

COUNTRY STUDIES

**COMMISSION OF THE EUROPEAN COMMUNITIES
DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS**



Number 7

March 1992

Spain

**Directorate-General
for Economic and Financial Affairs**

* Country studies are the result of internal analysis of the economic situation of the respective member country; they are made on the responsibility of the Directorate-General for Economic and Financial Affairs of the Commission of the European Communities.

Table of Contents

Executive Summary	1	Part II	
Part I		Chapter I	
The Economic and Financial Situation		The Price Wage Formation Process and	
in Spain	3	Labour Market Constraints	25
0. Introduction	3	Chapter II	
1. Supply-side performance and challenges	3	Competitiveness and External Performance	
2. Problems of stabilization	7	in the Catching-up Process	40
3. The pursuit of convergence as		Chapter III	
EMU progresses	11	Public Finance and Fiscal Reform	53
4. Summary and conclusion	13	Chapter IV	
Statistical Annex	14	Regime Applicable to Capital Movements	66
		Chapter V	
		The Financial System	68
		Chapter VI	
		The Conduct of Monetary Policy in Spain	77
		Chapter VII	
		Regional Disequilibria: Unbalanced Regional	
		Growth, Asymmetries and Consequences	84

Table of Graphs and Tables

Part I	Statistical Annex
Graph 1: Spain: GDP per Capita PPS, EUR12 = 100 3	Table 1: Final uses of goods and services and other key aggregates of the Spanish economy 14
Graph 2: Shares of GDP at Factor Cost 4	Table 2: Final uses of goods and services 15
Graph 3: Net Return on Net Capital Stock Total Economy (1973 = 100) 4	Table 3: Employment evolution 16
Graph 4: Nominal compensation per employee 5	Table 4: Prices (yearly changes in %) . . 17
Graph 5: GDP per person employed 5	Table 5: Contribution of the change (%) of the price deflator of total final uses 18
Graph 6: Real effective exchange rates ULC total economy and export deflator 5	Table 6: The balance of payments in Spain (as % of GDP) 18
Graph 7: Components of Domestic Demand: Contribution to real GDP Growth 7	Table 7: Imports and exports in volume terms (% annual growth) 19
Graph 8: Private Sector: Gross Saving and Investment 7	Table 8: Geographical breakdown of goods trade 19
Graph 9: Net Lending (+) or net borrowing (-) by sector 7	Table 9: Geographical breakdown of Spanish intra-community trade . 20
Graph 10: Real domestic demand & imports of goods 8	Table 10: Degree of openness , import penetration, and export activity in Spain and in the EC countries 21
Graph 11: Inflation by sector 8	Table 11: Nominal and effective exchange rates (index 1980 = 100) 22
Graph 12: Contribution to the change in the price deflator of total final uses (%) 8	Table 12: Receipts and expenditure of general government 22
Graph 13: Net lending or net borrowing of general government 9	Table 13: Monetary and credit indicators . 23
Graph 14: Bilateral spread between the Peseta and the weakest ERM currency . .10	Table 14: Counterparts of money creation . 23
	Table 15: Interest rates 24

Table 16: Economic performance relative to EUR-7 24

Part II

Chapter I

Graph 1: Change in wages, prices and unemployment rate 32

Graph 2: Contribution to the change in the price deflator of total final uses (%) 32

Table 1: Recruitment under the employment promotion programmes (EPP)

Table 2: Growth in total and temporary employment 34

Table 3: Temporary employment as a proportion of total wage-earners, total and by sector 35

Table 4: Employment growth 35

Table 5: Employers' social security contributions as a percentage of total taxation 35

Table 6: Unemployment rates by age group, 1989 35

Table 7: Changes in participation rates for men aged 55 and over. Spain, the Member States and international comparisons 36

Table 8: Principal characteristics of activity of those aged 14-24, 1989 36

Table 9: Unfilled job vacancies and skill shortages 36

Table 10: Education and training Information relates to education and training experiences during the four weeks preceding survey 37

Table 11: Participation rates and levels of education 37

Table 12: Part-time employees as a proportion of total employees, 1989 38

Table 13: Persons in employment by professional status, 1989 38

Table 14: Concentration of family working and self employment, by sector, 1989 38

Table 15: Persons in employment, by professional status and by age-group, 1989 39

Table 16: Nominal and real unit labour costs (% average growth) 39

Table 17: Contributions to the change of the price deflator of total final uses (%) 39

Chapter II

Table 1: The balance of payments in Spain (% of GDP) 41

Table 2: Degree of openness, import penetration, and export activity in Spain and in the EC countries 42

Graph 1: Product breakdown of non-energy imports Contrib. of non energy imports growth 43

Graph 2: Prod.breakdown of consumption imports Contrib. of consumption imports growth 43

Table 3: Spanish competitiveness between 1985 - 1991 44

Graph 3: Nominal effective exchange rates 45

Graph 4: Inflation by sector (% average annual rate) 45

Table 4: Invisible balance (% of GDP) 46

Graph 5: Tourism performance 46

Graph 6:	Saving and investment gap47	Table 10:	Central Government Debt (Distribution of outstanding debt according to the conditions of the issue) 63
Table 5:	Current and capital account balances (% of GDP)47	Table 11:	Central Government Debt (Outstanding debt at the end of the period) 64
Graph 7:	Current account's permanent finance (% of GDP)48	Table 12:	Public Debt of Central Government: Average residual life maturity of outstanding balances on 31 December 65
Table 6:	Net external financial position (December 1986 - September 1991, bn. \$)48		
Table 7:	Sectorial breakdown of direct foreign investment (% of total) . .50		
Chapter III			
Table 1:	Government revenue and expenditure (as % of GDP)54	Table 1:	Spanish banks' profitability ratios 70
Graph 1:	Net lending or net borrowing of general government cyclically adjusted55	Table 2:	Comparative importance of Spanish credit institutions (measured by total assets) 71
Table 2:	Increase in pensions, wages and income tax allowances and thresholds (% change)55	Table 3:	Structure of balance sheets of banking institutions 71
Table 3:	Overruns on the state budget (non-financial payments)56	Table 4:	Structural data for the stock exchange in 1989 72
Table 4:	Breakdown of general government net lending or net borrowing . . .57	Table 5:	New liabilities of non-financial enterprises and households . . . 73
Graph 2:	Net lending or net borrowing of general government57	Table 6:	New liabilities of non-financial enterprises Public issues through the stock markets 73
Table 5:	Financial assets and liabilities . .58	Graph 1:	Institutional Structure of the Spanish Stock Markets 75
Table 6:	Compliance with tax laws (Figures declared as a percentage of theoretical tax base)58	Chapter VI	
Graph 3:	Fiscal pressure EUR-9 = 10058	Table 1:	Monetary and credit indicators . 80
Table 7:	Structure of taxes (%)59	Graph 1:	Nominal short-term interest rates differentials 81
Table 8:	Receipts and expenditure of general government63	Graph 2:	Bilateral spread between the Peseta and the weakest erm currency . . 82
Table 9:	Table of flows63		

Chapter VII

Table 1 :	GDP per head with respect to EC, in pps	91	Table 7 :	Increase in training places required for adolescents aged 15-19 (% of places available in 1985) .	97
Table 2:	Investment in manufacturing, 1985-1987%	92	Table 8:	Distribution of the Fondo de Compensación Interterritorial in Objective 1 regions	98
Table 3:	Foreign and public investment, . .	93	Table 9:	Community Support Frameworks, MECU, 1989 prices	98
Table 4:	Level and structure of un- employment (1990)	94	Table 10:	Community grants in the objective 1 CSF, by axis	99
Table 5:	Population movements and activity rates	95	Figure 1:	Spain: Comunidades Autónomas	100
Table 6:	Structure of regional employment	96			

EXECUTIVE SUMMARY

In the second half of the eighties, the Spanish economy achieved among the fastest rates of GDP and investment growth within the Community. During this period, the country has made major progress in industrial reorganisation, in reforming and starting to open up the financial sector, and in liberalizing capital flows. It has also entered the ERM, albeit with wide margins.

Foreign capital inflows have been heavily encouraged by the twin factors of strong perceived opportunities for real investment and high rates of interest. That has been both necessary and appropriate in a period of demand dynamism characteristic of an economy engaged, after a painful readjustment between the mid-70s and the mid-80s, in a process of real convergence. Nevertheless, the spurt in growth in recent years has not yet restored the relative income level (*vis-à-vis* EC partners) of the early 1970s. But this strong real catching-up process caused inflationary pressures from the demand side which, taking account of the remaining rigidities in the economy, in due course have also become evident on the costs side.

Despite genuine supply-side improvements a number of structural deficiencies persist, particularly in the labour market, in the public finances and in an inadequately competitive structure of many sectors, most notably services, including financial services.

Fast growth of output in Spain has engendered impressive gains in employment (very largely temporary-contract employment) and an increase in participation rates. Nonetheless, the unemployment rate, while well below the peak of 22% reached in 1985, is still at a level (around 16%) much higher than in most other Community countries. Moreover, rapid employment expansion has been associated with mediocre growth in productivity. Inflation, which was below 5% in 1987, peaked at more than 7% last year and, currently at around 5.5% remains clearly out of line with inflation rates in the original narrow-band ERM countries. A notable feature of inflation performance in Spain has been the wide disparity between inflation in industrial goods (where inflation convergence with narrow-band countries has already been achieved) and services, where particularly high rates of increase in prices have been recorded recently.

At least part of the observed behaviour of relative inflation in services sectors in the recent past can probably be ascribed to macroeconomic factors - a demand boom outstripping current domestic supply potential. Nonetheless, there is clearly an underlying structural problem in services in Spain: insufficient competition combined with - or even created by - the regulatory public policies pursued in areas such as health, transport and communications has led to an inefficient allocation of resources in the economy as a whole and has thereby reduced the volume of output and employment consistent

with any given rate of overall inflation. Thus structural factors almost certainly contributed to the acceleration in overall inflation in Spain in 1988/90 as output and employment increased faster than the short-term capacity of the economy to grow without strains.

Domestic demand was growing fast and progressively in excess of output leading to a trade and current account balance deterioration. Public savings did not increase enough to compensate for the reduced saving rate of the households, resulting in insufficient domestic savings to finance the strong investment process.

The restrictive measures adopted in 1989 together with a further worsening in expectations in reaction to the Gulf crisis allowed a slowdown in domestic demand which halted the growth in the trade deficit and stabilized the inflation rate, despite the temporary effect of oil price increases.

Nevertheless, some confidence about moderation of disequilibria, combined with the optimism associated with the special events of 1992, could restore the economy to a temporary new expansionary path.

The main goal for the economic authorities has been and should be to maintain investors confidence in prospects for the economy. That means that improved economic efficiency should be translated into productivity, and external competitiveness gains, to allow a non-inflationary and sustained path of economic growth.

A policy of wage moderation would contribute to avoiding the risk of a re-emergence of overheating in the economy. But, an incomes policy will not be effective in restraining inflation if the growth of aggregate demand is excessive. In this respect, a slowdown in real wage costs would reduce the pressure on demand through a reduction in the real disposable incomes of households and would positively affect the cost formation process. In a dual labour market such as exists in Spain, where wages are set in the permanent segment of the market, an incomes policy presumably has a more institutional aim: to ensure, whether by persuasion or by legal compulsion, a degree of wage moderation that the non-competitive structure of the labour market is unable to produce. But it cannot replace the required reform of the labour market.

On the other hand, a policy of global wage moderation might prove to be ineffective in damping inflation since employers would be more ready to widen profits by simply increasing prices in a context of booming demand. In this respect, the slowdown of demand in 1991 has forced some moderation.

Monetary policy has faced significant constraints. Conditions of strong external confidence and high interest rates have encouraged substantial capital inflows and have created the well-known dilemma between allowing the peseta to ap-

preciate at the expense of preserving exchange rate stability (near the top of the ERM wide band) or continuing reducing interest rates, with the risk of an undesired domestic demand expansion. As Stage 2 of EMU approaches, the possibility of an independent Spanish monetary policy response would be further limited. But, as long as full nominal convergence has not been achieved, monetary policy, although subject to constraints, should remain restrictive.

Therefore, a major contribution from budgetary policy might be required. However, there would clearly be both practical

limitations and drawbacks to an active countercyclical use of fiscal policy. What is more, the key issue for fiscal policy will not only be its role as a demand stabilizer but rather its impact on the supply side through the implementation of tax reform (lowering corporation tax relief, reducing the direct tax burden on households, limiting tax fraud and indirect tax harmonization) and the reshaping of public expenditure (lower current expenditure and sustained public investment).

PART I

THE ECONOMIC AND FINANCIAL SITUATION IN SPAIN

0. Introduction

The Spanish economy, after a long-drawn-out and difficult period of adjustment in the 1970s and early 1980s, showed considerable dynamism in the second half of 1980s, with strong growth in employment, output and - in particular - investment, much of it financed by capital inflows. This dynamism has partly reversed the previous steep fall in income levels in Spain relative to those in the Community as a whole, but the country's income levels are still around 20% lower than the EC average.

The recent period of dynamism has since 1988 been associated with a rising real exchange rate and the emergence of a large current account deficit more than matched by capital inflows - but also with an overheating economy and an increase in the inflation rate that only began to turn down somewhat after spring 1990.

This study seeks to analyse and explain these developments in terms both of private sector behaviour and of economic policies, and to assess the challenges faced by the Spanish economy as it moves towards 1994 and the second stage of EMU.

The first part reviews the supply-side factors underlying Spain's recovery, from the mid-1980s, after a very difficult decade. It concludes that genuine supply-side improvements have taken place, even though they have not as yet been reflected in a sharp acceleration in productivity. It also points, however, to a number of persisting structural deficiencies. The second part analyses the problem of macroeconomic stabilization - in terms of demand, activity and inflation - under the impact of supply-side developments and in the presence of constraints on policy. A following section assesses the prospects for the current cycle to enter a new phase in which nominal disequilibrium can be reduced while avoiding too sharp a slowdown in activity so that earlier investment bears fruit in higher productivity and an adequate return to foreign and domestic investors. An improvement in competitiveness via greater mastery of domestic cost increases, coupled with an adequate budgetary policy, is identified as the key to achieving the degree of nominal convergence necessary for Spain to enter Stage 2 with confidence. However, as the penultimate section of the report recalls, the process - inevitably a long one - of Spanish real convergence is likely to generate new cycles in demand. The study reflects on the policies available to react to such cycles, and points to the choices that will have to be made in facing the challenge of carrying the catching-up process forward while achieving the degree of nominal convergence necessary for future stages of EMU.

1. Supply-side performance and challenges

The Spanish economy underwent a painful adjustment after 1974....

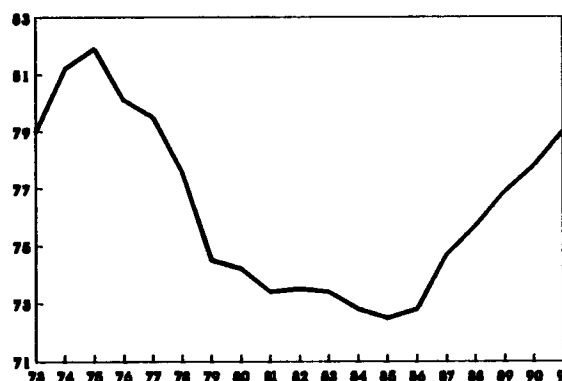
From 1986 to 1990 the growth of the Spanish economy (4.5% per year on average) was among the highest in the Community. The boom in investment and employment characterised this period, during which GDP per head caught-up five percentage points compared to the EC average.

Nevertheless the present situation only represents a return to the relative levels of the first half of the 1970s. Between 1975 and 1984, Spain lived through an exceptionally long and deep economic crisis. A new political and economic model was taking shape at a time when the economy was suffering the impact of the two oil shocks. Over ten years, fixed investment fell 22 %, employment declined 15 %, consumption suffered a long stagnation and GDP per head lost ten percentage points relative to the EC average.

During this period the Spanish economy was still characterised by widespread non-market behaviour of economic agents, trying to avoid competition and asking for public subsidies, a high degree of protectionism and large institutional rigidities in different markets.

As the unemployment rate grew from 3 % in 1974 to 22 % in 1985, the public sector tried to maintain social cohesion and support the costs of reorganisation of the industrial and fin-

**Graph 1: Spain: GDP per Capita PPS,
EUR12 = 100**



Commission Forecast Oct-Nov 91 for 1991
Source: Commission Services.

ancial sectors. The general government deficit, close to zero in the first half of the 1970s, reached some 7 % of GDP in 1985. Gross public debt rose from 12 % of GDP in 1974 to 45 % in 1985.

... but the ground was being prepared

At the end of 1982 the new government, enjoying a large majority and initially backed by the trade unions, implemented a stability-oriented economic strategy in order to regain domestic and external confidence.

After the devaluation of the peseta (December 1982), a more stringent monetary policy was implemented and an acceleration of the restructuring of the industrial and financial systems took place. The latter, together with the policy of wage moderation, led to both an improvement in productivity and a sharp deceleration in unit labour costs. This, in turn, resulted in a strong recovery of the gross operating surplus permitting an improvement in the financial situation of companies, and paved the way for a boost to investment.

Moreover the apparent rate of return in the Spanish economy has risen much faster than the EC average since 1984.

The business climate benefited from worldwide economic expansion, the prospect of EC entry, lower real interest rates and the 1986 fall in oil prices. Moreover the trend toward economic liberalisation gained momentum with the supply-side economic reforms enacted in 1984-1986, notably in the field of financial and exchange controls and labour market legislation¹.

EC entry led to the phased dismantling of external tariffs and to the introduction of the VAT, with an implicit widening of the tax base. As a result of some expenditure moderation and

increasing receipts, the general government deficit fell about 4 percentage points, in terms of GDP, to 3.2 % in 1987.

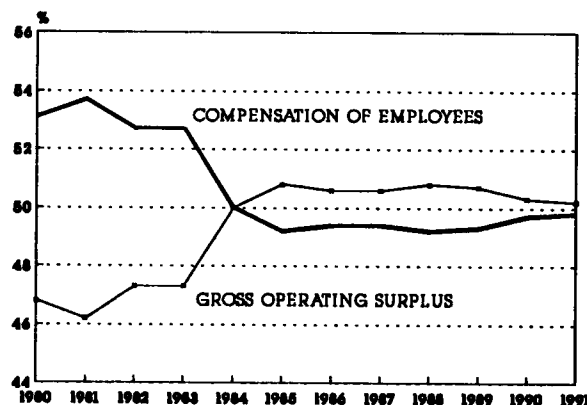
These changes under way considerably increased the attractiveness of the Spanish economy for foreign investors not only as a platform to reach the wider EC market (typical of US and Japanese investments), but also as a domestic market in itself with an enormous potential growth and high prospect of profitability. Foreign direct investment increased its role in sustaining rapid economic growth and in modernizing industrial structures, business management and know-how.

... for a major supply-side improvement ...

During the six years to 1990, Spain achieved an impressive investment performance (+ 80% in real terms partially supported by a four-fold increase in imports of capital goods), which laid the foundations for a strengthening of the productive base and for an acceleration of potential growth. In this period the manufacturing sector modernised its productive structure, even reorienting to some degree towards activities with higher capital content, new areas of specialization and diversification of products, and becoming more involved in intra-industry EC trade.

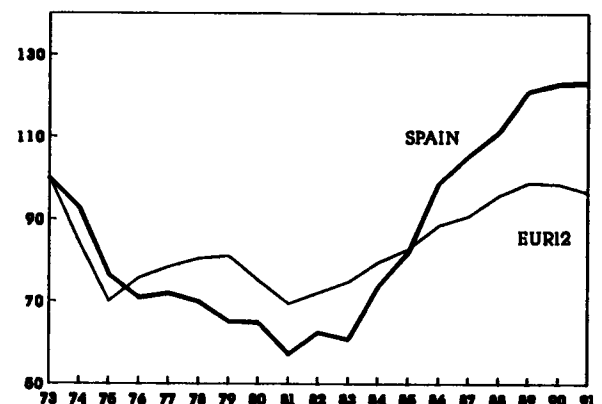
The good results in recent years have permitted a strengthening of the financial structure of the enterprise sector. The self-financing rate rose by 20 percentage points between 1983 and 1988 and the dependence on bank credit has been substantially reduced. Thus, in spite of a reduction in profits in 1990 and 1991 Spanish enterprises remain in a financial position which is much more solid than some years ago and comparable to European competitors.

Graph 2: Shares of GDP at Factor Cost



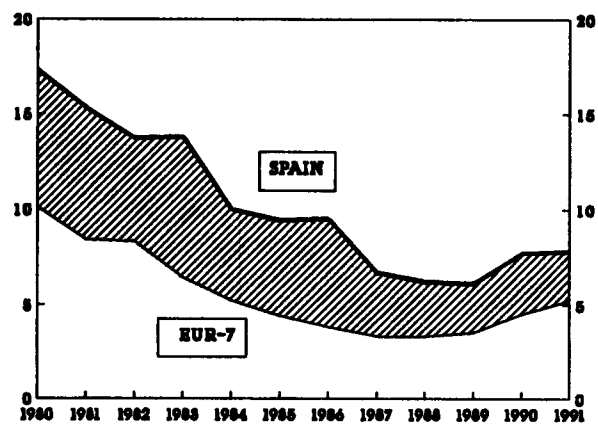
Source: Commission Services. Forecasts Oct.-Nov. 91 for 1991

**Graph 3: Net Return on Net Capital Stock
Total Economy (1973 = 100)**

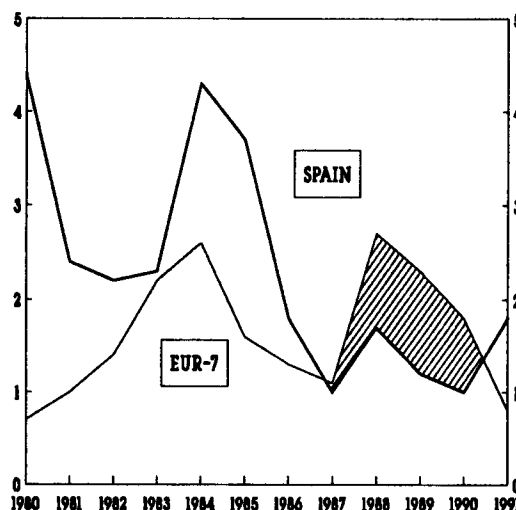


¹ Temporary contracts were introduced and an easing in the lay-off conditions attached to these contracts.

Graph 4: Nominal compensation per employee (annual percentage change)



Graph 5: GDP per person employed (constant prices, annual % change)



Source: Commission Services. Forecasts Oct.-Nov. 91 for 1991
EUR-7: B, DK, D, F, IRL, L, NL

The improved business climate resulted in a large increase in employment (+15% in the six years to 1990), but it was accompanied by a sharp increase in labour market participation and an increase in the potential labour force. In consequence, the unemployment rate fell slowly and has now stabilised around 16%, but without any apparent moderating influence on the wage formation process.

The main feature of the rise in employment has been a remarkable increase in temporary-contract workers, especially in the service sector. Between 1987 and 1990, 87% of total new employment was located in the service sector; 85% of it comprised temporary workers. That fact has had a double effect. First, the presence of a high share of temporary workers means that firms have been able to moderate average compensation per worker during a period when economic activity has accelerated rapidly. Second, temporary workers have expanded employment mainly in low-wage jobs in the service sector, pulling down the average.

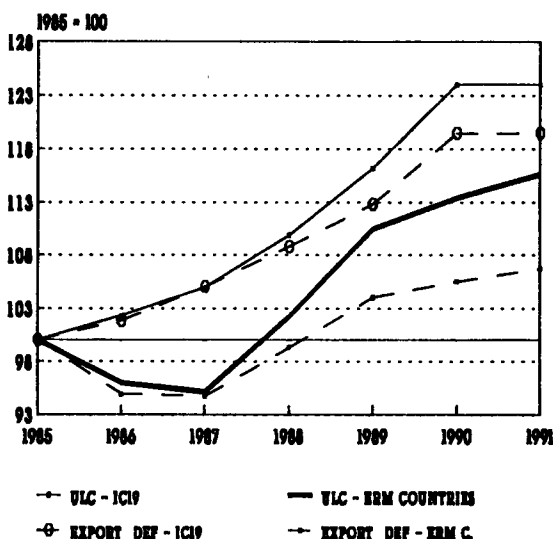
At the same time, a bigger increase of employment in the service sector, which is traditionally labour-intensive, than in the industrial sector explains why aggregate productivity growth in the upturn has been modest.

Unit labour costs have been growing faster than in those countries in the narrow band of the ERM since 1979. In terms of external competitiveness, higher growth of unit labour costs together with the nominal appreciation of the peseta meant a substantial appreciation of the real exchange rate and, therefore, a loss of competitiveness of Spanish goods and services in the external market, especially against all industrial countries (namely due to the US dollar fall).

In spite of the current productivity differentials, Spain's lower level of labour costs, compared with those of EUR 7,

still make it attractive for foreign investment. Moreover, an appreciation of the real exchange rate (or, in other words, a reduction in competitiveness) is a feature of a "catching-up" process.

Graph 6: Real effective exchange rates ULC total economy and exporte deflator



ERM = narrow band; IC19 = 19 industr. countries.

Source: Commission Services. Forecasts Oct.-Nov 91 for 1991.

..... that still needs to be carried further.

Although great efforts have been made to eliminate rigidities, some important structural constraints still exist

- The need for investment in infrastructure and social services is still very high. Combined with this is a need for technological innovation, management modernization and rationalization of the size of firms to be maintained.
- The opening-up of the economy as a result of Spain joining the EC has seen import penetration rise. The share of output going for export has remained at a low level in spite of gains in EC markets.
- The greater opening-up has not affected all productive sectors to the same extent. The service sector, except for tourism, remains quite closed. The lack of external competition in the service sector allows the existence of a wide divergence of product prices and inflation as between tradeables and non-tradeables. The persistence of a high core of inflation pressures from services affects the whole of the economy through the indexation of salaries to a global measure of inflation.
- The expansion in the number of temporary workers since 1985 has actually magnified the degree of segmentation in the labour market. The rigidities are mostly embedded in that part of the market where permanent workers predominate; they explain why nominal wages have not responded to comparatively high levels of unemployment and, at the same time, contribute to the persistence of that level of unemployment. The principal features are : evidence of mismatch, the difficulty of new entrants especially young workers in penetrating the permanent sector of the labour market, reduced job search, and the compression of regional pay differentials.
- From the regional side, the problems of finding a job in low activity regions, and the obstacles to formal employment creation in the private sector in those regions, are exacerbated by the structure of collective bargaining. National collective bargaining tends to be conducted within the high activity regions; the transmission of national wage settlements from high-activity to lower-activity regions leads to a comparatively low degree of dispersion in regional wage

differentials. But unlike experience in some other European countries, a more centralized collective bargaining has not contributed to some disciplinary effect in wages growth. In terms of output levels, the recent upswing in economic activity has failed to produce a trend towards regional convergence. The diversity of performance between backward and prosperous regions has not been corrected. This represents a fiscal burden and limits the potential market of the growing regions.

