6	23.8	26.9	25.9	24.6	24.2	24.8	25.5
Trade balance	**-3.1**	**-2.7**	**-2.4**	**-3.6**	**-5.1**	**-6.2**	**-5.7**	**-5.1**	**-5.2**	**-5.9**	**-6.4**
Exports of services	6.6	7.1	7.7	8.2	8.7	9.4	9.7	9.2	8.9	8.6	8.4
Imports of services	3.7	3.9	4.3	4.5	4.9	5.4	5.6	5.4	5.3	5.4	5.6
Services balance	**2.9**	**3.2**	**3.4**	**3.6**	**3.8**	**4.0**	**4.1**	**3.8**	**3.6**	**3.1**	**2.8**
External balance of goods and services	**-0.2**	**0.5**	**1.0**	**0.1**	**-1.3**	**-2.2**	**-1.6**	**-1.3**	**-1.6**	**-2.7**	**-3.6**
Balance of Primary Incomes w/ROW	**-0.2**	**-0.6**	**-0.9**	**-1.2**	**-1.0**	**-1.1**	**-1.5**	**-1.4**	**-1.3**	**-1.1**	**-1.0**
Balance of Current Transfers w/ROW	**0.4**	**0.3**	**0.2**	**0.2**	**0.2**	**0.0**	**-0.0**	**0.0**	**-0.3**	**-0.3**	**-0.3**
Balance of current transactions w/ROW	**-0.0**	**0.1**	**0.4**	**-0.9**	**-2.1**	**-3.3**	**-3.1**	**-2.7**	**-3.3**	**-4.2**	**-4.8**
Balance of capital transactions w/ROW	**1.0**	**1.1**	**1.1**	**1.1**	**1.1**	**0.9**	**0.9**	**1.1**	**1.2**	**1.2**	**1.2**
Net Lending (+)/ Net Borrowing of the Economy	**1.0**	**1.2**	**1.5**	**0.2**	**-1.0**	**-2.5**	**-2.2**	**-1.6**	**-2.1**	**-2.9**	**-3.6**

Note: 2004 and 2005 correspond to the 2004 Autumn Commission Forecast.
Source: AMECO

Although recent past figures of the external balance are not exceptional by historical standards, the current net borrowing position of the Spanish economy is especially worrisome because some of the instruments traditionally applied to compensating imbalances are not available now, whereas the net borrowing bias remains chronicle.

Adjustment policies based on imports cuts through tariff protection are excluded. Additionally, recourse to the exchange rate to compensate for competitiveness losses is not possible since the rate was fixed after 1999 Spain accession to EMU. Finally, while trade deficits remain of a structural nature, policies should turn to long term reforms, mainly supply side oriented (see Chapter 5 and 6), without which the external sector may face tensions that might eventually translate into price moderation and unemployment.

Since accession to the EU, red numbers were financed by foreign direct investment flows (FDI henceforth), which attained 2% of GDP in the early nineties and accounted for almost 9% of the total gross fixed capital formation.

[8] Mainly European Agricultural Guidance and Guarantee Fund (EAGGF section guidance) and Fund for Regional Development (FRD).

Before 1986, FDI inflows represented on average only 0.5 percentage points of GDP (Fernández-Otheo, 2003). All in all, FDI flows in the second half of the eighties might have been partly responsible for the 7 point increase in the investment ratio observed in that period[9].

Interestingly, the traditional net recipient position of Spain in relation to FDI has reverted since 1997. This has been caused by the growing presence of Spanish companies overseas, which largely concentrate on a few sectors and big companies, namely energy, telecommunications and banking, whose final destination is Latin America. This implies a high exposure of Spanish investment abroad to both sectoral and country-specific shocks.

Although from 1997 to 2000 FDI inflows grew sharply, 2003 registered a fall of € 16.5 billion. This fall was worldwide spread, and Spain was relatively less affected than other economies[10]. However, a growing share of FDI inflows is allocated to real estate (32% in 2003) as opposed to more productive and productivity-enhancing activities. Moreover, investment inflows in sectors with high technological content represented in the late 1990s and the early 2000s only at around 10% of total FDI (see Muñoz Guarasa, 2002).

Some other factors risk further worsening the external position of Spain. Specifically, the fading away of EU funds[11] by 2006, as well as a potential moderation of revenues from tourism (see Chapter 6) might imply growing difficulties in order to finance external deficits.

[9] Although the establishment of new companies has also implied additional investment projects, FDI flows cannot be fully assimilated to gross fixed capital formation since a part of them can merely consist of equity purchases.
[10] Actually in 2003 Spain jumped from the eight to the sixth position as FDI receptor.
[11] Overall, net transfers from EU represent around 1.2% of GDP per year (see next chapter).

3. Macroeconomic policies

This chapter assesses the role played by macroeconomic policies in the broadening of the growth differential of Spain vis-à-vis the euro area. A first element to be considered refers to the monetary policy stance. A second element deals with the process of fiscal consolidation registered in Spain and the extent to which fiscal retrenchment had a positive impact on activity. In particular, it seems relevant to review fiscal consolidation in Spain since 1996, and to assess the role played by tax reforms and budgetary institutions. Under a long-term perspective, sustainability issues are also considered.

The main feature of the period 1996-2003 is the achievement of a successful fiscal consolidation process, which translated into a drastic reduction of the debt ratio. During these years, no evidence of a marked growth contraction brought by the fiscal retrenchment can be identified. Although non-fiscal factors, especially monetary conditions, have also played an important role, positive effects on economic activity stemming from the fiscal consolidation should not be disregarded. In this respect, by helping ensure the sustainability of public finances, fiscal consolidation in Spain might have improved long-run growth prospects.

Moreover, the 1998 and 2000 tax reforms may have also contributed positively to growth and employment without jeopardising fiscal consolidation. In addition, strong economic activity coupled with buoyant job creation would have led to a much lower than expected loss of revenues.

As regards budgetary institutions, the rules and procedures set in the current GLBS are tighter than the requirements of the Stability and Growth Pact and ensure fiscal discipline at all levels of government. By taking a longer perspective, and in order to maintain sound fiscal finances, spending ceilings may be needed to avoid future tax increases, in particular in the light of the budgetary costs associated to ageing. In this context, given the relatively high decentralisation of the budget process in Spain, the reform of the General Law of Budgetary Stability, unless rigorously applied over the cycle, might lead to a looser spending control and higher deficits, mainly at the regional level.

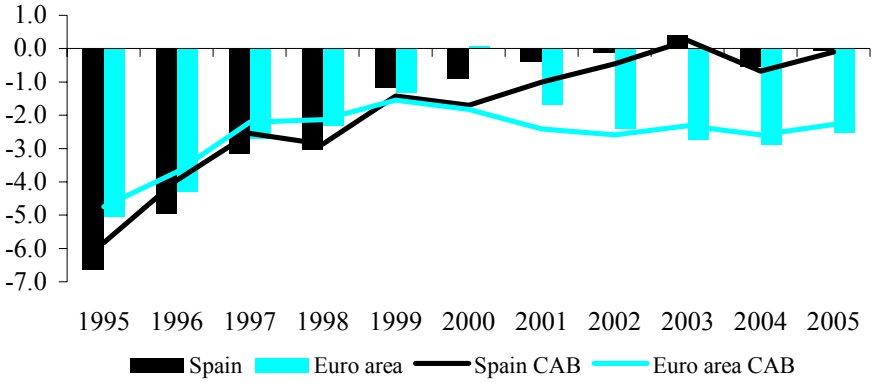
Given the uncertainty over future demographic trends and the effects of productivity growth on the average pension benefit, the possibility of large fiscal imbalances stemming from pension expenditure over the next decades cannot be ruled out. The measures adopted so far in order to increase labour market participation, to reduce public debt, and to build up a reserve fund should be complemented with a reform of the key parameters of the pension system, such as the number of contributory years, the retirement age and the replacement ratio.

3.1. A tale of a successful consolidation?

Fiscal consolidation has left behind the age of high deficits and debt accumulation in Spain. Partly fostered by the need to fulfil the Maastricht criteria[12] to join EMU in 1998, the public deficit, which had peaked to 6.6% of GDP in 1995, began shrinking gradually from 1996 onwards to almost reach a balanced budget in 2002 (-0.1% of GDP) and to register a surplus of 0.4% the year after (Figure 12).

According to the changes recorded by the cyclically-adjusted balance (CAB), the deficit reduction has been to a large extent discretionary (Figure 12). While fiscal tightening was a common feature in most euro area countries until 1999, in Spain the process was slightly more acute. Moreover, as from 2001 the CABs clearly display very different policy stances in Spain and the euro area. Actually, the consolidation process was reverted in the latter when recession showed up: expenditures rebounded (Figure 13) and revenues accelerated their declining path. According to Commission Autumn 2004 forecasts, Spain will record a transitory deterioration of the general government balances in 2004, mainly due to the effects of some statistical reclassifications, whereas the situation is not foreseen to improve in the euro area.

Figure 12: General Government balance (as % of GDP), 1995-2005



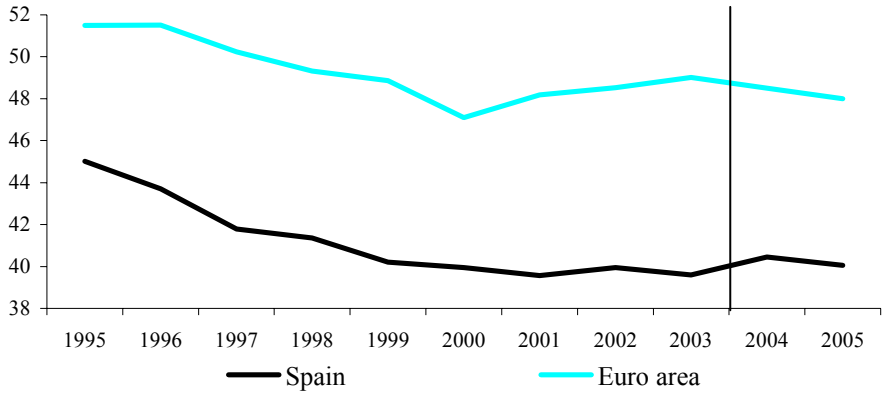
Source: AMECO

Where the composition of the adjustment is concerned, consolidation was mainly based on spending retrenchment, although revenues also grew with respect to GDP. Between 1995 and 2003 the share of government expenditures in GDP fell by around 5.4 percentage points, while the share of revenues increased by 1.6 percentage points. In spite of such a combination of higher revenues and lower spending, fiscal consolidation in Spain does not appear to follow a switching strategy'. One main characteristic of such switching strategies is that revenues are

[12] The Maastricht criteria were set on a ESA-79 basis. The figures provided in this chapter correspond to the ESA-95 methodology.

raised in the first place and, then, spending is cut (European Commission, 2000)[13]. However, the bulk of the adjustment in Spain took place on the expenditure side, while some taxes were actually cut and tax revenues largely increased through the automatic stabilising effects of high growth.

Figure 13: Total public expenditure (as % of GDP), 1995-2005



Source: AMECO

Regarding **expenditures**, two different periods can be distinguished (Table 3). Between 1995 and 1999 total expenditures fell by 4.8 percentage points of GDP. The bulk of this reduction was almost equally shared by interest payments (1.7 p.p.), social benefits (1.5 p.p.) and capital expenditure (1.4 p.p.). While the progressive rein on inflation allowed for a steady fall in interest rates, which, in turn, lowered the debt burden, the acceleration of economic activity and a higher job content of growth alleviated the pressure on social benefits. In parallel, total capital expenditure fell from 6.2% in 1995 to 4.8% of GDP in 1999. The burden of this adjustment in the second half of the nineties mainly fell on capital transfers (1.4% of GDP), while public investment was lowered by only 0.4 percentage points of GDP, from 3.7% in 1995 to 3.4% in 1999.

Between 2000 and 2003, total expenditures were only reduced by half a point of GDP. Although interest payments, driven by lower interest rates and debt stock, followed the previous downward path, no other spending item recorded a significant reduction, while government final consumption gained momentum to reach in 2003 the weight recorded previously in 1996 (17.9 percentage points). As a matter of fact, from 2000 onwards the fiscal adjustment in Spain faded out due to the so-called "Maastricht fatigue" that was also suffered, albeit with different intensity, by most of the European economies (see González-Páramo, 2001).

[13] See also Buti, et al. (1998). In addition, von Hagen et al. (2001) point out that switching strategies are due to the ineffectiveness of revenue-based adjustments to achieve successful consolidations (see box 2).

Table 3: General government accounts (% of GDP), 1995-2005

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Average 95-99	Average 00-03
INDIRECT TAXES	10.2	10.2	10.5	11.1	11.7	11.7	11.4	11.6	12.0	12.0	12.2	10.7	11.7
DIRECT TAXES	10.1	10.3	10.5	10.2	10.2	10.5	10.4	10.9	10.6	10.5	10.5	10.3	10.6
Of which paid by households	8.2	8.2	7.7	7.5	7.1	7.2	7.3	7.4	7.1	7.0	7.0	7.7	7.2
SOCIAL CONTRIBUTIONS	13.0	13.2	13.1	13.0	13.1	13.3	13.5	13.5	13.7	13.7	13.7	13.1	13.5
OTHER CURRENT RESOURCES	4.1	4.2	4.0	3.7	3.6	3.4	3.6	3.4	3.3	3.3	3.2	3.9	3.4
(1) TOTAL CURRENT RESOURCES	**37.4**	**37.8**	**38.0**	**38.0**	**38.6**	**38.8**	**38.9**	**39.4**	**39.6**	**39.5**	**39.6**	**38.0**	**39.2**
TOTAL CAPITAL RESOURCES	1.4	1.4	1.0	0.6	0.7	0.6	0.6	0.7	0.8	0.8	0.8	1.0	0.7
TOTAL RESOURCES	**38.4**	**38.8**	**38.6**	**38.3**	**39.0**	**39.1**	**39.2**	**39.8**	**40.0**	**39.9**	**40.0**	**38.6**	**39.5**
SUBSIDIES	1.1	1.0	0.9	1.1	1.2	1.2	1.1	1.2	1.2	1.3	1.3	1.1	1.2
SOCIAL BENEFITS	13.9	13.8	13.3	12.8	12.4	12.3	12.2	12.3	12.2	12.3	12.3	13.2	12.2
INTEREST PAYMENTS	5.2	5.3	4.8	4.3	3.5	3.3	3.1	2.8	2.5	2.3	2.1	4.6	3.0
GOVERNMENT FINAL CONSUMPTION	18.1	17.9	17.5	17.5	17.4	17.7	17.6	17.7	17.9	18.0	18.1	17.7	17.7
OTHER CURRENT EXPENDITURE	0.9	1.0	1.1	1.2	1.2	1.2	1.2	1.3	1.4	1.5	1.6	1.1	1.2
(2) TOTAL CURRENT EXPENDITURE	**39.2**	**39.1**	**37.6**	**36.8**	**35.8**	**35.7**	**35.2**	**35.3**	**35.2**	**35.4**	**35.4**	**37.7**	**35.3**
GROSS FIXED CAPITAL FORMATION	3.7	3.1	3.1	3.3	3.4	3.1	3.3	3.5	3.5	3.6	3.5	3.3	3.3
TOTAL CAPITAL EXPENDITURE	6.2	5.1	4.6	4.9	4.8	4.6	4.8	5.0	4.8	5.5	5.0	5.1	4.8
TOTAL EXPENDITURE	**45.0**	**43.7**	**41.8**	**41.4**	**40.2**	**40.0**	**39.6**	**39.9**	**39.6**	**40.4**	**40.1**	**42.4**	**39.8**
GROSS SAVING (1-2)	-1.8	-1.2	0.4	1.2	2.9	3.1	3.7	4.1	4.4	4.1	4.2	0.3	3.8
PRIMARY BALANCE	-1.4	0.4	1.6	1.2	2.4	2.4	2.8	2.7	2.9	1.7	2.1	0.8	2.7
NET CAPITAL EXPENDITURE	4.8	3.7	3.6	4.2	4.0	4.0	4.1	4.3	4.0	4.7	4.2	4.1	4.1
NET LENDING (+) OR NET BORROWING (-)	**-6.6**	**-5.0**	**-3.2**	**-3.0**	**-1.2**	**-0.9**	**-0.4**	**-0.1**	**0.4**	**-0.5**	**-0.1**	**-3.8**	**-0.3**
Net Lending(+) or Net Borrowing (-) before RTVE reclassification						-0.8	-0.3	0.0					
Tax Burden	33.4	33.8	34.2	34.5	35.1	35.6	35.4	36.1	36.3	36.1	36.2	34.2	35.8
GENERAL GOVERNMENT GROSS DEBT	**63.9**	**68.1**	**66.6**	**64.6**	**63.1**	**61.1**	**57.5**	**54.4**	**50.7**	**48.2**	**45.5**	**65.3**	**55.9**

(f) Forecast

Source: IGAE

In contrast, total **revenues** have been steadily increasing since 1995, when they were at 38.4% of GDP, to reach 40% in 2003. While capital revenues fell by 0.6 % of GDP, current receipts jumped by 2.2 percentage points, from 37.4% in 1995 to 39.6% in 2003. The bulk of this increase is attributable to higher indirect taxes (by 1.8 percentage points), particularly VAT, as well as to higher revenues from social contributions (0.7% of GDP). Such additional revenues partially financed the reform of the personal income tax, which lowered direct taxes paid by households by 1% of GDP.