- Although a significant reduction has been achieved, the general government deficit has persisted. At the same time, regional administrations have also had increasingly imbalanced accounts which have been an additional obstacle to reducing the overall deficit. As regards expenditure, the possibility of exceeding budgetary limits, the high level of subsidies to public enterprises and a lack of efficient control over expenditures are the principal features that still exist. On the revenues side, the extensive fiscal fraud and the long delays in achieving a consolidated tax system are the main structural problems.
- From the comparison of Spanish financial institutions with those in other countries, they seem to have had traditionally higher than average intermediation margins. The multiplicity of banks and overbranching involve diseconomies of scale. This, combined with overstaffing, has maintained the cost of channelling resources at a high level. However, the intensification of banking competition has caused, since 1990, a substantial decline in intermediation margins.
- The role of the Spanish Stock Exchange in channelling private sector savings towards investment projects is a modest one. Moreover, the low level of market capitalization (primary market) and the very limited volume of transactions (secondary market) denote a clear lack of development in the Spanish bond market, with the exception of the public debt market organized by the Bank of Spain.

These factors taken together are both symptoms and causes of the persistent gap between real incomes in Spain and those in the richer member countries of the Community.

2. Problems of stabilization

An improvement in supply prospects led to saving-investment imbalance...

From the first half of 1988 onwards the Spanish economy started to show signs of overheating which became more obvious in the following year. From 1986 to mid-1990, domestic demand has been growing fast and progressively in excess of output, reflected in a trade balance deterioration and, from Spring 1988, causing a rise in inflation. Buoyant domestic demand was pushed upwards not only by very strong investment but also by private and public consumption.

The high rate of employment creation, associated with accelerated economic growth, was reflected in a sustained rise in household disposable income. This upward trend was reinforced by increases in non-labour income also. In addition, asset inflation resulted in a significant "wealth effect" for asset holders, while simultaneously diverting household expenditure flows from investment into consumption goods. Finally, as consumer expectations turned markedly positive, after several years of depressed economic conditions, the household saving rate fell.

... and the economy overheated...

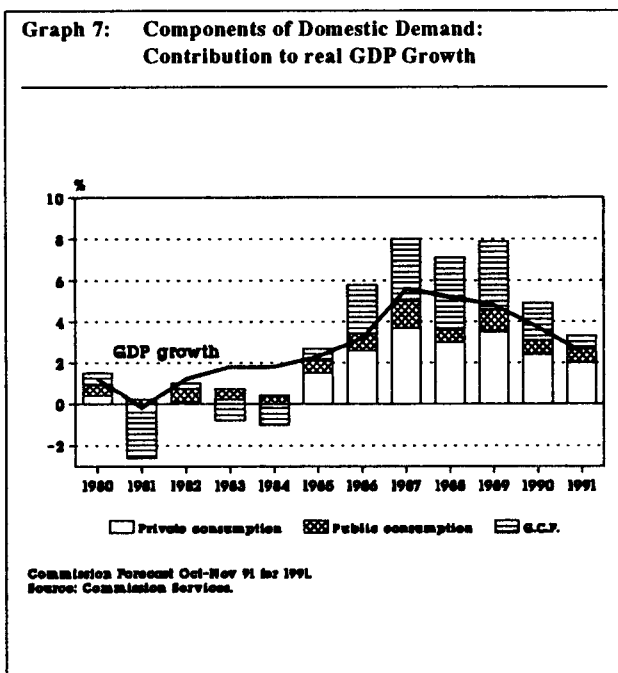
The incapacity of domestic saving to finance the strong investment caused a growing current account deficit. The ending of the period of budgetary adjustment meant that public saving did not increase enough to compensate for the reduced household saving rate.

The presence of very strong domestic demand, while constraints from productivity capacity left indigenous supply unable to respond and to adapt quickly to the new requirements of the domestic market, caused a switch to external sources. Thus, the shift in internal demand towards imported goods sharply increased the trade and current account deficits. A substantial fall in tourism receipts (from 5.2% of GDP in 1986 to 3.8% in 1990) further aggravated the deficit in the current account balance.

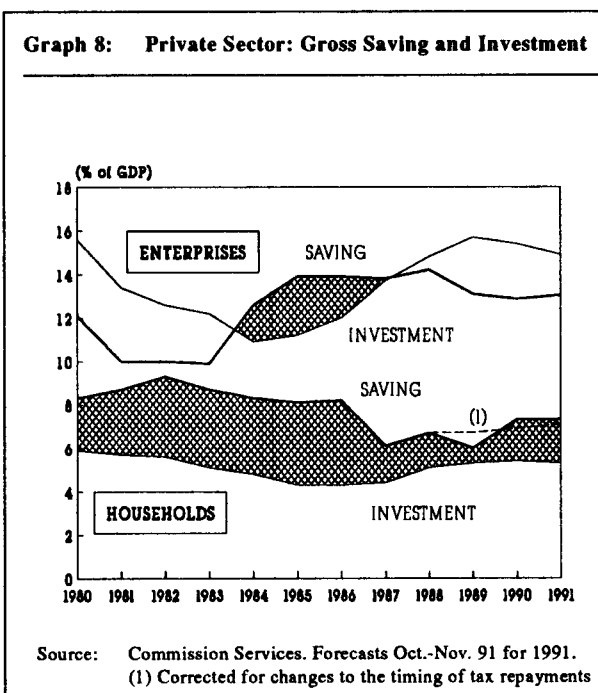
At the same time as domestic demand was growing clearly faster than that of Spain's main trading partners, the reappearance of accelerating inflation in the second half of 1988 together with a significant nominal appreciation of the peseta caused a substantial loss of external competitiveness which negatively affected trade in goods and services.

On the other hand, one of the main underlying factors behind the current inflationary process is the pressure from domestic demand on services. That sector, which still remains very closed to external competition, is able to transmit excess de-

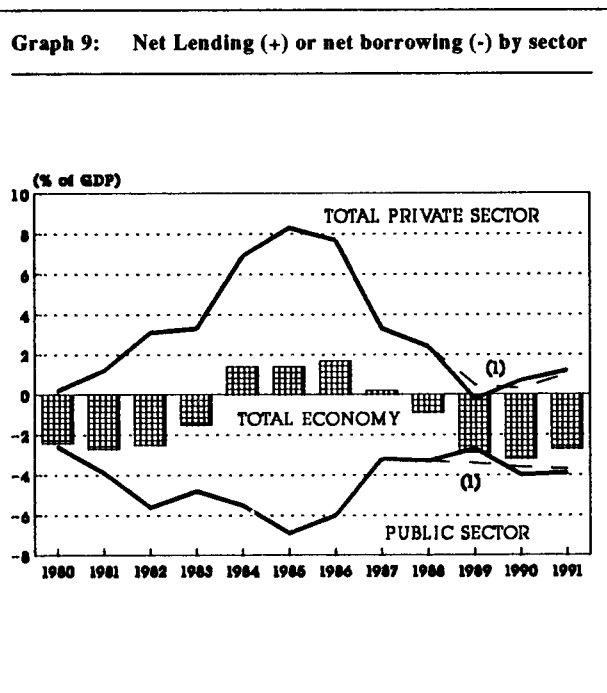
Graph 7: Components of Domestic Demand: Contribution to real GDP Growth



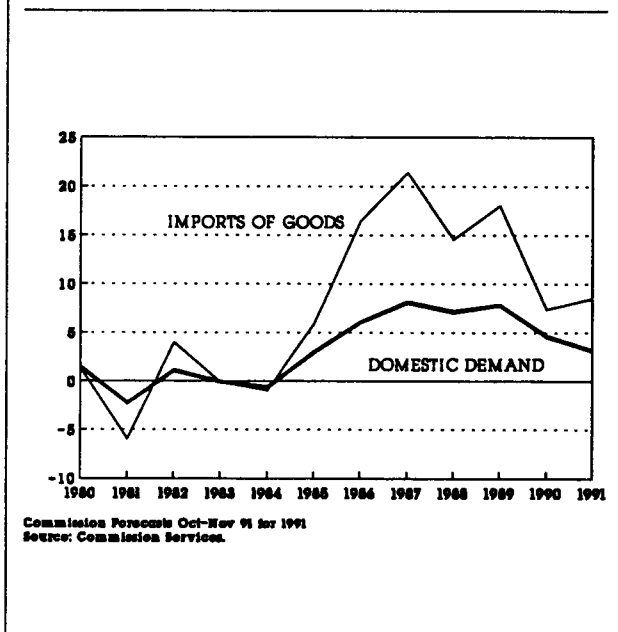
Graph 8: Private Sector: Gross Saving and Investment



Graph 9: Net Lending (+) or net borrowing (-) by sector



Graph 10: Real domestic demand & imports of goods (annual % change)



mand to prices, becoming the hard core of inflation and an obstacle to its reduction.

In 1988 and 1989, there is some evidence that rising profit margins contributed in the same proportion to final prices than did wage inflation : it seems that the presence of very strong domestic demand produced increased mark-ups. In 1990 and 1991, however, the fast increase in nominal wages was the main factor behind the rise in final prices. External factors, namely import prices and the exchange rate, have been playing an important role in partly offsetting the positive contribution to prices from domestic factors.

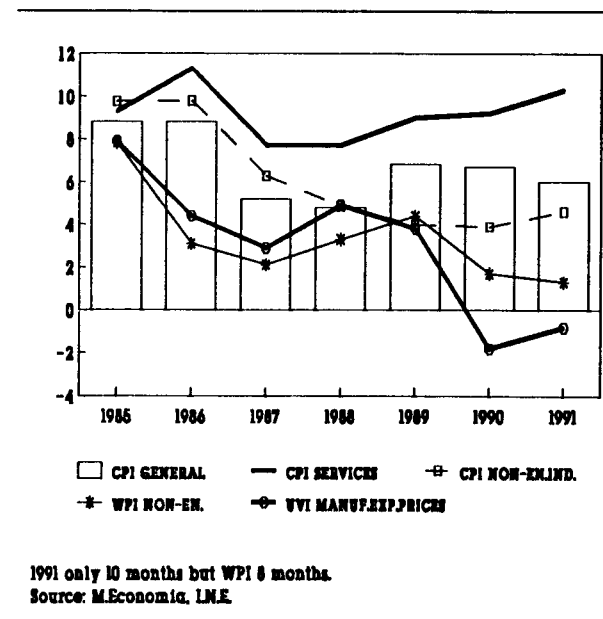
	% Change in prices				
	1987	1988	1989	1990	1991
Private consumption deflator	5.7	5.1	6.6	6.4	5.8
Total Final Uses	5.0	4.8	5.9	5.7	5.2
Of which contribution of domestic factors (1)	5.3	5.0	6.0	6.3	5.6

(1) Includes contributions of unit labour costs, net indirect taxes, gross operating surplus and the exchange rate change required to compensate for movements in domestic labour costs relative to those of competitors

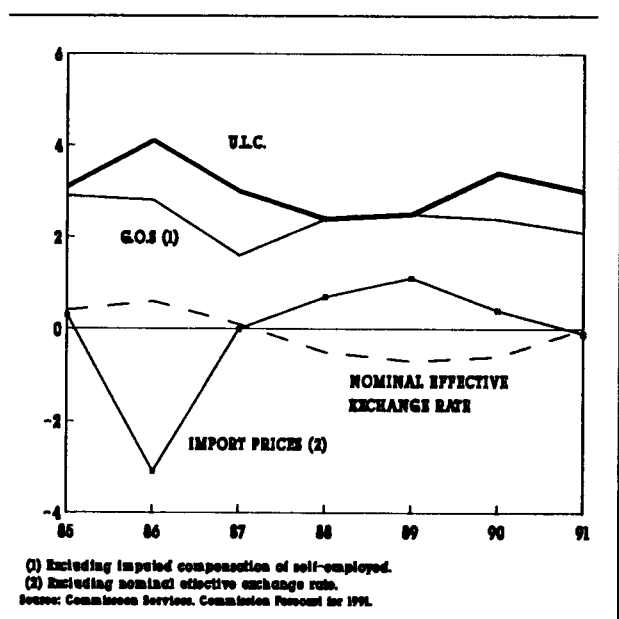
... incomes policy became less effective

After 1986, the possible scope for a successful anti-inflationary policy was reduced. In 1986, increased tension in industrial relations meant that only the wage provisions of the Social and Economic Agreement (AES) negotiated in 1984 were implemented. Since 1987, no further social pact between economic agents has been reached. Further, the official inflation target for 1988 (3%) was too ambitious and damaged the credibility of the economic authorities. This led the unions to ask for catching-up clauses in their collective conventions for that year while high profit margins made employers more ready to accept both the indexation formula and the high wage claims. The inflation target was again overshot in 1989, triggering a process of wage "catch-up", despite ERM entry : compensation per employee in 1990 rose by 1.7 percentage points faster than in the year before and unit labour costs reversed the previous downward trend, increasing by 6.6% in the total economy. These developments took place in a context of very strong demand growth which never helps wage moderation.

Graph 11: Inflation by sector (% average annual rate)



Graph 12: Contribution to the change in the price deflator of total final uses (%)



... as fiscal policy did not respond ...

Uncertainty about the extent of overheating as well as a breakdown in the social dialogue, and the apparently comfortable budgetary position achieved by 1988 (a primary balance close to zero and a decline in the debt/GDP ratio) resulted in a budget for 1989 that was clearly expansionary. As a result, domestic demand continued on an upward trend with an annual growth rate above 8% in the first half of 1989.

During 1989, some restrictive measures were implemented in order to reduce the expansionary effects of the initial budget. These measures (earlier payment deadlines as well as higher advanced payments of corporation tax, and increases in withholding tax) augmented revenues in 1989. But since they were not accompanied by changes in income tax, they implied a reduction in revenue in 1990 and 1991.

In addition, after several annual revisions to the salaries of public workers and state pensions in line with official inflation targets which were lower than the actual outcome for inflation, the so-called "social debt" also had to be paid in 1990.

On the other hand, institutional difficulties hampered budgetary policy. The Constitutional Court did not accept elements of the income tax legislation, thus, putting back the fiscal calendar for 1989 by several months and deferring income tax repayments to the next year. Consequently, net borrowing by general government was reduced by 0.7% of GDP in 1989, but raised by 0.4% in 1990 and 0.2% in 1991.

Moreover, the bringing forward of the general election to October 1989 acted as an additional obstacle to change in fiscal policy while the expansionary policies of regional government similarly excluded any significant moderation of expenditures.

Consequently, the net borrowing of general government has slightly deteriorated from the low level recorded in 1987, allowing for changes in the fiscal calendar.

... leaving monetary policy heavily burdened ...

The absence of a wage concertation policy for 1989 and the procyclical or, at best, neutral stance of fiscal policy left monetary policy the sole instrument for fighting inflation. But monetary policy faced significant constraints: conditions of strong external confidence and a fast-growing economy encouraged very substantial capital inflows and created the well-known dilemma between: (i) allowing the peseta to appreciate, at the expense of a deterioration of the foreign sector, while the trade deficit was already large; (ii) reducing short-term interest rates, producing in consequence a loss of control of monetary aggregates and an undesired domestic demand expansion that would contribute to the overheating of the economy.

The nature of the dilemma can be seen in that the restrictive stance of monetary policy from October 1988 onwards (interest rates rose from 10.5% in September 1988 to 14.5% in July 1989, remaining at around this level into 1990) induced short-term capital movements that benefited from interest-rate differentials in a framework of favourable expectations of the stability, or even appreciation, of the peseta. At the same time, a substitution from internal to foreign credits took place in order to cope with the higher than expected growth of private sector demand for credit (15% in 1988 against 11% targeted). As a result the growth of the targeted monetary aggregate (ALP) in the first half of 1989 accelerated and, subsequently, moved above (outcome of 10.4%) the upper limit of the target range announced for 1989 (6.5% 9.5%).

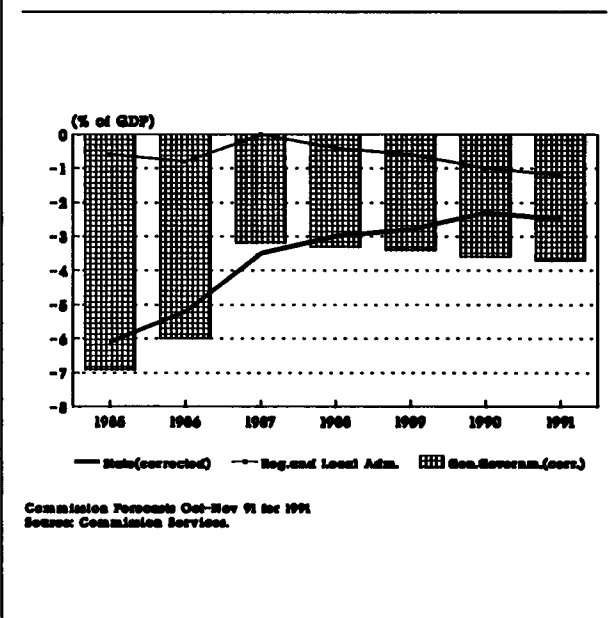
In response, the Bank of Spain applied restrictive monetary policy measures in January 1989 (both the compulsory reserve coefficient and the intervention rate were raised) and additional measures to discourage capital inflows (a 20% special non-interest bearing deposit with the Bank of Spain on new foreign borrowing by banks, and a 30% mandatory and non-remunerated deposit with the Bank of Spain on the amount of new foreign financial credits and loans by companies).

... while ERM entry was being prepared ...

The ERM entry did not imply a "qualitative jump" in the guidelines and implementation of exchange rate policy. On the institutional and technical side, the authorities had already introduced, since 1987, some specific changes in view of an EMS integration in the medium term:

- (i) the Bank of Spain signed, on 12 May 1987, the Adhesion Act to the Basle Agreement, according to which Spain participated in the process of creation, utilisation and remuneration of ecu's in the framework of the FECOM;
- (ii) The Bank of Spain admitted the official quotation of the ecu from 1 July 1987, which implied the consideration of the ecu as another foreign currency;
- (iii) A set of almost imperceptible institutional changes were applied in order to promote the required adaptation to the new EMS rules. A clear example of the latter were the liberalisation measures of 4 February 1988 in

Graph 13: Net lending or net borrowing of general government



the exchange market that suppressed the interventionist procedures, the prominent role of the Bank of Spain and the substitution of the US dollar by the DM as the intervention currency;

... and constraints were increasing.

On the policy instrument side, the efficiency of monetary policy has been increasingly constrained since 1986 by exchange-rate developments in combination with some liberalization of capital movements. In particular, during 1986-87 the monetary authorities seemed to be watching the DM/pta rate closely and from February 1988 to June 1989 the peseta was already a "de facto" member of the system when the Bank of Spain shadowed the ERM and intervened in the exchange markets accordingly. When the new exchange market intervention system was introduced in February 1988, the authorities decided to fix a central rate vis-à-vis the DM with a +/-6% fluctuation bands. Official statements prompted the markets to produce, in effect, a downward realignment of the peseta in the months leading up to official ERM entry.

It was thus perhaps in the period leading up to ERM entry that monetary policy was most constrained. Inflationary pressures were building up in 1988 and the first half of 1989. The initial inflation target for 1989 (of 3%) had first to be revised to 5% and then abandoned. This situation could have been counterbalanced through a policy of wage moderation and a more restrictive fiscal policy. Considerations of short-term stabilization would - in the absence of assistance from fiscal or other policies - have pointed to a tighter monetary policy that, if maintained, would have inevitably induced a significantly higher rate for the peseta. However, the authorities had ERM entry in mind; entry at a high rate might not have been compatible with the medium-term needs of the Spanish economy.

A dilemma of this sort may imply that the concept of the "right" rate for entry is irrelevant. Embracing the ERM discipline with all its credibility advantages rather implies that, in a dynamic economy, any entry rate means accepting policy implications in other areas.

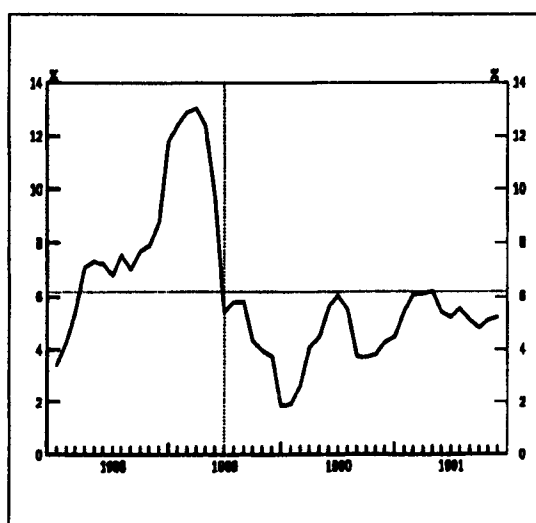
The decision to enter the ERM, on 19 June 1989, accordingly emphasized the need for a tighter stance of fiscal policies and for additional support to monetary policy. As a result, in early July 1989 the Government and the Bank of Spain approved additional restrictive fiscal and monetary measures and introduced a system of *credit ceilings* for each individual bank. These measures proved to be effective in decelerating domestic demand in 1989 (7.8%) and through 1990 (4.6%), and so the authorities lifted the credit ceilings on 1 January

1991 and the mandatory deposit on foreign borrowing in March.

Entry into the ERM immediately reduced short-term capital movements of a speculative nature since the expectations of further appreciation of the peseta were frustrated, but upgraded the status of the currency vis-à-vis international investors and attracted more permanent capital flows given the prevailing high interest-rate differential. By the time of entry, inflation had already accelerated but demand pressures were already at or near their peak. Thereafter, the position of the peseta near the top of the band undoubtedly contributed to containing, and ultimately reducing, the inflationary pressures already existing.

Nonetheless, the Spanish experience has again suggested that in a context where capital movements have become more intense and interest rate sensitive and within an adjustable-peg regime such as the EMS, domestic monetary policy has a reduced margin of manoeuvre. Although targets for both money aggregates and the exchange rate can be set consistently (*ex ante*), any disturbance, whether to money demand or to aggregate demand, in either Spain or some other important ERM countries, may make the two targets inconsistent *ex post*, if there is no policy offset in other areas, notably fiscal policy.

Graph 14: Bilateral spread between the Peseta and the weakest ERM currency



3. The pursuit of convergence as EMU progresses

Nominal disequilibria are being reduced ...

The restrictive measures adopted in 1989 started to overcome the main disequilibria in the Spanish economy in the course of the following years. The Gulf Crisis and, consequently, a further worsening in expectations also helped in the adjustment. Thus, the main feature of Spain's economic performance in 1990 and 1991 was a *slowdown in domestic demand* which halted the growth in the trade deficit and *slightly reduced the inflation rate*, despite the temporary effect of oil price increases.

The improved trend in the trade balance (from -6.3% of GDP in 1989 to -5.4% in 1991) was made possible by lower growth in the imports of capital and intermediate goods as well as by the slowdown in domestic demand and the emergence of external markets - Spanish trade has been positively affected by German unification² - which have raised exports. Nevertheless, the current account deficit remained above 3% of GDP due, mainly, to structural problems in the tourism sector.

Behind these trends *remain serious imbalances* which threaten short-term prospects for the economy. Within domestic demand, equipment investment appears to be particularly sensitive to the restrictive measures and the deterioration in expectations, while building investment remains supported primarily by public sector activity and consumption growth in non-durable goods remains high.

The deceleration in domestic demand has not been sufficient to dampen the hard core of inflation. Services prices (+9.9% in the twelve months to October 1991) are identified as the main source of inflationary pressure. At the same time, lower demand as well as the reappearance of internal cost pressures has squeezed profitability, resulting in a slowdown in investment and in a deterioration in the previously favourable employment trend (employment grew only by 0,5% in the second half of 1990, and did not change in the first half of 1991).

... but risks persist both in the short term and in the long term.

Some confidence about moderation of disequilibria, combined with the optimism associated with the special events of 1992 - Spain will host the Olympic Games and the Universal Fair - could restore the economy to a *temporary new expansionary path*. If, however, economic agents have not changed their previous patterns of behaviour, it will be very likely that a further serious adjustment will be necessary thereafter.

The sharp increase in salaries in 1990, followed by insufficient wage moderation in 1991, is causing a shift in inflationary pressures from the demand side to the cost side. Despite a slowdown in economic growth, the improvement in nomi-

nal convergence could be lower than required. The rise in indirect taxes planned for January 1992 and January 1993 could delay further a rapid reduction in the inflation rate.

The main goal for the economic authorities has been and should be to maintain the internal and external confidence in prospects for the economy, avoiding a situation in which ex post returns or investments are depressed. Improved economic efficiency should be translated in the medium term into productivity and external competitiveness gains, to allow a non-inflationary and sustained path of economic growth.

However, an improvement in competitiveness would allow external demand to more actively support domestic production. The required stability in the exchange rate after the peseta's entry into the ERM means that competitiveness must be maintained in the labour market through control of the trend of domestic unit labour costs relative to competitors.

A reduction in the inflation rate, transmitted to costs, would help the tradeable sectors of the Spanish economy to expand their share of external markets.

The credibility of anti-inflationary policy has played an important role in the recent prosperous period and it has been reinforced by ERM entry. The efforts to follow a credible path towards nominal convergence with the more stable countries has been a condition "sine qua non" for triggering the successful catching-up process. Nevertheless, it is essential to ensure that the catching-up process is sustainable, i.e. consistent with nominal stability so as to avoid the risks of an irregular "stop-go" path in economic growth.

In any case, the catching-up already achieved by consumption in durable goods and investment in equipment, suggests that a new strong recovery will not induce so high a growth rate in domestic demand and, consequently, the same level of disequilibria as experienced in the late 1980s.

Structural improvement is still necessary:

As far as *supply-side policy* is concerned, the flexibility of the different markets for factors of production in Spain has to be further enhanced, along the lines suggested in earlier sections. Special attention should be paid to eliminating rigidities in the permanent workless' segment of the labour market and to introducing higher competition levels in the service sector, namely, in transport, communications and health care services. Moreover, other policies of a structural nature should also be implemented in order to introduce greater price discipline in the non-tradeable sector of the economy.

The successful implementation of this policy would increase the overall efficiency of the economic system paving the way for higher expected returns on real capital, encouraging investment (which initially contributes to demand but not to supply), and for more optimistic real income expectations,

2 Spanish exports of goods to Germany rose by 23% in 1990 and 39% in the first ten months of 1991.

leading to reduced savings ratios. Thus, such supply-side improvements might also *trigger a renewed demand boom*.

Wage moderation is desirable.

A policy of wage moderation would contribute to *avoiding the risk of a re-emergence of overheating in the economy*, and help the convergence process as has been the case in a number of other ERM countries. Such a policy could involve agreements, extending over one to three years, and differentiated according to sectoral and regional productivity levels. A slowdown in real wage costs would reduce the pressure on demand through a reduction in the real disposable incomes of households and would positively affect the cost formation process.

But, a policy of global wage moderation might prove to be ineffective in damping inflation since employers would be more ready to widen profits by simply increasing prices in a context of booming demand. The slowdown of demand in 1991 offers a good opportunity to pursue this moderation. One possibility worth considering could be that both employers and employees should be ready to accept that a part of their revenues would be devoted to build up pensions funds and to finance training courses to cope with the labour market mismatches.

Monetary policy must be kept tight ...

In 1991, the constraints on monetary policy have become more evident as very heavy net long-term capital inflows (24.5 bn\$ from January to September 1991) have tended to interfere with the implementation of the liquidity control in the economy. The continuous strength of the peseta in the ERM and some moderation in inflationary pressures led to a reduction in interest rates by between two and three points in the first half of the year.

As Stage 2 approaches, the possibility of an independent Spanish monetary policy response would be further limited by full capital liberalization³ and a move to the narrow ERM band. Credibility of the stability-oriented Spanish economic

policy would however be reinforced and the parity-grid of the pre-1994 period would be more credible for economic operators even in the presence of short-term prospects of economic divergence vis-à-vis ERM countries in terms of domestic demand growth, price-inflation and current account widening. As long as full nominal convergence has not been achieved, monetary policy, although subject to constraints, should remain restrictive.

... medium-term budgetary action is needed and fiscal reform remains important.

A major contribution from budgetary policy to counteract a period of nominal divergence in output and price performance might be required. However, there would clearly be both practical limitations and drawbacks to an active countercyclical use of fiscal policy.

First, countercyclical changes in tax rates or expenditures are likely to be inimical to the supply-side. Moreover, the process of closer monetary integration will force all member countries towards some form of (net) tax competition. Second, fiscal fine-tuning may become procyclical rather than stabilizing, since inadequacies in forecasting, the existence of lags and uncertainty about the final impact of fiscal policy may appear. Third, the process of regionalisation inaugurated in the 1978 Constitution has led to some degree of fiscal federalism in which the control of the central authorities over expenditure magnitudes for the public sector as a whole has been reduced.

The key issue for fiscal policy will not only be its role as a demand stabilizer but rather its *impact on the supply side* through : (i) the implementation of the tax reform would reduce tax fraud, the deductions allowed to the corporation tax and the tax burden for households and would harmonize indirect taxes with the EC; (ii) the reshaping of public expenditure - namely subsidies to corporations - to diminish the weight of current expenditure and to maintain public investment so as to improve the supply-side of the economy.

³ Recently, economic authorities have announced the removal of the remaining capital movements restrictions before January 1992.

4. Summary and conclusion

Spain has in recent years enjoyed a period of strong growth, sparked mainly by the important structural changes that preceded and accompanied the country's accession to the Community.

Although this dynamism - reflected in particularly strong growth of investment - can be expected to produce, eventually, a sharp improvement in productivity and potential output, its manifestation has so far been largely in an expansion of demand, together with strong growth in employment, notably in services.

Demand in the Spanish economy ran ahead of short-term potential, producing a real appreciation of the peseta and the emergence of a large current-account deficit. The very substantial catching-up in consumption, mainly for durable goods, and investment which already occurred during the second half of the 1980s suggests that growth in the next few years is likely to be less hectic than experienced in the period following accession to the Community. In consequence, the risk of re-emergence of disequilibria on the scale experienced in the late 1980s will be much less. What is more, the persistence of existing imbalances and the requirements for entry to EMU preclude any possibility for expansionary economic policies. So, while growth will remain above the

Community average (real GDP should expand at a rate slightly above 3% in 1992), the economy can now be said to have entered a new phase in which real activity and employment will expand at a more moderate pace. It might be expected that recent reductions in both the current account deficit and the inflation rate will be carried forward, this latter after absorbing the effect of TVA increases. A premature relaxation of policies combined with expectations linked to the special events of 1992 could lead to an undesirable "stop-go" process, in turn putting long-term capital inflows at risk. The key to avoiding such an outcome lies in an improvement of competitiveness via greater moderation of domestic costs, a process in which the expectations-shifting impact of the ERM will play a role.

In any event, the spurt in growth in recent years has not yet restored the relative income level (*vis-à-vis* EC partners) of the early 1970s. This reflects both the accelerated growth momentum in the core Community countries and the negative effect of remaining structural deficiencies in Spain. These persist in labour markets, in public finance, in an inadequately competitive structure of many sectors, most notably services, including financial services. Such structural improvements would lead to an increase of productivity and competitiveness which, in turn, would permit the current process of real and nominal convergence to be maintained.

Table 1: Final uses of goods and services and other key aggregates of the Spanish economy					
	1986-88	1989	1990	1991(a)	1992(a)
% change over preceding period at constant 1986 prices					
Private consumption	4.9	5.5	3.7	3.1	3.3
Public consumption	6.2	7.6	4.4	4.2	3.8
Gross fixed capital formation	12.7	13.7	6.7	2.2	3.6
of which :					
construction	10.2	14.9	10.7	5.3	4.0
equipment	16.4	12.1	1.2	-2.5	3.0

Domestic demand	7.0	7.8	4.6	3.1	3.4
Exports of goods and services	4.4	2.9	4.2	6.7	7.0
of which :					
goods	4.0	6.4	8.3	8.5	7.4
tourism	4.5	-7.2	-8.6	1.0	6.0
Imports of goods and services	16.3	17.0	8.1	8.1	7.5
of which					
goods	17.4	17.7	7.4	8.5	7.8
GDP at market prices	4.9	4.8	3.7	2.5	3.1
% change over preceding period					
GDP at current market prices	12.5	12.1	11.3	9.3	9.0

Industrial production	3.6	4.5	-0.1	---	---
Employment	3.1	3.6	2.6	0.7	1.2
Unemployment rate	20.3	17.1	16.1	15.8	15.5
Compensation of employees per head	7.5	6.1	7.7	7.8	7.0
U.L.C.	5.9	4.8	6.7	5.9	5.1
Implicite price deflators:					
GDP	7.3	7.0	7.3	6.7	5.8
Private consumption	6.5	6.6	6.4	5.8	5.6
Exports of goods and services	1.3	4.4	1.7	1.6	3.5
Imports of goods and services	-4.5	2.3	-1.2	-0.4	3.2
Terms of trade	6.1	2.0	2.9	2.0	0.3

Trade balance (Fob/Fob) in % of GDP	-3.8	-6.3	-5.7	-5.4	-5.6
Current balance in % of GDP	0.2	-3.2	-3.5	-3.1	-3.2

Current receipts of General Government	14.6	17.5	10.1	11.9	11.2
Current expenditure of General Government	11.4	13.9	13.0	11.9	10.8
G.F.C.F. of General Government	13.9	26.9	26.8	15.0	9.3
Net borrowing General Government in % of GDP	-4.2	-2.7	-4.0	-3.9	-3.6

Money supply (ALP) - end of year	12.7	11.0	11.8	8.6	8.3
Internal credit private sector - end of year	14.7	17.6	10.2	8.1	9.0

(a) Commission Forecasts October-November 1991.
SOURCE: I.N.E. and M. of Economy.

Table 2: Final uses of goods and services (constant prices, quarterly figures)								
	1989-III	1989-IV	1990-I	1990-II	1990-III	1990-IV	1991-I	1991-II
percentage change over preceding quarter								
Private consumption	7.1	3.2	2.8	3.8	2.0	2.5	2.9	3.5
Public consumption	7.6	4.0	2.6	4.1	4.3	3.6	4.1	5.6
G.F.C.F.	13.1	10.5	6.1	3.1	1.0	1.0	1.1	0.8
Domestic demand	8.7	5.2	3.6	3.7	2.2	2.0	2.7	3.3
Exports of goods and services	0.4	2.6	3.9	6.7	6.9	7.5	6.3	5.5
Final demand	7.4	4.8	3.7	4.1	2.9	2.8	3.3	3.6
Imports of goods and services	11.2	7.6	8.0	8.0	4.4	3.5	6.5	8.5
GDP	6.4	4.1	2.6	3.2	2.5	2.6	2.4	2.4
	1989-III	1989-IV	1990-I	1990-II	1990-III	1990-IV	1991-I	1991-II
percentage change over preceding year								
Private consumption	6.0	5.7	5.0	4.2	2.9	2.8	2.8	2.7
Public consumption	8.4	7.4	5.7	4.6	3.8	3.6	4.0	4.4
G.F.C.F.	13.8	13.1	11.3	8.2	5.2	2.8	1.6	1.0
Domestic demand	8.3	7.8	6.7	5.3	3.7	2.9	2.6	2.5
Exports of goods and services	2.5	2.1	2.2	3.4	5.0	6.2	6.8	6.6
Final demand	7.3	6.9	6.0	5.0	3.9	3.4	3.3	3.2
Imports of goods and services	17.3	13.9	11.0	8.7	7.0	5.9	5.6	5.7
GDP	5.1	5.3	4.8	4.1	3.1	2.7	2.7	2.5

Source: I.N.E. and Bank of Spain.

Table 3: Employment evolution (% change over preceding year)(a)					
	1988	1989	1990	1991(b)	Accumulative % change
Total employment	2.8	4.1	1.7	0.5	8.9
Agriculture	-3.0	-7.6	-8.1	-8.2	-20.2
Industry	0.6	4.3	0.7	-3.2	3.3
Construction	11.9	8.7	6.1	5.0	32.0
Services	4.0	6.3	3.6	3.3	16.0
Total wage and salary earners	4.6	6.0	3.7	1.7	15.1
Agriculture	-1.0	-14.8	2.5	4.2	-10.1
Industry	1.1	4.3	1.4	-3.1	4.0
Construction	13.8	11.3	6.1	3.0	36.4
Services	5.8	8.3	4.5	3.6	20.9
of which:					
Permanent contracts	-2.3	1.6	-1.1	-1.8	-2.7
Agriculture	-16.2	-9.04	-5.92	-3.9	-27.1
Industry	-4.1	-0.5	-2.1	-5.8	-9.8
Construction	-3.76	0.4	1.1	-1.1	-5.0
Services	0.1	3.7	-0.6	0.4	3.7
Fixed term contracts	32.7	19.0	15.9	9.8	87.2
Agriculture	18.5	-20.0	11.2	12.2	11.7
Industry	29.3	23.9	12.6	5.3	79.6
Construction	44.5	23.9	10.9	6.5	108.8
Services	34.7	25.7	20.4	12.7	107.8

(a) IV Quarter figures.
(b) II Quarter figures.
SOURCE : EPA - Bank of Spain.

Table 4: Prices (yearly changes in %)

	1986	1987	1988	1989	1990	1991	
General CPI							
average (b)	8.8	5.2	4.8	6.8	6.7	6.0	
end of period (b)	8.3	4.6	5.8	6.9	6.5	5.5	
General CPI without energy and non-elaborated food products (a)(b)							
Services in CPI (a)(b)	10.8	8.0	7.6	9.2	9.7	9.9	
Private consumption deflator (c)	8.6	5.7	5.1	6.6	6.4	5.8	
GDP deflator (c)	10.5	5.9	5.6	7.0	7.3	6.6	
Export prices (c)	-1.7	2.6	3.1	4.4	1.7	1.6	
Import prices (c)	-14.5	0.8	1.1	2.3	-1.2	-0.3	
	1988-I	1988-II	1989-I	1989-II	1990-I	1990-II	1991-I
Consumer price index (a)	annual % change						
General	4.4	5.8	7.1	6.9	6.5	6.5	6.2
General without energy and non-elaborated food prod.	5.4	6.1	7.0	7.1	6.7	6.1	6.3
Services							
Residential property	6.3	8.3	8.4	8.6	8.3	6.4	6.3
Health care	9.0	9.2	8.0	8.0	9.9	10.5	12.5
Intercity public transport	6.5	3.8	3.4	5.1	9.7	8.2	6.8
Leisure	9.0	5.9	5.7	7.3	6.6	6.3	7.1
Tourism	7.2	7.4	8.8	9.2	9.7	10.1	9.7
Housing services	6.6	9.7	11.1	8.0	11.1	13.4	10.5
Urban transport	8.6	7.7	4.6	4.9	3.2	6.8	13.4
(a) End of period.							
(b) Only 10 months for 1991.							
(c) Commission forecasts Oct.-Nov. 1991 for this year.							
Source: I.N.E. and Bank of Spain.							

Table 5: Contribution of the change (%) of the price deflator of total final uses

	1987	1988	1989	1990	1991(c)
Unit labour cost nom.(adj.) (a)	3,0	2,4	2,5	3,4	3,0
Gross operating surplus (adj.) (a)	1,6	2,4	2,5	2,4	2,1
Ind. tax net subv.	0,4	-0,1	0,8	0,2	0,4
Import prices	0,1	0,2	0,4	-0,2	-0,1
-Import prices excl. nom. eff. exch. rate	0,0	0,7	1,1	0,4	-0,1
-Nom. eff. exch. rate	0,1	-0,5	-0,7	-0,6	0,0
Total final uses	5,0	4,8	5,9	5,7	5,2
-Domestic factors (b)	5,3	5,0	6,0	6,3	5,6

(a) Excluding imputed compensation of self-employed.

(b) Domestic factors include contributions of unit labour costs, net indirect taxes, gross operating surplus and relative unit labour costs in national currency

(c) Commission forecasts October-November 1991.

Table 6: The balance of payments in Spain (as % of GDP)

	1986	1987	1988	1989	1990	1991(a)
Trade balance	-2.4	-3.9	-4.7	-6.4	-6.0	-6.0
Service balance	4.1	3.5	2.7	2.3	1.8	1.8
Transfer balance	0.4	0.8	1.1	1.2	1.0	1.4
Current balance	2.1	0.5	-0.9	-3.0	-3.2	-2.8
Long-term capital balance	-0.6	3.3	2.9	4.5	3.9	6.2
Basic balance	1.5	3.8	2.0	1.5	0.7	3.4
Short-term capital balance	-0.1	0.3	0.2	-0.1	0.0	0.4
Central reserves change	1.1	4.9	2.8	1.2	1.7	2.4
Memorandum items:						
Central foreign reserves	6.0	10.0	11.5	11.0	10.6	12.2
Foreign debt	9.8	9.1	9.2	8.5	8.7	10.4

(a) - Estimations.

Source : Bank of Spain - Cash register

Table 7: Imports and exports in volume terms (% annual growth)

	1986	1987	1988	1989	1990	1991(a)	Accumulative growth 89/91
Imports							
Total	16.7	26.0	18.5	16.8	9.2	10.0	109.5
Non-energy products	23.8	27.0	21.9	17.8	10.8	10.9	124.1
Exports							
Total	-4.0	7.6	7.0	4.7	12.2	12.2	51.7
Non-energy products	-7.1	8.2	7.3	5.1	12.4	12.9	54.8

(a) - Only 10 months

Source: M. of Economy.

Table 8: Geographical breakdown of goods trade

A. Imports of goods (% of total imports)								
	1985	1986	1987	1988	1989	1990	1991(a)	Difference 85/91
From:								
OECD	56.5	71.8	73.9	77.5	77.7	78.7	78.5	22.0
* EC	36.6	50.5	54.5	56.8	56.9	59.5	59.6	23.0
* EE.UU.	10.9	9.9	8.3	9.0	9.1	8.4	8.0	-2.9
* Japan	3.4	4.9	4.5	5.1	4.8	4.4	4.6	1.2
* Others OECD	5.7	6.5	6.6	6.6	6.9	6.4	6.2	0.5
New ind. countries	1.0	1.6	2.2	2.6	2.4	2.3	2.6	1.6
OPEC	20.0	11.1	9.5	6.7	7.5	7.2	7.4	-12.6
B. Exports of goods (% of total exports)								
	1985	1986	1987	1988	1989	1990	1991(a)	Difference 85/91
To:								
OECD	69.9	77.4	79.3	80.9	81.6	82.1	82.5	12.6
* EC	52.1	60.5	63.7	65.6	66.9	69.3	71.3	19.2
* EE.UU.	9.9	9.2	8.1	7.9	7.5	5.8	4.9	-5.0
* Japan	1.3	1.1	1.1	1.2	1.2	1.1	1.0	-0.3
* Others OECD	6.6	6.7	6.4	6.3	6.0	5.8	5.3	-1.3
New ind. countries	0.9	0.9	1.0	1.4	1.2	1.1	1.3	0.4
OPEC	7.2	5.6	4.5	4.5	3.9	3.5	3.4	-3.8

(a) - Only 10 months.

Source: Bank of Spain (Customs basis).

Table 9: Geographical breakdown of Spanish intra-community trade

Imports of goods (% of total imports from the EC)								Accumulative nominal growth 1985/1999 (%)
1985	1986	1987	1988	1989	1990	1991(a)		
Germany	29.01	30.09	29.63	28.53	28.23	27.57	27.21	186.2
Belgium-Luxemb.	4.49	5.21	5.80	5.14	5.57	5.20	4.85	230.0
France	25.75	23.81	24.15	24.10	24.72	25.07	25.61	203.4
Denmark	1.25	1.30	1.32	1.19	1.23	1.24	1.25	205.0
Greece	0.53	0.45	0.53	0.44	0.35	0.35	0.39	127.1
Ireland	1.29	1.13	1.08	0.92	0.97	0.92	0.90	113.0
Italy	12.38	14.49	16.19	16.83	17.27	16.93	16.41	304.4
Holand	5.44	5.59	5.60	7.03	6.60	6.87	6.66	273.7
Portugal	2.11	2.52	3.11	3.72	4.19	4.29	4.67	576.7
United Kingdom	17.77	15.41	12.60	12.10	10.85	11.56	12.05	106.9
Total EC	100.00	100.00	100.00	100.00	100.00	100.00	100.00	205.1
Exports of goods (% of total exports to the EC)								Accumulative nominal growth 1985/1999 (%)
1985	1986	1987	1988	1989	1990	1991(a)		
Germany	18.49	19.56	18.92	18.44	18.03	19.36	22.29	142.4
Belgium-Luxemb.	4.83	4.68	4.71	5.21	4.80	4.38	4.39	82.7
France	29.98	30.14	29.67	28.49	29.33	30.19	27.94	87.4
Denmark	1.20	1.38	1.14	0.95	0.87	0.79	1.17	97.0
Greece	0.77	1.14	1.03	1.08	1.12	1.10	1.07	181.0
Ireland	0.67	0.67	0.63	0.66	0.71	0.49	0.53	60.2
Italy	13.61	13.29	14.00	14.76	14.21	15.52	16.51	143.9
Holand	10.11	9.21	8.19	7.21	6.71	6.61	5.77	14.8
Portugal	4.11	5.54	7.08	8.54	9.40	8.76	9.40	359.6
United Kingdom	16.22	14.40	14.64	14.65	14.83	12.80	10.91	35.3
Total EC	100.00	100.00	100.00	100.00	100.00	100.00	100.00	101.1
Intra-community trade balance (% of Spain's GDP)								
1985	1986	1987	1988	1989	1990	1991(b)		
Germany	-0.4	-0.8	-1.2	-1.3	-1.5	-1.3	-1.0	
Belgium-Luxemb.	0.1	-0.1	-0.2	-0.1	-0.2	-0.2	-0.1	
France	0.6	0.4	0.1	-0.1	-0.3	-0.2	-0.4	
Denmark	0.0	0.0	0.0	0.0	-0.1	-0.1	0.0	
Greece	0.0	0.0	0.0	0.0	0.0	0.1	0.0	
Ireland	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	
Italy	0.2	-0.1	-0.4	-0.5	-0.7	-0.5	-0.3	
Holand	0.4	0.2	0.1	-0.1	-0.2	-0.2	-0.2	
Portugal	0.2	0.2	0.3	0.3	0.3	0.2	0.3	
United Kingdom	0.1	-0.1	0.0	0.0	0.0	-0.2	-0.3	
Total EC	1.2	-0.3	-1.4	-1.8	-2.6	-2.4	-2.1	

(a) - Only 9 months.

(b) - Estimation for 1991.

Source: Eurostat

Table 10: Degree of openness, import penetration, and export activity in Spain and in the EC countries

	1980-1985	1986	1987	1988	1989	1990	1991 (a)	1980-1985	1986	1987	1988	1989	1990	1991 (a)
	1. Goods and services							2. Goods						
SPAIN														
Degree of openness	40.8	45.5	48.8	51.1	54.0	55.5	58.2	31.7	35.1	38.4	41.0	44.4	46.2	48.9
Import penetration	17.2	18.8	20.9	22.4	24.5	25.4	26.4	15.3	16.9	19.1	20.4	22.5	23.1	24.2
Export activity	20.1	22.4	22.5	22.5	22.1	22.2	23.1	13.2	14.3	14.5	14.9	15.1	15.8	16.7
EUR11														
Degree of openness	58.9	62.4	64.1	66.0	69.1	71.5	74.0	49.1	52.6	54.2	56.0	58.6	60.3	62.6
Import penetration	22.6	23.7	24.5	25.3	26.2	26.8	27.4	19.5	20.7	21.4	22.1	22.9	23.3	24.0
Export activity	29.6	31.2	31.6	32.1	33.6	34.8	36.2	23.9	25.5	25.8	26.4	27.6	28.4	29.6
GERMANY														
Degree of openness	57.1	59.5	59.9	61.0	64.6	67.7	74.4	47.7	50.8	51.3	52.5	55.7	58.0	64.0
Import penetration	21.7	22.2	22.6	23.0	23.9	24.9	26.6	17.5	18.4	18.9	19.2	20.2	21.2	23.0
Export activity	29.4	31.0	30.7	31.2	33.2	34.6	38.1	25.4	27.1	26.9	27.5	29.2	29.9	32.6
FRANCE														
Degree of openness	46.2	47.2	48.8	51.0	53.9	55.5	56.0	39.0	40.1	41.5	43.7	45.7	47.0	47.4
Import penetration	18.8	19.5	20.4	21.1	21.9	22.5	22.6	16.7	17.4	18.1	18.9	19.5	19.9	20.0
Export activity	23.0	23.0	23.2	24.2	25.9	26.5	26.9	18.4	18.5	18.8	19.8	20.8	21.3	21.6
ITALY														
Degree of openness	44.0	46.4	48.3	49.1	52.1	54.8	55.9	37.2	39.9	41.4	42.1	44.3	45.0	45.8
Import penetration	18.2	19.2	20.3	20.8	21.8	22.6	23.1	16.4	17.3	18.2	18.6	19.2	19.2	19.6
Export activity	21.8	22.7	22.8	22.8	24.1	25.5	25.8	17.1	18.5	18.5	18.6	19.7	20.1	20.3
UNITED KINGDOM														
Degree of openness	54.4	58.0	59.2	60.3	62.4	63.7	64.5	42.7	46.4	47.3	48.8	50.8	52.1	53.0
Import penetration	20.9	22.3	22.9	24.2	25.1	25.2	25.0	17.2	19.0	19.3	20.6	21.4	21.5	21.4
Export activity	28.0	29.2	29.5	28.3	28.9	30.1	31.1	20.9	22.0	22.2	21.6	22.2	23.4	24.5

(a) Commission forecasts October-November 1991.

EUR11: PPS EUR11; EUR12 excl. Spain

Notes: - Degree of openness: ratio of exports plus imports to GDP, in real terms
- Import penetration: ratio of imports to final demand, in real terms.
- Export activity: ratio of exports to GDP, in real terms

SOURCE: Commission Services.

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991(a)
Nominal exchange rates												
Pesetas per												
- USD	100.0	128.5	153.0	199.8	224.2	237.0	195.3	172.1	162.4	165.2	142.1	146.1
- DM	100.0	103.5	114.5	142.2	143.3	146.8	163.7	174.0	168.1	159.6	159.8	158.5
- ECU	100.0	103.1	107.8	127.9	127.0	129.5	138.0	142.8	138.2	130.9	129.9	128.9
Nominal effective exchange rates relative to 19 industrial countries	100.0	90.4	84.9	70.3	68.6	67.1	66.0	66.2	68.2	71.0	74.7	74.3
Real effective exchange rates relative to 19 industrial countries												
Double exports weights												
-Price deflator gross domestic product	100.0	92.7	91.5	79.7	82.2	83.4	87.5	89.8	94.3	100.8	108.6	110.1
-Unit labour costs; total economy	100.0	93.1	90.2	79.3	79.0	78.6	80.4	82.4	86.4	91.3	97.5	97.5
(a) Commission Forecasts October-November 1991.												
SOURCE : Commission Services.												

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991(a)
Indirect taxes	6.6	7.3	7.8	8.5	9.0	9.5	10.5	10.4	10.3	10.4	9.9	9.9
Direct taxes	7.0	7.2	6.8	7.9	8.3	8.4	8.2	10.3	10.5	12.0	11.7	12.2
Direct taxes adjusted (b)										11.3	12.1	12.4
Social security contributions	13.1	13.4	13.3	13.7	13.1	13.0	12.8	12.8	12.5	12.7	13.0	13.4
Other current receipts	3.5	3.8	4.0	3.9	3.4	3.8	4.2	4.0	4.0	4.0	4.1	4.2
Total current receipts	30.2	31.7	31.9	34.0	33.8	34.7	35.7	37.4	37.2	39.0	38.6	39.6
Total current receipts adjusted (b)										38.3	39.0	39.8
Current transfers	16.2	17.6	18.1	18.8	18.8	19.1	17.6	17.2	17.4	17.6	18.0	18.5
to enterprises	2.1	2.0	2.5	2.6	2.8	2.6	2.0	1.8	2.1	1.8	1.8	1.8
to households	12.7	14.1	14.0	14.5	14.5	14.7	13.9	13.8	13.9	14.0	14.6	15.1
to the rest of the world	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Actual interest payments	0.7	0.8	1.0	1.3	2.0	3.1	3.9	3.5	3.3	3.4	3.5	3.6
Government consumption	12.7	13.2	13.4	13.9	13.7	13.9	14.7	15.1	14.8	15.1	15.1	15.4
Compensation of employees	9.8	10.3	10.2	10.6	10.5	10.5	10.3	10.4	10.5	10.5	10.7	10.9
Purchases of goods and services	2.4	2.4	2.6	2.7	2.7	2.7	3.3	3.7	3.3	3.6	3.4	3.4
Total current expenditure	29.7	31.6	32.4	34.0	34.6	36.1	36.2	35.8	35.5	36.1	36.6	37.5
Gross saving	0.6	0.1	-0.5	0.1	-0.7	-1.4	-0.5	1.6	1.7	3.0	2.0	2.1
Gross saving adjusted (b)										2.3	2.4	2.3
Net capital transfers	1.3	1.7	2.0	2.0	1.7	1.9	1.8	1.3	1.2	1.4	1.1	0.8
Gross fixed capital formation	1.9	2.3	3.1	2.8	3.0	3.7	3.7	3.5	3.8	4.3	5.0	5.2
Total expenditure	32.8	35.6	37.5	38.8	39.3	41.6	41.7	40.6	40.5	41.8	42.6	43.5
Net lendign(+) or net borrowing(-)	-2.6	-3.9	-5.6	-4.8	-5.5	-6.9	-6.0	-3.2	-3.3	-2.7	-4.0	-3.9
Net lendign(+) or net borrowing(-) Adjusted (b)										-3.4	-3.6	-3.7
Gross public debt	17.6	21.6	26.8	33.1	39.9	45.2	46.2	46.6	42.9	44.2	44.5	45.6
(a) Commission forecasts October-November 1991.												
(b) Adjusted for delaying tax reimbursement for General Government in 1989, 1990 and 1991.												
Source: Commission Services.												