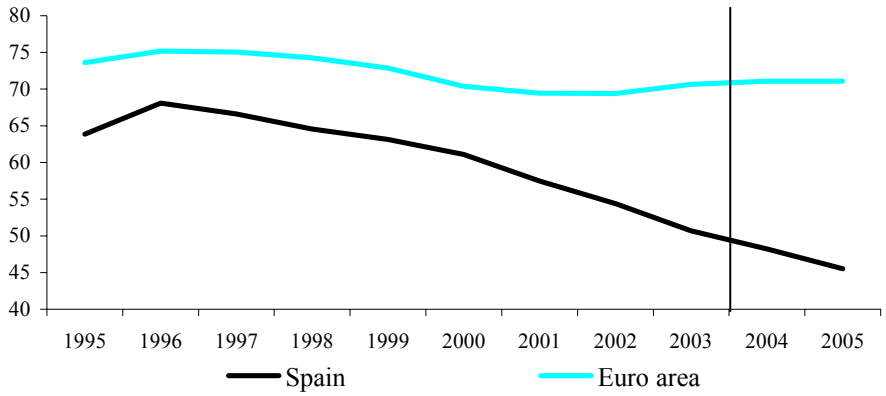
Box 3: Factors conditioning the success of budgetary retrenchments

There has been a fruitful debate in the literature on the factors conditioning the success of fiscal consolidation programmes. Firstly, the size of the adjustment is a question of major importance. If a sizeable consolidation effort is made, it may avoid the necessity of even more painful adjustments in the future, which translates into higher permanent income because consumers anticipate lower taxes. In addition, fiscal consolidations, by reducing risk premia, lead to lower interest rates and higher wealth. These factors, coupled with higher credibility of fiscal policy, help boost consumption. Thus, if initial imbalances are sizeable and public finances are unsustainable, the larger the adjustment to bring public finances back to a sustainable path, the larger the benefits derived from the adjustment. These positive effects might even offset the direct contractionary impact of the fiscal retrenchment, giving rise to the appearance of the so-called "non-Keynesian" effects of fiscal policy (see, for instance, Alesina and Perotti, 1995, Giavazzi and Pagano, 1996, Alesina et al., 1999, Giavazzi, Jappelli and Pagano, 2000, or Von Hagen et al., 2001. De Castro, 2003a, 2003b, offers some empirical evidence for Spain). Moreover, Alesina and Ardagna (1998) and Perotti (1999) find such effects on growth are more likely to occur in countries and periods where debt ratios are high.

On the other hand, fiscal consolidations are considered to enjoy a higher probability of success and entail more beneficial effects provided they are expenditure-based, mainly if they rely on current transfers and public wage expenditures. Accordingly, cuts in wage expenditure could ease wage pressure in the private sector, increasing the profitability of investment and the positive response of GDP (Alesina et al., 1999 and Alesina and Ardagna, 1998, among others).

The consolidation process had a positive effect on primary balances and on debt reduction. While primary balances had been in the red up to 1995, the trend was reversed in 1996 when the **nominal deficit** (5.0%) fell below interest payments (at 5.3% of GDP). Since then, primary surpluses have steadily increased to reach figures close to 3% between 2001 and 2003. Consequently, between 1996, when the debt ratio peaked at 68%, and 2003 gross debt has fallen by more than 17 percentage points of GDP to attain 50.7% of GDP (see Figure 14). According to the Commission Autumn 2004 forecast, the debt ratio is projected to further fall to around 45% in 2005.

Figure 14: General government debt ratio in Spain and the euro-area, 1995-2005



Source: AMECO

Albeit significant, the contribution of the primary balance to the debt ratio reduction has been outpaced by that of nominal growth even during the recent slowdown (see box 4), when the GDP deflator peaked above 4% (see table 4). In parallel, the contribution of interest payments to the stock of debt has followed a decreasing path since 1995.

Table 4: Decomposition of changes in the public debt ratio (as % of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Level of government debt	**68.1**	**66.6**	**64.6**	**63.1**	**61.1**	**57.5**	**54.4**	**50.7**
Change in government debt ratio:	4.2	-1.5	-2.0	-1.4	-2.0	-3.6	-3.1	-3.7
• Contribution of primary balance	-0.4	-1.6	-1.2	-2.4	-2.4	-2.8	-2.8	-2.9
• GDP growth contribution	-3.6	-4.1	-4.3	-4.3	-4.7	-4.1	-3.7	-3.4
• Contribution of interest payments	5.3	4.8	4.3	3.5	3.3	3.1	2.8	2.5
• Stock-flow adjustment (residual)	2.9	-0.6	-0.8	1.7	1.7	0.0	0.6	0.0
Pro Memoria: official figures before RTVE reclassification								
Level of government debt					60.5	56.8	53.8	
Stock-flow adjustment (residual)					1.2	0.0	0.6	

Note:The decomposition of changes in the gross debt ratio is based on the following equation for the budget constraint:

$$\frac{Dt}{Yt} - \frac{Dt-1}{Yt-1} = \frac{PDt}{Yt} + \frac{Dt-1}{Yt-1} \bullet \frac{i-yt}{1+yt} + \frac{SEt}{Yt}$$

with: D_t = government debt; PD_t = primary deficit; Y_t = GDP at current prices; y_t = nominal GDP growth rate; i = implicit interest rate; SF_t = "stock-flow adjustment".

Box 4: Fiscal targets and overestimated growth. Spain 2001-2003

One feature of the fiscal consolidation process in Spain has drawn analysts' attention: while real output growth has been in the most recent years worse than official forecasts, the fiscal targets have generally been overachieved.

The main causes behind such an apparent contradiction are the following:

- Lower real GDP growth was accompanied by higher inflation, which pushed nominal GDP up. This implied higher nominal revenues since no tariff updates were carried out.
- Employment growth remained strong and no large deviations from official forecasts were registered. This contributed to the growth of the tax base and resulted in healthy revenue growth.
- Strong domestic demand helped sustain indirect tax collection.
- An excessively prudent budgetary objective setting. As indicated in the Council opinion on the assessment of the Updated Stability Programme, Spanish authorities could have set more ambitious fiscal targets (see Official Journal of the European Union, 2004).

For exposition purposes the table below shows the differences in GDP growth rates between actual and forecast in the corresponding budget laws:

	1998	1999	2000	2001	2002	2003
Real GDP	0.9	0.4	0.5	-0.8	-0.9	-0.6
Nominal GDP	1.1	1.1	2.0	1.2	0.7	0.9

The reduction of the debt ratio has gone on steadily throughout the period despite financial operations reflected in positive stock-flow adjustments for some years, especially in 1999, 2000 and 2002. Part of such adjustments is capital injections from the general government sector to State-owned entities to finance investment projects. The most important agencies receiving capital injections were:

i) "*GIF*" (Gestor de Infraestructuras Ferroviarias), for investments in high-speed railway network. Capital injections received by the GIF amounted to around € 601M, € 901M, € 1202M and € 1268M from 2000 to 2003 respectively (between 0.10% and 0.17% of GDP).

ii) "*Sociedades de Aguas*", to cope with the necessities of water supply (less than 0.1% of GDP).

iii) Reclassification of the unit RTVE (Radio Televisión Española) from the sector "non-financial corporations" to the General government sector, which added around 0.7 p.p. to the debt ratio in 2000 (see *Pro Memoria: official figures before RTVE reclassification* in Table 3). Part of this increase, around 0.5 p.p. of GDP, is

due to RTVE cumulated debt, which led to an equivalent increase in the stock-flow adjustment[14].

Moreover, for 2004 an historical debt of € 2.5 billion (0.3%) of the central government with Andalusia will be recognised. Such debt stems from the liquidation of the financial system for regional governments in the period 1997-2001. Furthermore, the government has recently announced its intention to assume the cumulated debt of the Spanish Railway network corporation (RENFE) already in 2004. Such debt amounts to € 7.3 bn., of which € 3.659 bn. (0.47% of GDP) correspond to the historical debt and will affect the deficit through capital transfers and € 1.8 bn (0.23% of GDP) correspond to the acquisition of RENFE's infrastructure, which increases the deficit through gross fixed capital formation. The rest of the debt (€ 1.659 bn or 0.21% of GDP) corresponds to acquisition by the new operator company of RENFE's assets, with no impact on the public deficit. These changes do not affect either the deficit of previous years.

To sum up, fiscal consolidation has been supported by healthy growth rates and buoyant job creation, especially in the late nineties. In parallel, the sharp fall of interest rates reduced the financial charges and helped sustain the decline of expenditures in terms of GDP. Expenditure restraint, although sharper at the beginning of the period, went on even during the 2001-2002 downturn. The same factors, high growth and job creation, coupled with the increase of some indirect taxes and excise duties allowed for a smooth and steady increase in the revenues-to-GDP ratio, even in spite of the income tax reform carried out in 1998 and 2002.

Within this framework, a couple of issues seem relevant at this stage. First, how we can characterise the fiscal policy stance in Spain and how it has interacted with monetary policies. This is the subject of the next section 3.2. Second, and under a longer term perspective, to what extent the current sound position of the Spanish public finances, including low debt levels, can be ensured in the future. On the one hand, leaving aside the increase in some indirect taxes, the main feature on the revenue side has been the reform of income taxes, which, by reducing distortions, should have positive effects on potential growth. A detailed analysis of this tax reform and its effects is provided in section 3.3. On the other hand, the overall increase recorded by tax receipts has a non-negligible cyclical component. Therefore, expenditure discipline is needed in order to avoid raising taxes in the future. The main features of the Spanish budgetary institutions are analysed in section 3.4. Finally, although the drastic reduction of debt levels should have relatively long-lasting effects on interest payments, while interest rates are not under control of the Spanish authorities, much of the expenditure retrenchment has taken place through automatic stabilisers (social benefits) or through the

[14] It is worth noting that stock-flow adjustment figures not only reflect the effect of "below the line" operations, as was the case of RTVE own debt. It also captures pure financial operations, like debt issues to cover odd cash needs or strategic debt movements in a context of decreasing interest rates, i.e. discretionary debt maturities and interest rates shifts. The latter seems to have been the case during some years of the period considered.

trimming of capital expenditure, thus leaving untouched much of the factors underpinning positive trends of current expenditures. Section 3.5 looks at the long term position of public finances in Spain, paying particular attention to the pension system.

Box 5: The EU transfers: Did EU help?

The EU transfers have contributed to the performance of the Spanish economy since 1986 and, especially, since the mid-nineties. Overall, the positive Spanish balance with the EU averaged 1.1% of GDP in the period 1996-2003 (see table below). This positive balance has enabled Spain to finance its infrastructures, as well as human and knowledge capital. Specifically, the Cohesion and Structural Funds, at around 1.1% of GDP on average, allowed for the implementation of investment and development projects in Objective 1 regions while mitigating substantially their effects on the general government balance.

	1996	1997	1998	1999	2000	2001	2002	2003	Average
EAGGF section Guarantee	4054.6	4605.6	5304.6	5243.0	5498.6	6184.5	5959.7	6485.4	
Cohesion and Structural Funds	6304.8	6376.8	6825.2	7405.0	5114.7	7141.6	8833.0	9037.6	
EAGGF section Guidance		*827.1*	*858.7*	*1271.3*	*297.9*	*619.4*	*645.7*	*810.1*	
ERDF		*3017.5*	*2748.7*	*2732.8*	*2752.2*	*4355.4*	*3964.7*	*4397.3*	
ESF		*1151.6*	*1526.8*	*1869.4*	*756.6*	*1049.0*	*1922.1*	*1738.3*	
Cohesion Fund		*1018.9*	*1064.3*	*942.6*	*1138.1*	*979.5*	*2071.8*	*1724.8*	
Other structural funds		*361.7*	*626.7*	*588.9*	*169.9*	*138.3*	*228.7*	*367.1*	
Internal policies	275.6	294.3	294.7	284.9	287.4	290.2	382.5	319.2	
Total EU expenditure	10635.0	11276.7	12424.5	12932.9	10900.7	13616.3	15175.2	15842.2	
as % of GDP	**2.3**	**2.3**	**2.4**	**2.3**	**1.8**	**2.1**	**2.2**	**2.1**	**2.2**
Spanish Contribution	4547.2	5367.6	5752.4	6231.4	6445.4	6591.5	6551.1	7429.4	
Balance	6087.8	5909.1	6672.1	6701.5	4455.3	7024.8	8624.1	8412.8	
as % of GDP	**1.3**	**1.2**	**1.3**	**1.2**	**0.7**	**1.1**	**1.2**	**1.1**	**1.1**

Source: European Commission

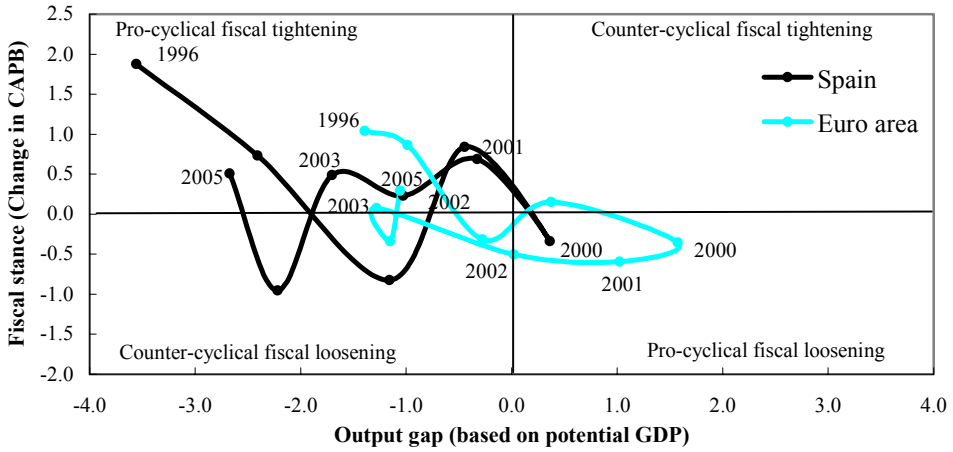
Measures of the effects of the Cohesion and Structural Funds on economic performance vary depending on the methodology employed. Until 2000 they are estimated to have increased GDP by at around 1.2% (ESRI, 2002). Regarding their foreseen impact from 2000 to 2006, Beutel (2002) obtains an average positive increase of GDP of 1.7%, whereas the MOISEES, HERMIN and QUEST II models estimate their impact in 1.0%, 2.1% and 0.6%, respectively. Differences in the estimations stem from the different methodologies employed. Thus, while Beutel (2002) yields estimations based on input-output tables and accounts basically for demand effects, the HERMIN and QUEST II models mainly reflect supply side effects in the long term. In addition, one important difference between the HERMIN and QUEST II models is that the latter allows for some crowding-out, whereas the former excludes this possibility by imposing fixed interest and exchange rates (see European Commission, 2004b, for technical details). In any case, the Cohesion and Structural Funds have contributed to increase Spanish potential growth. No doubt, Spain wins, but it is not the only one. The whole game is of a win-win nature, since Spain has also contributed to final demand in other Member States.

3.2. The policy mix: Enough fiscal tightening?

A pro-cyclical fiscal loosening, coupled with the failure to achieve close-to-balance positions when growth conditions were favourable, has led to growing fiscal imbalances in the euro area in the 2000s (see European Commission, 2003a). This contrasts with the fiscal policy stance in Spain where leaving aside 1998 and 2000 fiscal stance has been tight (see Figure 15). The tightening was pro-cyclical between 2001 and 2003, which allowed Spain to achieve small budget surpluses in a context of negative output gaps. Although the fiscal stance is

expected to transitorily loosen in 2004 (see section 3.1), according to the Commission Autumn 2004 forecasts, a pro-cyclical fiscal tightening is expected to take place in 2005.

Figure 15: The fiscal stance in Spain and the euro area, 1996-2005



Source: AMECO

Monetary policy conducted by the Bank of Spain since the mid-nineties aimed at keeping inflation under control with a view to meeting the Maastricht criteria. The achievement of historically low inflation rates in 1997 enabled Spain to qualify for the adoption of the euro in 1998. In parallel, lower inflation rates allowed for a steady reduction of real interest rates, which resulted in loose monetary policies between 1996 and 1998. Since then, when monetary policy was transferred to the ECB, a single nominal interest rate responding to the euro area average inflation has induced further monetary loosening in Spain, which, due to the positive inflation differential with the rest of the euro area, enjoys easier monetary conditions than other Member States. The only exceptions are 2000 and 2001, when the monetary policy stance in Spain was neutral or slightly tight. No doubt such monetary conditions have supported consumption and facilitated access to credit[15]. In particular, low interest rates have boosted mortgages and helped underpin the boom in the housing market, while contributing to improving balance sheets through lower financial costs. Accordingly, monetary policy has been especially growth-supportive in Spain since the mid-nineties, but most particularly since 1999 (Figure 16).

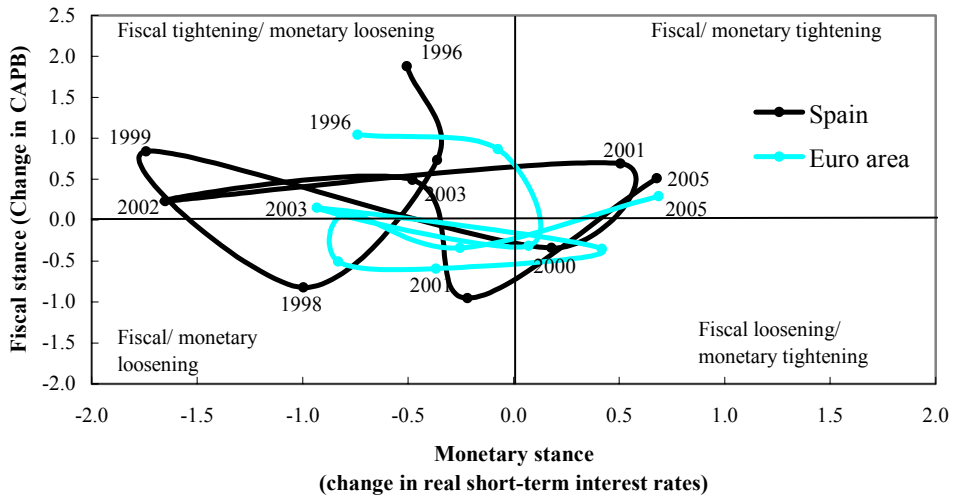
Overall, it is difficult to assess whether the policy mix has been more expansionary in Spain than in the euro area as a whole. For most of the period the monetary stance has been more expansionary in Spain than in the euro area. However, such loose monetary conditions have been accompanied by a much

[15] Domestic credit to corporations, households and non-profit institutions serving households has grown between 14% and 18% on the year in the last three years, whereas total domestic credit to non-financial sectors including the general government has grown by above 10%.

tighter fiscal policy in Spain (see Figure 16). Therefore, the policy mix only seems to provide a very partial explanation of the comparative performance of the Spanish economy since the mid-nineties. According to the Commission Autumn 2004 forecasts, a transitory loosening is expected in 2004, while the policy mix should slightly tighten. In 2005, however, it is foreseen to tighten somehow.

At this passage of the Spanish consolidation tale, natural question emerges: Is there enough fiscal tightening? With credit growing above 15%, coupled with high households' indebtedness and a large and persistent inflation differential, risks seem to be on the downside. With a view to preventing economic imbalances, in particular overheating, from deepening further, fiscal policy should be tightened.

Figure 16: The policy mix in Spain and the euro area, 1996-2005



Source: AMECO

3.3. Consolidating tax-cuts?

In 1998 an in depth reformulation of the personal income tax was implemented. A second amendment, in 2002, was a step further in the same direction. Both steps aimed at simplifying the income tax structure[16] while providing incentives for labour force participation and saving. The main features of these reforms can be summarised as follows:

- The maximum and minimum marginal rates were lowered significantly while the number of tax brackets was considerably reduced (see Table 5). The maximum tax rate fell from 56% to 45% and the number of tax brackets from 16 to 5.

[16] Nevertheless, a lot of amendments for specific cases are introduced every year. This situation creates uncertainty and reveals the complexity of the current tax framework.

Table 5 Personal income tax. Marginal rates and brackets

	1996	1998	2002
Maximum marginal rate	56	48	45
Minimum marginal rate	20	18	15
Number of brackets	16	8	5

- The new income tax code redefined the concept of taxable income by only taxing the remaining income after deducting a tax-free allowance. This is the so-called "exempted minimum living standard" which replaced a vast set of tax-relieves (on health, education expenditure, renting charges etc.) and therefore simplified tax administration[17]. The minimum tax-exempt living standard varies in function of personal and family circumstances.

- In order to boost labour supply the reform introduced a number of targeted tax-relieves: for women at work, disabled workers, as well as for unemployed accepting a job requiring geographical mobility.

- Fiscal advantages are granted to promote the letting house market, which is little developed in Spain and represents a major impediment for labour mobility. However, as shown above, this measure does not seem to have had a noticeable impact on housing prices (see 2.3).

- More favourable fiscal treatment was foreseen for long term savings, especially those associated with the 3rd pillar of the pension system.

- Fiscal rebates on labour incomes were introduced for workers aged above 65, which aimed to postpone on a voluntary basis the effective retirement age beyond the legal age of 65.

The new income tax code has brought about a reduction of households' direct taxation in terms of GDP, which has been offset by an increase of corporate tax receipts and some indirect tax rates and receipts sustained by consumption.

In general, the reform of the personal income tax included a set of positive measures such as incentives to encourage labour participation and improve the functioning of the labour market. Moreover, the new tax scheme also represented a more favourable treatment of savings. Specifically, higher relief thresholds for

[17] The replacement of tax allowances by an exempted living standard minimum has given rise to a discussion on the progressive nature of such a system. A fixed tax-free amount regardless of the income level compared to a system without this fixed tax-free amount with the same rates leads to some disagreements on its effects on tax saving. In general, the former implies that the percentage of tax saving decreases significantly with the income level, but in absolute terms the total amount saved increases along with income level.

private pension contributions favoured long-term savings related to retirement. Furthermore, the reduction of the maximum marginal rates is deemed to have involved positive effects, mainly on labour supply, by reducing the distortionary effects of taxation.

These tax reforms seem to have also contributed positively to growth and employment without jeopardising fiscal consolidation. The official estimates for the loss of revenues were set at 0.6% and 0.3% of GDP for the 1998 and 2002 reforms respectively. However, strong economic activity coupled with buoyant job creation led to a loss of revenues much lower than expected. Such reforms seem to be an example of financed tax cuts enhancing potential growth and job creation (e.g. see European Commission, 2001a, and Leibfritz et al., 1997). Furthermore, neither income brackets nor allowances have been updated with inflation. Therefore, the fiscal drag has contributed significantly to sustain tax collections in a slowdown context. In the 2005 Draft Budget Law the government has updated income brackets with inflation, but only by the targeted rate of 2% (according to the Commission Autumn 2004 forecast, inflation will be at around 3% in 2004). All in all, since tax rebates have not been updated and, according to the Commission Autumn 2004 forecast, inflation will be at around 3% in 2004, less than 1/3 of the total effect of inflation will be offset in 2005.

3.4. Regional budgets and fiscal prudence: Are they compatible?

The progressive assumption of competences by territorial governments has made of Spain one of the most decentralised EU Member States. This process already began in 1978 after the approval of the Constitution and took its latest step in 2002 when a further reform of the financing scheme for regional governments was implemented. In 1978 local and regional entities represented less than 10% of total public expenditures, whereas this percentage reached nearly 46% in 2003 (33% corresponds to regional authorities and 13% to local authorities)[18].

Although this large decentralisation has been so far compatible with the fiscal consolidation process initiated in the mid 90s (Table 6), some concerns were raised on insufficient co-ordination among general government tiers, which might not be ensuring budgetary stability and promote fiscal co-responsibility at all government levels. As a result, the new financing system for regional governments, which included the transfer of greater spending powers to regional authorities, was implemented in 2002 along with the General Law of Budgetary Stability (GLBS). This law established the obligation by all general government levels to register a balanced budget or a surplus (see annex for the details). In this respect, the requirements set up by the GLBS are tighter than those of the Stability and Growth Pact (SGP). However, the government has launched a discussion on the reform of the GLBS. According to it, budgetary stability will be understood in

[18] See Ministerio de Hacienda (2003).

terms of cyclically adjusted balances, in line with the proposals put forward by the Commission in November 2002 to implement the SGP.

Within the current financial system, regional governments can be divided into two groups. The first group comprises regional governments with a "special status", which has historically entitled them to collect taxes and have their own system of general taxation[19] (although the effective tax burden cannot be lower than in the rest of Spain). In turn, these territorial governments have to make transfers to the central government for services provided by the latter, such as for instance defence or foreign affairs. The amount of these transfers is negotiated every five years.

Table 6: General government balance by sub-sectors as a percentage of GDP

	Central Government	Social Security	Regional governments	Local governments	Total
1995	-5.7	-0.3	-0.6	0.0	-6.6
1996	-3.9	-0.4	-0.6	0.0	-5.0
1997	-2.7	-0.2	-0.3	0.0	-3.2
1998	-2.4	-0.3	-0.4	0.0	-3.0
1999	-1.1	0.1	-0.2	0.0	-1.2
2000	-1.0	0.4	-0.5	0.1	-0.9
2001	-0.7	0.8	-0.5	0.0	-0.4
2002	-0.5	0.9	-0.3	-0.1	-0.1
2003	-0.4	1.0	-0.2	-0.1	0.4

Source: INE and IGAE

The second group -i.e. regional governments with the so-called "common status"- has traditionally had lower fiscal autonomy. In order to increase it, a new financing scheme for this second group was approved in 2002. The new system featured the transfer of the health and social services management and, accordingly, an increase of these regions' revenues were granted through a higher participation in the Central Government's tax collection, as well as through the transfer of the management of other taxes. Table 7 summarises the main features of the previous and new system from the revenue side.

Transferred competences have enhanced regional governments' fiscal joint responsibility, as they have strengthened the link between expenditure obligations and revenues at the regional level. At the same time, an inter-territorial "common sufficiency fund" for solidarity was established in order to avoid sharp financial disparities among regions, which might arise from the implementation of the new system. Moreover, with the new financial system, indirect taxation becomes more important than direct taxation as a source of revenue for regional governments (see Table 7). This shift reduces the variability of region's resources to revenues shortfalls, since the indirect tax base is less volatile than the direct one. Nevertheless, with the new system, revenues are overall more sensitive to the

[19] Excluding social security contributions and tariffs.

business cycle because they rely more on taxation than with the old one, in which transfers negotiated every five years were the main resource.

Finally, although the system was meant to be re-assessed every five years, a revision may take place in the near future. Some regional governments have recently asked for a financial reform since they consider that the current system does not provide enough resources for the correct functioning of the public health care system[20]. Moreover, for the three-annual stability programme, which is being discussed in the Parliament in the framework of the GLBS, the central government has allowed for two of the regions to present a fiscal balance in red in 2005, 2006 and 2007. Since an overall regional balanced budget has to be maintained to fulfil the requirements of the current law, this decision also implies that some other regions will have to run a surplus to offset the authorised deficits, which might prove unrealistic. It might actually create incentives for negotiating loose fiscal conditions in a majority of regions, thus leading to aggregate deficits in the regional government accounts (see annex). In this context, a looser interpretation of the requirements of the GLBS would lead to higher pressures on the expenditure side in good times, which would result in persistent structural deficits in the future.

Table 7: Regional government (common status)

<table>
<tr><th colspan="2">Former agreement (1997-2001)</th><th colspan="2">New system (2002-)</th></tr>
<tr><td>Common services</td><td>Indirect taxes and fees, and 15% of personal income tax (PIT), directly imputed to regional budgets.
15% of PIT transferred by the State.
Shares in the State revenues. In the first year, this part is calculated to assure to each regional government a balance between revenues and expenditure.</td><td rowspan="3">Indirect taxes and fees transferred up to now.
33% of PIT
35% of VAT
40% of excise duties on hydrocarbons, tobacco, beer and alcohol.
100% of excise duties on electricity and car registration.
Compensatory transfers (“Fondo de suficiencia”).</td><td rowspan="3">Financing of all services.</td></tr>
<tr><td>Health-care</td><td>Transfers for the whole cost of health-care to the Social Security, which in turn gives the funds to those regional governments with transferred powers in this field.</td></tr>
<tr><td>Social services</td><td>Transfers in the same way as health-care</td></tr>
<tr><td colspan="4">Source: Ministry of Finance (Draft Budget 2002).</td></tr>
</table>

[20] Some of these regional governments have approved an additional tax on petrol to finance the health care system.

3.5 Long-term uncertainties

While the general government sector in Spain shows a comfortable close-to-balance position, the long-term sustainability of public finances remains uncertain and raises concerns due to the expected increase in old-age related expenditure. The future pressure on spending appears particularly high in relation to pension expenditure.

The public pension system in Spain comprises a compulsory contributory insurance scheme operating on a pay-as-you-go basis and a non-contributory scheme paying minimum pensions to people non eligible for the contributory regime.

Contributory pensions are, by far, the most important expenditure item of the social security sub-sector, representing more than 8% of GDP. As for receipts, social contributions are the main financial resource and cover expenditure on contributory benefits. The rest of the receipts, mainly transfers from the State, finances non-contributory benefits.

One important feature of the current public pension system in Spain is that the parameters behind the calculation of pensions are assessed to be more generous than in other OECD countries (OECD, 2000). For instance, in other EU large economies pensions are calculated taking into account earnings over the whole working life and not only the latter part of it, as in Spain, where only the latest 15 years are considered. According to OECD calculations, in the majority of OECD countries the average accrual rate[21] of entitlement varies between 0.5% and 2% compared to 2.9% in Spain.

Despite this generosity, at less than 10% of GDP, total pension expenditure is significantly lower in Spain than in most EU member States (see Figure 17). In addition, the average pension in Spain represented 64% of GDP per capita in 1998 whereas the European average was 75% and, therefore, "the widespread opinion in the Spanish society that pensions are low would appear to be confirmed by cross-country comparisons" (see OECD Economic Surveys, Spain, 2001). Thus, over one-third of pensioners receive only a minimum pension and approximately 50% of pensions for farm-workers, self-employed and domestic employees are covered by a supplement to reach the minimum benefit[22].

The public pensions system shows a healthy financial position and the social-security sub-sector has registered a surplus of around 1% of GDP on a national accounts basis in the latest years. This can be explained mainly by two factors: strong job creation, which increased the receipts from social contributions, and a deceleration of the increase of new pensioners.

[21] The estimated rate of return stemming from contributory payments that entitles for a pension.
[22] In addition, the average retirement pension has exceeded the minimum wage only since 1990.

Figure 17: Total pension expenditure as percentage of GDP (2001)

(1) Occupational pension schemes for private-sector employees with constituted reserves are not included.
Source: EUROSTAT

However, despite this healthy financial situation, according to most of the available pension expenditure projections, released by both individual researches and public institutions, the sustainability of the current public pension system could be threatened by the budgetary impact of ageing population.

In particular, the projection made by the Economic Policy Committee (EPC) working group on ageing (see European Commission, 2001b) foresees a sharp increase in pension expenditure from less than 9% of GDP in 2005 to nearly 17% in 2050 (other projections are included in Table 8).

The limitations of these projections are clear: they are in some cases bound to show highly accentuated profiles and therefore their results need to be interpreted with caution. However, even if the projections presented in table 8 are based on a different methodology and assumptions, all of them foresee a non-negligible budgetary impact on the public pension system in Spain in twenty or twenty five years time.

Indeed, demographic trends are a main determinant of such projections. Although later than most European countries, the Spanish demographic structure will show a sharp increase in the old-age dependency ratio, especially from the second quarter of the current century. This could reduce potential output growth by shrinking labour supply while the effects of ageing on expenditure will be exacerbated by the expected increase in health-care spending related to elderly people.

Table 8: Pension expenditure projections as a percentage of GDP (2000-2050)

	2000	2005	2025	2050	Peak year		Peak-2000	Type of pensions
EPC (2001)								**Total pensions**
Baseline scenario	9.4	8.8	11.0	17.3	2050	17.3	7.9	
Lisbon scenario	9.4	8.9	10.6	16.2	2045	16.2	6.8	
Herce and Alonso (2000)								**Contributory**
Baseline scenario	9.8	8.1	9.9	13.4	2045	13.7	3.9	**pensions**
Jimeno* (2000)								**Contributory**
Baseline scenario	8.9	10.3	14.8	32.0	2050	32.0	23.1	**pensions**
a) retirement age 70	8.9	6.4	7.6	15.1	2050	15.1	6.2	
b) whole working life	8.9	-	12.8	25.2	-	-	-	
c) 75% current replace. ratio	8.9	-	13.3	27.0	-	-	-	
Ministerio de Trabajo (2002)**								**Contributory**
Baseline scenario	8.4	7.5	9.9	13.0	2050	13.0	4.6	**pensions plus pension supplements. Civil servants' scheme for central government is not included**
Balmaseda and Tello (2003)								**Contributory**
Baseline scenario	5.5	5.3	6.0	8.0	2045	8.2	2.7	**old-age pensions**
a) retirement age 70	5.5	5.3	4.6	6.8	2050	6.8	1.3	
b) whole working life	5.5	5.3	6.1	7.2	2045	7.5	2.0	
Serrano, García and Bravo* (2003)**	-	8.2	9.9	11.3	2040	11.3	3.2	**Total pensions**

*For the J.F. Jimeno study the figures for 2005 correspond to 2010
** For the Ministry of Labour projection, figures for 2025 correspond to 2030
*** For Serrano, Gracía and Bravo, figures for 2050 correspond to 2040

A growing net immigration flow could dampen down some of the consequences of ageing by offsetting partially the current demographic trends. High net immigration registered in latest years in Spain, which is not fully reflected in most of the projections shown in Table 8, might partially counterbalance the budgetary implications of ageing. However, the relief that immigration may suppose for the sustainability of public finances is only of a transitory nature, since these new workers will eventually become pensioners. Nevertheless, given the low participation rates of the Spanish economy, there is still a wide margin of manoeuvre to raise employment rates, which would attenuate the financial impact of ageing.

Another important element directly influencing pension expenditure projections refers to the assumptions on the link between the average pension benefit and average productivity per worker. In this respect, a steady increase of the latter relative to the former would ease some pressure on pension expenditure. However, given the uncertainty over future demographic trends and the effects of productivity growth on the average pension benefit, the possibility of large fiscal

imbalances stemming from pension expenditure over the next decades cannot be ruled out. There is therefore a case to ask whether the strategy put in place so far is adequate to meet the budgetary cost associated with ageing in Spain.

This strategy is based on several building blocks: first, the Permanent Commission of the "Pacto de Toledo"[23] regularly reviews progress in the pension system towards financial sustainability, i.e. equilibrium between contributions and payments. Second, Spain is accumulating reserve funds for future pension payments: they should account for 2.6% of GDP in 2007. Third, structural reforms are underway in labour markets to increase participation rates. Fourth, the development of a multi-pillar pension system should also contribute to the long term sustainability of the pension system. Finally, the ongoing policy strategy of debt reduction is deemed to contribute very positively to improve the long term sustainability of public finances, since it involves a steady reduction of the interest rate burden.

All measures adopted so far in order to increase labour market participation, reduce public debt and build up the pension fund reserve go in the right direction. Nevertheless, they appear insufficient on their own to avoid risks derived from ageing and should be complemented with a reform of the key parameters of the pension system, such as the number of contributory years, the retirement age and the replacement ratio (European Commission, 2003b). The agreement within the recently renewed "Pacto de Toledo" considers several recommendations to reform the pension system. These recommendations, consistent with the BEPGs for Spain, aim at prolonging working life and raising employment rates (especially of women) while strengthening the relationship between the contributory effort and benefits. This would in fact involve the reform of the key parameters of the system. However, such recommendations have not been translated yet into concrete measures.

Annex: The General Law of Budgetary Stability

Spain's General Law of Budgetary Stability (GLBS) was approved in 2002 and entered into force in 2003. Its goal is to ensure that increased fiscal decentralisation following the new financing system for regional governments does not come at the expenses of budgetary stability. Its principal provisions can be summarised as follows:

- Each entity in the public sector will have to fulfil the criterion of budgetary stability defined as "a situation of balance or in surplus in terms of financing capacity according to ESA 95 methodology".

[23] The "Pacto de Toledo" is a politically broad-based agreement approved by the Parliament, which aims at ensuring the viability of the public pension system. The content of the text is made up of recommendations and general guidelines for a future reform of the public pension system.

- The central government will release each year budgetary stability objectives for the whole of the general government and for each sub-sector for the next three years, consistent with the Stability Programme economic scenario.

- Each public entity will have to produce a budget respecting the balanced budget or surplus requirement. Budget planning will take place over a three-year framework.

- The central government will monitor budgetary execution and will examine the degree of fulfilment of the stability objectives. Imbalances will have to be justified by the entities concerned and will require the formulation of a three-year plan to correct them.

- The central government will be able to condition any recourse to debt by sub-national governments to the fulfilment of the budgetary stability objectives. Eventual financial penalties stemming from non-fulfilment of Spain's obligation under SGP and the Maastricht Treaty will be shared by those public entities responsible for the deficits.

The GLBS was a direct answer to the problems raised by the interaction between EMU fiscal rules and fiscal decentralisation. Thus, the Law has been mainly justified by the necessity to consolidate the recent achievements in a context of growing fiscal decentralisation. The budgetary challenges associated with ageing along with the absence of an institutional culture of fiscal discipline are additional arguments that support the need for a constraining framework to guarantee long-term sustainability. The Law can be seen as a means to maintain sound public finances, while allowing for sharing fiscal responsibility among all general government tiers for the respect of fiscal commitments undertaken at European level. It redresses the potential asymmetry regarding the budgetary stability objective between the central government, which is the only responsible for fiscal consolidation commitments vis-à-vis EU authorities, and regional and local governments that have an increasing role in public expenditure.