	M3		ALP		M1	M2	Domestic Credit Expansion
	Target	Outcome	Target	Outcome			
1980	16-20	16.1			12.2	11.4	19.8
1981	14.5-18.5	15.7			12.5	11.6	19.8
1982	13.5-17.5	15.2	15-19	17.7	6.9	8.0	20.1
1983		12.7	14-18	15.8	6.7	8.7	16.1
1984		12.9	10.5-14.5	14.4	7.7	7.1	11.6
1985		6.3	11.5-14.5	13.3	12.0	11.5	14.8
1986		4.1	9.5-12.5	12.1	13.0	12.9	13.3
1987		6.3	6.5-9.5	14.6	15.2	11.7	14.3
1988		11.2	8-11	12.1	17.8	15.6	15.4
1989		10.5	6.5-9.5	10.4	14.9	11.5	14.8
1990		14.8	6.5-9.5	11.3	27.0	17.9	10.2
1991		15.4	7-11	12.1	16.4	14.0	12.5

Source: Bank of Spain.

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1. ALP	16,9	17,1	16,6	16,0	13,3	12,9	12,6	14,2	11,3	10,9	11,0
2. Internal counterparts (2 = 3+4+5)	19,1	16,1	19,1	14,7	9,7	12,9	12,3	11,2	11,3	12,1	12,8
3. Lending to state sector	48,0	52,4	61,4	51,3	53,9	35,8	23,3	13,7	12,0	12,0	10,9
4. Lending to compan.& hous.	17,7	16,7	15,1	10,2	1,8	7,5	8,9	14,6	17,1	16,2	11,7
5. Non-monetary liabilities	33,5	87,3	31,6	30,6	29,5	29,6	20,7	33,9	36,4	26,6	6,6
6. External counterparts (6 = 7+8)	-32,5	53,1	-57,5	120,1	169,4	13,3	19,9	63,3	11,3	-2,4	-10,1
7. Net official reserves	-4,6	30,9	-20,6	34,5	69,7	-18,7	15,3	85,2	25,7	7,4	4,8
8. Net external lending by commercial banks	26,2	17,7	7,9	8,6	8,4	-67,6	-4,6	230,8	72,9	28,0	28,7

Source: Banco de España

		Short-term(a)		Long-term(b)	
DATE		Nominal	Inflation adjusted(c)	Nominal	Inflation adjusted(c)
annual average					
1986		11,66	2,68	11,37	2,41
1987		15,82	9,89	12,77	6,99
1988		11,64	6,23	11,81	6,39
1989		15,03	7,89	13,82	6,76
1990		15,16	8,23	14,71	7,85
1991		13,20	6,99	14,39	6,24
monthly averages					
1991	January	15,16	:	14,52	
1991	February	14,74	:	14,25	

Source: Commission Services.
Notes: (a) 3-month interbank rates.
(b) Central Government bonds: 2 to 4 years
(c) Private consumption deflator

	1986	1987	1988	1989	1990	1991(b)
GDP at constant prices, % change						
SPAIN	3.2	5.6	5.2	4.8	3.7	2.5
EUR-7	2.3	1.7	3.5	3.5	3.8	2.2
GDP per head of population (in PPS)						
Index EUR-7=100	66.3	68.8	70.1	71.3	71.7	72.3
Domestic demand at constant prices, % change						
SPAIN	6.0	8.1	7.1	7.8	4.6	3.1
EUR-7	3.7	2.6	3.4	3.2	3.9	2.0
Private consumption deflator, % change						
SPAIN	8.6	5.7	5.1	6.6	6.4	5.8
EUR-7	1.2	1.8	2.0	3.3	2.8	3.2
Total employment, % change						
SPAIN	1.4	4.5	3.5	3.6	2.6	0.7
EUR-7	1.0	0.6	0.8	1.2	1.9	1.4
Unemployment rate, % of civilian labour force						
SPAIN	21.1	20.4	19.3	17.1	16.1	15.8
EUR-7	8.6	8.6	8.2	7.6	7.3	7.3
Unit labour costs, % change						
SPAIN	7.6	5.6	4.5	4.8	6.6	5.9
EUR-7	2.5	2.1	0.6	1.2	2.6	4.4
Current account balance, % of GDP						
SPAIN	1.6	0.0	-1.1	-3.2	-3.5	-3.1
EUR-7	2.3	1.9	2.1	2.4	1.6	0.9
General Government deficit, % of GDP						
SPAIN	6.0	3.2	3.3	2.7	4.0	3.9
EUR-7	2.7	2.6	2.5	1.3	2.4	2.8
Nominal effective exchange rate, 1985=100 (c)	92.0	88.6	92.5	97.3	97.1	98.2

(a) EUR-7: B DK D F IRL L NL.
(b) Commission forecasts October-November 1991.
(c) against EUR-8 (EUR7+ITA), double export weights.
SOURCE: Commission Services.

PART II
CHAPTER I
THE PRICE WAGE FORMATION PROCESS
AND LABOUR MARKET CONSTRAINTS (*)

Contents

<p>Introduction 26</p> <p>1. Theoretical framework on labour market rigidities and the path of nominal wages 26</p> <p>1.1 The non-accelerating inflation rate of unemployment (the NAIRU) 26</p> <p>1.2 "Insider-outsider" and hysteresis 26</p> <p>1.3 The significance of the structure of collective bargaining 27</p>	<p>2. Rigidities in the labour market and wage determination in Spain 28</p> <p>2.1 The sources of rigidity in the permanent sector of the labour market 28</p> <p>2.2 The structure of collective bargaining . . 30</p> <p>2.3 The significance of the new temporary employment 30</p> <p>3. Recent performance of unemployment, wages and prices in Spain 31</p> <p>4. Summary and conclusions 33</p>
--	---

(*)This chapter was mainly prepared by Robert BUSHHELL and Julia SALAVERRIA MONFORT of the National Economies Directorate.

Introduction

The remarkable feature of the recent history of the labour market has been the very high level of unemployment. Rates of increase in nominal wages have nevertheless remained well above the average for the narrow-band Member States. Unemployment has more recently fallen from the very high levels of the first half of the last decade, promoted by the introduction of temporary contracts and the expansion of the Employment Promotion Programmes. The expansion in employment has been concentrated in lower-paid jobs in services, and has contributed to overall wage moderation during a period of rapid economic expansion.

The labour market nevertheless remains segmented into a temporary and a permanent sector. Wage growth began to accelerate much faster in 1988 and 1989, and the data suggest that this acceleration was concentrated within pay settlements in the permanent sector. The Chapter investigates the reasons for this acceleration and attempts to explain why the non-accelerating inflation rate of unemployment (the NAIRU) is particularly high in Spain compared with the rest of Europe. The principal explanations are to be found in the rigidities in the permanent sector of the labour market, combined with the inappropriate levels of skills on offer from amongst the unemployed.

1. Theoretical framework on labour market rigidities and the path of nominal wages

1.1. The Non-Accelerating Inflation Rate of Unemployment (the NAIRU)

The Non-Accelerating Inflation Rate of Unemployment (THE NAIRU) is a concept which embodies the identification of a behavioural relationship between the rate of increase in nominal wages and the level of unemployment. In its most basic form, the concept states that there is one level of unemployment at which workers are willing to accept the wage offers which are compatible with firms' pricing ambitions. Wage offers are made and negotiated within a framework of expectations about the rate of growth of nominal GDP. Wages are the dominant element in production costs and exercise a strong influence over the rate of increase of prices. Prices are an important influence upon workers' expectations for the rate of increase in nominal wages. The level of unemployment which eventually exercises a constraint upon the rate of increase in nominal wages is determined by structural features in the labour and product markets.

The current level of unemployment also comprises a cyclical element, so that the level of measured unemployment may find itself either above or below that equilibrium level which is consistent with stable prices. The cyclical element is the outcome of the effect of various "shocks" which intrude upon labour and product markets and which will require an adjustment in the rate of growth of nominal wages. The speed and efficiency with which wages respond to cyclical changes in unemployment will be strongly influenced by various structural features and institutions in the labour market. The speed and efficiency of adjustment also determines

the time which is required for unemployment to return to the equilibrium level which is consistent with a stable path for prices.

The various structural features and institutions which determine the level of unemployment which is consistent with stable prices, and which determine the speed of adjustment of the rate of change of nominal wages to cyclical changes in unemployment, can be identified as follows.

- *Mismatch*, which implies that an important part of the available labour supply is unattractive to employ given the state of technology and the potential productivity of that labour in relation to the distribution of nominal wages by occupation, industry or region,
- *Job search*, where the unemployed (or potential employed) search less hard for work, perhaps because unemployment benefits have become more generous (the reservation wage has risen) or because of discouragement amongst the unemployed at the difficulties of gaining access to work or access to better or permanent job opportunities,
- *Legislative features*, where employment legislation (perhaps relating to hiring and firing procedures or the level of employer contributions to social funds) impose additional costs upon employment and discourage the use of labour,
- *Union militancy*, where workers in permanent jobs or in sectors containing particularly skilled workers are able to exert important influence over the development of employment legislation and over the conduct of labour relations within the wider labour market.

The combination and strength of these features also determines the ability of workers to resist a reduction in the net real wage when 'shocks' appear. Primary examples of 'shocks' include:

- *Taxes*, where rising taxes (perhaps employee contributions to Social Funds) lead to compensating increases in nominal wages and a rise in overall costs of employment per worker because the path of nominal wages is unchanged,
- *Relative import prices*, where the underlying trend in the price of imports is raised relative to the price of final domestic output, leading to a rise in the price of final domestic output relative to value-added, and
- *A productivity slowdown*, where the trend rate of growth of productivity turns down (for whatever reason) and the consequences for wage growth are resisted. Nominal wages sustain their previous path.

The effect of these structural features or imperfections is to shift the relationship between real wages and productivity in favour of real wages for those in work. The following examines the circumstances which enable this shift to be achieved in practice.

1.2. "Insider-outsider" and hysteresis

The manner and circumstances in which workers (unions) are able to impose upward movements in the real wage, or resist downward pressures upon the real wage, has been the subject of sophisticated analysis. The most convincing explanations are based upon developments of the "insider-out-

sider" models of the labour market. In these models, unions select the wage by virtue of their "insider" power and firms choose the number of workers they will employ. "Insiders" will encourage the recruitment of "outsiders" only for as long as additional recruitment adds to the marginal revenue product of those in work.

"Outsiders" will be willing to enter work provided the expected marginal revenue product exceeds the reservation wage, measured by the level of out-of-work income. "Insiders" will exercise and maintain their power by constructing rules and codes which can be used to restrict access and raise labour turnover costs for firms. Power may very well be exercised through trade unions, but this is not a necessary condition. The possession of power may be supported by the complexity of production techniques inside the enterprise (and the associated complexity of skills) or power may be won by the formation of informal coalitions among those with higher or professional skills.

The incentive to exclude "outsiders" is enhanced if "outsiders" have lower order skills and abilities compared to "insiders". "Insiders" will then prefer to maintain barriers to employment and capture for themselves the additional rent from future increases in profits. The situation will be sustainable provided firms are willing to negotiate only with "insiders". However, firms may be quite willing to deal only with "insiders" because recruitment of "outsiders" has certain risks of failure (choosing the wrong workers) and they may prefer to maintain good relations with the highly-skilled (and more productive) "insiders".

The outcome is consistent with behaviour which finds firms preferring to invest in labour-saving capital equipment rather than recruit new workers, and being encouraged to do so by "insiders" because the benefits for their "insider" revenue product (and subsequent real wages) are superior. The potential for "insider" behaviour will be further enhanced where firms are operating in oligopolistic or monopolistic markets, because firms will then have fewer incentives to resist the construction of barriers to "insider" entry and will be able to pass on cost pressures in higher product prices. In fact, "insiders" will have still further incentives to erect barriers (and capture economic rent) where product markets are subject to restricted competition because their bargaining strategy is also subject to fewer constraints.

Separate analysis has claimed to find evidence of hysteresis in the labour market. Hysteresis might be seen to occur when the labour market establishes equilibrium at a given level of unemployment and then (*ceteris paribus*) maintains that equilibrium level of unemployment into the future. However, the equilibrium level of unemployment which is established is in no sense unique and there are various (perhaps numerous) levels of unemployment which might be consistent with a similar path of real wages. History then matters and the best explanation of current levels of unemployment

is past levels of unemployment. The implication is that rates of change, rather than any particular level, of unemployment influences real wages. The hysteresis proposition is at least partly consistent with the "insider-outsider" model of the labour market.

In the specific case of Spain, hysteresis could be said to be gestating during the years before democratisation when the rate of technological adjustment to changes in the structure of demand and prices on world markets was delayed by policies for trade, industry and the labour market. The "shock" of the change in inflation régime at the beginning of the 1980s led to a widespread release of labour (and abandonment of capital) and a very fast rise in unemployment. The rise in unemployment was so fast that the labour market was unable to cope with the required adjustment. Unemployment was then locked in at the higher level by malfunctions in labour and product markets, and particularly by the effects of inactivity upon the skills of those displaced into unemployment. One important implication of hysteresis is that the effects of unemployment on job-seekers are cumulative and skills and motivation deteriorate with duration of unemployment spell.

The explanation for the failure of real wages to respond to the high levels of unemployment is nevertheless incomplete. The important, remaining questions are why "outsiders" fail to approach firms directly and why they do not set up new businesses in order to compete with the "insiders". The answer to the first question might be that firms delegate a component of screening costs of new workers to "insiders", and "insiders" have incentives to exclude many of the new applicants.

The answer to the second question may be that "outsiders" lack the required skills and knowledge for forming coalitions with other "outsiders" and may be unable or unwilling to accept the risks inherent in forming new enterprises. The rules, structure and generosity of the unemployment benefit system may offer strong disincentives. The creation of new enterprises, or the adoption of innovative working patterns which might enable re-entry to work, may be discouraged by rules and regulations and by codes of conduct constructed by "insiders". One further problem is that access to capital markets for "outsiders" may be restricted because of collateral requirements and the associated risks attached to borrowing.

1.3. The significance of the structure of collective bargaining

Other research has adopted elements of both the "insider-outsider" and hysteresis proposals and asserted that institutional features in the bargaining system¹ may lead to failures in the adjustment of real wages to particular levels of unemployment and that these failures may be durable. Spain appears to have a system of collective bargaining which combines both

1 See, for example, Calmfors, L. and Driffill J. (1988). "Bargaining Structure, Corporatism and Macroeconomic Performance", *Economic Policy*, Number 6.

elements of national and decentralised bargaining². The analysis supposes that nominal wages are determined by reference to labour market conditions in the regions, or local labour markets, which are experiencing the most buoyant conditions. Nominal wage increases are then transmitted throughout labour markets in low activity regions. The rigidity of wage determination is emphasised by failures in labour mobility.

The inefficiencies imposed by the structure of collective bargaining will be magnified by failures in expectations regarding the future path of domestic demand and inflation. Inflation surprises will be resisted in wage determination in the high activity regions or labour markets and these will again be transmitted across all labour markets. Failure by the monetary authorities to implement the stated path for monetary and fiscal policy will encourage settlements which attempt to anticipate the path of inflation in the determination of real wages, thereby cultivating an inflationary attitude in economic life. The persistence of inflationary expectations (or the presumption that growth in nominal incomes will inevitably be faster than predicted by official projections) combined with inefficiencies in the hybrid system of collective bargaining will also substantially delay the speed of adjustment of real wages to changes in the rate of growth of economic activity.

2. Rigidities in the labour market and wage determination in Spain

2.1. The sources of rigidity in the permanent sector of the labour market

Various factors impede the speed and efficiency of adjustment in the case of Spain. Research evidence³ support the probability of pervasive mismatch in the labour market,

- large inter-industry shifts of employment have taken place during the past two decades, but industry-specific unemployment rates (relating to individual job-seekers) appear to have persisted,
- high pay differentials can be identified across occupations and sectors, and an important part of these differentials remains after adjustments are made for the personal characteristics of those in work.

The adjustment for personal characteristics includes factors such as concentrations of male or female workers by sector, comparative investment in human capital, marital status and tenure of work contract. The size of residual differential by sector appears particularly significant in banking and financial services. The presence of important, residual pay dif-

ferentials can be interpreted in various ways. However, the pattern of differentials is suggestive of a labour market where firms pay wage premia in order to retain scarce workers. Wage premia for retention are surprising at a time when levels of unemployment have been particularly high.

The evidence from wage differentials can be supported by reference to statistical analysis which identifies wide differences in the probability of entering and leaving unemployment across particular groups of labour market participants. After adjustment for the characteristics of individual job-seekers and sectoral composition by region, the differences in entering and leaving unemployment are perpetuated. The statistical evidence also suggests important wastage of skills, so that duration of unemployment has important consequences for subsequent unemployment experience and duration has cumulative consequences for the speed and probability of re-entering work. Certainly, the very high levels of long-term unemployment (as a proportion of total unemployment) would indicate potential for wastage of skills amongst important parts of the labour supply. The problems of re-entering work have also contributed to declining participation (partly discouraged worker effects) amongst older workers, and led directly to the encouragement of early retirement programmes.

The rational response to shortage of experienced workers (the requirement to pay wage premia) is to educate and train young workers, because young workers will have made the least investment in human capital and should expect to receive the lowest relative wage. The concentration of unemployment (and long-term unemployment) amongst young people suggests that firms have been required to accommodate the inflexibilities within the permanent sector of the labour market by reducing the recruitment of new entrants (see tables 6 and 8). The apparent compression of the overall pay distribution (and a narrowing of age-related pay differentials) negotiated through collective bargaining should be expected to have contributed to a reduction in the number of entry-to-work jobs for young people. The compression appears to have been particularly emphatic during the strengthening of national collective bargaining during the 1970's. The situation may have been made worse by the priority given to the negotiation of minimum wages through free collective bargaining. The effect of this priority is to further increase the employment costs of new entrants to work and to reduce the incentives for firms to offer training and education to those at the lower end of the pay distribution.

Job search. Mismatch may be enhanced where labour mobility across areas, regions or borders is reduced or where mobility across occupations within the same area or region is constrained. The statistical evidence indicates a substantial

2 The collective bargaining system in Spain displays more tendencies towards centralised than decentralised bargaining.

3 Vinals, J, et al, "Spain and the 'EC cum 1992' shock", in *Unity with Diversity in European Economy: the Community's Southern Frontier*, editors C. Bliss and J. Braga de Macedo, Cambridge, 1990.

fall in inter-regional mobility within Spain during the period since about 1960⁴. Cross-border migration has reversed during the same period, and particularly after 1973. The major explanation for the decline in migration is the trend rise in national and European unemployment, coinciding with the first oil price "shock" in 1973. The effect of rising unemployment (particularly on the scale experienced in Spain) is to influence the perceptions of potential migrants about the probability of re-employment in the new region. The re-employment prospects of older workers will anyway be smaller, and the expected rate of return for older workers will probably be modest in comparison to costs because of the shorter period during which older workers can expect to receive earnings in the new job and region. The incentives for migration are then low, particularly where the skills of potential migrants are inappropriate for vacancies in the higher activity regions or where barriers to entry in the sectors concentrated in those regions are substantial⁵.

The rise in unemployment has also encouraged resort to the informal sector, and has emphasized the attractions of remaining in close proximity to the family unit. That is particularly important in Spain and in Southern Europe. The family is also often the nucleus of informal working in tourism and agriculture (see tables 13,14 and 15). The capacity of the family to offer support may have been improved by the household income effect of the rise in the number and value of pensions which has arisen through the encouragement of early retirement programmes. It may also have been improved by special unemployment benefit schemes, such as that which exists for agricultural workers in Andalusia and Extremadura. The level of inter-regional mobility should be influenced by the considerable differences in regional house prices, itself an outcome of the concentration of economic activity in certain key areas or cities. The inflexibilities of the capital market, leading to the concentration of investment within those location, has had further implications for the functioning of the labour market. The rigidity in the rented housing sector has contributed to the problems created by differences in regional house prices.

Further evidence⁶ has suggested that falling job search may be associated with improvements in the level of unemployment benefits. The combination of comparatively high severance pay and improved unemployment benefits should certainly be expected to reduce job search during the early weeks of unemployment, although econometric analysis has found only small effects arising from improved levels of unemployment allowances. The disincentives to job search may nevertheless be magnified where public employment services fail to impose a régime which creates a direct link between the payment of allowances or grants and the pursuit

of formal work. Evidence suggests⁷ that the claiming of allowances and concurrent working in the informal sector is relatively common in some regions or sectors.

Legislative features, the favoured position of those in permanent and higher-skilled work is improved by employment legislation, and particularly by legislation relating to severance pay. The tradition of high severance pay, determined partly by legal requirements but apparently enhanced through collective bargaining, has reduced the incentives for firms to recruit additional labour and also reduced the potential for releasing labour during periods of downturn in the rate of growth of economic activity. The adoption of early retirement programmes (partly subsidised by government) to attempt to offset the effects of rising unemployment has at the same time reduced labour supply to the formal sector and further improved the competitive position of those working in permanent jobs inside that sector. The adoption of early retirement programmes has reduced formal participation by older workers in a labour market where participation is already very low by European standards (see tables 7 and 8).

The very low levels of part-time working in the labour market suggest a significant rigidity imposed by employment legislation, particularly when comparisons are made with work patterns in other Member States. The alternative to part-time working is the use of existing workers on overtime, which is likely to be more costly because those already in jobs have a preferential position in bidding for the additional work. The low participation rate (across the whole labour force) indicates substantial discouraged worker effects, leading either to inactivity (and still lower competition in bidding for work) or to resort to the informal sector. High severance payments will have further effects on labour supply, particularly where high severance payments are combined with the introduction of substantial improvements in unemployment allowances.

Taxes on jobs, employer contributions to the Social Fund represent a high proportion of total government revenue from taxation in Spain (see table 5). The levels of revenue from this form of taxation appear to have been particularly high at the beginning of the 1980's. The proportion of taxation raised from employer contributions has fallen in more recent years but remains higher than many of the Member States and in comparison with countries such as the United States and Japan. Some analysts⁸ claim to have found an important correlation between the rise in the gap between wages and labour costs and the rise in the NAIRU during the past decade. It is difficult to imagine that the level of taxes upon jobs in the formal labour market could explain such a substantial rise in unemployment. However, the level of tax-

4 Bentolila, S, and J.J. Dolado, Mismatch and internal migration in Spain, 1962-1986, Banco de España, 1990.

5 The evidence suggests that significant differences exist in the structure of industry and occupations across high-activity and low-activity regions, although regional wage differentials appear to be comparatively low.

6 Bentolila, S, and O.J. Blanchard, Spanish Unemployment, *Economic Policy*, 10 April 1990.

7 Muro, J, et al, Analisis de las Condiciones de Vida y Trabajo en Espana, *Ministerio de Economía y Hacienda*, 1987.

8 Dolado, J.J., Malo de Molina, J.L. and Zabalza, A. (1986), Spanish industrial unemployment ; some explanatory facts, *Economica*, 53.

ation upon jobs may well have encouraged resort to working in the informal sector. The level of taxes on jobs may also have magnified the "shock" to employment of the change in inflation régime at the beginning of the 1980's, encouraging firms to adopt strategies which would lead to a substitution of labour in the long term.

2.2. The structure of collective bargaining.

The problems of entry to work in lower-activity regions, and the obstacles to formal employment creation in the private sector in those regions, are exacerbated by the structure of collective bargaining. Nationwide agreements were used (as a form of partnership) to reduce the core rate of inflation during the period of the 1970's but the reduction was achieved at the expense of implanting important inefficiencies in the bargaining process, and in the labour market in general, during the subsequent period. National collective bargaining tends to be conducted within the high-activity regions and the transmission of national wage settlements from high-activity to lower-activity regions is one of the factors in the low response from nominal wage settlements to rising unemployment in the wider labour market. The structure of collective bargaining has contributed to a comparatively low degree of dispersion in regional wage differentials.

One indicator of the resulting rigidity is that sectoral wages appear to be closely associated with the aggregate industry (consumption) real wage and appear to respond very little to own-sector variations in productivity trend or general labour supply conditions in that sector or industry⁹. The research findings suggest a system of collective bargaining where the principal influences upon nominal wage determination by sector is not the level of sectoral or local unemployment but the relative level of nominal wages in comparison with other sectors. The regional transmission of nominal wage settlements through the structure of collective bargaining is a particularly important issue at a time when entry to the European Community is encouraging trade unions to pursue pay increases which are consistent with a "catching-up" process in imitation of pay levels in other Member States. The extent of the transmission process should be expected to have important implications for levels of unemployment in the lower-activity regions during the period of adjustment to membership of the Exchange-Rate Mechanism.

2.3. The significance of the new temporary employment

The importance of temporary work in employment expansion is illustrated in table 2. During the period from 1987 to 1989, the total growth in temporary employment was 932,000 and this compares to an estimated fall in permanent employment during this period of 45,000. The growth in temporary employment during these years appears to be important across all sectors except agriculture but is particularly concentrated in services. Nevertheless, growth in permanent employment is also important in services whereas

falls in employment were evident in Industry and Construction. Within the Services sector, growth in temporary employment in Commerce and Hotels and "others" (probably government agencies or public services) was particularly strong. Growth was also strong in Construction.

The increasing importance of temporary employment in total employment is confirmed in table 3. Temporary employment has increased from 18.6% of total employment in 1987 (final quarter) to 31.5% of total employment at the end of 1990. The data in the table also illustrate the dominance of temporary employment in agriculture and construction and the growing importance of temporary employment throughout services. The growth in Commerce and Hotels and in Transport and Communication is particularly notable. Temporary employment in "Industry" recorded rapid growth during the two-year period, and the rate of growth was comparable across all the sub-sectors of the industry sector.

The data in table 7 shows that the growth in temporary employment has coincided with an important expansion in the labour force. The growth in population aged 25 and over has been particularly strong but the notable feature is a rapid acceleration in participation amongst women aged 25-54. The availability of temporary contract work does not necessarily explain the rise in female participation. However, it seems reasonable to suppose that there is some association because of the need to register at government employment offices in order to qualify for entry to the Employment Promotion Programmes. Changes in the rules relating to unemployment benefits and pensions will also explain part of the rise in female participation and there has been an important change in attitudes about the extent to which women should participate in work outside the home.