A principal criticism, which has been levelled also at the Stability and Growth Pact, is that the objective of budgetary stability defined as a balanced or surplus budget hampers the stabilisation function of fiscal policy. Arguably, the fiscal rule implemented by the GLBS is more rigid that the SGP's "close to balance or in surplus". The budgetary stability objectives of the GLBS have to be fulfilled every year, independently of the cycle. Neither can surpluses in one sub-sector offset deficits in others (although the State and Social Security System accounts will continue to be consolidated for the next ten years). Moreover, should deficits occur, the responsible public entities will have three years to restore the balanced

budget[24]. In case of a severe recession, this period might prove to be insufficient and could give rise to a pro cyclical policy while making difficult to apply the tax smoothing principle.

In addition, the increased planning and information requirements placed on sub-national governments, if carried out as foreseen in the Law, should improve the quality of public finances while facilitating its monitoring. However, little progress has been made so far in this respect and the information on regional government accounts continues to be scarce.

All in all, the bounds and procedures set in GLBS are tighter than the requirements of the Stability and Growth Pact. However, some margin of flexibility arguably exists, especially for the budget implementation phase. Moreover, by taking a longer perspective, and in order to maintain sound fiscal finances, spending ceilings may be needed to avoid future tax increases, in particular in the light of the budgetary costs associated to ageing. In this context, given the relatively high decentralisation of the budget process in Spain, the reform of the GLBS, unless rigorously applied over the cycle, might lead to a looser spending control, and higher deficits[25].

In parallel to the claims expressed by some regional authorities asking for a new financial scheme for regional governments, the new government in office after the general elections in March 2004 is planning to relax the rules raised by the GLBS. According to the available information, this reform will entail a new definition of "budgetary stability" based on the cyclical position of the economy while respecting the jurisdictional powers on fiscal issues of the regional and local governments.

These changes might imply that the Central government should negotiate with each regional government its budgetary objectives, which according to the planned reform would take into account three elements:

1) The fiscal effort made by the richest regions in order to transfer resources to the poorest regions;

2) The economic situation of each region; and

3) Particular and unforeseen events having a budgetary impact on public regional accounts (e.g., the ecological disaster caused by the oil tanker "Prestige").

[24] The average cycle length in Spain is about seven years. Thus, a three year period for correcting imbalances might turn out to be too short, specially taking into account that the cycle affects public finances and the balance is known with a certain delay.

[25] For fragmentation of budgeting institutions as a source of excessive spending see Hallerberg and von Hagen (1999) and von Hagen and Harden (1994).

As a result, these elements would entail a specific budgetary target for each regional government, which contrasts with the current obligation of registering a balanced budget or in surplus for all regional authorities. While there is still a high degree of uncertainty regarding the reform of the GLBS, a close coordination among general government levels and a strict monitoring of their budgetary outcome should be preserved.

Part II: A virtuous long-lasting cycle?

As shown in the introductory section, Spain has made significant progress in the last twenty years in terms of real convergence with the rest of the euro area. This process has taken place within a context of growing openness, further enhanced by the accession to the EU in 1986. Convergence has been especially strong since the mid-nineties. While the Spanish per capita income represented 79.3% of the average income of the euro area in 1995, the corresponding figure in 2003 was 86.4%. These figures stem from a large growth differential between Spain and the euro area: in the period 1995-2003, GDP in Spain grew at an annual average rate of 3.25% compared to 2.0% in the euro area[26].

GDP per capita can be decomposed into the apparent labour productivity, the employment rate and the ratio between working age and total population[27]. Since the latter can be taken as given over periods of ten years or so[28], changes in the employment rate and productivity growth are the major explanatory factors of per capita income growth in the medium-term.

Since 1995, employment growth in Spain has been buoyant. Between 1995 and 2003, annual employment growth averaged 2.6% (1.2% in the euro area as a whole), which contrasts with the rate of 1.6% recorded between 1985 and 1995 (0.7% in the euro area). As a result, since the mid 1990s the employment rate in Spain[29] rose by almost 13 percentage points to attain 59.7% in 2003. These figures compare with a much more modest performance in the euro area, where the employment rate grew by 4.5 percentage points (from 57.9% in 1995 to 62.4% in 2003). The strong job creation brought the Spanish unemployment rate down from 19% in 1995 to slightly above 11% in 2003. In contrast, the unemployment rate in the euro area only fell by 1.8 percentage points in the same period, standing at 8.8% in 2003.

However, where productivity growth is concerned, the Spanish performance is less brilliant. Labour productivity in Spain has slowed down from 1.4% on average in the period 1985-1995 to 0.6% since 1995 (1.6% and 0.9% in the euro area). Moreover, total factor productivity in Spain has also decelerated from 0.7%

[26] The growth differential in the previous business cycle was much narrower. During the period 1985-1995, Spain and the euro area registered average growth rates of 3.0% and 2.4%, respectively.

[27] Note that GDP per capita, Y/P, where Y is GDP and P population can be expressed as Y/P = (Y/L)(L/WAP)(WAP/P), where L represents persons employed and WAP stands for working age population. While (Y/L) is the apparent labour productivity, (L/WAP) is the employment rate.

[28] For the period 1960-2003, this rate varies between 64% and 68% for both Spain and the euro area

[29] The employment rate is the ratio between total employment and population aged between 15 and 64.

to 0.3% during the same period (1.2% to 0.5% in the euro area). High job creation in low-productivity activities along with low educational attainment of the labour force, modest expenditure on R&D and ICT, limited innovation and insufficient competition in some sectors are often mentioned as the main elements behind the poor productivity developments in Spain (see European Commission, 2003b).

In the light of this growth model, characterised by an intensive use of labour coupled with slow productivity growth, a central question appears particularly relevant: is the current convergence process sustainable in the medium and long term?

Employment performance is determined by the functioning of the labour market and institutional factors, whereas the evolution of apparent labour productivity will depend on capital intensity (capital/labour ratio) and total factor productivity.

But nominal factors also matter, for convergence, in the long-run. A persistently positive inflation differential with the euro area due to malfunctioning of labour and/or product markets translates into growing cost pressure for export sectors, whose ability to set up prices without losing market share is rather limited. In the context of EMU, it is no longer possible to recover competitiveness through currency devaluations and the existence of persistent inflation differentials involve deteriorations of mark-ups of export companies that contribute to deteriorate the competitive position of the economy, unless they are offset by productivity gains.

Accordingly, in order to get further insight as regards the evolution of GDP per capita, the next chapter focuses on the functioning of the labour market. Chapter 5 will focus on the determinants of labour productivity, namely the evolution of the capital-labour ratio and total factor productivity. Finally, since the interplay between productivity growth, prices and wages determines the external competitive position of an economy, chapter 6 explores nominal developments and the associated risks for the real convergence of the Spanish economy with the euro area.

4. The labour market

The employment rate in Spain has increased by 13 percentage points in the last decade, helping sustain convergence in GDP per capita with the euro area. However, there is still a wide margin to improve labour market outcomes. Employment rates are still far from the Lisbon targets and the unemployment rates, particularly for female and youth, are high by EU standards. Further efforts should be pursued in order to increase female employability, notably through higher provision of childcare facilities, greater use of part-time contracts and more provision of vocational training matching labour market needs.

One relevant characteristic of the Spanish labour market is a lower use of part-time contracts, but a much higher use of fixed-term contracts than in other Member States. Specifically, one third of wage earners have a fixed-term contract. This could hamper human capital investment while affecting other elements of labour flexibility such as geographical mobility. Four lines of action can be considered to reduce segmentation. Firstly, given the success in promoting employment on a permanent basis achieved by the new open ended contract with lower firing costs introduced in 1997, further steps in this direction appear advisable. Secondly, despite the recent implementation of some legal mechanisms of control, fixed-term contracts are often used beyond their legal purpose of covering temporary needs of firms. Therefore, a closer monitoring appears appropriate. Thirdly, measures targeted at promoting part-time contracts should help reduce the share of temporary contracts while promoting female participation. Apart from these horizontal measures, the considerable concentration of fixed-term contracts in some particular sectors may call for targeted measures in some activity branches, namely construction. Finally, a reform of wage-setting oriented to better reflect productivity developments across regions and economic circumstances at the firm level, jointly with a further review of the employment protection legislation would help create more permanent jobs.

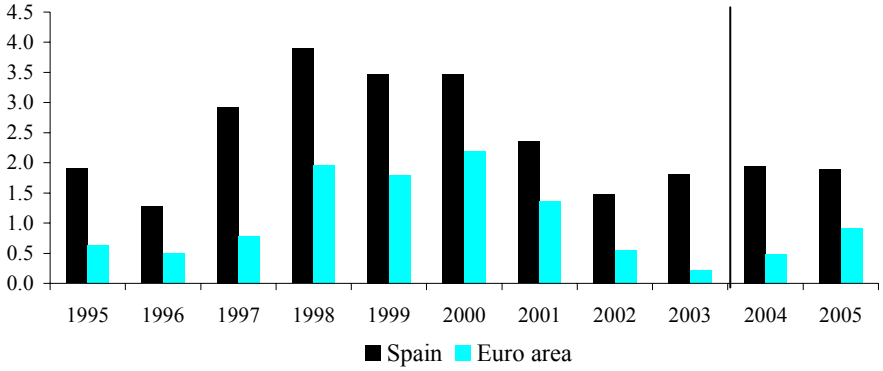
4.1. Working hard

Sharp downturns and the equally strong recoveries translated into a more erratic evolution of employment growth than in the euro area (see Figure 18). The remarkable dynamism of the labour market since the mid-90s led to an impressive record of employment growth and unemployment reduction. Specifically, in the period 1995-2003 employment in Spain grew by 2.5% on average per year on a national accounts basis (Figure 18) compared to 1.1% in the euro area[30].

[30] Between 1986 and 1991 employment in Spain grew by 3.2% compared to 1.5% in the euro area. This strong employment growth came hand in hand with an average GDP growth of 4.2% and 3.2% in Spain and the euro area, respectively. In contrast, in spite of similar GDP growth rates in

Moreover, job creation in Spain continued at a sustained pace during the 2001-2003 slowdown (1.9% compared to 0.7% in the euro area), sharply contrasting with the massive employment destruction experienced in previous downturns[31]. According to the Commission Autumn 2004 forecasts, employment in Spain will keep growing faster than in the euro area. However, the gap is envisaged to narrow. Employment growth will resume at 1.9% in Spain, compared with 0.5% and 0.9% in the euro area in 2004 and 2005, respectively.

Figure 18: Employment growth (annual rates), 1995-2005



Source: AMECO

As a result, since 1995 the Spanish employment rate has increased briskly by more than 13 percentage points (see Table 9), standing now close to 60% (slightly below 62% for the euro area). Furthermore, although sharing the same downward trend as in the rest of the EU, in terms of hours worked per week, Spain still remains above the euro area. The average weekly working time is 39.7 hours in Spain against 37.4 in the euro area. In 1995, the corresponding figures were 40.4 and 38.4, respectively.

Table 9: Labour market performance

	Employment rate			Participation rate			Unemployment rate			NAWRU		
	1995	2003	Change	1995	2003	Change	1995	2002	Change	1995	2003	Change
Spain	46.9	59.7	12.8	59.0	67.3	8.3	18.8	11.3	-7.5	16.1	11.8	-4.3
Euro area	57.9	62.4	4.5	65.2	68.6	3.4	10.6	8.4	-2.2	9.6	8.9	-0.7

Sources: EUROSTAT and AMECO

the period 1992-1994 (0.8% in Spain and 1% in the euro area), employment fell by 1.6% in Spain compared with 0.9% in the euro area. In the trough of the recession in 1993, employment fell by 2.8% in Spain against 1.6% in the euro area.

[31] During the 1980s and the first half of 1990s, GDP growth at around 2% entailed job losses. In contrast, in 2002 output grew by 2.2% and employment rose by 1.5% on a national accounts basis.

The remarkable improvement in the employment rate vis-à-vis the euro area has taken place in parallel with an increase in the participation and a sharp reduction of unemployment[32]. The activity rate in Spain rose from 59.0% in 1995 to 67.3% in 2003, narrowing the gap vis-à-vis the euro area, where the rate stood at 68.6%. The unemployment rate in Spain, although still the highest in the euro area, has been steadily falling from its peak of around 20% in 1994 to slightly above 11% in 2003. The positive change in labour market outcomes with respect to past trends is explained by:

i) EMU membership and the associated stability-oriented macroeconomic policies brought about a less volatile pattern of output growth and a more stable financial framework. Stability, in turn, improved business expectations and had an expansionary impact on labour demand from firms.

ii) The labour market reforms implemented in the 1990's have improved the functioning of the labour market (Box 6).

iii) Some social and demographic changes, especially high net immigration registered in recent years[33], has increased labour supply and enhanced work force flexibility while reducing labour shortages experienced in past upturns. In this respect, the increase in female labour participation has also played a significant role.

iv) A significant change in trade unions' strategy with respect to the late eighties and early nineties, accepting wage moderation in exchange of higher employment growth. This has resulted in a marked moderation in nominal unit labour costs (ULC) since the mid 1990s, in sheer contrast with what happened during the expansionary cycle in 1986-1991 (see chapter 6)[34].

v) Finally, the expansion of some labour-intensive sectors, namely construction and some services, has significantly contributed to sustain employment growth.

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[32] The sharp rise in the employment rate was due to both a significant increase in the activity rate coupled with a marked unemployment fall. The following identity is illustrative:

$$\text{Employment rate} = \frac{\text{Employment}}{\text{Working age population}} = \frac{\text{Active population}}{\text{Working age population}} * \frac{\text{Employment}}{\text{Active population}} =$$

$$= (\text{Activity rate}) * (1 - \text{unemployment rate})$$

Thus, the high increase in the employment ratio in Spain during the period 1995-2003 relative to the euro area (nearly 13 and 5 percentage points respectively) stems from a much higher rise in the activity rate (8 and 3.5 percentage points approximately) and a much sharper decline in the unemployment rate (around 7 and 2 percentage points).

[33] Latest data released by the INE estimate the total foreign population at around 2.500.000 people in 2003 compared to 637.000 in 1998. Additionally, the average age of these population inflows is significantly lower than the resident population.

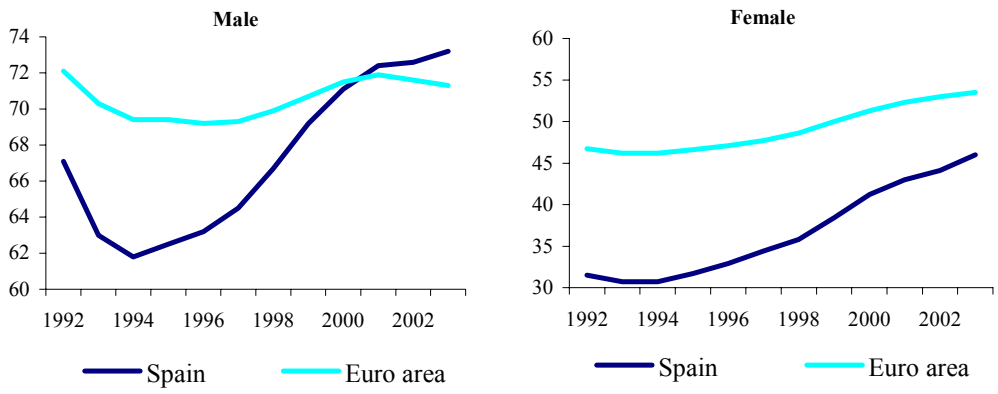
[34] It is worth noting an additional important feature in relation to ULC. Since the mid 1990s real ULC (nominal ULC adjusted by GDP deflator) have been registering negative growth rates, which is also in sharp contrast with the previous business cycle. This represents factual wage moderation, since real wages have been growing below productivity.

All in all, these elements allowed not only for a steady reduction in the unemployment rate but also for a significant decline in the structural unemployment measured by the NAWRU (Non-accelerating wage rate of unemployment) which is estimated to have fallen from 16.7% in 1993 to 11.8% in 2003 (Table 9). The remarkable labour market performance seems to have given rise to a virtuous interaction between job creation and output growth. Specifically, resilience of employment growth during the 2001-2003 slowdown has supported domestic demand through private consumption and investment in dwellings, which, as shown in chapter 2, has in turn stimulated GDP growth. Given the prominent role played by the labour market in the last business cycle in Spain, it seems relevant to raise the following two questions: 1) To what extent current developments can be maintained in the short to medium-term?, and 2) what particular aspects of the Spanish labour market should be improved in order to sustain employment and economic growth in the long-term? The next sections address these questions.

4.2. Gender and age discrimination in an immobile labour force

In spite of the notable results achieved during the last decade in Spain in terms of employment growth and unemployment reduction, there still is much room for improvement in the labour market. Somewhat lower than 60%, the employment rate in Spain still remains below the euro area average (62.4%) and far from the Lisbon objectives. The Lisbon strategy sets specific targets to be achieved by 2010: the overall employment ratio should reach 70% of the working age population (67% in 2005).

Figure 19: Employment rates by gender in Spain and the euro area, 1992-2003



Source: EUROSTAT

Aggregate figures conceal sizeable divergences across genders (Figure 19). Male employment rates in Spain rose from 62.5% in 1995 (69.4% in the euro area) to 73.2% in 2003, exceeding the euro area average of 71.3%. However the performance of female employment is far from satisfactory. The female employment rate rose from 31.7% in 1995 to 46% in 2003 (46.6% and 53.5% in the euro area, respectively), still very far from the Lisbon targets (60% by 2010).

Box 6: Main labour market reforms in Spain

1984 **Deregulation of fixed-term contracts** by abolishing the "causality principle". New kind of temporary contracts, namely, the employment promotion contract (see paragraph 4.2), the training and practice contracts for young workers and a specific contract for launching new activities which benefited from tax exemptions.

Unemployment benefits: minimum period of contribution established at 6 months allowing for 3 months of benefits. Maximum entitlement period 2 years. Substitution rate 80/70/60.