The other important trend is the fall in male participation rates, particularly surprising at a time when the rate of growth in economic activity was reaching very high levels (table 7). The fall is concentrated not only amongst older workers but also in the age-group 25-54, although most of the effect will be apparent in the age-group of 45 years and over. The information in table 7 can be compared with table 4, which shows that part-time employment has fallen steeply amongst males during 1988 and 1989. More surprisingly, part-time employment amongst females has fallen during a period when total employment growth was expanding rapidly.

Recruitment under the Employment Promotion Programmes (EPP) represented more than 50 per cent of total hirings in 1988 and 1989 (table 1) and temporary contracts were used for almost one-half of total recruitment in the latter year. Part-time jobs represented 15 per cent of total recruitment under EPP in 1989, which is surprising in a labour market where part-time working is very low in comparison to most of the other Member States (see table 12).

The economic consequences of the expansion of temporary working under EPP are difficult to estimate without full

⁹ Vinals, J, et al, op.cit, 1990.

evaluation evidence. It is certainly beneficial for those who have been out of work for a prolonged period to re-enter employment and to improve their search credentials in the labour market. However, the encouragement of an important part of temporary contract work has been achieved through special incentives and these should be expected to have costs:

- temporary contract working may have displaced other job-seekers or other forms or sources of activity;
- resources will have been diverted between sectors, and the efficiency of that diversion is questionable;
- it is debatable whether temporary contract workers will find permanent work at the end of contract, or whether they will simply enter a prolonged period of further unemployment.

Employment Promotion Programmes do appear to have included a number of training and apprenticeship schemes. However, information needs to be obtained on the extent to which these are genuine net additions to apprenticeship and training positions or whether they are really positions which would have existed anyway. The quality of training delivered also needs to be investigated, because this will determine the extent of later employability and the potential for skill augmentation in later career. Experience in other Member States suggests that training positions embedded in special employment programmes are subject to low quality outcomes and poor (post-graduate) employability.

The temporary work sector created by the *Employment Promotion Programmes*, and by the wider legislative innovation, is unlikely to have many permanent benefits for the quality of labour supply. Many of the individuals participating in the Programmes or benefiting from the legislation, have few incentives to acquire new skills and education because entry to the permanent sector of the labour market (and access to higher-quality jobs) remains subject to the same barriers which existed prior to the changes in temporary work legislation. Firms have few incentives to offer substantial training and education in specific skills because temporary workers are likely to be replaced at the end of contract and would carry any acquired skills and education away with them.

The introduction and development of the *Employment Promotion Programmes* and the wider easing of restrictions on the adoption of temporary contracts have enabled recruitment of low-cost labour with the use of contracts which provide much greater flexibility for firms. Temporary contracts created within EPP include financial incentives through disregard upon employer social security contributions as well. The recruitment provides enhanced flexibility because the temporary workers have been and are employed mainly on short-term contracts and the terms of the contract include the legal right to much lower termination payments than for permanent sector workers.

One of the effects of the *Employment Promotion Programmes*, and the wider legislative innovations, is that firms have been able to reduce average compensation per worker during a period when economic activity has accelerated rapidly. The reason for this is that temporary contracts have opened up the possibility of recruiting workers into jobs which are at the lower end of the skill-range and which will be mostly suitable for young people and other lower-paid workers. The availability of low-cost labour has also contributed to the strength of the expansion in the economy.

The development of EPP, and the promotion of temporary-contract working, has made an important impact upon the availability of lower-paid job opportunities and upon the degree of flexibility in employment structures. It has been particularly beneficial for very young job-seekers. However, the expansion in the stock of temporary workers since 1985 may also have contributed to segmentation in the labour market. The *Employment Promotion Programme* and the wider deregulation have introduced alternative routes into work but are unlikely to have had much effect upon the rigidity which has existed (and which persists) within that part of the market which contains permanent workers. The major effect of these rigidities is to reduce competition for jobs in the permanent sector and to enable that sector to exert substantial powers over the determination and rate of growth of nominal wages.

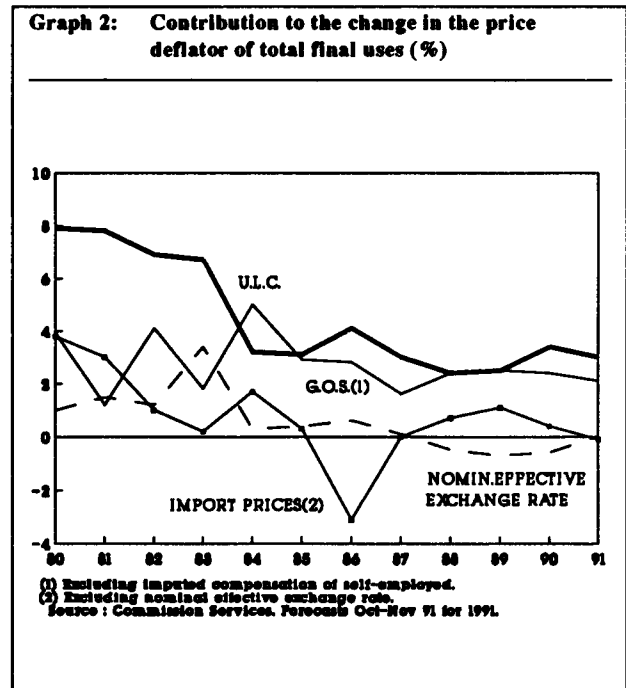
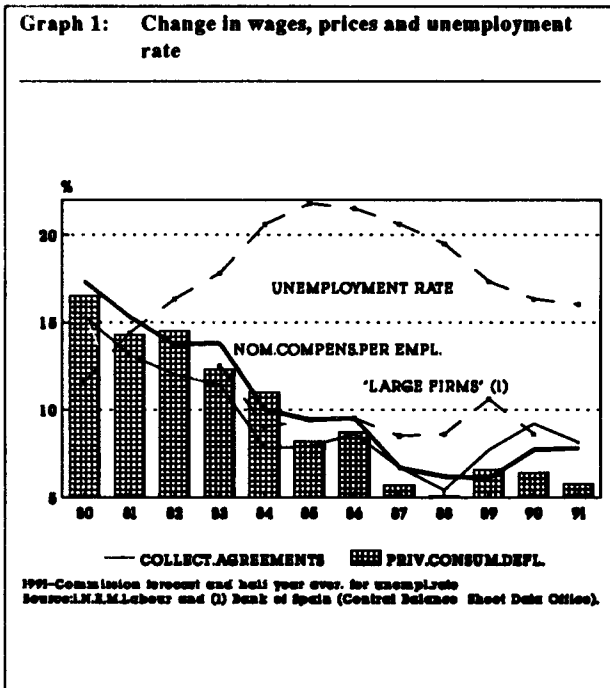
3. Recent performance of unemployment, wages and prices in Spain

During the last decade the evolution of nominal salaries was characterized by a growth rate moderation. The very high unemployment rate played a role in the deceleration of nominal wage growth which was only reversed since 1989.

Despite the sharp fall in unemployment from 1986, the expansion in temporary contracts working has had important benefits for wage moderation in nominal compensation per employee of total economy.

The associations between trends in wages, prices and unemployment are investigated in Graph 1 which provides the background to the later analysis. The information in Graph 1 illustrates the association between trends in consumer prices and the rate of increase in wages negotiated through collective agreements¹⁰. However, it also shows that the rate of increase in wage settlements responded only temporarily to the downward trend in consumer prices and began to move ahead of the trend in prices in 1987. The principal factor appears to have been the rate of increase in earnings in "large firms", which began to accelerate much more rapidly in 1989 and likely in 1990. The difference between basic wage settlements negotiated through collective agreements and the rate of increase in average earnings reported for "larger firms" became much wider in 1989. The relative trends in pay data

10 In graph 1, the figures of "collective agreements" and "nominal compensation per employee" take into account the effect of the safeguard clause (difference between output inflation and the expected figure) in the year of payment.



reveal the build-up in the pressure of wage increases (and of rising labour costs) which now needs to be reversed.

It also shows the modifying effect of the innovations for temporary working upon nominal compensation per employee. The rate of growth in average earnings had begun to move away from the trend in nominal compensation per employee. Temporary contract workers have been recruited into lower-paid jobs and the rate of increase in nominal compensation per employee was consequently on a downward trend between 1986 and 1989.

The trend in nominal unit labour costs in relation to the level of unemployment is consistent with research findings at OECD, and is broadly supported by evidence taken from the Quest model of the Commission Services. The synthesis of that evidence¹¹ shows that wages are highly responsive to rises in the consumer price index but adjust more slowly to downward movements in that index. The level of measured unemployment which is consistent with moderation in the rate of growth of nominal wages is very high in comparison to other Member States.

The downward trend in compensation per employee combined with increases in productivity caused a deceleration in the growth of nominal unit labour costs for the total economy, which actually fell in real terms (see Table 16).

The deceleration in wage growth rates has translated to a decrease in price inflation as well. According to the figures in Table 17, the price deflator of total final uses went down from a growth rate of 14% in 1980-1984 to 6% in the second

half of the decade. Since 1987, exchange rates have played an important role by reducing positive contribution to prices.

In 1988-1989 the contribution of unit labour costs to the rise in final prices was the same as that of the gross operating surplus. So, it seems that the presence of very strong domestic demand has induced prices rises through an increased mark-up to the same extent as through labour market pressures.

In 1990 and 1991 the conclusion is not the same; it was the high increase in nominal wages which mainly caused the rise in the final uses price deflator.

The lack of confidence in the inflation target, the acceleration of inflation in 1989 and less cooperation from trade unions explain the high increase of nominal compensation per employee in 1990 in comparison with previous years. However, there is another factor which shows the threaten of relying on the downward path of salaries until 1990. The composition effect from the entry of non-permanent workers into the labour markets lowers the growth rate of salaries when a favorable economic context allows a continuous increase in new employment. When expectations change and demand is not so strong, the reaction from firms may be to lay-off temporary workers. So that a new upward drift in wages may be introduced.

11 OECD, Spain, Economic Surveys, OECD, Paris, 1986. Commission of the European Communities, One Market, One Money, Directorate General for Economic and Financial Affairs, Brussels, 1990. OECD, Economies in Transition, OECD, Paris, 1989.

4. Summary and conclusions

The labour market in Spain exhibits features which are particularly consistent with "insider-outsider" and hysteresis influences upon wage determination. The associated rigidities in the labour market explain an insensitivity in the response from nominal wages to comparatively high levels of unemployment, and contribute to the continuation of those high levels of unemployment.

The principal features which indicate "insider-outsider" and hysteresis in the labour market are:

- evidence of mismatch, partly an outcome of a decline in inter-regional mobility but more accurately a reflection of the inability of the education and training markets to bring about sufficient improvements in the quality of the stock of labour across the overall labour market;
- the difficulty of new entrants (young workers) in penetrating into the permanent sector of the labour market, partly because the pattern of pay differentials reduces the incentives of firms to recruit new entrants but also explained by the influence of "insiders" over the level of turnover costs;
- reduced job search, itself an outcome of persistence in unemployment but aggravated by changes in unemployment allowances and pensions and promoted by high levels of severance payments and other benefits for those in higher-quality jobs;
- the compression of regional pay differentials, attributable to the system of collective bargaining and which can be expected to have further reduced the efficiency of local labour markets in allocating workers to jobs.

The outcome of these various features is a reduction in competition for those in the permanent sector of the labour market. The power of workers in the permanent sector to dictate the terms and conditions of employment encourages resort to

working in the informal sector by those denied entry to the permanent sector.

The rigidities and inflexibilities in the labour market have important implications for economic performance in the future,

- entry to the exchange-rate mechanism and the completion of the Internal Market will place increasing emphasis upon stability in trends in nominal wages,
- the tendency for wage growth to accelerate even at high levels of unemployment places a constraint upon the growth of productive potential,
- the concentration of unemployment (and particularly long-term unemployment) amongst young people has serious implications for the quality of future labour supply.

The success of the temporary contract initiative illustrates that a strong, potential demand exists for lower-paid workers. However, much firmer links must be created between the temporary and permanent sectors of the labour market if lower-paid workers are to have sufficient incentives to gain education and skills in the longer-term. Mismatch, combined with barriers to entry to the permanent sector, are at the core of the problem of unemployment.

The completion of the Internal Market may have important benefits for the structure of collective bargaining in Spain. Greater competition in product markets should encourage firms and industries to adopt a different attitude to pay determination and impose greater wage moderation upon the permanent sector. However, the more efficient bargaining solution may take time to appear and the process of adjustment may be brought about at the expense of slower output growth for a significant period of time. The easing of entry to the permanent sector of the labour market will improve the speed of adjustment and particularly if pay differentials widen in order to provide entry to permanent jobs for younger workers.

Table 1: Recruitment under the employment promotion programmes (EPP) (thousands)

	1984	1986	1987	1988	1989	1990	1991 (1)
Total recruitment in the labour market	1830	3020	3449	3712	4327	5159	3039
Total recruitment under EPP	500	1416	1680	2005	2300	2336	1343
Recruitment under EPP as % of total recruitment of which,	27.4	46.9	48.7	54	53.2	45.3	44.2
Temporary contracts	235	537	667	862	1104	1170	694
Part-time	48	179	222	291	356	412	251
Training & Apprenticeships	41	248	346	434	554	512	271
Youth employment (2)	0	104	119	92	---	---	---
Agreements with government agencies (3)	101	309	293	293	260	209	107

Notes:

(1) Only 7 months.

(2) Under 26 years old.

(3) Agreements between the National Institute of Employment (INEM) and government agencies, mainly local authorities and autonomous regions, for employing (mainly in construction) registered unemployed persons.

Source: Boletín de Estadísticas Laborales, Ministerio de Trabajo y Seguridad Social, and Síntesis Mensual de Indicadores Económicos, Ministerio de Economía y Hacienda

Table 2: Growth in total and temporary employment (thousands) (1)

	1988			1989			1990			IIQ 1991			1988 to IIQ 1991		
	Total	Temp.	Perm.	Total	Temp.	Perm.	Total	Temp.	Perm.	Total	Temp.	Perm.	Total	Temp.	Perm.
Total	378	527	-149	510	405	105	333	405	-73	12	68	-56	1232	1406	-174
Agriculture	-6	44	-50	-79	-56	-23	11	25	-14	18	15	4	-55	28	-83
Industry	26	111	-85	107	111	-10	35	76	-41	-70	-3	-67	98	301	-203
of which:															
Energy	12	4	8	-1	1	-3	1	0	1	-9	0	-9	2	5	-3
Primary	6	18	-12	30	13	17	0	14	-14	-16	4	-19	20	49	-28
Metal	21	44	-24	43	58	-15	-3	9	-12	-19	1	-20	42	113	-70
Manufactures	-12	44	-56	35	45	-10	37	53	-16	-27	-8	-19	33	134	-101
Construction	101	118	-17	94	92	2	57	52	5	15	27	-13	265	289	-23
Services	256	254	2	389	253	136	230	252	-23	49	29	20	924	789	136
of which:															
Commerce & Hotels	107	121	-14	122	112	10	96	96	0	3	8	-5	328	336	-9
Transport & Communications	30	13	17	43	31	12	14	19	-4	-15	-12	-3	72	50	22
Banking & Insurance	43	30	13	26	30	-5	41	39	2	23	8	14	132	108	25
Others	76	90	-15	198	80	118	79	99	-20	40	26	14	392	295	98

(1) IV quarter figures, but IIQ figures for 1991.

Source: Encuesta de Población Activa (EPA), Instituto Nacional de Estadística (INE).

Table 3: Temporary employment as a proportion of total wage-earners, total and by sector

Total and by sector	End 1987	End 1988	End 1989	End 1990	IIQ-1991
Total	19.8	25.1	28.2	31.5	32.2
Agriculture	43.7	52.4	49.1	53.3	54.4
Industry	15.4	19.7	23.4	26.0	26.6
of which:					
Energy	6.1	8.5	9.4	9.2	9.9
Primary	11.6	16.1	18.0	21.3	22.9
Metal	10.6	15.8	21.9	23.0	23.7
Manufactures	21.0	25.1	28.2	31.7	31.8
Construction	36.3	46.2	51.4	53.7	55.7
Services	16.5	21.0	24.4	28.1	28.4
of which:					
Commerce and Hotels	22.6	29.6	34.6	38.5	38.9
Transport and Communication	11.5	13.4	18.1	21.0	19.3
Banking and Insurance	10.9	15.8	20.6	25.8	26.3
Others	15.3	18.7	20.4	23.7	24.3

Source: Encuesta de Población Activa (EPA), Instituto Nacional de Estadística (INE).

Table 4: Employment growth

Type of employment	1988	1989
Total employment	2.9	4.1
Total full-time	3.3	4.7
part-time	-3.7	-7.4
Men full-time	1.9	3.7
part-time	-11.1	-19.7
Women full-time	6.9	7.2
part-time	-0.7	-3.0

Source: OECD, Employment Outlook, July 1990.

Table 6: Unemployment rates by age group, 1989

Age groups	Spain	European 10
14-24	34.3	15.5
25-49	14.6	7.1
50-64	9.0	5.8
65 and over		2.8
Total	17.3	8.3

Source: Community Labour Force Survey, 1989. (Eurostat)

Table 5: Employers' social security contributions as a percentage of total taxation

	1980	1984	1988
Spain	37.8	31.1	27.2
Belgium	19.4	18.4	20.6
Denmark	0.8	2.0	0.2
France	28.4	27.7	27.2
Germany	18.5	19.1	19.1
Greece	14.3	15.3	14.9
Ireland	9.4	9.2	8.4
Luxembourg	16.1	14.0	13.6
Portugal	17.7	14.7	16.6
United Kingdom	9.5	9.1	9.5
Netherlands	17.8	17.6	16.9
Italy	28.4	24.3	23.4
Japan	14.8	15.2	14.4
Switzerland	10.4	10.2	10.1
United States	15.5	17.5	17.0

Source: OECD.

Table 7: Changes in participation rates for men aged 55 and over. Spain, the Member States and international comparisons

	1975/80		1979/85		1985/88	
	1	2	1	2	1	2
Spain	-0.27	-0.09	-0.37	0.76	-0.47	1.88
Belgium	-0.32	0.39	-0.26	0.11	-0.41	0.11
Denmark	-0.50	1.08	-0.08	1.21	-0.02	0.66
France	-0.13	0.86	-0.33	0.47	-0.20	0.25
Germany	-0.15	0.50	0.00	0.64	-0.02	0.92
Greece	0.02	1.06	-0.19	2.43	-0.34	0.58
Ireland	-0.27	1.60	-0.31	0.91	0.02	0.65
Italy	-0.14	1.21	-0.03	0.75	-0.09	1.41
Luxembourg	-0.84	0.06	-0.11	0.56	-0.01	2.73
Netherlands	-0.35	0.75	-0.47	0.39	-0.38	0.89
Portugal	-0.06	1.98	-0.03	0.91	-0.05	0.75
United Kingdom	-0.33	0.62	-0.31	0.73	-0.10	0.71
Japan	-0.08	1.20	-0.05	1.09	-0.02	1.12
United States	-0.12	2.71	-0.17	1.54	-0.07	1.76

1. Contribution to change in total growth of labour force from changes in participation rates, men aged 55 and over.
2. Total growth in the labour force.

Source: OECD, Employment Outlook, July 1990.

Table 8: Principal characteristics of activity of those aged 14-24, 1989

	Spain	European 10
Males, activity rate	46.3	54.5
Employment/population ratio	33.6	47.0
Unemployment rate	27.5	13.8
Females, activity rate	39.2	48.5
Employment/population ratio	22.5	40.0
Unemployment rate	42.6	17.4

Source: Community Labour Force Survey, 1989 (EUROSTAT)

Table 9: Unfilled job vacancies and skill shortages

	Thousands	Per cent of total "open" vacancies	Percentage of firms for which labour force is insufficiently qualified
1985	113	19	
1986	147	23	
1987	161	25	
1988	190	26	
1989	201	26	65.6

Source: Ministerio de Trabajo y Seguridad Social (and OECD, Economic Surveys of Spain, 1990/91)

Table 10: Education and training
Information relates to education and training experiences during the four weeks preceding survey (1)

	Spain	European 10
Aged 14 - 24		
No training	44.5	44.1
General education	35.0	24.8
Further education	19.7	19.8
On-job training	0.0	0.9
Apprenticeship	0.0	4.8
Dual system	0.0	0.4
Other training	0.7	2.9
Part-time college		1.2
Total	100.0	100.0 (2)
Aged 25-49		
No training	96.3	92.6
General education	0.6	0.2
Further education	2.2	2.1
On-job training	0.1	1.1
Apprenticeship	0.0	0.2
Dual system	0.0	0.2
Other training	0.7	2.8
Part-time college		0.7
Total	100.0	100.0

(1) Figures represent percentage of total age category involved in specific types of training activity.

(2) Figures round to almost 99% because of cases of "no reply".

Source: Community Labour Force Survey

Table 11: Participation rates and levels of education

	1975	1980	1985	1989
Participation rate				
- % of population of working-age -				
Total	62.4	59.6	55.0	56.1
Men	91.0	87.6	83.0	81.1
Women	33.8	33.8	34.8	41.3
Structure of labour force according to education level				
- % of total labour force -				
Illiterate	4.1	3.2	2.3	1.7
Without studie	12.9	11.4	10.2	10.8
Primary degrees	62.6	59.2	48.4	38.6
Secondary degree	17.6	22.9	34.8	43.5
University degree	2.7	3.3	4.4	5.4

Source: Ministerio de Trabajo y Seguridad Social.

Table 12: Part-time employees as a proportion total employees, 1989

	Spain (percentages)	European 10 (percentages)
Distributing trades, hotels, catering, repairs (*)	4.0	24.3
Banking and finance, insurance, business services, renting (*)	3.8	13.4
Other services (*)	1.6	10.5
All sectors	4.1	14.9

(*) Part-time employees as a proportion of total employees in the sector.

Source: Community Labour Force Survey, 1989 (Eurostat).

Table 13: Persons in employment by professional status, 1989

	Spain (percentages)	European 10 (percentages)
Employer and self employed	21.7	14.8
Employee	72.3	82.6
Family worker	6.0	2.6

Source: Community Labour Force Survey, 1989 (Eurostat)

Table 14: Concentration of family working and self employment, by sector, 1989

	Spain (percentages)	European 10 (percentages)
Self employment ⁽¹⁾		
Agriculture	33.9	24.1
Distributive trades, hotels, catering, repairs	33.2	29.7
Transport and communication	7.9	3.7
Family working ⁽²⁾		
Agriculture	45.3	50.6
Distributive trades, hotels, catering, repairs	39.1	31.9
Employees in employment by sector ⁽³⁾		
Agriculture	13.2	5.9
Distributive trades, hotels, catering, repairs	22.0	18.6

(1) Percentage of total numbers of self employed in the respective labour markets.

(2) Percentage of total numbers of family workers in the respective labour markets.

(3) Percentage of total employees in employment in the chosen sectors.

Source: Community Labour Force Survey, 1989 (Eurostat)

Table 15: Persons in employment, by professional status and by age-group, 1989 (1)

		Spain (percentages)	European 10 (percentages)
Self employed,	14 – 24	5.4	3.7
	25 – 49	16.5	10.4
	50 – 64	28.9	16.9
	65 and over	55.7	39.6
Family worker,	14 – 24	11.0	2.4
	25 – 49	4.5	2.1
	50 – 64	5.8	4.0
	65 and over	12.3	10.2

(1) Figures represent percentage of each age group in self employment or family working.

Source: Community Labour Force Survey, 1989 (Eurostat)

Table 16: Nominal and real unit labour costs (% average growth)

	1980-1984	1985-1986	1987-1988	1989-1990	1991 (1)
Nominal compensation per employee	14.0	9.5	6.4	6.9	7.8
Productivity	3.1	2.7	1.4	1.1	1.8
Nominal unit labour costs	10.6	6.6	5.0	5.7	5.9
GDP deflator	12.5	9.8	5.7	7.1	6.6
Real compensation per employee	1.3	-0.3	0.7	-0.2	1.0
Real unit labour costs	-1.7	-3.0	-0.7	-1.3	-0.7

Sources: Commission Services

(1) Commission Forecasts October-November 1991

Table 17: Contributions to the change of the price deflator of total final uses (%)

	1980-1984	1985-1986	1987-1988	1989-1990	1991 (1)
U.L.C. nom. (adj.)	6.4	3.6	2.7	2.9	3.0
G.O.S. (adj.) (2)	3.2	2.9	2.0	2.4	2.1
Net indirect taxes	0.8	1.7	0.2	0.5	0.4
Import prices:	3.5	-0.9	0.2	0.1	-0.1
– Import prices excluding nom. effect. exchange rate	2.0	-1.4	0.4	0.8	-0.1
– Nom. effect. exchange rate	1.5	0.5	-0.2	-0.7	0.0
Total final uses	14.0	7.0	4.9	5.8	5.2
– Domestic factors estimated (3)	11.0	8.6	5.2	6.2	5.6

(1) Commission Forecasts October-November 1991.

(2) Excluding imputed compensation of self employed.

(3) Domestic factors include contributions of unit labour costs, net indirect taxes, operating surplus and the exchange rate change required to compensate for movements in domestic labour costs relative to those of competitors.

Source: Commission Services

CHAPTER II
COMPETITIVENESS AND EXTERNAL PERFORMANCE
IN THE CATCHING-UP PROCESS (*)

Contents

<p>1. Introduction41</p> <p>2. The trade balance41</p> <p>2.1. Trade performance since 198641</p> <p>2.2. Some explanatory factors42</p> <p>2.3. Competitiveness effects44</p> <p>3. The invisible balance45</p>	<p>4. The current account balance 46</p> <p>5. The current account financing 47</p> <p>5.1. Overview 47</p> <p>5.2. The explanatory factors 48</p> <p>6. Threats and constraints from the external sector 50</p> <p>7. Summary and conclusions 51</p>
--	---

(*) This chapter was mainly prepared by Julia SALAVERRIA MONFORT of the National Economies Directorate and Manuel SANCHIS I MARCO of the Monetary Directorate.

1. Introduction

Since 1986, the external account of the Spanish economy has been characterized by:

1. a considerable deterioration in the trade balance;
2. a significant fall in the surplus on the services balance;
3. a stabilization of the net transfers' position at around the level achieved in 1988;
4. a deterioration in the current balance;
5. a favourable trend in the basic balance which has remained in surplus.

These developments have coincided with a *strong recovery* in the economy. However, this expansionary phase resulted in an *overheating*, as reflected in inflationary pressure and the currently high level of the external deficit.