1989 **Unemployment assistance extended for some groups** (older and long-term unemployed)

1992 **Reform of the unemployment benefit scheme by raising the contributory period**: minimum contributory period extended to one year (3 months of benefits).Tax exemptions for training and practice contracts were eliminated.

1994 **Reestablishment of the principle of causality as a general rule for fixed-term contracts**: the employment promotion fixed-term contract is only kept for some specific groups (workers over 45 and long-term unemployed). Elimination of the training contract and creation of apprenticeship contract. The "ordinary" fixed-term contracts are kept but subject to "causality principle".

Changes in the regulation of dismissals procedures: conditions for collective dismissals were clearly stipulated and the time the authorities were given to take a decision in this kind of firings was shortened. Economic circumstances were included in the reasons justifying individual dismissals.

A range of issues on working conditions are no longer regulated and can be negotiated through collective bargaining.

Unemployment benefits are considered as taxable income

1997 **The employment promotion fixed-term contract is completely abolished**.

New permanent contract with lower dismissals costs only applicable to workers below 30 or over 45, long-term unemployed and disabled workers. The new amount to be paid by firms in case of unfair dismissal was set at 33 day's wages per year of seniority with a maximum of 24 months' wages compared to 45 day's wages per year of seniority with a maximum of 42 month's wages in the standard permanent contract. In addition, non-negligible social security rebates for the two first years of the contract were implemented.

1998 **New part-time contract**: clear definition of what is considered part-time job by establishing a limit on total hours worked (77% of hours worked in a full-time job). The total number of hours worked and their distribution must be specified in the contract. Social protection of workers with part-time contract is enhanced.

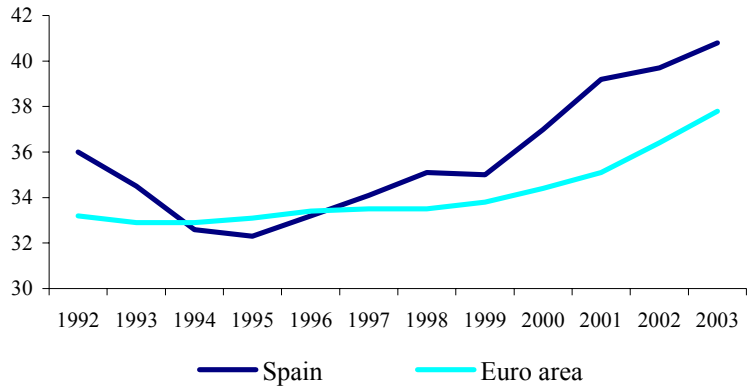
2001 **Extension of the permanent contact introduced in 1997** with lower dismissals costs to some categories of wage earners and while maintaining social security rebates (However, male aged between 30 and 45 remained outside the scope of such contracts).
Dismissals costs introduced for fixed-term contracts (8 days per year worked)
New part-time contract deregulating almost completely the distribution of working time. The limit of 77% of hours worked in a full-time job was abolished.

2002 **Tougher criteria for unemployment benefit eligibility** (both contributory and non-contributory, the latter are now to be means-tested) along with stricter requirements in relation to labour mobility for unemployed people receiving benefits.
Lower dismissals costs through the transitional wages ("salarios de tramitación") paid pending judicial proceedings for unfair dismissals: if the employer accepts within 48 hours that the dismissal is unfair and makes effective the corresponding severance payment, then the transitional wages do not have to be paid.

Gradual phasing out of the special unemployment benefit scheme for the agricultural workers in force in Andalucía and Extremadura. However, in 2003 a system with similar characteristics to the previous one was implemented for agricultural workers excluded by the reform in 2002.

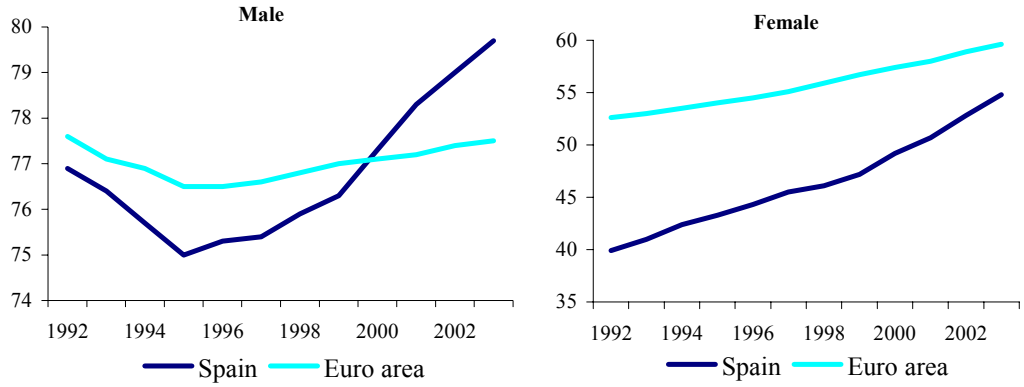
Labour market outcomes also largely vary in function of age. The employment rate for elderly workers, which fell markedly to 32.3% in 1995 due to staff adjustments through early retirement schemes in the aftermath of the early 90s' recession, rose again in 1996 to reach 40.8% in 2003, which compares with 37.8% in the euro area (see Figure 20). Despite such a positive performance, the employment rate of elderly workers in Spain remains distant from the Lisbon objective set for this cohort (50% by 2010). At the opposite extreme of the age scale, at 33.4%, the youth employment rate in Spain in 2003 remains below the euro area (36.2%), although the gap has narrowed markedly in the latest years. In 1995, only 24.4% of young Spaniards were employed, which compares with 33.7% in the euro area.

Figure 20: Employment rates of old workers (55 to 64 years)



Source: EUROSTAT

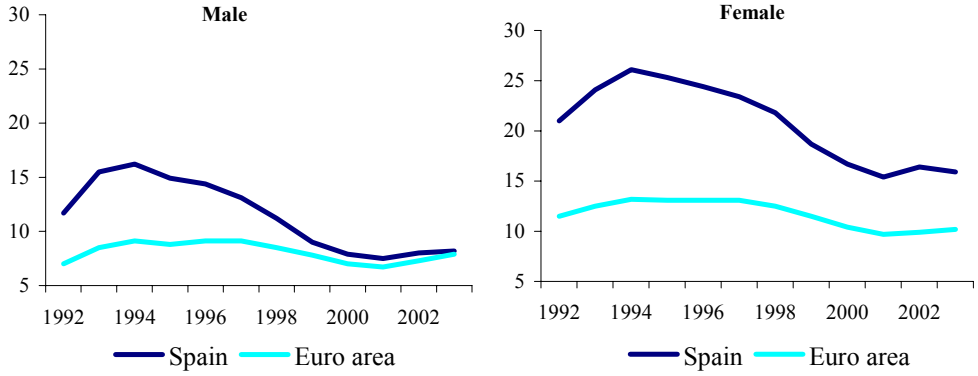
Figure 21: Participation rates by gender in Spain and the euro area, 1992-2003



Source: EUROSTAT

The sharp divergences in the employment rates by gender are mirrored in participation and unemployment rates. While at present the men participation rate in Spain is higher than in the euro area average (nearly 80% and 78%, respectively), the rate for females increased by nearly 15 percentage points since 1992 to attain 55% in 2003, but it still remains clearly below the euro area average (60%).

Figure 22: Unemployment rates by gender in Spain and the euro area, 1992-2003



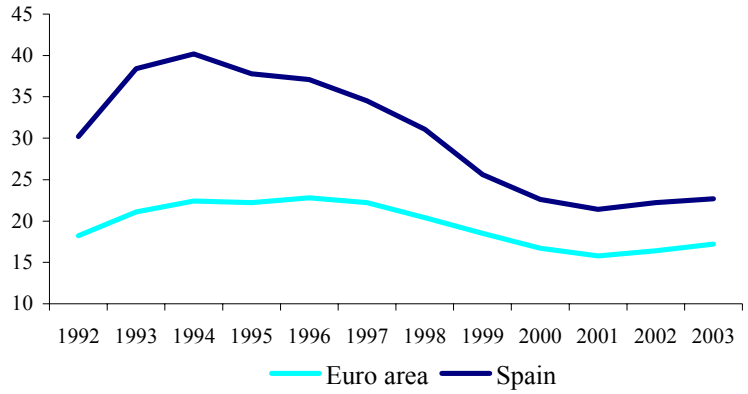
Source: EUROSTAT

Despite the recent strong job creation, the unemployment rate in Spain (11.3% in 2003) still remains the highest in the euro area (8.4% on average). In line with the employment and participation rates, the high unemployment in Spain relative to the euro area is to a large extent explained by the female component that tracked 16.4% in 2002, almost twice as high as the euro area average. In contrast, male

unemployment has considerably narrowed the gap with respect the euro area during the latest years. Male unemployment in Spain dwindled from 18% in 1995 to 8.0% in 2002. This compares with euro area rates of 8.8% and 7.3% for the same years (see Figure 22).

In terms of age distribution differences in unemployment are also sharp between, on the one hand, people in the prime age and, on the other hand, the elderly and the youngest. The situation is particularly worse for young workers. Youth unemployment rate stood at 22.2% in 2003, 8.2% in the euro area, (see Figure 23). Conversely, although in 1995 the unemployment rate for old workers (aged between 55 and has closed 64) was four points higher in Spain than in the euro area, the gap has closed and the unemployment rate for this age category is 6.5% in both Spain and the euro area in 2003[35].

Figure 23: Unemployment rate for youth (15-24 years)

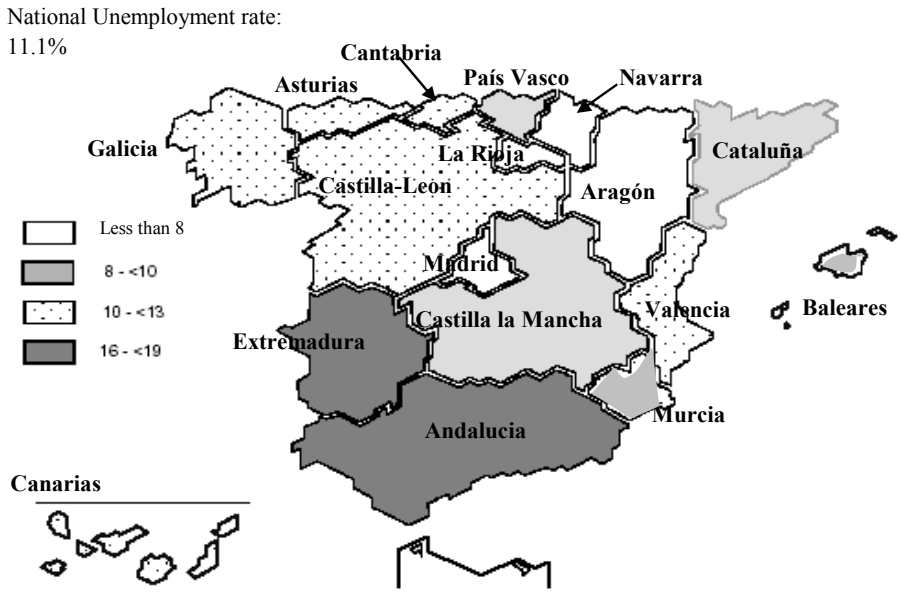


Source: EUROSTAT

In addition, there are large inequalities in the geographical distribution of unemployment. Andalucía and Extremadura, two southern regions, with 18.6% and 17.4%, respectively, recorded the highest unemployment rates in 2003, whereas at the opposite geographical and socio-economic extremes, Navarra and La Rioja registered rates of 5.5% and 6.1% respectively. In Madrid and Catalonia, the corresponding figures were 7.2% and 9.3% respectively (see Figure 24). These disparities across regions point to a low geographical mobility of the labour force, which in turn is amplified by the functioning of housing market, particularly by the poor development of rental housing. Moreover, the wage bargaining system does not sufficiently take into account productivity differences across regions (European Commission, 2003b) and, therefore, a more decentralised wage setting is frequently recommended (see box 7).

[35] In 1995, old-workers unemployment rates were 12.3% and 8.3% in Spain and the euro area, respectively (source Eurostat, New Cronos).

Figure 24: Regional unemployment rates in 2003



Source: INE

According to these facts, labour is not a scarce input in Spain and the remarkable results achieved in terms of growing activity and employment rates still have a wide margin of manoeuvre to improve and approach the Lisbon objectives. Active labour market policies aiming at further increasing employment rates should be particularly targeted at promoting women and youth employability (see European Commission, 2003b). In this respect, it must be pointed out that the resources allocated to active labour market policies (ALMP) are lower than in the large euro area economies (except Italy), and funding for the employment service and for training of unemployed workers is very limited (see OECD, 2003)[36], especially taking into account the unemployment rate differential vis-à-vis other large EU economies.

Further efforts aiming at increasing female employability should be pursued, notably through higher provision of childcare facilities and the promotion of greater use of part-time contracts (see European Commission, 2003b). The use of such contracts has hardly made any progress between 1995 and 2003 (8% of total employment in Spain) and remains well below the EU standards[37]. The reforms of part-time contracts implemented in 1998 and 2001 did not succeed in promoting this contractual labour arrangement. The reform of 1998 established a new part-time contract imposing a strict regulation of working time distribution, which

[36] ALMP in Spain represented 0.84% of GDP in 2001 compared to 1.31%, 1.21% in France and Germany respectively. Resources to finance the national employment service reached 0.18% and 0.23 % of GDP in France and Germany in contrast with 0.09% in Spain in the same year.

[37] This contrast with the increase registered in the euro area during the same period: from 14% to nearly 17% of total employment.

resulted into a too rigid contract for employers. Conversely, the 2001 reform deregulated working[38] time almost completely and rendered this contract little attractive for workers.

Box 7: The wage bargaining system in Spain

Despite the low level of unionization, at around 15% of wage earners, nearly 90% of wage earners in the private sector in Spain are covered by collective agreements negotiated by the most representative trade unions and employers' associations (see Izquierdo et al. (2003) and Pérez Infante (2004) for a thorough description of the Spanish wage bargaining system).

Collective bargaining in Spain can take place at different levels: company level or industry level. The latter has in turn different geographical levels (local, provincial, regional or national). In terms of number of workers collective agreements are negotiated mostly at the industry and provincial level (more than 50% of wage earners under wage agreements). The second most important bargaining level is the national industry level, covering nearly 25% of workers, while regional industry agreements only affect 9% of workers. Finally, the working conditions of only 10% of wage earners are settled at company level.

This specific distribution of the bargaining level is closely linked to the average size of the Spanish companies according to the number of workers. Thus, company and national industry agreements involve large firms (more than 250 workers on average) while provincial industry level is made up of small companies (at around 15 workers on average).

Therefore, most of the collective agreements are at a sectoral and provincial level and affect mainly small firms. From a theoretical point of view, such an intermediate system of collective bargaining (neither centralised nor decentralised) is not optimal since it yields less efficient results in terms of wage adjustment in the face of changing labour market conditions. On the one hand, a more centralised system would make easier the internalization in the agreement of constraints stemming from macroeconomic conditions. On the other hand, a more decentralised wage setting should provide more margin of manoeuvre so as to take into account specific firms' situations (see Bentolila and Jimeno, 2002).

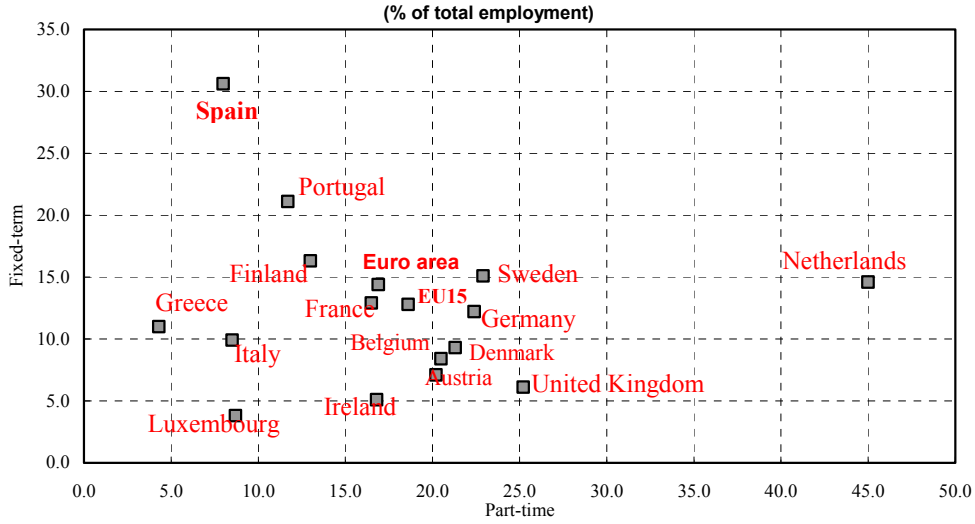
Nevertheless, given that around 75% of Spanish firms have 10 workers or less, and thus according to the current regulations they do not have union elections, a fully decentralised system would be difficult to implement. Rather, it would seem desirable to increase coordination among the different levels of bargaining by more clearly delimiting the areas to be covered at each level. This should give room to better reflect local labour market conditions as well as specific circumstances at the firm level. In this respect, in 1997 the social partners signed an agreement on collective bargaining ("Acuerdo Interconfederal") in order to raise the level of co-ordination of the wage bargaining system. However, so far the progress made in applying this agreement has been rather modest and no further steps in this direction have been taken recently.

[38] Most workers with a part-time contract in Spain declare they hold such a contract because they could not find a full-time job.

4.3. A segmented labour market

The high share of fixed-term contracts and the low number of part-time jobs in Spain may have a close relationship (Toharia et al., 2004). The flexibility provided by part-time contracts in other Member States appears to be achieved in Spain by the disproportionate use of fixed-term contracts (see Figure 25).

Figure 25: Fixed-term and part-time contracts



Source: EUROSTAT

Spain presents the characteristics of a formally segmented labour market, i.e. permanent contracts offering a high degree of on-the-job protection coexist with temporary contracts with almost no restriction on hiring and firing. At present, temporary contracts account for nearly one third of total employment, more than twice the EU average (Figure 25).

The origin of this segmentation dates back to the first half of the 1980s, when the high unemployment rate registered in Spain triggered the adoption of deregulating measures aimed at increasing labour market flexibility. Given the opposition of trade unions to these measures, the 1984 labour market reform introduced significant changes in the regulation of fixed-term contracts while leaving untouched the employment protection legislation for permanent workers, giving rise to the so called "flexibility at the margin"[39]. The result of this reform was a

[39] Specifically, the prevailing "causality principle" for fixed-term contracts, according to which fixed-term contracts could only be used for temporary needs of the firms, was weakened and companies were allowed to hire non permanent workers to carry out their permanent activities. The most important new temporary contract brought about by the 1984 reform was the

significant increase in the use of fixed-term contracts during the second half of the 1980s: from a share lower than 10% before the 1984 reform to near 30% in 1989 and a first peak at around 34% in 1992. Despite the legal changes introduced since 1994 restricting the use of temporary contracts (see below), the proportion of fixed-term contracts has only decreased slightly and appears to have stabilised at around 30%.

All sectors of activity in Spain record a higher share of fixed-term contracts than in the rest of the euro area. Nevertheless, more than 50% of temporary jobs concentrate on six sectors: agriculture, construction, wholesale and retail trade, hotels and restaurants, domestic services and public administration. Construction shows by far the highest percentage of fixed-term contracts (nearly 60% compared to 22% in the euro area). By specific groups, almost 50% of temporary workers are below 30 years old, while females record a higher share of fixed-term contracts than males (at around 34% and 29% respectively). In terms of educational levels, workers with lower education attainment have the highest probability of being employed on a temporary basis (42%), although 24% of temporary workers are university graduates.

The success of fixed-term contracts in Spain is still a matter of discussion. Given the strict regulations on permanent employment, the main attractiveness of fixed-term contracts is the flexibility and low firing costs they entail. This kind of contracts allow for a quick adaptation of the staff to changing economic conditions. An important element in the assessment of fixed-term contracts is whether workers with temporary arrangements are trapped in this situation for a long time or, on the contrary, can obtain a permanent job after a relatively short period. In the latter case, temporary contracts would be used as screening devices that allow employers to observe workers' performance. Accordingly, skilful workers would obtain a permanent contract after a probation period holding a fixed-term contract (Guell Rotllan and Petrongolo, 2000). However, current and historical data suggest that the transition from a temporary to a permanent post in Spain is, in general, rather slow and takes longer at present than in the past (Amuedo Dorantes, 2000) [40].

During the last decade, labour market reforms have aimed at reintroducing constraints in the use of temporary contracts while easing employment protection legislation for permanent workers[41]. These reforms, however, do not seem to have

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"employment promotion fixed term contract", which had to last at least for 6 months and could be renewed up to 3 years. After this maximum period, the firm had to offer a permanent contract; if this were not done, the vacancy could not be filled by another temporary worker.

[40] A non negligible share of workers with fixed-term contracts remains in this situation one year later. This percentage has tended to increase during the period 1987-2001: from around 55% and 45% to nearly 70% and 65% for males and females, respectively.

[41] In 1994, the "employment promotion fixed-term contract" was restricted to some specific groups (workers over 45 and long term unemployed) whereas the "causality principle" was to apply to the "standard" fixed-term contracts. The 1997 reform entailed the complete elimination of the "employment promotion fixed-term contract" and the approval of a new contract on permanent

lowered significantly the share of temporary contracts since the mid 1990s. Two aspects regarding the effects of these reforms deserve further attention: i) the lifting in 1994 of a minimum time limit on the duration of fixed-term contracts seems to have induced employers to roll over an increasingly large number of contracts for shorter periods of time, leading to growing contract turnover[42]; ii) during the last ten years the share of temporary contracts in the private sector employment has recorded a significant decline (from nearly 40% in 1995 to 32% in 2002) while the share in public employment recorded a sharp rise (from 15% to around 22% in the same years). The reduction in the private sector is generally explained by the successful introduction of the new permanent contract in 1997 (see box 5.1). The lower dismissal costs and the social security contribution rebates offered by the new contract have worked as incentives to promote employment on a permanent basis[43]. In contrast, the increase registered in the public sector was due to the budgetary restrictions imposed in the second half of the 90s on the replacement of civil service vacancies.

Overall, fixed-term contracts have been instrumental in increasing employment in Spain. Such contracts have enhanced labour flexibility to deal with changing economic conditions while facilitating a higher outflow from unemployment (Dolado et al, 2002). This has benefited some specific groups of workers, mainly low skilled, and is clearly a better option than remaining unemployed (Estrada, García-Perea and Izquierdo, 2002).

Nevertheless, a high segmentation between permanent and temporary workers might imply negative spillovers on human capital investment. The generalised use of fixed term contracts coupled with a high turnover rate of temporary jobs gives little incentive either for employers or workers to invest in human capital. In this regard, Dolado et al. (1999) estimate that the probability of receiving on-the-job training is significantly lower for workers with fixed-term contracts.

Furthermore, a disproportionate use of fixed-term contracts results in a reducd overall labour mobility. A temporary nature, inherent uncertainty, and lower remuneration, coupled with high housing prices, are characteristics of fixed-term contracts hampering mobility. This is especially relevant since the share of temporary contracts is the highest among young workers who should be more mobile geographically (Dolado et al., 2002). Moreover, Toharia and Malo (2000)

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basis with lower dismissals costs. Finally, in 2001 dismissals costs for temporary contracts (8 days per year worked) were introduced.

[42] Thus, in 2002 there were approximately 13 million fixed-term contracts of which around 30% were to last less than one month and nearly 45% less than three months. By contrast, the restoration of the link with the temporary needs of the firm does not seem to have prevented employers from continuing to resort to "ordinary" fixed-term contracts for covering permanent activities (i.e. breaching the causality principle).

[43] It is, however, unclear whether the success of these contracts is due to the lower dismissal costs or to the direct social security rebates. The latter aspect might be crucial in order to explain their success.

stress the role played by the high share of temporary contracts in explaining the low fertility rates registered in Spain in the recent past.

According to the negative effects that such a high degree of segmentation entails, its reduction becomes a priority. As for policy recommendations, four kinds of actions can be identified. *Firstly*, given the success in promoting employment on a permanent basis achieved by the new open ended contract with lower firing costs introduced in 1997, further steps in this direction appear advisable. *Secondly*, despite the recent implementation of some legal mechanisms of control, fixed-term contracts are often used beyond their legal purpose of covering temporary needs of firms. Therefore, a closer monitoring of the use of fixed-term contracts might be appropriate. *Thirdly*, measures targeted at promoting part-time contracts should help reduce the share of temporary contracts while promoting female participation. Apart from these horizontal measures, the considerable concentration of fixed-term contracts in some particular sectors may call for specific policy measures addressed to these activity branches, namely construction. *Finally*, a reform of wage-setting oriented to better reflect productivity developments across regions and economic circumstances at the firm level jointly with a further review of the employment protection legislation would help sustain employment growth.

5. Labour productivity

This chapter analyses the factors behind labour productivity growth in Spain, the main characteristic of which is a significant slowdown since the eighties. Labour productivity grew in Spain at an annual average rate of 0.7 between 1995 and 2003, which compares with 0.9% in the euro area. Available data suggest that such a productivity growth slowdown should be mainly attributed to low total factor productivity (TFP) growth. Moreover, in spite of growth rates similar to those in the euro area, the level of the capital-labour ratio in Spain is much lower. This reflects the high share of some labour-intensive activities with low content of human and knowledge capital.

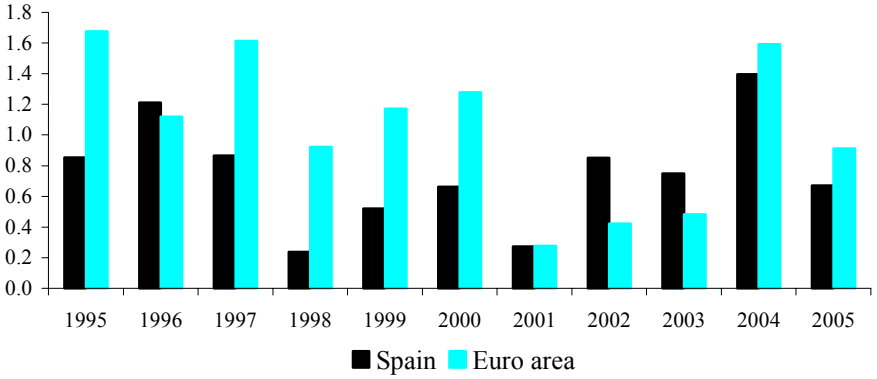
Low TFP growth registered in Spain is the result of a number of structural factors, including low educational attainment of the labour force, coupled with insufficient provision of vocational training. Furthermore, resources allocated to R&D activities are scarce by European standards, and the relative weight of information and communication technologies is also lower than in the EU.

High job creation is indeed paramount to real convergence in the short to medium term. However, in the long run, real convergence can only be ensured through high productivity growth and, more specifically, through high TFP growth. Although the ingredients necessary to increase TFP growth are relatively well-known, the recipe is rather ambiguous about quantities. Consequently, it is rather difficult to set productivity growth targets associated specific policies. Overall, such measures strongly interplay with other factors and measures, which makes difficult to assess their effects ex-ante. Nevertheless, it appears crucial to improve the functioning of product and labour markets, as well as to invest more in human capital and to allocate more public and private resources to R&D activities. Moreover, given its positive spillovers, a more widespread ICT use and diffusion would help raise productivity in Spain.

5.1 Down the road

The recent remarkable achievements in terms of job creation and unemployment reduction have not been accompanied by sound productivity growth (Figure 26). Labour productivity grew by 0.7% in Spain in the period 1995-2003, compared with 0.9% in the euro area. These figures implied a slowdown with respect to the period 1985-1995, when labour productivity grew by 1.4% and 1.6% on average in Spain and the euro area, respectively. As a result, labour productivity per hour worked in Spain is only approximately 85% of the euro area average. Therefore, the GDP per capita convergence experienced by the Spanish economy since the mid 1990s mainly relied on a more intensive use of labour.

Figure 26: Labour productivity growth in Spain and the euro area (annual growth rates)



Source: AMECO

A trade-off between labour productivity growth and employment rate seems to exist in Spain (see Herce, 2004). Figure 27 displays three expansionary periods, namely 1960-1974, 1985-1991 and the most recent one 1994-2003[44]. While in the first period, increases in GDP per capita were achieved by sharp productivity increases coupled with almost negligible employment reductions[45], in the other two periods, increases in the employment rate are registered at the expense of much lower productivity growth. Furthermore, the intense employment destruction during the period 1974-1985, due to industrial restructuring, was accompanied by high labour productivity growth, leaving GDP per capita barely changed[46]. Simultaneous steep increases of both labour productivity and employment rates have not been observed in Spain in the last forty years.

A similar trade-off seems to exist in the euro area (see Sapir et al., 2003), although to a lesser extent than in Spain. In particular, employment destruction between 1974 and 1985 was less intense in the euro area than in Spain. Contrary to the European pattern, the USA does not seem to show such a trade-off. This could suggest that the productivity-employment trade-off could stem from the relative malfunctioning of European labour markets. Labour productivity developments depend on capital intensity and total factor productivity[47]. The next two

[44] Right-upward movements imply increases in GDP per capita.

[45] In this first period, slight employment rate reduction was accompanied by a high migration flows mainly to other EU countries.

[46] A similar although less acute movement took place during the 1993 recession.

[47] Assuming a standard production function:

$$Y(t) = F[K(t), L(t), t]$$

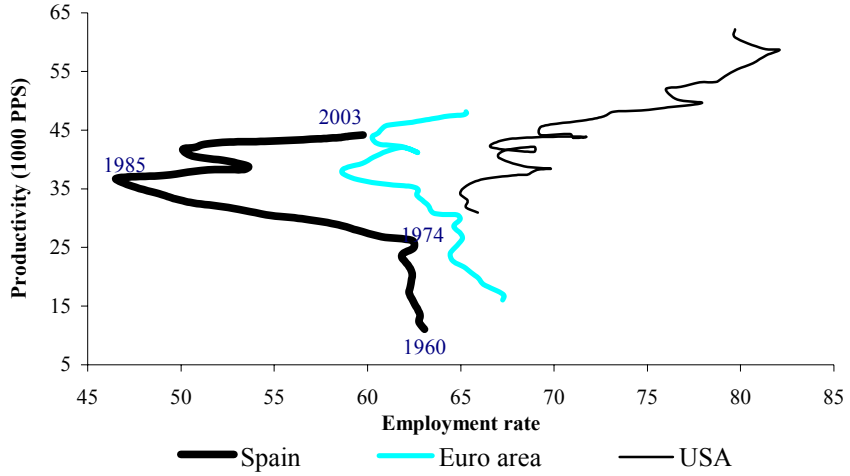
with K, L and t being Capital, Employment and time, respectively. Differentiating and taking logarithms, yields

$$d\log\frac{Y}{L} = (1 - w_K)\, d\log\frac{K}{L} + \dot{TFP}$$

where $(1\text{-}w_k)$ is the share of labour in Y, and TFP is total factor productivity growth.

subsections analyse such driving forces of labour productivity. Special attention will be paid to the determinants of TFP.

Figure 27: Decomposition of GDP per capita (1960-2003)



Source: AMECO

5.2. Give labour some more capital

Since the 60s Spain has benefited from an intense process of capital accumulation linked to a fast process of industrialisation and modernisation of the productive structure. More recently, as mentioned in chapter 2, since the accession to the EU and until 1992, large FDI inflows led net capital stock to grow well above the main EU economies[48]. During the 1993 recession capital accumulation slowed down significantly, although still exceeding the rates registered in the largest EU countries. Prospects associated with EMU membership contributed to sustaining and even widening the differential in capital accumulation rates from 1997 onwards. The recent economic slowdown does not seem to have modified this picture.

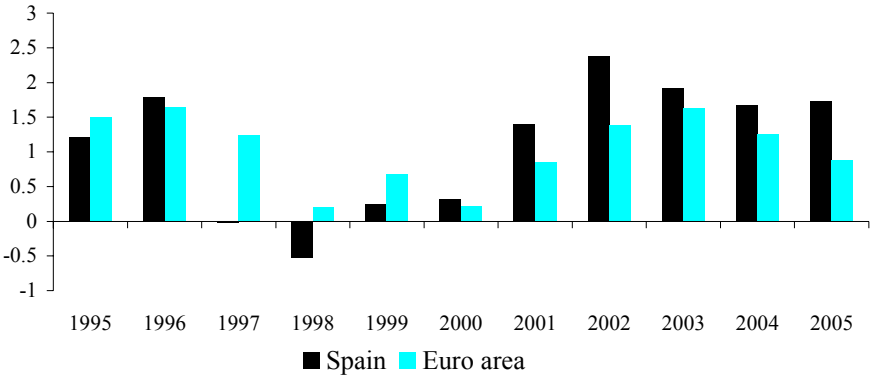
In spite of faster capital accumulation than in the European countries in the last years, the capital stock per person employed grew at similar rates, at around 1%, in Spain and the EU in the period 1995-2003 (Figure 28)[49]. This compares with 1.9% in the USA. As a result, the capital-labour ratio in Spain remains well below the USA (59%) and of the euro area, 67% in 2003. The relatively low capital-

[48] Between 1960 and 1985, FDI inflows represented 0.5% of GDP on average. After the accession to the EU and until the early 1990s recession, FDI grew significantly reaching more than 2% of GDP in 1990. Since 1995, FDI increased again and in some years has stood at around 5% of GDP. It is worth noting that in net terms, since the late 1990s Spanish FDI abroad is higher than FDI inflows (Fernández-Otheo, 2003).

[49] In contrast, the capital-labour ratio growth averaged 2.0% in Spain during the period 1985-1995.

labour ratio in Spain reflects a high share of labour intensive activities, notably tourism and construction, in total gross value added.

Figure 28: Capital stock per person employed (annual growth rate)



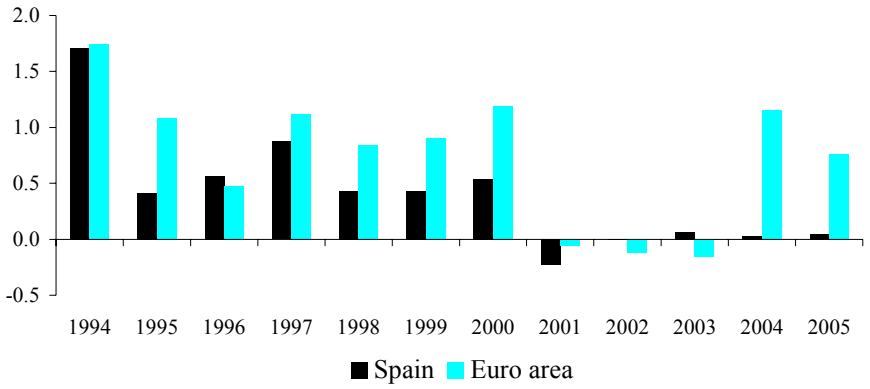
Source: AMECO

5.3. Not much technology in it

The recent slowdown recorded by labour productivity since 1995 in Spain relative to the euro area does not therefore come from capital accumulation, but from the low growth of total factor productivity (TFP). While in the period 1985-1995 TFP growth averaged 0.7% in Spain, it dwindled to 0.3% between 1995 and 2003. Something similar happened in the euro area: from an average growth of 1.2% between 1985 and 1995 it decelerated to 0.5% since 1995. Thus, although decelerating sharply in both cases, TFP growth in Spain remains half of the euro area (see Figure 29). A number of structural factors determine the evolution of productivity (see Barro, 1997, Barro and Sala-i-Martin, 1995, or Aghion and Howitt, 1998). Among them, we consider here human capital, training, research and development, the incorporation of information and communication technologies, the productive structure and the composition of imports. These two latter factors are discussed in the next section.

Specifically, the 2003-2005 Broad Economic Policy Guidelines for Spain (European Commission, 2003b) highlight the need to support growth by increasing productivity through encouraging R&D and human capital formation and enhancing competition. Accordingly, the specific recommendations addressed to Spain are: a) step up efforts to increase skilled human capital, business involvement in R&D and innovation, and ICT diffusion; and b) Continue to take measures to strengthen competition in certain sectors, such as electricity and retail trade, and to reduce the administrative burden on business establishment. These elements will be analysed in more detail in the following paragraphs.