Another factor which must be taken into account in explaining external trade developments in Spain since 1986 is *accession to the EC*. With respect to trade, integration into the Community has meant that some of the barriers which were protecting Spanish markets from import penetration must be progressively dismantled as well as barriers to Spanish exports to the rest of the EC. Similarly, accession has led to the disappearance of export subsidies and to the imposition of Community tariffs on imports from third countries.

Meanwhile, the *Peseta* has appreciated continuously since 1987, as a consequence of *large capital inflows* financing the current deficit and in response to expectations of high profitability and high interest rates. However, as predicted by the exchange rate paradox, this hardening of the currency has been translated into a significant *loss of competitiveness*, which, in turn, has acted as an obstacle to an improvement in the trade balance of goods and services. In this respect, the entry of the peseta into the ERM in June 1989 has not eliminated appreciation pressures but has imposed a ceiling on upward movement in the value of the currency.

The aim of this chapter is to explore the factors which are behind the external account performance. The extent to which the Spanish economy will be able to reduce this imbalance in the near future and to arrive at a competitive situation to absorb the shock of free movements of goods, capital and labour implied by the Single Market within the constraints that the way to the EMU implies will also be considered.

The structure of this chapter is as follows: Sections 2 and 3 analyse the trade and invisible balances respectively together with their explanatory variables. In Section 4, the current account is examined from the point of view of the gap between saving and investment. Section 5 analyses the financing of the current account. In section 6 some threats and restraints from the present current deficit are described. Finally, conclusions and assessments are provided in the last Section.

2. The trade balance

2.1. Trade performance since 1986

Between 1986 and 1991, the trade deficit, in nominal terms, of the Spanish economy has widened from -2,4% of the GDP to -6,0% (see Table 1). This deterioration has been due to a strong growth in imports and a more moderated performance in exports, both in nominal and real terms. In this period, the volume of total imports has risen by 109,5% while total exports have risen by 51,7%; excluding energy, these data are 124,1% and 54,8%, respectively.

Table 1: The balance of payments in Spain (% of GDP)

	1980-1985	1986	1987	1988	1989	1990	1991
Trade balance	-4.8	-2.4	-3.9	-4.7	-6.4	-6.0	-6.0
Service balance	2.7	4.1	3.5	2.7	2.3	1.8	1.8
Transfer balance	0.7	0.4	0.8	1.1	1.2	1.0	1.4
Current balance	-1.3	2.1	0.5	-0.9	-3.0	-3.2	-2.8
Long-term capital balance	1.4	-0.6	3.3	2.9	4.5	3.9	6.2
Basic balance	0.1	1.5	3.8	2.0	1.5	0.7	3.4
Short-term capital balance	0.0	-0.1	0.3	0.2	-0.1	0.0	0.4

(a) Estimation.
Source: Bank of Spain - Cash register

These results are not unrelated to the opening-up of the domestic market after Spain joined the Community in 1986. To be precise, the degree of openness of the Spanish economy¹ was to 43,5% in 1985, whereas the average of the rest of the Community members - including Portugal - was 61,6%. Therefore, Spain was the country with the lowest level of goods and services trade relative to GDP within the Community. In 1991, this ratio has risen to 58,2%, still clearly below the Community average of 74%. However, opening process has been accompanied by a sharp increase in import penetration (from 17,2% of the final demand in 1985 to 26,4% in 1991) while export activity of goods and services has slightly been raised (see Table 2).

The geographical pattern of imports and exports has changed substantially, mainly due to the new structure of barriers and tariffs imposed by the EC. Intra-Community trade has increased, although EC imports into Spain have grown more than Spanish exports to other Community countries. In 1985, 36,6% of imports came from the EC and 52,1% of exports went to this area; in 1991, Community imports and exports stand at 59,6% and 71,3%, respectively.

1 The degree of openness is measured by the ratio of the volume of exports plus imports of goods and services to GDP.

Table 2: Degree of openness, import penetration, and export activity in Spain and in the EC countries

	1985	1988	1991(a)		1985	1988	1991(a)
	1. Goods and services				2. Goods		
SPAIN				SPAIN			
Degree of openness	43.5	51.1	58.2	Degree of openness	33.7	41.0	48.9
Import penetration	17.2	22.4	26.4	Import penetration	15.3	20.4	24.2
Export activity	22.7	22.5	23.1	Export activity	15.2	14.9	16.7
EUR11				EUR11			
Degree of openness	61.6	66.0	74.0	Degree of openness	51.7	56.0	62.6
Import penetration	23.2	25.3	27.4	Import penetration	20.1	22.1	24.0
Export activity	31.4	32.1	36.2	Export activity	25.5	26.4	29.6

(a) Commission Forecasts October-November 1991.

EUR11: PPS EUR11; EUR12 excl. Spain

Notes: - Degree of openness: ratio of exports plus imports to GDP, in real terms.
 - Import penetration: ratio of imports to final demand, in real terms.
 - Export activity: ratio of exports to GDP, in real terms.

SOURCE: Commission Services.

This asymmetrical response to accession has been accompanied by fewer imports and exports from/to the United States and OPEC countries² and more from/to the newly industrialized countries.

Within the member states of the EC, the distribution of Spanish market gains has not been uniform. There are some countries which clearly have improved their penetration of the Spanish market, viz. Portugal, Italy, the Netherlands and Belgium. On the other hand, the United Kingdom has suffered a significant loss in exports to Spain. Losses in the Spanish market have been less important for Germany, France, Ireland and Greece. Finally, in Denmark no change is apparent. At the same time, Spain is now selling more products to Portugal, Italy, Germany, and Greece than before 1986, whereas it has lost share in the rest of the Community imports, especially in the Netherlands and the United Kingdom. Overall, the Spanish intra-community trade balance have become notably more negative (-0,3% of the GDP in 1986; -2,1% of the GDP in 1991).

The product breakdown of Spanish non-energy trade sheds some light on the nature of the underlying demand. Intermediate goods continue to represent the greatest part of non-energy imports. However, their share has decreased. Since 1990, consumer products have become more important than

capital goods. Nevertheless, as is clearly showed in Graph 1, the main cause of the growth in non-energy imports has been the performance of intermediate goods, with the exception of 1987, 1990 and 1991³. Capital goods were the most important component of imports only in 1987; since 1990, consumer goods have been the main cause of the growth of non-energy imports.

With regard to exports, 46,3% of Spanish non-energy exports were intermediate products, 40,1% consumer products and 13,6% capital products in 1990; the change in weights - of each category between 1985 and 1991 has been -5,4, 4,3 and 1,2 points, respectively.

2.2. Some explanatory factors

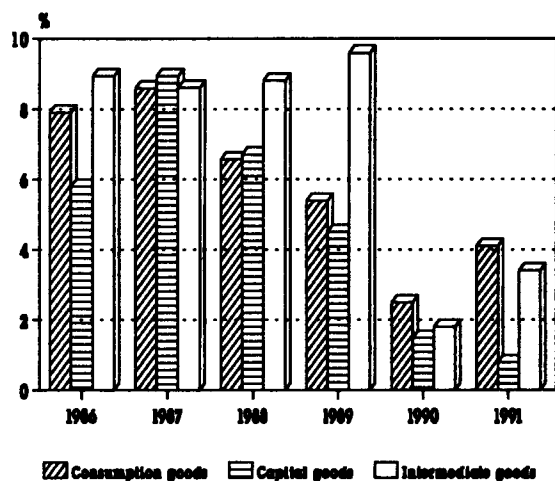
As shown above, the deterioration in the trade balance has been caused by a much sharper rise in imports than exports. In this section the analysis will focus on the "non-competitiveness" factors which have contributed to the trade deterioration.

The reduction of trade barriers since January 1986 has allowed new goods to appear on the domestic market, providing a wider choice to consumers. In some cases, these products were cheaper than those produced domestically

2 These data are in nominal terms, so they do not take the fall in oil prices into account.

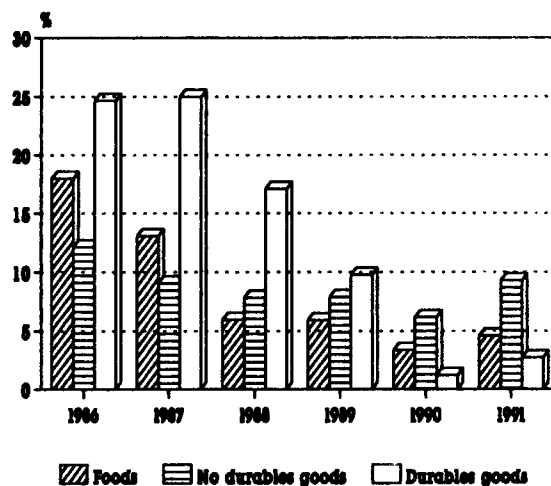
3 The remarkable growth in the import of intermediate goods in 1989 could be explained by several factors: the continuation of very strong growth in domestic demand during the first half of that year; the previous low level of stocks; and a double effect from the exchange rate, initially as a consequence of the appreciation of the peseta and then the restraint of further appreciation imposed by the ERM discipline since June 1989.

Graph1: Product breakdown of non-energy imports
Contrib. of non energy imports growth



Estimated figures for 1991.
Source: Bank of Spain.

Graph2: Prod. breakdown of consumption imports
Contrib. of consumption imports growth



Estimated figures for 1991.
Source: Bank of Spain.

while others were not previously available or their prices were substantially increased by tariffs. It may be argued, however, that this factor has had only an initial impact on imports during the time when demand patterns were changing. This conjunctural effect was probably more important with regard to consumer goods, especially when, at the same time, disposable income was rising after a long period of low growth in the Spanish economy.

According with Graph 2 the high growth in the import of durable consumer goods in 1986 and 1987 supports this argument. However, since 1988 the contribution of durables to total consumer imports has fallen and in 1990 and 1991 non-durable goods have emerged as the main component of consumer imports.

Economic activity in Spain has been growing much more than in its main commercial partners and consequently it has been importing more as well. Empirical evidence shows that the income elasticity of Spanish imports is higher than that of other industrialised countries⁴. So, income trends have played a positive and important role in the rise in imports, while lower elasticities as well as lower demand growth in its trade partners partly explains the poor response of exports. Moreover, the income elasticity of Spanish imports is higher than that of exports, which is another element explaining the worsening of the trade balance.

On the other hand, the catching-up process underway in Spain since 1986 has been made possible only by the availability of foreign goods and capital. During this period, Spain has made a great effort to modernize its productive structure as clearly reflected in high investment rates. This structural improvement has affected imports in two aspects. Firstly, a country with a very low degree of R&D activities and having a relatively outdated technology has to increase capital imports in order to increase its capital stock. Secondly, constraints from productivity capacity left indigenous supply unable to respond to growing domestic demand and to its new requirements which has caused a switch to external markets. The presence of very strong domestic demand, among other factors, has boosted the attractiveness of the internal market relative exporting activity which, in turn, has had a negative influence on the export performance. The lower export activity of the Spanish economy is reflected in the figures presented in Table 2. Moreover, according to these data, Spain has the lowest share of exports of goods and services in GDP within the rest of EC countries.

Finally, researches made by the Bank of Spain⁵ show that, between 1985 and 1989, Spain's high domestic demand growth accounts for a larger share of the deterioration in the trade balance than the loss of competitiveness. However, there is also a third factor due basically to the unfavourable effects of the dismantling of tariffs following entry into the Com-

4 According to estimations made by the IMF for the volume of imports and exports of goods and services.

5 See Ortega, E. et al, "Spain's current and capital account balances within the EC", Bank of Spain, Economic Bulletin, november 1989.

munity who, at least until 1989, was more important than competitiveness in affecting the change in imports.

Nevertheless, it is useful to analyse the role of nominal and real exchange rates in the trade performance, as a means to predict the likely short-term evolution in this regard.

2.3. Competitiveness effects

The performance of the Spanish trade balance has mirrored the development of competitiveness in the economy. Independently of the price or cost deflators chosen to derive the real effective exchange rate, the conclusion is the same: the Spanish economy has lost competitiveness relative to its main trade partners.

As can be seen in Table 3, the greatest loss of competitiveness has been against other major industrial countries with appreciation ranging between 15,3%, if the real exchange rate is calculated with producer prices of manufacturing industry, and 32,3%, if relative prices are GDP deflators.

As can be seen in Graph 3, there has been a significant divergence in *exchange rate movements* between the industrial countries and the EC or ERM members. To be precise, the nominal effective exchange rate against all industrial countries appreciated by 10,9% between 1985 and 1991. The

nominal appreciation of the Peseta against the US dollar has been around 40%. Thus, the weakness of the dollar explains the big difference when considering some other sets of countries excluding the United States.

Moreover, the nominal effective exchange rate of the Peseta against the ERM countries has depreciated by 1,8%. This result is not independent of Spain's incorporation into the Exchange Rate Mechanism in June 1989, which has acted as a brake on the previous upward trend. Finally, the reason from the appreciation by 3,1% in relation to all the member states is the appreciation of the Peseta against currencies not included in the ERM.

As regards *relative prices*, Spanish costs and prices have been rising at a faster rate than in others countries. However, the size of the divergence is not the same for all prices. There are a wide range of inflation measures within domestic prices depending on whether the product or the sector is tradeable or non-tradeable.

What is more, *the main characteristic of present inflationary process* of the Spanish economy is the big gap between prices of services and that of industrial products, e.g. between non-tradeables and tradeables product prices. The 1991 growth rates of different components of the consumer prices index give an idea about that divergence: the whole of

Table 3: Spanish competitiveness between 1985 - 1991 (a)
Loss (+) or gains (-) (%)

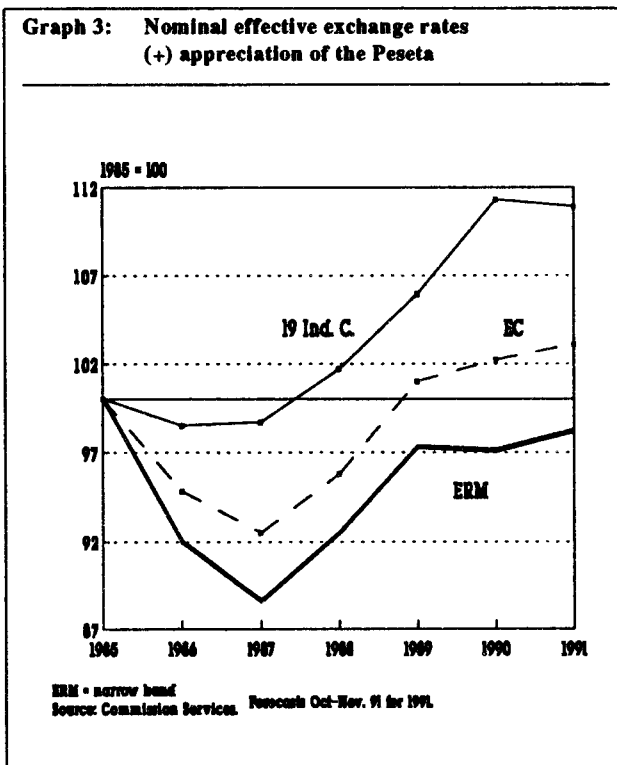
	Industrial countries	Community countries	ERM countries (b)
Real effective exchange rates with:			
1. Unit labour costs of total economy	24,2	14,3	15,6
2. Producer prices of manuf. industry (c)	15,3	6,0	6,0
3. Deflator of total exports (goods and services)	19,7	9,2	6,7
4. GDP deflator	32,3	20,7	20,6
5. Deflator of private consumption	29,0	19,8	19,8
Nominal effective exchange rates	10,9	3,1	-1,8
Relative prices:			
1. Unit labour costs of total economy	12,0	10,9	17,8
2. Producer prices of manuf. industry (c)	3,6	2,7	4,3
3. Deflator of total exports (goods and services)	7,9	5,9	8,6
4. GDP deflator	19,2	17,1	22,8
5. Deflator of private consumption	16,3	16,3	22,0

(a) Commission Forecasts October-November 1991 for 1991.

(b) ERM is narrow band except for: 2. Producer prices of manufacturing industry.

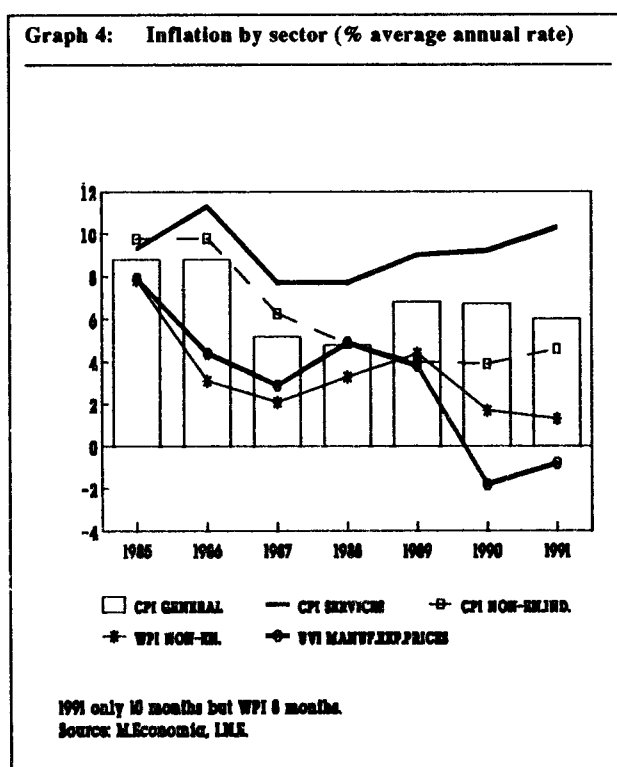
(c) 1991 is three quarters average.

Source: Commission Services.



consumer prices grew 6,0% while services and industrial prices - excluding energy - grew 10,3% and 4,6%, respectively (see Graph 4).

This fact is not independent on the low degree of external competition of the service sector which is very close to the non-tradeable sector definition which allows it to transmit excess demand to prices. Therefore, the strong performance of the domestic demand, which, in turn, offered a big domes-



tic market, have pushed up services prices which have become the hard core of inflation.

At the same time, industrial prices have followed a moderated trend when they went to domestic market and they have had a negative growth rate to be sale in external markets. That implies that in the last upswing of inflation, exporters have resisted the translation of inflationary pressures from labour costs and non-tradeable sectors into higher export prices.

On the other hand, Spain prices has performed better in comparison with industrial countries than with the Community and ERM countries. Here, the core of ERM low-inflation economies is the main factor behind these results.

Combining exchange rate and relative price performance, some conclusions on the competitiveness performance of Spain between 1985 and 1991 may be drawn:

- (1) Spain has lost much more competitiveness against 19 industrial countries than against its European counterparts. This difference is mainly explained by the dollar devaluation.
- (2) Although nominal effective exchange rate of the peseta against ERM countries has not achieved at the level of 1985, showing a depreciation for the whole of the period, the continuous upward trend of the Spanish currency since 1987 and the differences in prices and costs performance have also provoked a loss of competitiveness with those countries.
- (3) The loss of competitiveness against EC12 has been more important than with the ERM countries because a higher appreciation of the nominal exchange rate. Nevertheless, divergence of costs and prices are smaller.

Consequently, Spanish losses in extra-Community markets have been due not only to a re-orientation of trade to the EC after 1986 but also to a higher rise in prices.

3. The invisibles balance

While the trade balance was worsening, net income from services and transfers was also suffering a significant decline (Table 4). This balance has been a traditional surplus item in the Spanish current account but its weak performance since 1987 has failed to compensate for the rise in the trade deficit, which, in turn, explains the negative trend in the current balance.

The underlying factor in the declining services surplus is the *emarkable change in the tourism balance*. Since 1988 to 1990, tourism incomes have registered a clear downward trend, whereas expenditure by Spanish residents abroad has risen.

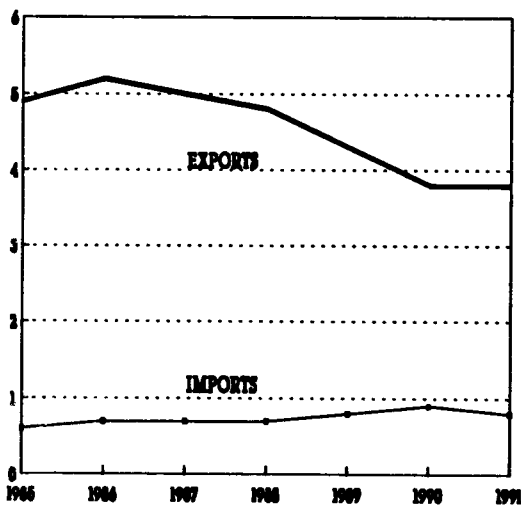
The fall in income from tourism has been mainly due to the loss of competitiveness suffered by this sector : the implicit deflator of expenditure by non-residents in Spain has risen by 48% since 1985 to 1991 whereas that of Spanish residents abroad has grown only by 17,6%. In other words, the present core of Spanish inflation is in the service sector, which in-

Table 4: Invisible balance (% of GDP)

	1985	1986	1987	1988	1989	1990	1991
							(a)
Service balance	3.8	4.1	3.5	2.7	2.3	1.8	1.8
Tourism balance	4.3	4.5	4.4	4.1	3.5	2.9	2.9
Service balance excluding tourism	-0.5	-0.4	-0.9	-1.4	-1.2	-1.1	-1.1
Transfer balance	0.7	0.4	0.8	1.1	1.2	1.0	1.4
Service and Transfer balance	4.4	4.5	4.3	3.8	3.4	2.8	3.2

(a) - Estimations.

Source: Bank of Spain (Cash Register)

Graph 5: Tourism performance (In % of GDP)

Estimated figures for 1991.
Source: Bank of Spain (Cash Register)

cludes tourism activities which, in turn, is one of the components of services with higher prices. At the same time, the nominal appreciation of the Peseta has also had a negative influence on visitors from abroad. Between 1985 and 1989, 71% of Spanish tourists were from four European countries: the United Kingdom (22,4%), Germany (21,1%), the Netherlands (10,1%) and France (17,3%). In the same period, the cumulative real appreciation⁶ of the Peseta visàvis each of these countries was 16,0%, 11,7%, 13,8% and 14,1%. Consequently, the increases in Spanish prices have clearly discouraged tourists. In particular, when we consider the rest of the Mediterranean members of EC, e.g. Italy and Greece, as competitor countries, the Spanish loss of price competitive-

ness between 1985 and 1989 relative to these two countries (6,5% with Italy and 14,6% with Greece) gives an idea of the likely effect of prices on the choice of tourists.

There have also been other factors - besides prices - which are directly related to competitiveness in tourism such as transport strikes, low service quality, changes in the weather, which have also had continuous and negative repercussions on tourism demand. Moreover, all of these elements explaining the fall-off in tourism income in Spain have equally determined the increase in tourism payments from Spain to the rest of the world. It is clear that a country with high domestic prices, a strong currency, a rising level of disposable income, and low quality in tourism services, will have less tourist demand not only from abroad but also from the internal market. Nevertheless, 1991 figures show some improvement in the tourism balance due to an stabilization of incomes at the level achieved in 1990 and a slightly decrease in payments.

The worsening of tourism incomes was not the only cause of the decrease in the service surplus. A deficit in the balance of services, excluding tourism, has been accentuated by large payments for incomes and royalties, amongst others. The substantial increase in foreign investment, the possibility - with some restrictions - for residents to borrow abroad, and the need to import technology in order to improve infrastructure are some explanatory factors.

Finally, the increase in incomes from public transfers, particularly from the EC, was the main reason for the initial and current growth of the surplus in the transfer balance.

4. The current account balance

From the previous analysis, it is clear that the worsening of the current account deficit has been due not only to the deterioration of trade but also to a less positive performance of the services balance. In both cases, one of the main underlying reasons is the major loss of competitiveness in the production of the Spanish economy. However, in analysing the current account we should also look at the gap between saving and investment, i.e. the net loans received or granted by a country. What is more, it is interesting to analyse trends in terms of components within both the public and private sectors.

Looking at the profile of national savings and investment, it is clear that the performance of investment did not follow a similar path to savings. Moreover, since 1988, national saving as a percentage of GDP has stabilised whereas investment has maintained an upward trend.

The stabilization by 22% GDP of national saving combines a fall of private saving from 22,1% in 1986 to around 20,0% in 1991 with an increase of that of public sector by 2,5 points of the GDP in the same period. Within the private sector, both

6 Relative prices used are consumer prices.

households and enterprises have reduced their savings. However, the reduction of households savings have been stronger.

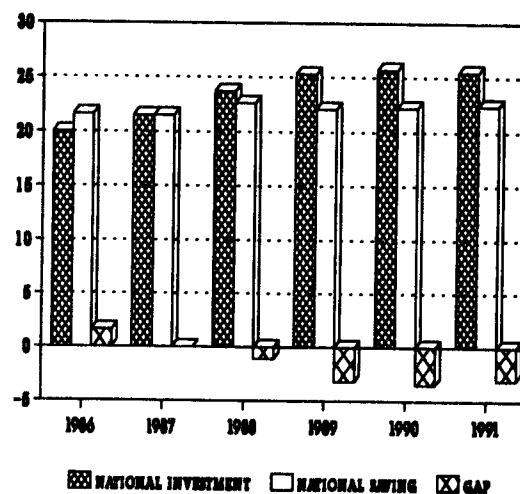
Therefore, the rise in domestic consumption has been translated into an increasing need for borrowing from abroad. Efforts made by the public sector have not been sufficient to offset the fall in private savings.

5. The current account financing

5.1. Overview

The growing current account deficits have been financed until now by spontaneous capital inflows. However, it is very important to consider the degree of stability in capital inflows in order to appreciate potential threats to the favourable capital account position. Moreover, to the extent that non-speculative flows are financing the current account deficit, the availability of stable funds and, in some respects, investor confidence and expectations will determine the economy's capacity to support the deficit. Nevertheless, part of private capital imports have resulted from appropriate interest-rate differentials and/or exchange-rate expectations and proved to be more volatile given its speculative character, namely short-term capital and a part of portfolio investment (specially in money market instruments such as Treasury Bills). However, a high share responded to structural factors, such as higher expected real returns and improved institutional framework, and had, subsequently, a more permanent character through the time.

Graph 6: Saving and investment gap (% of GDP)



Source: Commission Services.
Commission Forecasts for 1991.