Figure 29: Total factor productivity growth



Source: AMECO

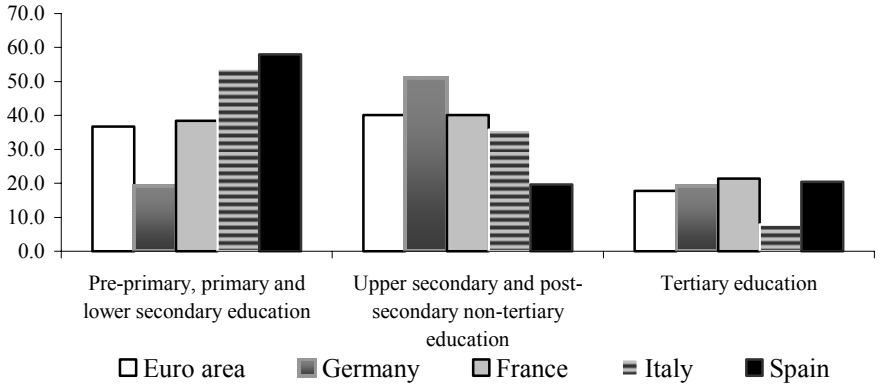
Human capital accumulation

Although having progressed fast in the last decade[50], educational attainment in Spain (measured by the percentage of the population aged 20 to 24 having completed at least upper secondary education) is still below the EU average (63.4% as against 74% in the EU-15 in 2003) and public spending in education as a percentage of GDP remains among the lowest in the EU, 4.5% in 2000, which compares with almost 5% in the EU-15 (see European Commission, 2003b). As a result, the educational attainment of the working age population is lower in Spain than in other large EU economies (see Figure 30). In particular, secondary education, the educational level with largest impact on economic growth (Barro, 1997, and Aghion and Howitt, 1998), is significantly below the euro area average[51]. Additionally, according to the PISA 2003 report (OECD, 2004b) based on achievements of 15 year old students, the quality of secondary school in Spain is significantly below the OECD average.

[50] Moral and Hurtado (2003) show that employment in Spain has increased its "quality content" in recent years due to the higher educational attainment and work experience (age) of Spanish workers while employment growth composition has tended to lower labour quality because of the expansion of the less productive sectors.

[51] The proportion of adults with upper-secondary school is only slightly more than half of the OECD average (OECD, 2003).

Figure 30: Working age population and educational level (%)



Source: EUROSTAT

Vocational training

In order to improve productivity, labour skills are of major importance. A skilful workforce allows for management improvements, cost reduction, and greater sophistication and ability to incorporate new technologies. In Spain the share of workers with secondary education is relatively low. Additionally, skills do not always match firms' requirements. This mismatch is partially explained by a less developed vocational training in Spain than in other advanced economies: only 31% of students in upper secondary school in Spain follow vocational training compared to an average of 41% in the OECD area (OECD, 2003)[52]. This situation is to some extent caused by the lack of social reputation of vocational training, which in Spain is perceived as a secondary option for the "less brilliant students". Moreover, as said before, the large share of temporary contracts provides little incentives for investing in human capital. Overall, the educational system should be reoriented so as to cope with the professional skills demanded by firms.

Research and development

R&D can have a significant impact on productivity and long-run economic growth (OECD, 2002b). Although the tax credit scheme for promoting R&D activities in Spain is the most generous in the OECD area[53], innovation and expenditure on R&D are among the lowest in Europe, and further efforts should be pursued so as to promote quality and product differentiation. This could be partly explained by the fact that the legal background is unclear on which cases

[52] Likewise, after upper secondary school, only 41% of students in Spain join advanced vocational training while this percentage reach 58% in the EU. However, in clear contrast with these figures, employability of vocational training graduates is higher than workers with a university degree (OECD, 2003).

[53] One third of expenditure on R&D by large companies is recovered, which is the highest share among the OECD countries and almost twice as high as the second country ranked (OECD, 2003).

are prone to qualify for such tax credits. Despite recent progress in the last years, R&D expenditures in Spain amount to around 1% of GDP, which is below half of the euro area average[54]. Specifically, low expenditure in R&D activities is translated into fewer patents. Only 24 patents per million inhabitants were registered in 2001 compared to 161 in the EU-15.

On the other hand, the banking system is the main channel that provides funds for new investment projects. In this regard, the big banks' business involvement is closer to more traditional activities such as construction, electricity and chemistry, which in general are characterised by comparatively low technological content. However, the insufficient degree of expansion of risk-capital funds constitutes a big obstacle for most innovative projects to develop. The absence of a deep capital market hampers the embracement of innovative but risky medium-large size projects in the long term.

The 2005 budget, echoes the need of promoting high value-added activities and increasing spending on R&D activities in order to underpin productivity growth. In fact, funds devoted to these policies increase by more than 25% with respect to the previous year. The bulk of such funds are allocated to subsidies and direct financing of research projects. Notwithstanding the sharp increase, public funds devoted to R&D activities only amount to around 0.5% of GDP.

Information and communication technologies (ICT)

It is also paramount to pursue further efforts on ICT take-up: 29.5% of households had internet access at home in 2002 as against 38.9% in the EU-15. The share of both gross value added and per capita expenditure on ICT activities stands below 75% of the EU-15 average. Although these latter activities have contributed to increase productivity growth significantly in the late-nineties (see Hernando and Núñez, 2002), their contribution to productivity growth is still well below the USA and could largely be improved. ICT diffusion is especially important since it allows for new technology dissemination and quick information processing while contributing to reducing production, coordination and distribution costs in mature sectors. Finally, a wide use of ICT improves the ability to respond to demand changes and thus reinforce competitiveness via other elements different from prices (see for instance European Commission, 2001c).

5.4. All inclusive but chips

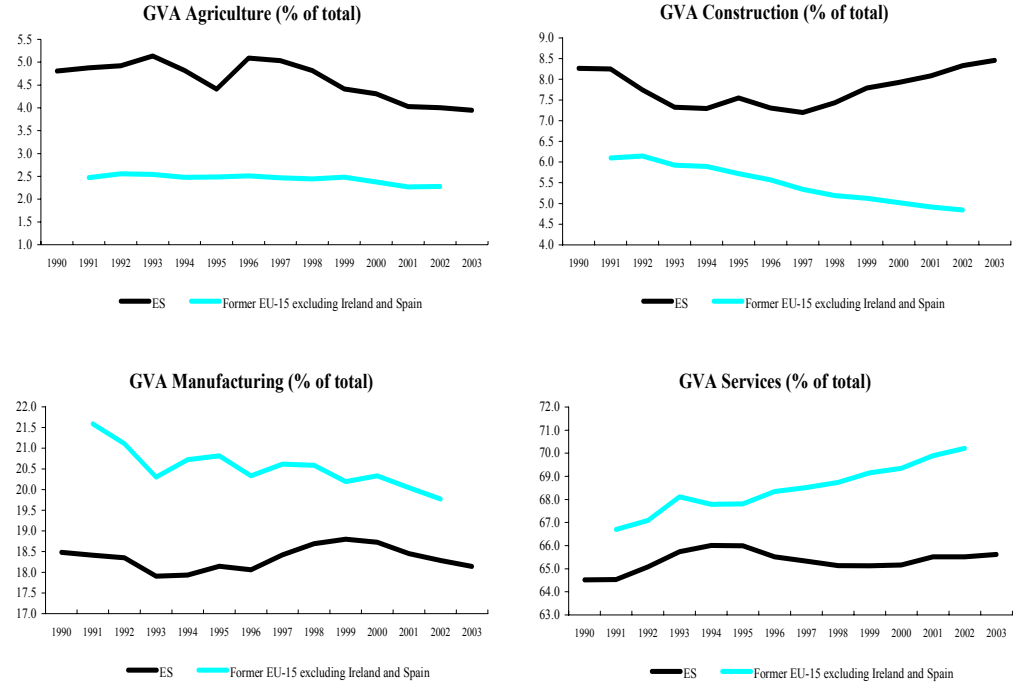
Behind the labour productivity developments lies a particular production structure that determines growth and performance in international markets. The most remarkable feature of the breakdown by branches of total gross value added in

[54] This applies to both private and public sector. For the former, business R&D expenditure in Spain represents 0.5% of GDP approximately compared to 1% in the euro area. For the public sector, expenditure on R&D is also comparatively low: 0.4% and 0.6% of GDP for Spain and the euro area respectively.

Spain shows a clear increase of construction linked to the buoyant residential investment that differs clearly from the fall or stabilisation of this activity in other European economies. On the other hand, the share of manufacturing remains below those of the largest EU countries, and its fall in the last years is in accordance with the trends observed in the EU (Figure 31).

It is worth noting the higher importance of agriculture and construction in Spain, coupled with the relatively low share of services and, to a lesser extent, manufactures. Both agriculture and construction are labour intensive activities, characterised by low productivity growth and low-skilled labour requirements. In particular, a high concentration of job creation in low productivity sectors has been observed since the mid-nineties. In addition to market services, as explained in detail in chapter 2, construction has experienced an unprecedented expansion and employment in this sector has risen well above other activities (Figure 32). This phenomenon has also contributed to the overall productivity slowdown observed in the recent past.

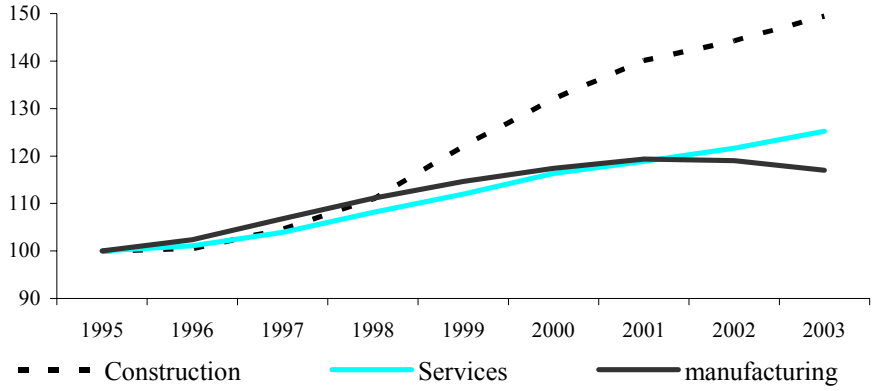
Figure 31: Composition of Gross Value Added



Source: AMECO

Furthermore, the share of services linked to tourism activities, where unskilled labour is dominant and productivity gains are also poor, is much higher than in the rest of the countries considered and in the EU as a whole. According to the Tourism Satellite Account, tourism represented around 12% of total GVA in 1999. Therefore, branches of low productivity levels are relatively more important in terms of gross value added in Spain than in other European countries.

Figure 32: Employment growth by sectors in Spain (1995=100)



Source: AMECO

Industry, in line with other advanced countries, accounts for slightly above 20% of total GVA. But its importance goes beyond these figures, notably due to its induced effects on the rest of the economy. In particular, manufacturing is crucial as far as production and absorption of new technologies are concerned. Therefore, its composition and evolution largely affects total factor productivity growth.

In the last years a tendency to reduce the share of low-technology goods to European standards and to increase the share of medium-high technology ones is observed. As regards high technology goods, however, the gap with the EU has widened further as production and exports of such products in the EU grew faster than in Spain.

Moreover, some sectors are made up of a large number of small and medium sized companies with low innovative capacity[55]. Other sectors are dominated by few firms involving a low degree of competition (electricity, petrol distribution, some telecommunication branches, etc.), which might discourage innovation.

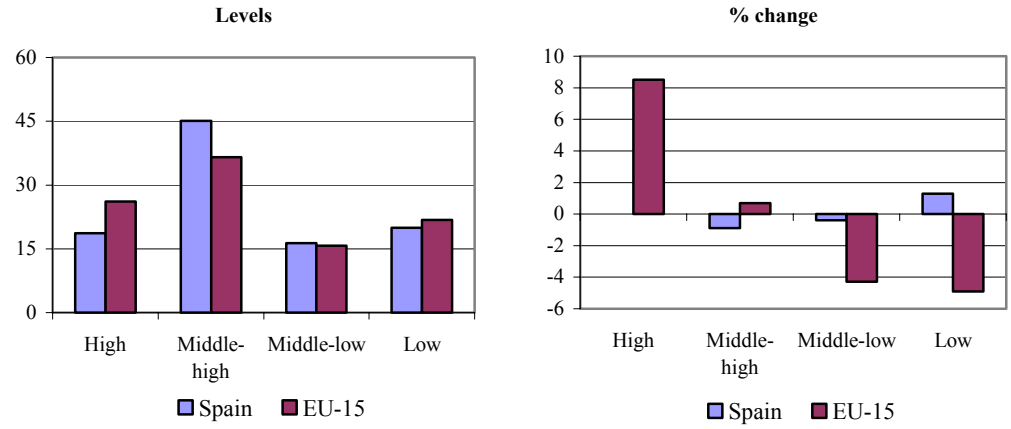
Consequently, the Spanish productive structure seems to be focused on low productive branches and mature sectors where productivity gains are low and with moderate growth of world demand, while real convergence requires efforts to improve productivity. Means and policies to be implemented in order to reach such an objective are not obvious and their effects will take some time before being perceived. Nevertheless, it appears crucial to improve product and labour market functioning so as to raise skilled human capital and resources allocated to R&D activities through both public and private sectors. Finally, a more widespread ICT diffusion is advisable given its positive spillovers.

[55] Nearly 75% of Spanish firms have 10 or less workers.

Shopping technology

Spanish imports of manufactures are largely concentrated on middle-high technology goods[56]. This is due to the growing importance of intra-industry trade in this segment of the productive structure between Spain and its main EU trade partners. In contrast, the recent evolution of high-technology imports shows that the technological gap with the EU has widened further (Figure 33). Given that imports are also an important factor enhancing technological diffusion and absorption, especially in countries like Spain with a low degree of innovation, the recent evolution of high-technology imports is a matter of concern (Gordo et al., 2003).

Figure 33: Imports structure in 2001 by technological intensity



Source: Gordo et al. (2003)

[56] This category includes machinery and mechanical equipment, motor vehicles, chemical products except chemistry, railway equipment and other transport machinery. Thus, although entailing spillovers mainly on some manufacturing industries, these imports barely affect ICT diffusion.

6. Price developments and competitiveness

A main goal of this chapter is to analyses the causes and economic implications of the relatively large inflation differential of Spain with the euro area. Although cyclical and monetary conditions play a non-negligible role, the inflation differential in Spain appears to a large extent associated with structural factors. Low productivity growth, coupled with rigidities in some markets, are key elements behind the persistent higher inflation.

Inflation differentials are deteriorating Spanish competitiveness by appreciating the real effective exchange rate and eroding mark-ups in the tradable sector. Therefore, liberalising measures undertaken in the recent past may help alleviate inflation pressures. However, they need to be complemented by measures aiming at increasing effective competition through a deeper process of market deregulation, particularly in services sectors.

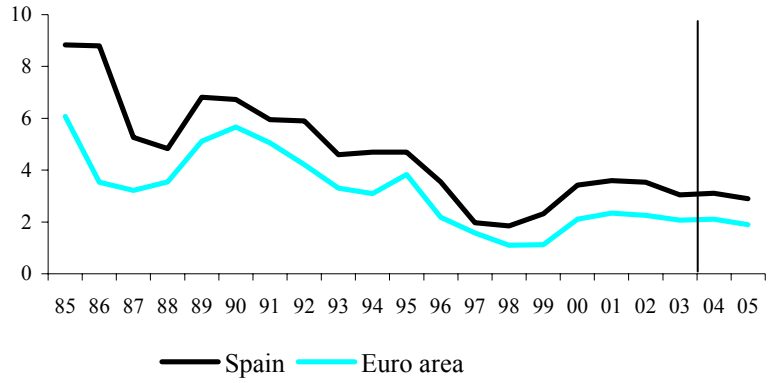
Such measures, coupled with those aiming to raise productivity growth, should lead by new production and export specialisation patterns increasingly based on quality and product differentiation. This would reduce the price elasticity of exports and help maintain, or even improve, the external competitiveness. Otherwise, stronger competition coupled with persistent inflation differentials may end up by magnifying current external imbalances of the Spanish economy.

6.1. The role of prices

The traditional comparative advantages that Spain has enjoyed since the accession to the EU, based on low production costs and price levels, seem to be fading away as a result of cumulated inflation differentials. Before 1998, appreciations of the real exchange rate were offset by currency devaluations, which helped restore competitiveness, especially during the first half of the nineties (Bravo y Gordo, 2003). However, since accession to EMU, the exchange rate is not a policy instrument anymore and inflation differentials result in competitiveness losses.

Although since the late 1980s, when Spain joined the ERM, tighter monetary policy has led inflation rates to converge to those in the EU, significant inflation differentials vis-à-vis the euro area still persist and, according to the Commission Autumn 2004 forecast, are foreseen to remain in the medium term (see Figure 34). While the annual average inflation rate in the euro area between 1998 and 2003 was 1.8%, the rate registered in Spain amounted to 3.0%. Inflation differentials entail constant pressure on costs, and competitiveness losses. In order to design the most appropriate economic policy, is essential to know the sources of such differentials. This chapter analyses the nature of the inflationary pressures in Spain and the associated risks for the Spanish growth model.

Figure 34: Inflation rates Spain versus the euro area, 1995-2005



Source: INE, AMECO and New Cronos

6.2. Determinants of inflation differentials across countries

A number of different factors can determine inflation differentials in a monetary union. Depending on their nature, inflation differentials can be considered as "benign" or "malign". The first category comprises: i) cyclical divergences, which can be considered benign since inflation differentials help restore equilibrium after an asymmetric shock; ii) Balassa-Samuelson effects, according to which inflation differentials reflect equilibrium-restoring factors stemming from different productivity growth between the tradables and non-tradables; and iii) price level convergence, associated with real convergence enhanced by price transparency and market arbitrage.

"Malign" inflation differentials, which tend to accentuate economic imbalances, are related to structural and institutional features of the economy, such as the wage setting process and the functioning of product markets (mark-ups).

Cyclical factors: Inflation rates are affected by the cyclical position of the country. For instance, positive output gaps would imply higher inflation on a temporary basis. Since EMU enhances synchronization of national business cycles, the importance of inflation differentials of a cyclical nature will diminish over time (Egert et al, 2004).

Balassa-Samuelson effects: According to the well-known Balassa-Samuelson[57] effects, lower productivity growth in sheltered activities, combined with productivity in the open sector growing faster than in the rest of the world, would result, ceteris paribus, in higher inflation rates accompanying catch-up in income levels[58]. This is the case of catching-up countries, where real economic

[57] Balassa (1964) and Samuelson (1964).
[58] Under the assumption of a certain degree of wage equalisation across sectors, faster productivity growth in tradables pushes wages up for the whole economy, which in turn leads to higher

convergence goes hand in hand with positive inflation differentials. However, empirical evidence indicates that the Balassa-Samuelson effects may not be large. Honohan and Lane (2003) find evidence of a weak Balassa-Samuelson effect in EMU. Lommatzsch and Tober (2003) also find weak effects in Greece, Portugal and Spain.