The development of financial markets and the specific characteristics of some of the capital items classified as long term suggest that a more detailed breakdown is necessary to ensure a correct analysis. Table 5 provides several balances obtained by combining the current account balance with different net capital flows. The most permanent capital flows

Table 5: Current and capital account balances (% of GDP)

	1986	1987	1988	1989	1990	1991(a)
(1) Current account	2.1	0.5	-0.9	-3.0	-3.2	-2.8
(2) Current account+Direct investment	2.8	1.1	0.1	-1.9	-1.6	-1.6
(3) Current account+Direct investment+ +Real estate investment	3.4	1.7	0.7	-1.3	-1.1	-1.3
(4) Current account+Direct investment+ +Real state investment+Portfolio investment	4.0	3.1	1.4	0.9	0.0	2.2
(5) Current account+Total investment	4.0	3.1	1.5	0.9	0.2	2.3
(6) Current account+Total long term capital	1.5	3.8	2.0	1.5	0.7	3.4
(7) Current account+Total capital account	1.4	4.0	2.2	1.4	0.7	3.8
(8) Central reserves change	1.1	4.9	2.8	1.2	1.7	2.4
Memorandum items :						
Central foreign reserves	6.0	10.0	11.5	11.0	10.6	12.2
Foreign debt	9.8	9.1	9.2	8.5	8.7	10.4

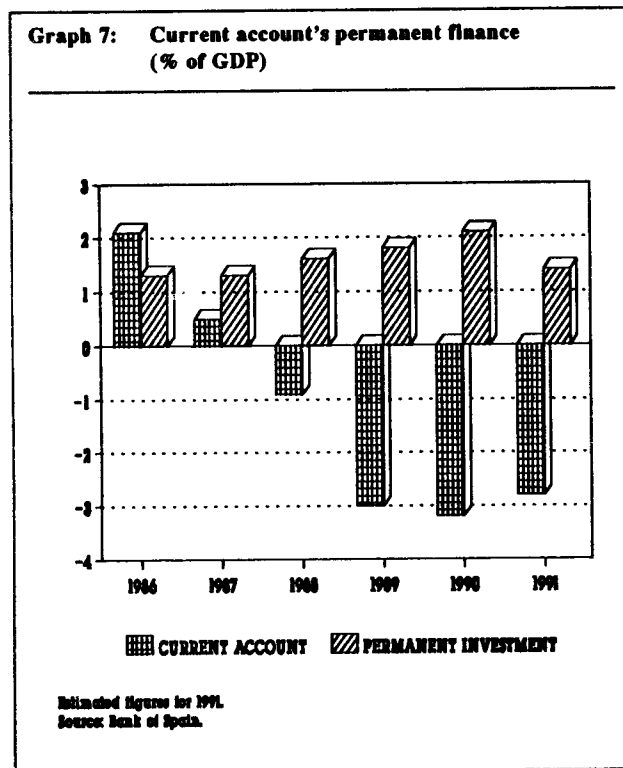
(a) Estimations.

Source: Bank of Spain, cash register

are firstly, direct investments and, then, real estate investment. Therefore, as indicated in rows 2 and 3, since 1989 the capital flows under these two headings have not been sufficient to cover the current account deficit, although, until 1991, permanent capital flows have maintained a continuous upward trend.

Looking at Graph 7, the need for additional capital flows can be attributed to the fast deterioration in the current account and not to any moderation in net permanent capital inflows. Consequently, as the current deficit has widened, dependency on non-permanent capital inflows has increased. This latter has not changed in 1991: current account deficit has slightly been decreased but permanent investment has fallen as well.

Nevertheless, looking at the path of the basic balance (row 6), although it has been continuously in surplus, it has been declining in recent years and the previous high overfinancing of the current deficit clearly decreased in 1990. It has sometimes been argued that the relatively reduced level of external debt (51.3 bn \$ in September 1991) and the considerable amount of official reserves (63.7 bn \$ in the same date) provides, even apart from spontaneous capital inflows, sufficient room for manoeuvre for the present current account deficit to be sustainable in the medium-term. However, we should look also to the net external financial position of a country when assessing the current account balance sustainability.



In fact, the spontaneous capital inflows, reflected in rising "external debt" as officially defined⁷ (an increase of \$27.3 bn between end-1986 and September 1991), were also associated with a large increase in official reserves (by \$47.7 bn over the same period). However, the net external liabilities of the banking sector (excluding the Bank of Spain) also increased significantly, by \$24.3 bn over the same period, thus leaving an increase of \$23.4 bn in the net external assets of the consolidated monetary system. Over the same period, the total net external liabilities of all domestic sectors rose from \$21.3 bn to \$85.6 bn.

Therefore, a further deterioration in the current account or a switch in the financial markets could push the economy to an underfinancing position.

Table 6: Net external financial position (December 1986 - September 1991, bn. \$)

1. Increase in central reserves	47.7
2. Increase in external assets of the banking system	11.1
3. Total increase in external assets	58.8
4. Increase in external liabilities of the banking system	35.4
5. Increase in external assets of consolidated monetary system (5 = 3 - 4)	23.4
of which Increase in net external assets of banking (= 2 - 4)	-24.3

5.2. The explanatory factors

The financing of the growing current account deficits by long-term capital inflows was made possible by a combination of factors:

- 1) *The Spanish commitment towards EEC and ERM*: the adherence of Spain to the EEC in 1986 reduced the autonomy of some economic policies (namely trade and agriculture policies) and required the implementation of Community regulations and directives, specially those concerning the banking and financial services and capital movements liberalization. The latter contributed to reduce the uncertainty concerning the medium-term orientation of economic policies.

In addition to that, non-European companies, namely from the United States and Japan, were taking strategic positions that would allow them to benefit from the single market programme. The full exploitation of both a potential market in an expansionary economic situ-

⁷ That is, foreign currency and convertible pesetas indebtedness of resident units vis-à-vis non-residents and includes liabilities materialized in credits and paper, usually negotiables, that implies the obligation of interest payments and reimbursement of the principle according to an amortization plan.

ation and the comparative advantages of the Spanish economy, with relatively low labour costs and labour-intensive, average know-how, and standard-technology productions also played a major role.

Finally, the entry of peseta into the ERM of the EMS in June 1989 reduced the uncertainty on the global economic climate and, subsequently, the risk premium of investment denominated in pesetas since it put a floor to the currency's depreciation and increased the credibility of economy policies, especially the monetary policies, and contributed to moderate inflation expectations.

- 2) *Prospects of higher real returns on capital and increased returns on the Spanish Stock Exchange*: the improvement in profitability, the increase in capital productivity, the reduction of some labour-market rigidities and the removal of certain supply-side constraints resulted in an improved business climate that paved the way for an investment-led recovery of the Spanish economy since the second half of 1985. The latter represented a permanent flow of direct investment amounting to a range between 0.6% and 1.6% of GDP during the period 1986-90.

Portfolio investment, in contrast, was more volatile since most of portfolio investment in 1987 and 1989 was due in equities; in 1989, however, a marked increase in the acquisition of medium- and long-term public debt seems to have reduced its variability.

The important upsurge of portfolio investment in 1987 (around a 85% increase from 1986) in a context of high expected returns, was reversed in 1988 after the financial crash of October 1987. As a result, portfolio investment in 1988 fell back to around the same level (246.2 bn Ptas) than it was in 1986 (235 bn Ptas). In 1989, however, it recovered again up to 733 bn Ptas although this time it cannot be solely attributed to the expected returns differential, but also to the improvement in the institutional framework concerning the stock exchange, public debt bookkeeping and capital liberalization. The exemption from taxation provided to the public debt interest income paid to non-residents since January 1991 has fostered a strong foreign demand this year, specially for the medium and long-term maturities.

- 3) *New institutional framework: improved market efficiency and capital liberalization*: since Spain joined the European Community in 1986, the authorities have implemented a series of measures to ease progressively the exchange controls. The process of capital liberalization has been particularly intense as far as capital outflows of residents is concerned, and only a small number of short-term operations are subject now to

authorization. The current account borrowing requirements and the need to comply with EC directives led the authorities to liberalize portfolio investment by non-residents. Sometimes the liberalization process was ahead of the compulsory calendars, but in other cases the constraints imposed by the capital inflows on the monetary policy obliged the authorities to reintroduce capital controls previously lifted.⁸

On the other hand, two structural measures proved to be instrumental in increasing the transparency and efficiency of the Spanish capital markets and, therefore, the attractiveness of Spanish assets to non-residents: first, the electronic book entry settlement system (Central de Anotaciones en Cuenta) introduced in May 1987 and by means of which issuing and transmission costs were reduced and a more secondary market was fostered. Second, the Spanish Securities Market Act put in force in July 1989. The latter dealt with the organisation of the primary and secondary markets, with the discipline and intervention rules imposed on financial institutions, and provided a free and more efficient capital market whose transparency has already increased sharply by the introduction of the continuous computerized market.

- 4) *Widening of interest rate differentials in a context of exchange-rate strength*: the uncovered 3-month interest rate of the peseta vis-à-vis the DM has been above 7 pct. points from 1984 up to March 1990. Thereafter it was somewhat reduced but still remains high (around 3.3 pct points in October 1991). The latter took place at a time when domestic demand was booming and expectations of exchange-rate stability, or even appreciation, were building up. As a result, the demand of credit by both the private and the public sector increased, large inflows of short-term foreign capital continued and the long-term capital rose inducing, thereafter, a substantial rise in liquidity. As the growth of money supply remained strong the monetary authorities reacted by rising short-term interest rates from 12 to 22% in three months during the spring of 1987. This reaction produced additional short-term capital inflows and provoked an appreciating pressure on the peseta.

This "vicious circle" of the Spanish monetary policy reappeared in a recursive way in 1988 and 1989, and made clear the impossibility to fix simultaneous and independently two nominal targets for an economy: on the one hand, a very strict target for money growth and, on the other hand, the commitment to maintain a certain exchange-rate stability. As a result, the authorities reintroduced some capital controls and implemented credit ceilings.⁹

8 For more details see Chapter V: Regime applicable to capital movements.

9 See Chapter VII for the operation of monetary policy.

6. Threats and constraints from the external sector

In the development of the Spanish external sector in the last three years, there is another worrying element¹⁰: consumer goods have been increasing their share in the demand for non-energy imports when the share of capital product has remained at the same level. In 1990, 26,9% of total non-energy imports were consumer products and 22,7% capital products. Therefore, independently of the structure of capital which is financing the deficit, we cannot say that this deficit is not worrying when it is due, partly, to a high level of consumption. If the same deficit was reflecting an increase in capital investment, the prognosis would be completely different. A country which increases capital imports to improve domestic productive capacity and infrastructure will ultimately be able to transform the current deficit into a surplus.

The assumption that a current account deficit due to a productive investment process is sustainable is not always true. If new investment is located in the tradeable sectors, we can expect an improvement in export activity in the future. In contrast, if investment is located in the non-tradeable sector, greater efforts to raise the competitiveness of the tradeable sector become the key to a correction in the trade deficit.

A sectoral breakdown of direct inward investment in Spain sheds some light in this respect. Until 1987, more the 50 %

of total foreign direct investment was located in mining and chemical, metal products and others manufacturing sectors (see Table 7). Since then, financial services and other services, here the main part of non-tradeable sector is included, have increased their shares.

The misallocation of external resources, in the context of correcting the balance of payment disequilibrium, has been produced at the same time as the hard appreciation of the peseta has begun. The later phenomenon joined with a very strong domestic demand has increased the profitability of investment in sectors without external competition as compared to the tradeables sector. Furthermore, the absence of risks associated with exposure to external competition and the high level of internal consumption are some of the underlying explanatory factors of the persistence of the inflationary core in the services sector; this insulation of the non-tradeable sector, in turn, has acted as an obstacle to the improvement in the competitiveness of the more exposed tradeable sectors.

Nevertheless, the presence of foreign investors in the service sector could increase the internal competition within that sector and improve its efficiency, in terms of the market structure, paving the way to the correction of the current divergence within domestic prices.

Table 7: Sectorial breakdown of direct foreign investment (% of total)

	1985	1986	1987	1988	1989	1990	1991(a)
(1) Agriculture	1.3	1.7	1.5	1.2	4.4	0.9	0.6
(2) Energy	0.4	0.4	0.3	2.0	0.0	3.5	10.9
(3) Mining and chemical	17.3	14.0	28.4	10.7	12.3	12.7	6.2
(4) Metal products	28.2	29.9	11.3	9.1	10.2	10.2	6.5
(5) Others manufacturing	17.4	17.5	12.9	17.1	16.9	12.1	13.5
(6) Building	0.9	0.1	0.2	0.6	0.9	2.2	1.2
(7) Financial services	17.6	19.3	24.4	43.3	37.4	46.5	40.7
(8) Others services	17.2	17.1	21.2	15.8	18.0	11.9	20.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Pro-memo:							
(3)+(4)+(5) Manufacturing	62.9	61.4	52.6	36.9	39.4	35.0	26.2

(a) Only 6 months.
Source: Ministry of Economy.

¹⁰ See section 2.2.

7. Summary and Conclusions

Since 1985, the Spanish current account has been affected by, firstly accession to the European Community and, secondly, the recovery in economic activity.

Both elements have caused a considerable deterioration in the trade balance; this combined with a poor performance on the invisibles balance explain the widening deficits on the current account since 1989.

The adoption of the Community common external tariff - which broke with the previous tradition of extensive protectionism against external competition - at a time when domestic demand was growing more rapidly than its main competitor countries, has resulted in a significant increase in imports which has not been matched by export growth.

Moreover, a very high domestic demand growth resulted in the reappearance of accelerating inflation in the second half of 1988. The increase in the interest rate to control inflation induced large capital inflows and a consequent appreciation of the peseta. The loss of external competitiveness as a result of combining both, rising prices and appreciating exchange rates, has negatively been affecting goods and services exports.

The current account deficit also reflects the incapacity of domestic saving to finance the investment process.

Since 1986, the public sector has reduced its deficit but this reduction has been insufficient to compensate the gap between saving and investment in the private sector.

In this regard, increases in disposable income have been translated into a growth in consumption which, in turn, has provoked a higher share of consumer goods in the total demand for imports.

Foreign capital inflows are overfinancing the current account deficit.

The Spanish economy has become increasingly dependent on speculative capital inflows attracted basically by high interest rates and a strong currency. In this context, the discipline implied by membership of the Exchange Rate Mechanism of the EMS since June 1989 has enhanced the attractiveness of Spanish interest rate differentials as the risk of losses through a depreciation has been reduced.

However, liberalization of capital movement will imply a progressive narrowing of interest rate differentials among EC countries. Thus, the present attractiveness of the Spanish economy to speculative investment will not continue in the long term. On the other hand, long-term investors are more sensitive to the structural conditions of the economy which, in turn, could be threatened by a persistent and growing current deficit, among other disequilibria.

Consequently, greater efforts to correct present unbalances would be required, if the Spanish authorities wish to consoli-

date the economy in advance of the Single Market and to follow the process towards Monetary Union.

- With regard to *imports*, productive sectors have been more sensitive to the restrictive measures than consumers. Import growth in 1990 was below that of previous years. This import trend is in line with the moderation of domestic demand especially in the second half of 1990. The easing in demand is a consequence of restrictive measures implemented by the authorities one year before and of the additional deterioration of expectation due to the Gulf crisis. Nevertheless, import growth is still high and consumer products have increased their share in non-energy imports.
- From the *export* side additional competitiveness improvements will be needed to correct the external deficit. The 1990 and 1991 export figures suggest stronger growth compared with previous years. Domestic demand moderation, efforts to improve price competitiveness in tradeable sectors and the emergence of external markets - Spanish trade has been positively affected by German unification - could be contributing to this recovery. However, the reallocation of resources towards non-tradeable sectors might to have reduced export capacity.
- *Inflation convergence* with the low inflation European countries is a key issue to restore external equilibrium. Price and cost moderation is the only possibility for an economy with quasi-fixed exchange rates and about to be integrated into a large free market, to improve competitiveness. A reduction in the inflation rate and costs will help the tradeable sectors to expand their share of external markets.

Consequently, this implies the maintenance of a moderate growth in domestic demand so as to avoid further pressure on import demand and prices. Other measures to encourage domestic saving would also help to narrow the gap between saving and investment, while simultaneously reducing demand for imported consumption goods.

- *Improvement of the credibility of the anti-inflationary policy* within the ERM framework is also required to avoid any reversal of both speculative and permanent capital flows. Even if no financial constraints in the external sector have emerged until now the progressive widening of the current account deficits might be considered as unsustainable by the markets and lead to a reversal of capital inflows.

The stability of capital inflows has to be assured by appropriate returns. Within the ERM framework, both the change in the present policy mix, allowing for a more stringent fiscal policy and a less tight monetary policy, and the moderation of wage increases are required to preserve domestic price stability and external competitiveness, otherwise, current account deficits will widen raising the spectre of a subsequent recession, expected returns on foreign investment will be reduced and foreign investment will be tempted to withdraw.

Changes in Spain and EC commercial protection

Industrial products

1. Quantitative restrictions were completely dismantled in 1.1.1990.
2. Gradual tariff rate reduction process from the base rate (approximately 14 %) to zero in the case of other EC countries, and from the base rate to the lower Common External Tariff rate (approximately 4-5 %) is as follows:

March, 1st	1986:	10 %	
January, 1st	1987	12,5 %	
"	1988:	15 %	
"	1989:	15 %	(effectively in October 1988)
"	1990:	12,5 %	
"	1991:	12,5 %	
January, 1st	1992:	12,5 %	
"	1993:	10.0 %	
TOTAL:		100 %	

3. EC Commercial protection for Spanish industrial products was completely removed in June 1989.

Agricultural products

1. Products originating in any EC country have preference to products originating in third countries in other EC countries.
2. Gradual tariff rate reduction for agricultural products to be completed by 1-1-1993. The time-table for fruits, vegetables, and vegetable fats extends to 1-1-1996.

CHAPTER III PUBLIC FINANCE AND FISCAL REFORM (*)

Contents

Introduction	54	5.1. Structure of the tax system	58
1. Fiscal policy in the years of economic expansion	54	5.2. Harmonization of indirect taxation	59
2. The control of public finances	56	5.3. The reform of direct taxation	59
2.1. Budgetary procedure	56	6. Deficit funding and public debt management	60
2.2. The scope for moderating expenditure	56	6.1. Deficit funding	60
3. Impact of budgetary decentralization on the general government deficit	57	6.2. Public debt management	61
4. Tax evasion	58	7. Conclusions	61
5. Tax reform and harmonization	58	Statistical appendix	63

(*) This chapter was mainly prepared by Enrique LANGA MORA of the National Economics Directorate and Manuel SANCHIS I MARCO of the Monetary Directorate.

Introduction

In the first part of the 1980s the public finances in Spain were characterized by :

- a sharp expansion of expenditure and revenue expressed as a proportion of GDP (a trend which had already become perceptible in the 1970s);
- a growing public deficit, which increased from 2.6% of GDP in 1980 to 6,9% in 1985;
- an increase in gross public debt from 17.6% of GDP in 1980 to 45.2% in 1985, as a result of which debt servicing costs rose from 0.7% of GDP in 1980 to 3.9% in 1986.

The political reform process, the economic recession and the efforts made to maintain social cohesion were reflected in a sharp increase in expenditure until 1986. The public sector tried to meet a variety of social demands at the same time as it had to pay large unemployment benefits and deal with the restructuring of certain industrial and financial sectors.

From 1985 onwards, revenue increased sharply as a result of economic growth, the introduction of VAT and the fight against tax evasion. However, there were also an increase in expenditure (budgetary overruns were considerable) and the strengthening of a public investment policy geared to improving infrastructure. Consequently, the drive to cut the deficit slowed down since 1988.

On the other hand, in the absence of an effective policy for moderating incomes, the peseta's entry into the EMS exchange rate mechanism in June 1989 meant that fiscal policy has to play a more active role.

The structure of this chapter is as follows : Section 1 analyses the main characteristics of fiscal policy in the second half of

the 1980's. In Sections 2 and 3, existing problems with the control and the possible reduction of public expenditures are described. Section 4 analyses tax evasion. In Section 5, the present structure of the tax system and the main elements of the current reform are examined. The financing of the public deficit is described in Section 6. Finally, conclusions are presented in the last Section.

1. Fiscal policy in the years of economic expansion

Two periods can be identified in the fiscal policy of recent years :

- the first, consisting of the years 1986 and 1987, during which the general government deficit fell by 3,7 points (from 6,9% of GDP in 1985);
- the second, covering since 1988 to 1991, during which the deficit, adjusted for the change in the timetable for tax reimbursements increased slightly (see table 8 in the Appendix).

1987 was the first year in which there was no primary deficit. The public debt registered a strong reduction in 1988 (from 46,6% of GDP in 1987 to 42,9% in 1988), because certificates of investment which were considered as state liabilities up to 1987 became the liabilities of Official Credit Institutions. After 1988, this ratio has tended to increase slightly.

The evolution of general government net borrowing since 1987 hides two different periods when adjustments for cyclical effects and for changes to the schedule of tax repayments are made. Therefore, general government deficit grew from 2,7%, in terms of GDP in 1987 to 4,7% in 1990. Afterwards, the net borrowing decreased to 4,3% in 1991.

Table 1: Government revenue and expenditure (as % of GDP) (1)

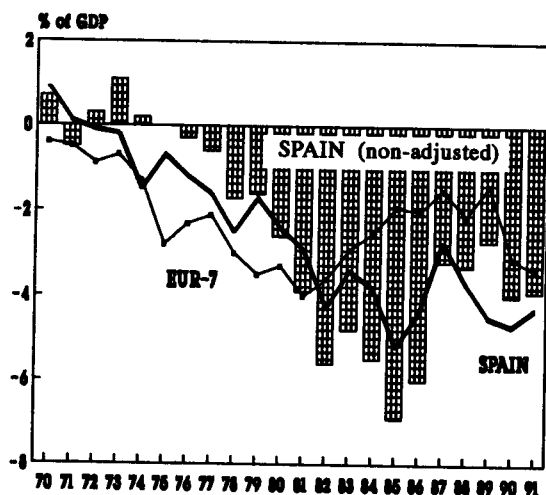
	SPAIN				SPAIN	EUR7(2)
	1985	1987	1989	1990	1991	1991
Current revenue	34.7	37.4	39.0	38.6	39.6	47.3
	--	--	(38.3)	(39.0)	(39.8)	
Current expenditure	36.1	35.8	36.1	36.6	37.5	46.5
Gross saving	-1.4	1.6	3.0	2.0	2.1	0.8
	--	--	(2.3)	(2.4)	(2.3)	
Net capital transfers	1.9	1.3	1.4	1.1	0.8	0.9
G.F.C.F.	3.7	3.5	4.3	5.0	5.2	2.7
Net lending (+) or borrowing (-)	-6.9	-3.2	-2.7	-4.0	-3.9	-2.8
	--	--	(-3.4)	(-3.6)	(-3.7)	
Primary balance	-3.8	0.3	0.7	-0.5	-0.3	1.1
	--	--	(0.0)	(-0.1)	(-0.1)	

(1) The figures in brackets are corrected for changes to the timing of tax repayments.

(2) Excluding Portugal, Greece, Spain, Italy and United Kingdom

Source : Commission Services. Forecasts Oct-Nov 91 for 1991.

Graph 1: Net lending or net borrowing of general government cyclically adjusted (*)



(*) - Also corrected for changes in the timing of tax repayments.
EUR-7: D DK D F IRL L NL.

Source: Commission Services. Forecasts Oct-Nov 91 for 1991.

Fiscal policy seems to have had a positive impact on the process of reducing inflation in 1986 and 1987. However, from 1988 fiscal policy has been somewhat accommodating and it has not helped in the correction of disequilibria in the economy: in the first half of 1989, domestic demand continued on an expansionary trend with an annual growth rate above 7%.

What is more, uncertainty about the extent of overheating as well as a breakdown in the social dialogue and the apparently comfortable budgetary position achieved in 1988 resulted in a budget for 1989 that was clearly expansionary.

During the course of 1989, some restrictive measures were implemented in order to reduce the expansionary effect of the initial budget.

Principal fiscal policy measures adopted in 1989

May

- Reduction of central government expenditure (0.3% of GDP)
- Advance payment of an additional instalment of corporation tax (advance payments increased from 30% to 55%)
- Expenditure adjusted in order to increase social welfare expenditure (0.3% of GDP)

July

- Withholding taxes on interest income increased from 20% to 25%
- Certain financial assets made subject to regulation by an increase in fiscal supervision
- Income tax law provisionally amended to conform with the Constitutional Court judgment

December

- Advance payments of corporation tax increased from 55% to 60%.

At the same time :

- deductions at source from earned incomes did not vary;
- tax allowances and thresholds were raised (but by less than inflation), and,
- corporate tax remained unchanged.

Therefore, one of the results of these measures was a temporary increase in receipts and a rise in future reimbursements.

In addition, civil service pensions and wages were increased by less than inflation, this reduced social cohesion and gave

Table 2: Increase in pensions, wages and income tax allowances and thresholds (% change)

	Inflation (in December)		Public wages			
	Target	Final	Pensions (average)	Budget	Final Gen.Gov.	Income tax allowances and thresholds
1988	3.0	5.8	5.3	4.0	7.1	(1)
1989 (2)	3.0	6.9	5.3	4.9	7.2	3.0
1990	5.7	6.5	9.2	6.0	8.2	5.0
1991	5.0	--	7.2	6.3	7.4	5.0

(1) The structure of the tax was changed by reducing thresholds and rates.

(2) The inflation target was increased to 5% and subsequently abandoned. Pensions were finally increased by 7.6%.

Source: Ministry for Economic Affairs and Finance.

rise to the claim that a "social debt" existed which had to be acknowledged in 1990.

Furthermore a Constitutional Court judgment in 1989 repealed much of the law relating to personal income tax and wealth tax. The result was a change in the dates on which tax was payable for 1989 and delays of income tax reimbursements. As a result the general government borrowing requirement first fell by 0.7% of GDP in 1989 and then increased again by 0.4% in 1990 and 0.2% in 1991.

The bringing forward of the parliamentary elections to 29 October 1989 delayed the approval of the budget for 1990 until June of that year. Finally, the budget for 1991 which was presented after the start of the Gulf crisis, was relatively restrictive, concentrating to some extent on reducing inflation. The central government deficit was initially planned to fall below 1.5% of GDP. Nevertheless, the lower economic growth in 1991 has widened the gap between expenditure and revenue, provoking that this figure will probably increase to 2.7% of GDP.

2. The control of public finances

2.1. Budgetary procedure

A number of reforms to the general budget law have improved the management and control of public expenditure (particularly after the 1990 Budget), but budgetary procedure still allows a margin of freedom.

First, part of the total appropriations for non-financial operations is not used. However, in some cases, in particular for capital expenditure, unused appropriations may be carried forward to the next financial year. In addition, some budgetary heads can automatically be increased in keeping with circumstances.

Second, the existence of additional appropriations seems to indicate that the forecasts are incomplete. Consequently Parliament may approve extraordinary and additional appropriations.

These special features reduce the effectiveness of the ex ante political control of budget targets and actual expenditures have regularly overrun initial appropriations.

On average for 1987-89, revenue (non-financial operations) was 11.7% higher than forecast in the budget; this is equivalent to 2.1% of GDP, roughly double the figure for expenditure overruns.