Price level convergence: In catching-up countries, real convergence would lead to a redistribution of consumption towards goods and services with higher income elasticity. This would push inflation up, in particular in the services sector. Moreover, as shown by Rogers (2001, 2002), EMU is expected to further boost price convergence through a higher inflation rate in those countries with lower price level. These elements can be especially relevant for Spain, which records a per capita income slightly above 85% of the EU-15 average and a general price level among the lowest.

Structural factors: By distinguishing between the open and the sheltered sector of the economy, inflation in the latter will be higher the higher the difference in unit labour costs between both sectors and the lower the mark-up in the open sector (Canzoneri et al, 2002). Therefore, persistent inflation differentials are closely associated with the functioning of the labour market, the degree of competition in product markets and productivity performance. Persistent differences in these elements across countries will entail different relative price tendencies.

Such structural factors, namely labour and product market rigidities, interact with Balassa-Samuelson effects and price level convergence, exacerbating inflation differentials across countries. As a result, inflation may not exclusively be due to higher productivity growth in the open sector, and persistent inflation differentials stemming from market rigidities and malfunctioning may threaten convergence and competitiveness in the medium term (Alberola and Tyrväinen, 1998).

6.3. Spanish-EU inflation differentials: Where is the culprit?

It was not the output gap

Where Spain-euro area inflation differentials are concerned, differences in cyclical positions are only one element among the rest. Moreover, in the recent past the output gaps have been similar in Spain and in the euro area. For instance, in 2002 the output gap in Spain was 0.5% of trend GDP, which compares with 0.6% in the euro area. Therefore, differences in the cyclical position may only give a very partial explanation of the higher inflation rate in Spain.

In the recent past relatively low nominal interest rates in the euro area may have fuelled domestic demand in Spain. While during the previous slowdown in 1993

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inflation in non-tradables, where productivity growth cannot keep pace with nominal wages. Within this framework, dual inflation between tradable and non tradable sectors would be a natural consequence.

nominal interest rates were at around 15% in Spain, at present they record values close to 2%. Similarly, real interest rates were around 10% at that time and have recorded negative values since the second half of 2002. This has boosted credit growth, especially for mortgages, underpinning demand for housing and putting further pressure on prices. However, looser monetary conditions in Spain than in the euro area are a very partial explanation of inflation differentials. Although to a lesser extent, other countries have also enjoyed relatively loose monetary conditions since 1998 without recording as high inflation differentials as in Spain. Different responses to a common monetary policy can only be due to the presence of idiosyncratic elements, which condition the monetary policy stance. Therefore, differences in either the monetary stance or the cyclical position do not seem to account *per se* for the observed inflation differential in Spain. Higher inflation expectations linked to the structural and institutional features of the Spanish economy seem to be behind persistent inflation (Ledo et al., 2002). Therefore, in order to properly assess the nature of the inflation differentials between Spain and the euro area structural factor must be brought to the forum.

Do not blame the unions

One notable feature of the Spanish economy in the last twenty years has been the continuous fall of inflationary expectations and the slow but gradual accommodation of agents' behaviour to the new economic setting. Despite this, nominal unit labour costs (ULCs) have continued to record higher growth rates in Spain than in the euro area. Hard data suggest that the functioning of the labour market, albeit one of the usual suspects, is not one of the main culprits.

Figure 35: Wages, nominal ULC and RULC evolution

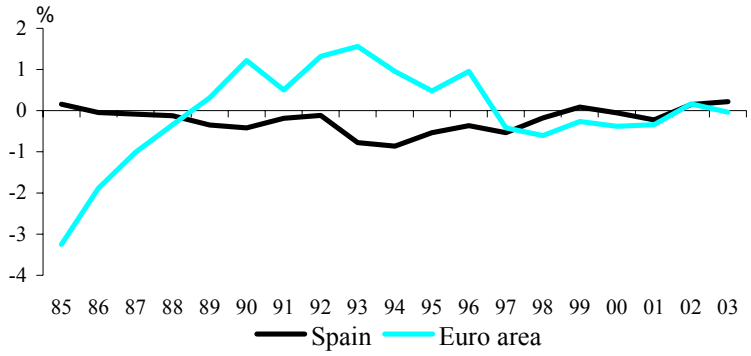
Source: AMECO

A new wage growth pattern has emerged since the mid-1990s, which was further underpinned by the stable macroeconomic framework of EMU. As a result, the wage differential with the euro area has narrowed significantly (Figure 35) and, in parallel, relative wage inflation between tradables and non-tradables has converged in the last years (Figure 36). Therefore, the still remaining gap in unit labour costs has to be mainly found in poorer labour productivity developments

rather than in insufficient wage moderation. In other words, as compared with the euro area, the Spanish labour market does not seem to embed especially tight rigidities. Moreover, real ULCs have registered negative growth rates in the last years and, therefore, real wages have been growing below labour productivity. Although also observed in the euro area, this behaviour has been especially acute in Spain.

However, some labour market institutions may still be a source of inflation tensions. This appears to be the case for wage indexation. In Spain, indexation clauses are still applied to almost half of the workers. Backward-looking wage indexation introduces distortions in the functioning of the labour market and contributes to inflation persistence, especially when there exist high and persistent inflation differentials with the euro area. Moreover, at the current juncture, when inflation is rising due to external shocks, indexation clauses can magnify the effect and persistence of such shocks. In this respect, the substitution of indexation by other bargaining mechanisms including a closer link between wage increases and productivity growth would lead to more efficient results. However, such pervasive effects of indexation may have been more important in the past than at present. While indexation was largely responsible for the episodes of high inflation in Spain during the two oil price shocks, its current impact on inflation developments is likely to be much milder[59] .

Figure 36: Relative compensation per employee (non-tradables vs tradables)



Source: AMECO

Where are you, productivity?

As shown in chapter 5, labour productivity growth is lower in Spain than in the euro area, and has contributed to the persistently higher inflation in Spain. In addition, average labour productivity growth in manufacturing in the period 1996-2003 was also lower in Spain than in the euro area: 0.9% compared with 2.0%,

[59] In fact, wage increases agreed through collective bargaining are lower when indexation clauses are present. Izquierdo et. al. (2003) provide evidence on this statement.

respectively (see table 10). Apart from Italy, labour productivity for manufacturing in Spain is also lower than in the largest and more advanced EU economies. Hence, Balassa-Samuelson effects do not seem to be behind the Spanish higher inflation (Box 8).

Table 10: Labour productivity growth. Manufacturing

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	**96-03**
DE	N/A	N/A	5.6	-0.6	8.5	2.6	-0.2	5.0	1.7	-0.9	3.6	-0.6	2.0	2.9	**1.7**
ES	-0.7	3.2	3.0	1.6	3.7	2.1	-1.0	2.2	0.7	0.7	0.9	0.4	0.6	3.1	**1.0**
FR	1.2	2.4	3.8	0.5	7.9	4.8	0.8	5.9	5.0	3.7	3.3	1.9	2.5	1.8	**3.1**
IT	0.5	1.7	4.4	0.6	6.0	3.6	-0.6	2.8	-0.4	0.3	2.9	0.0	-1.9	-1.2	**0.3**
UK	3.3	4.2	7.1	5.1	3.4	-0.8	-0.1	1.7	1.0	4.6	5.5	2.3	0.4	4.4	**2.5**
US	0.3	0.8	4.9	2.5	5.6	5.6	3.5	6.0	4.4	5.5	6.8	-1.3	10.2	6.8	**5.2**
EUR-12 (1)	N/A	N/A	N/A	N/A	N/A	N/A	0.3	4.6	2.0	1.1	3.7	0.4	1.7	2.0	**2.0**
EUR-15 (2)	N/A	N/A	N/A	N/A	N/A	N/A	0.3	4.4	2.0	1.9	4.3	0.6	1.8	2.5	**2.2**

1) At 1995 exchange rates; Euro area
2) At 1995 exchange rates; Former EU-15
Source AMECO

Box 8: Balassa-Samuelson estimates for Spain in the literature

As shown in the table below, the recent literature suggests that Balassa-Samuelson effects on Spanish inflation have become less important over time (sample period getting closer to EMU). For instance, Canzoneri et al. (2002) find that around 1.5 percentage points of the Spanish inflation rate were due to such effects in the period 1973-1991/97. In contrast, more recently Lommatzsch and Tober (2003) estimate a more modest Balassa-Samuelson effect since 1995 (less than 0.5 percentage points).

	Inflation due to B-S effect	Average Inflation
Alberola and Tyrväinen (1998)		
1975-1993	3.1	11.6
1985-1993	3.5	6.4
Sinn and Reutter (2001)		
1987-1995	1.5	5.5
Canzoneri et al. (2002)		
1973-1991	1.5	12.5
1973-1997	1.4	10.5
Lommatzsch and Tober (2003)		
1995-2002	0.4	3.1

Marking up the inflation race

Low productivity growth in tradables, particularly when coupled with distortions in product markets, allow producers to discriminate prices, contributing to inflation stickiness (Andrés et al., 2003). Persistently higher inflation in Spain is apparently due to faster growth of mark-ups in services coupled with a poor productivity growth in the open sector, thus constituting a systematic deviation

from the Balassa-Samuelson paradigm. The reasons behind high mark-up growth are to be found mainly in the functioning of product markets.

Álvarez et al. (2003) provide evidence on the effects of market structure on inflation. Since 1995, mark-ups in services have been increasing in contrast with moderate growth of unit labour costs, putting pressure on prices of services. In parallel, the income convergence process has led to a demand shift towards the service activities with higher income elasticities, pushing prices up further in these branches[60].

As for branches of activity, the inflation differential appears to a large extent in services. Specifically, transport, services related to renting of dwellings, restaurants and hotels and some professional services, such as health care, register the highest inflation differentials with the euro area.

As a result, in spite of cyclical and monetary conditions playing a non-negligible role, the inflation differential in Spain seems to be caused to a significant extent by structural factors. Income convergence, higher wage growth coupled with lower productivity growth than in the euro area and the presence of product market rigidities in some sectors are key elements behind the persistent higher inflation. Therefore, cumulated inflation differentials might eventually jeopardise Spanish competitiveness by an appreciation of the effective real exchange rate and eroding mark-ups in the tradable sector. In this regard, liberalisation initiatives undertaken in the recent past may alleviate inflation pressures. However, they need to be complemented by measures aiming at increasing effective competition through a deeper process of market deregulation. Furthermore, efforts devoted to increasing labour productivity growth should contribute to narrowing the currently sluggish differential.

6.4. Competitiveness. A dangerous position?

Exports and imports of goods represent around 20% and 25% of GDP, and manufacturing is by far the main good traded (nearly 80%). While the healthy growth rates of exports of goods in the second half of 1990s are largely explained by the complete integration of the Spanish economy in the European single market and the devaluations of the peseta, the slowdown observed since 2000 might be partially explained by price competitiveness losses registered in the latest years, the pattern of export specialisation and the high dependency on intra-EU markets[61] (Bravo y Gordo, 2003 illustrate these aspects).

The more common price and cost competitiveness indicators clearly show a gradual deterioration in the competitive situation of the Spanish economy

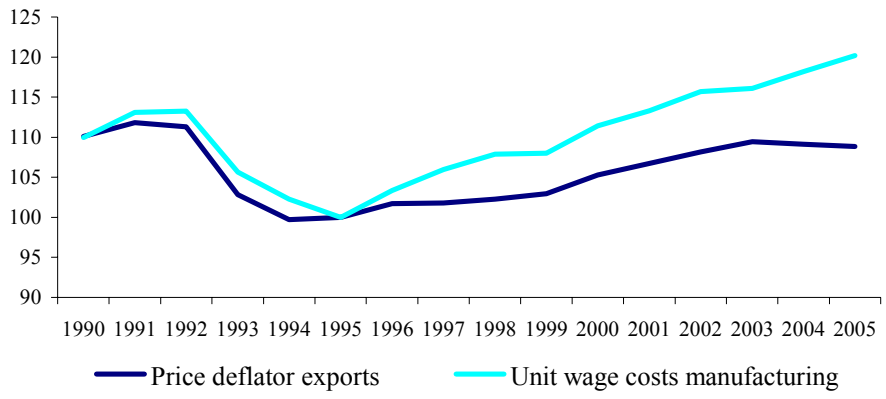
[60] Additional evidence on this issue is provided by Ortega (2003) and Estrada and Lopez Salido (2004).

[61] Similarly to total export figures, exports of goods grew by more than 10% on average in the period 1996-1999 compared to an average growth rate below 5% during 2000-2003.

vis-à-vis its main trade partners since 1995 (see Figure 37). Specifically, since 1995, Spanish competitiveness, measured by the evolution of export prices relative to either the euro area or the main industrialised countries, has deteriorated by 10%. When competitiveness is measured by using unit labour costs in manufacturing, which is close to the concept of tradable goods, the deterioration turns out to be above 16% relative to the euro area. This deterioration has almost offset the competitiveness gains obtained through the devaluations that took place in the first half of the nineties (see European Commission, 2004a, for more details).

These price competitiveness losses are particularly relevant given that export price elasticities in Spain seem to be above the EMU average (see Buisan and Caballero, 2003) and can partially explain the modest performance of the Spanish exports of goods in the most recent past[62]. A high price elasticity of exports is the consequence of a particular pattern of trade specialisation, which, in turn, is coherent with the patterns of production specialisation showed in the previous section. Overall, Spanish exports of manufactures concentrate on products with low degree of technological sophistication and limited degree of product differentiation, which, therefore, are more influenced by price competitiveness[63]. Moreover, as shown by Bravo and García (2004), Spanish exports of manufactures are specialised in "mature" activities whose international demand is less vigorous, namely average technology goods (at around 52% of the Spanish exports of manufactures) and low technology products (around 20%).

Figure 37: Price competitiveness indicators of Spain versus the euro area (1995=100)



Source: AMECO

[62] Buisan and Caballero (2003) also point to a higher income elasticity of Spanish exports than in other EU countries. This would be the result of the recent and rapid process of openness of the Spanish economy and should tend to moderate gradually.

[63] This is closely linked to the shrinkage observed in the margins of manufacturing-exporting sector in order to keep market shares.

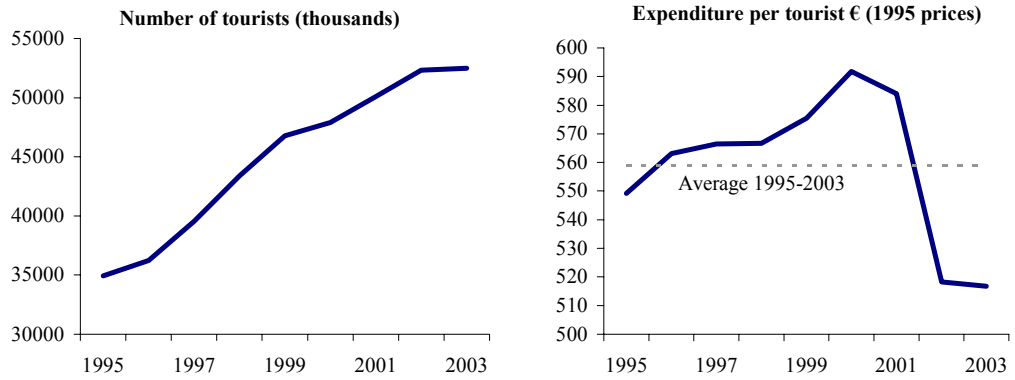
Specifically, exports of motor vehicles represent at around 25% of total exports of goods. These are included in the middle-high category and are closely linked to the presence of export-oriented multinational corporations. This high degree of export-specialisation in a branch leaves Spanish trade highly exposed to external sector-specific shocks. Machinery and equipment (above 10%) and chemical products (above 15% of total exports) and electrical and electronic goods (above 10%) are also main export sources. On the other hand, medium-low and low technology activities such as textiles, clothing and footwear (at around 6%), processed and non processed food (above 15%) and wood and paper (above 5% of the total) are also predominant in total exports.

Moreover, the negative gap between Spanish imports and exports of high-technology goods, for which the world demand is most dynamic, has widened. This specialisation pattern is similar to that in some new Member States, although the latter have significantly lower production costs. Furthermore, destination markets are also far from been the most dynamic ones, Far East Asian countries, which prevents Spain from making the most of world growth.

Exports and imports of services represent 9% and 5 % of GDP respectively. Tourism accounts for more than 50% of services exports and 15% of services imports. While other services (transports, services to companies etc) have traditionally registered a deficit, tourism has generated important surpluses at around 4% of GDP, playing an important role in sustaining economic growth in Spain in the latest decades.

Spain is the second largest tourist destination in the world with about 50 million arrivals, only behind France (75 millions), and collects 7% of world tourism revenues (Martínez and Andrés, 2003). Although still dynamic, tourism and travel sectors are not free from threats, and since 2000 the relative economic performance of these sectors in terms of contribution to GDP growth has worsened significantly.

Figure 38: Tourism industry trends in Spain



Source: INE and IET

Inflation differentials and the appreciation of the euro in the last years could have contributed to deteriorating the competitive position of this sector. In turn, more than 90% of tourists arriving in Spain come from other EU member States, which given the economic slowdown in the largest EU economies, is a major factor behind the stagnation in the number of tourists in the latest years as well as the declining ratio of expenditure per tourist (see Figure 38).

Other factors, by nature more structural, help also explain the less brilliant performance of tourism since 2000. In particular, the supply of tourist services with similar characteristics in other countries with lower costs has widened considerably in the last decade[64]. This stronger competition along with some degree of obsolescent tourist facilities and price competitiveness losses are posing gradually more difficulties in keeping the market share of the Spanish tourism industry. Similarly to goods, it would appear advisable to shift from broad price competition towards more differentiated tourist services in order to maintain the dynamism of this sector in Spain.

[64] The political unrest in some competitor areas has to some extent limited the adverse effects on the tourism demand services addressed to Spain during the last decade. However, generalised lower transport costs have dramatically enhanced the attractiveness of far destinations that enter in competition with domestic ones while encouraging Spaniards to travel overseas and thus changing existing patterns.

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