2.2. The scope for moderating expenditure

From analysis of the composition of current expenditure it can be seen that in general there is no great margin for reducing it. In 1991, the ratio of current expenditures to GDP was the lowest of all the Community countries : 37.5% compared with 45.2% for EUR 9 and 49.3% for Italy. For instance, current transfers to households are 15.1% of GDP whereas in EUR 9 they are 17.7% and, taking account of the relatively low protection level, a significant reduction of this item cannot be anticipated.

Although the ratio of public consumption to GDP (15.4% in 1991) is lower than for EUR 9 (18.3%), its evolution could certainly slow down. Once the process of budgetary decentralization is more advanced, at least a slowdown is to be expected for the heading compensation of employees, because public employment should increase more slowly. There should also be some room for manoeuvre with regard to purchases of goods and services : once more progress has been made in modernizing general government, a slowdown in purchases could also be hoped for.

Table 3: Overruns on the state budget (non-financial payments)

	As % of initial appropriations		As % of GDP	
	average 1987-89	1990	average 1987-89	1990
Extraordinary and additional appropriations(1)	1.4	0.8	0.3	0.2
Automatically increased appropriations(2)	6.4	2.4	1.4	0.5
Appropriations from earlier financial years(2)	3.9	3.0	0.8	0.7
Others(3)	0.7	0.3	0.1	0.1
Total appropriations	12.4	6.5	2.7	1.5
p.m. Unused final appropriations	7.1	5.4	1.5	1.3
Overruns (of initial appropriations)	5.3	1.1	1.1	0.2

(1) These appropriations have been limited to 5% of initial appropriations in the Budget Law of 1991.

(2) In fact, these appropriations have been limited since the Budget law of 1990.

(3) Financed by anticipated receipts.

Source : Ministry for Economic Affairs and Finance.

Another heading under which savings could surely be made is current transfers to enterprises. Such savings will in part be helped by the privatizations which have been completed.

It is possible that interest payments will stabilise as a proportion of GDP. On one hand, the reduction in the public deficit and the foreseeable convergence in interest rates would have favourable effects on this item. But, on the other hand, an increase of the proportion of debt issued under market conditions, due to the removal of the investment coefficient and of the fiscal advantages of Treasury Notes, will tend to counter-balance somewhat.

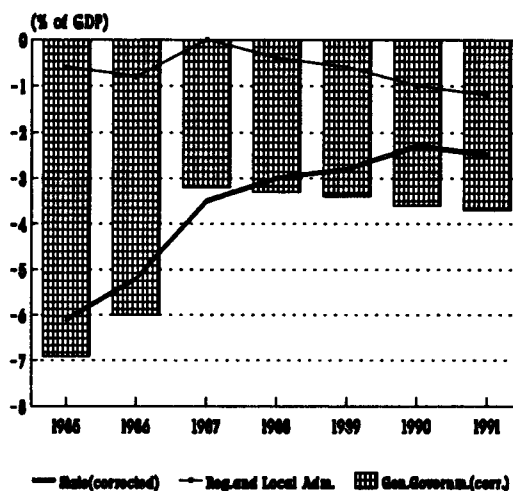
Capital expenditure could fall as a percentage of GDP. In 1991, gross capital formation stood at 5,2% of GDP (2,7% for EUR 9). The structural Funds also helped to achieve this. Starting in 1993, public investment could stabilise somewhat. Net capital transfers (0,8% of GDP in 1991) are at the same level than the average for EUR 9, after decreasing in the last years.

In fact, total transfers to public enterprises have fallen less in the last few years than might have been expected in a period of sharp expansion. Moreover, such transfers could delay the requisite structural adjustments. A more rapid reduction of transfers together with the abandonment of certain non-viable activities would increase the competitiveness of the industrial sector.

3. Impact of budgetary decentralization on the general government deficit.

One of the consequences of the process of budgetary decentralization has been the emergence of a sizeable borrowing requirement for the territorial authorities. In 1991, this is projected to increase above 1.0% of GDP.

Graph 2: Net lending or net borrowing of general government



Commission Forecasts Oct-Nov 91 for 1991
Source: Commission Services.

In the budget for 1991, 32% of the non-financial resources of local authorities come from central government transfers; for regional government this figure is over 70%.

In 1989, a large increase in the financial liabilities of the territorial entities was recorded, and the increase virtually matches the expansion of the financial assets of the entities over the same period. This suggests that a part of borrowed funds has been used for financial placements. This problem has been alleviated by an agreement between central and territorial authorities.

Table 4: Breakdown of general government net lending or net borrowing (as % of GDP) (1)

	1986	1987	1988	1989	1990	1991
Central government	-5.3	-3.3	-2.9	-2.1	-3.0	-2.7
- State	-5.2	-3.5	-3.0	-2.1	-2.7	-2.7
- Social security	-0.1	0.3	0.1	0.1	-0.3	0.0
Local and regional government	-0.8	--	-0.4	-0.6	-1.0	-1.2
- Regional government	-0.5	0.1	-0.3	-0.4	-0.8	-1.0
- Local authorities	-0.3	--	-0.1	-0.2	-0.2	-0.2
General government	-6.0	-3.2	-3.3	-2.7	-4.0	-3.9
	--	--	--	(-3.4)	(-3.6)	(-3.7)

(1) The figures in brackets are corrected for changes to the schedule of tax repayments.

Source : Ministry of Economy and Commission forecasts for 1991.

Table 5: Financial assets and liabilities (as % of GDP)

	1985	1988	1989	1990
Territorial authorities				
- assets	2.3	2.6	4.3	3.5
- liabilities	3.6	4.4	6.4	6.4
General government				
- assets	18.1	11.9	13.9	12.9
- liabilities	45.2	42.9	44.2	44.5

Source : Bank of Spain

4. Tax evasion

Although in the last few years important progress has been made to reduce the level of tax evasion, the scale of evasion still leaves significant scope for further increases in receipts.

In recent years, real estate, especially in large cities, has increased sharply in value but these increases are not as yet reflected in the rateable value. As a result, the value for tax purposes declared in transactions or forming the basis for the wealth tax is substantially lower than the market value¹. The Ministry for Economic Affairs and Finance has updated the land register, but the application of the new values has been postponed for one year. There is also large-scale evasion of VAT; this is said to have been 28% in 1986 and to have fallen to 26% in 1988-89².

From the direct tax side, despite the progress realized, tax evasion is still very high, particularly with respect to capital and other non-labour incomes. In 1986, tax evasion (in relation to the theoretical tax base) was about 25% of the GDP.

Table 6: Compliance with tax laws (Figures declared as a percentage of theoretical tax base)

	Average 1979-83	1984	1985	1986
Returns	56.1	58.7	61.0	64.1
Total income	48.0	50.5	52.0	55.1
Earned income	62.2	66.7	68.9	71.3
Other income	24.0	24.6	26.2	30.4

Source : Lagares, M., "Fraude fiscal y aceptación social del sistema tributario", 1990.

5. Tax reform and harmonization

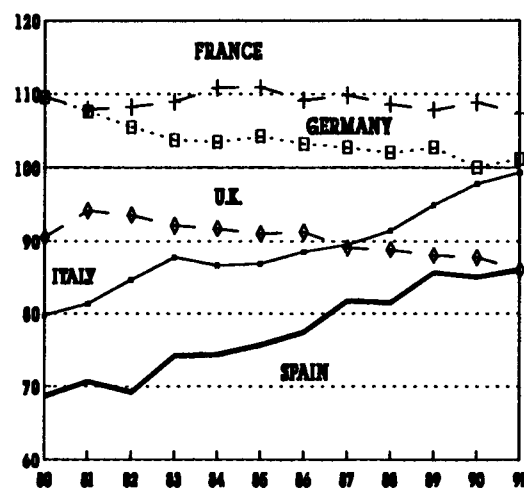
5.1. Structure of the tax system

The present tax system has its origin in the reform made in 1977-78 which implemented three key direct taxes : income tax, wealth tax and corporation tax. Since then, several modifications have been implemented, the more important being that of June 1991 affecting personal income and wealth taxes.

Indirect taxes were substantially modified in 1985 and 1986. The entry into the European Community implied the introduction of VAT, replacing more than twenty indirect taxes which distorted relative prices. The customs' legislation was also adapted to conform with the common external tariff.

As may be observed in the following table, the structure of taxes have not changed significantly since 1985. Within direct taxes, the main source of receipts in social security contributions, mainly paid by employers. Although between 1985 and 1988 the share of this item in total revenues had fallen a little, it remains substantially above of the EUR 12 average. On the other hand, at least until 1988, Spain relied less heavily on income and profit taxes than in the Community on average.

At the same time, despite a notable and continuous increase in the fiscal pressure, the overall tax burden in Spain remains below that of the main European countries. Therefore, there

**Graph 3: Fiscal pressure
EUR-9 = 100**

EUR-9: 1979-83 incl. GR P IMP.
 Eurozone Oct-Nov 91 for 1991.
 Source: Commission Services.

1 A 1989 law increased the values declared in transfers of property.

2 The evasion index is calculated on the basis of actual receipts and those which in theory should have been paid. See Diaz, C. et al, "Evaluación del fraude en el IVA", Instituto de Estudios Fiscales, 1990.

Table 7: Structure of taxes (%)

	1985		1988	
	Spain	EEC (1)	Spain	EEC (1)
Income and profits	26.2	33.4	29.6	33.3
- Income of households	19.7	26.3	21.5	26.6
Social security contr.	41.3	29.7	35.7	28.8
- Employers	31.1	17.3	27.2	17.0
Wealth	3.5	4.1	4.1	4.5
Goods and services	28.7	31.6	30.5	32.5
Other	--	--	0.2	0.9
Total	100.0	100.0	100.0	100.0
p.m. :				
Total as % of GDP	31.2	39.8	32.8	40.1

(1) Non-weighted average of 12 countries.
Source : OECD

is still some room for manoeuvre to raise revenues. However, a higher global tax burden could be achieved without a rise in the individual burden by reducing fiscal fraud. Moreover, an increase in the tax burden on earned incomes could act as a disincentive to household savings.

5.2. Harmonization of indirect taxation

At present, there are three VAT rates (6%, 12% and 33%). The normal rate of 12% will be increased to 13% in January 1992, and to 15% in January 1993. The Spanish authorities envisage a superreduced tax for some specific products.

As concerns to the excise duties, the tobacco products and oil prices will be raised in January 1992. This should produce a similar increase in revenue to that deriving from the increase in VAT.

Although harmonization originally had been planned for 1990-92³, it has been postponed to 1992-93, apart from certain alterations to excise duties, because of difficulties in bringing down inflation. Harmonization should have a favourable effect in reducing the deficit, even though this effect may be at least partly offset by a reduction of income tax. Nevertheless, some upward pressure on the inflation rate is likely to result.

In any event, harmonization should be gradual and a tight economic policy should be maintained. This would reduce

the impact on prices. The effect on the population's purchasing power will be attenuated by the cut in direct taxes.

5.3. The reform of direct taxation

In the period 1981 to 1988, direct taxation of personal income was reduced for taxable amounts of less than PTA 3 million whereas for larger amounts, in particular amounts in excess of PTA 5 million, it was increased. The tax has therefore become more progressive.

This has chiefly affected persons in receipt of labour income (officially monitored) and particularly those who, because of their higher incomes have a greater capacity for saving. The problem is further exacerbated by the lack of horizontal equity; the same levels of income are in fact taxed differently depending on their origin.

In June 1991, a new law on personal taxation (effective from the 1992 fiscal year) and other complementary measures were introduced. Under this reform, tax rates will be reduced⁴. With regard to income from securities, the law introduces a tax relief on long term savings and increases fiscal advantages for pension funds. Simplification, technical improvement and enhanced transparency in the treatment of capital gains and losses are envisaged; a time limit on liability for certain specific long term capital gains is introduced.

³ Ministry for Economic Affairs and Finance : Macroeconomic and budgetary scenario, 1989-1992, Madrid, 1988.

⁴ The top marginal rate is reduced from 55% in 1991 to 53% in 1992 and 50% in 1993, while the lowest falls from 25% to 20% in 1992 and 18% in 1993.

The main aim of these measures are to provide a tax incentive for household saving and to introduce a more neutral treatment of the different income sources. Although the relationship between personal saving and the tax burden is uncertain in the Spanish case, one must at least examine fiscal considerations as one of the factors explaining the weakness of the personal saving ratio.

In the run-up to the Single Market, an additional problem is harmonization of the treatment of interest income, at present subject to a 25% withholding tax: this rate should come down. A decree-law of 21 December 1990 provides an exemption from taxation on capital gains and interest income deriving from government securities and paid to non-residents. This treatment is extended to any kind of securities for residents in another Community country.

The reform of income tax also presupposes a reform of corporation tax, not only in order to achieve better technical structure and to avoid double taxation, but also to reduce evasion and increase neutrality when investment decisions are taken. In addition, the difference between the tax rate which applies to companies (35%) and the top marginal rate which applies to household incomes (55%) has caused distortions, with companies being formed to avoid the need to pay progressive personal taxation. There are two solutions to this: either to increase the rate of corporation tax, or to reduce the deductions now allowed against it, mainly on the grounds of investment and job creation. Spain is at the lower end of the corporation tax range, so that there is some room for increasing it.

6. Deficit funding and public debt management

6.1. Deficit funding

During 1983-1987, the Government diversified the source of financing the public deficit and issued short-term Treasury Notes (*Pagarés del Tesoro*) and medium- and long-term government bonds (*Bonos del Estado* and *Obligaciones del Estado*). However, a high percentage of the financing schemes was held through compulsory coefficients by the banking system. In 1985 the Government redefined the compulsory investment coefficient (prevailing at 23% at that time) and a part of it (10% at that time) had to be fulfilled with Treasury Notes (*Pagarés del Tesoro*) at a price unilaterally fixed by the Treasury. This weakened the impact of the budget deficit on the liquidity of the banking system but did not change the consequences of a privileged financing of the deficit.

Since 1987 a progressive change in the system of deficit funding based on the coefficients and the Treasury Notes has been introduced.

- (i) The Treasury started to issue in June 1987 a new instrument, Treasury Bills, a one-year public asset that, in contrast with the former Treasury Notes, were issued at market conditions, had no fiscal opacity and did not have to be held by the banking system in order to meet any investment coefficient requirements. Since Decem-

ber 1991, the Treasury issues three-months Treasury Bills too.

- (ii) The authorities introduced in May 1987 the Electronic Bookkeeping System (*Central de Anotaciones en Cuenta*) of public debt in the Bank of Spain which improved the material basis and the efficiency of the public debt markets and paved the way for a more orthodox financing of public deficits.
- (iii) The compulsory coefficients started to be gradually reduced. The Government approved (13.1.1989) a Royal Decree setting up a timetable for a gradual phasing out of the investment coefficient, to be completed by 31 December 1992.
- (iv) From January 1992, the Treasury Notes held by the public will not have fiscal opacity. Until this date, it is possible to change these assets with other ones, namely "Deuda Especial", which are issued at six-year term, at 2% interest rate and offer opacity advantages at their redemption.

A further source of privileged funding for the authorities has been via the Bank of Spain system of reserve requirements, which has generated substantial profit transferred to the Treasury. The reserve requirement coefficient was significantly changed in February 1984 to 18% from 7.75% in August 1983. The non-remunerated tranche of the coefficient was reduced to 5% from 7.75% earlier, and a new remunerated (at a 13.5% interest rate) tranche of 13% was established.

In early March 1990, there was a cash coefficient with two tranches, one of 9.5% with an average remuneration of 7.75% and a non-remunerated one of 7.5%; under this old system, the present market value of bank reserves with the Bank of Spain (a nominal amount of about 3.3 billion Ptas) would have been around 1.4 billion Ptas, (the reserve tranche was in effect a perpetual loan to the Bank of Spain; applying the 5 to 10 year bond rate, in the absence of a perpetual bond rate, the present value can be calculated). On 23 March 1990, the Bank of Spain implemented a major reform in the system of reserve requirements, which:

- (i) introduced a non-remunerated minimum reserve coefficient of 5%;
- (ii) From 2 May 1990 the new remunerated tranche (12% out of the total of 17% coefficient) was substituted by Certificates of Deposit (CD) issued by the Bank of Spain at a 6% interest rate. The banks have to hold these CD's in their portfolio as non-negotiable assets but are able to transmit them with certain limits between credit institutions. The CD's will be progressively redeemed every six months starting March 1993 and ending September 2000.
- (iii) The stock of CD issued on 23 March and 3 April 1990 amounted to 3.316 bn Ptas and was equivalent to the average of the liabilities included in the reserve requirements during October, November and December 1989 and January 1990.

Again taking the average of the 5 to 10 years' public debt issues after March 1990 (13.75%) as the discount

rate, and assuming that there is an extra coupon in order to assimilate the CD issued on 3 April 1990 with those on 23 March, the net present value of 3.316 bn Ptas can be calculated at 2.023 bn Ptas (cf. Table 9). In other words, the change in the system of reserve requirements has increased the implicit market value of public sector debt by around 600 billion Ptas (this compares with explicit outstanding public sector debt of 16.993 bn Ptas by end 1990) or about 3.7% of GDP.

- (iv) The Treasury decided to intensify in 1989, but especially in 1990, the issues of medium- and long-term government bonds (namely Bonos del Estado) in an attempt both to compensate the smaller financing stemming from the reduction of the coefficients and to implement a more orthodox deficit funding. Actually, the share of outstanding balances of government debt issued under market conditions has increased from 67% in 1986 to 81.6% in 1990 (cf. Table 10). Although the bulk of public debt is still concentrated on short-term paper, that is, Treasury Notes (Pagarés del Tesoro) and Treasury Bills (Letras del Tesoro). (cf. Table 11), in 1991 the issue of medium and long-term debt has been very large, so that it has increased its share in total debt in nearly ten points.

6.2. Public debt management

The issue of medium- and long-term public debt by the Treasury has been low since 1978 when the fiscal deficit started to grow rapidly. The authorities were reluctant to accept the increase in interest rates required by the market. As a result, they used the direct access to the Bank of Spain and relied heavily on short-term financing (namely in Treasury Notes and Treasury Bills). In 1986, the expectations of a fall in interest rates created by the relatively accommodating monetary policy, induced the Treasury to implement an active public debt policy. The authorities issued a substantial amount of medium- and long-term government bonds (Bonos del Estado and Obligaciones del Estado) that were predominantly taken up by the financial institutions. Nevertheless, the share of short-term debt (0-2 years of residual maturity) in the total remained very high in 1986. During the period 1988-90 this active policy was reinforced but the share continued to rise (84.5% in 1990) far beyond the levels of other EC countries. The average residual life to maturity of issues and outstanding balances of public debt in Spain has been reduced respectively from 2.6 years and 2.6 in 1986 to 1.6 years and 1.4 in 1990 (cf. Table 12). As noticed before, in 1991 there has been a halt in this process, recording an increase in the maturity of the total debt.

On the other hand, the process by means of which the public debt is marketed (namely sales of public sector paper under repurchase agreements by the banking system to the public) implies the transformation of a high share of liabilities issued by the Treasury, irrespective of their maturity, into liabilities of the banking system which are mainly short-term. In fact, the financial institutions can buy public debt either in the primary market or through the sales of these instruments by the Bank of Spain in its repurchase agreement operations.

The financial institutions might hold these assets in their portfolio, sell them to the public, or hand them over temporarily to non-banks under a repurchase agreement. The latter case would constitute a liability for the bank concerned and would represent (abstracting from any possible offsetting external flows) additional money creation resulting from the arrangements for financing of public debt; in fact the temporary repo transfer by the financial institutions to the public of any public asset, even long-term issues, is included in the ALP definition. As a result, the major role played by the hand over of repo by the banks to the public has not favoured control over domestic money creation since the public debt market does not directly relate the public with the Treasury but with the banking system.

The 1990 budget adopted a new rule limiting strictly non-financial appropriation to the amount approved by the Parliament and also introduced an end-year zero limit for the increases in the balances of the Treasury borrowing from the Bank of Spain. The previous regulation, the progressive decline of the investment coefficient and the reduction of the reserve requirements will lead the Treasury to have a higher recourse to the public debt markets and probably to a rationalization of the public debt management policy.

7. Conclusions

- In 1986 and 1987, fiscal policy, assisted by a favourable economic situation, reduced the general government deficit from 6.9% of GDP in 1985 to 3.2% in 1987. However, it could be said that, in the context of the strong economic growth, it was not taken advantage enough of two years (1988 and 1989) for establishing a combination of more balanced policies which would have improved the pace of convergence. During these years, fiscal policy made virtually no contribution to the process of reducing inflation, with monetary policy bearing the brunt. Fiscal policy started to be tightened in the second half of 1989, in keeping with what was needed as a result of the peseta joining the EMS exchange rate mechanism in the middle of 1989.
- The fiscal policy which was followed from 1985 onwards was based, at least partly, on supply-side policies.

On the public expenditure side, a great effort was made in the field of public investment to make the economy more efficient. A policy of privatizing public enterprises was also implemented.

On the revenue side, the introduction of VAT simplified and removed many distortions in the old system of indirect taxation. Rates of income tax and corporation tax deductions were also reduced. Certain measures limiting overspending by the State and the Treasury's direct access to the Bank of Spain were also approved.

- The elimination of the public deficit continues to be one of the most important challenges for economic policy. However this objective, that was previously targeted for being achieved in 1992, has now been postponed.

- With regard to budgetary procedure, it can be seen that the initial budgets, voted by Parliament, are not a very effective instrument from the point of view of limiting expenditure. In recent years, actual expenditures have overrun initial appropriations. The procedure should therefore be reformed in order to avoid this and to ensure that the budget is implemented on figures closer to those of the initial budgets.
- It is also important to monitor efficiency with regard to operating costs and the performance or usefulness of services and investment in order to modernize the management of expenditure and to improve control.
- The fact that the current account is in deficit also indicates the need to increase the savings ratio of the economy. In view of the fall in the personal, and possibly the corporate, savings ratio, the only valid option, at least in the short term is to increase public saving. This implies that the central government will have to make an additional effort (the accounts of autonomous bodies of State and the social security funds are generally more or less balanced).
- It is not proving easy to reduce, or even moderate, public expenditure, given that the ratio of current public expenditure to GDP is the lowest of the Community countries. However, there is some room for manoeuvre, particularly in public consumption, transfers to enterprises and capital expenditure (especially from 1993 onwards). This should make it possible, in the medium term, to increase social expenditure.
- In view of the impact on the territorial authorities' deficit, and since the present system of financing regional government is about to come to an end, an attempt should be made to extend the principle of "fiscal co-responsibility", which would enable regional government to have direct control over more taxes than it does at present.
- Tax evasion is a problem which must be urgently solved, because it makes fiscal policy less effective, stands in the way of reducing the public deficit and erodes social cohesion.
- A comprehensive reform of the system of tax collection is proving necessary (the budget law for 1991 establishes a "Tax Agency", that will begin to work in 1992, in order to bring about an improvement). The reduction of the tax burden on households, could help to reduce income tax evasion.
- Limiting tax fraud and indirect tax harmonization should help to reduce the deficit, even if income tax rates and employers' social security contributions are cut. Harmonization should take place gradually to prevent a surge in prices.
- To fully exploit the current opportunities it would be appropriate for the Treasury to keep on with the issues of public debt at longer term. The success of a public management policy aiming at lengthening the average maturity of the outstanding debt and avoiding the high degree of monetary policy repercussions of public debt held by the non-banks (by means of repos) will depend on the willingness of the authorities to offer the returns sought by the markets. This implies after-tax yields that compensate investors for expected inflation and future interest rates. Another possibility would be that investors become more used to holding medium- and long-term debt in their portfolios. That could contribute to improve the interest of the Spanish investor for medium- and long-term assets and, in any case, would foster foreign capital inflows.
- Only tighter control of public expenditure, the reform of the tax system and more orthodox financing of the deficit will pave the way to a more balanced combination of policies. Budgetary policy should be much more active than recently in squeezing inflation out of the economy and, in general, in stabilizing demand. These reforms, and moderation of the regional government deficit would not only contribute to nominal convergence - reducing the public deficit and the inflation rate - but also to more balanced growth, with public saving then being able to increase. Any disadvantages - with regard to real convergence - which might result from a more restrictive budgetary policy would be amply offset by a reduction in the inflation rate and more balanced growth. Nominal stability is required so as to avoid the risks of an irregular "stop-go" path in economic growth.

Table 8: Receipts and expenditure of general government (as percentage of GDP)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991(a)
Indirect taxes	6.6	7.3	7.8	8.5	9.0	9.5	10.5	10.4	10.3	10.4	9.9	9.9
Direct taxes	7.0	7.2	6.8	7.9	8.3	8.4	8.2	10.3	10.5	12.0	11.7	12.2
Direct taxes adjusted (b)										11.3	12.1	12.4
Social security contributions	13.1	13.4	13.3	13.7	13.1	13.0	12.8	12.8	12.5	12.7	13.0	13.4
Other current receipts	3.5	3.8	4.0	3.9	3.4	3.8	4.2	4.0	4.0	4.0	4.1	4.2
Total current receipts	30.2	31.7	31.9	34.0	33.8	34.7	35.7	37.4	37.2	39.0	38.6	39.6
Total current receipts adjusted (b)										38.3	39.0	39.8
Current transfers	16.2	17.6	18.1	18.8	18.8	19.1	17.6	17.2	17.4	17.6	18.0	18.5
to enterprises	2.1	2.0	2.5	2.6	2.8	2.6	2.0	1.8	2.1	1.8	1.8	1.8
to households	12.7	14.1	14.0	14.5	14.5	14.7	13.9	13.8	13.9	14.0	14.6	15.1
to the rest of the world	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Actual interest payments	0.7	0.8	1.0	1.3	2.0	3.1	3.9	3.5	3.3	3.4	3.5	3.6
Government consumption	12.7	13.2	13.4	13.9	13.7	13.9	14.7	15.1	14.8	15.1	15.1	15.4
Compensation of employees	9.8	10.3	10.2	10.6	10.5	10.5	10.3	10.4	10.5	10.5	10.7	10.9
Purchases of goods and services	2.4	2.4	2.6	2.7	2.7	2.7	3.3	3.7	3.3	3.6	3.4	3.4
Total current expenditure	29.7	31.6	32.4	34.0	34.6	36.1	36.2	35.8	35.5	36.1	36.6	37.5
Gross saving	0.6	0.1	-0.5	0.1	-0.7	-1.4	-0.5	1.6	1.7	3.0	2.0	2.1
Gross saving adjusted (b)										2.3	2.4	2.3
Net capital transfers	1.3	1.7	2.0	2.0	1.7	1.9	1.8	1.3	1.2	1.4	1.1	0.8
Gross fixed capital formation	1.9	2.3	3.1	2.8	3.0	3.7	3.7	3.5	3.8	4.3	5.0	5.2
Total expenditure	32.8	35.6	37.5	38.8	39.3	41.6	41.7	40.6	40.5	41.8	42.6	43.5
Net lendign(+) or net borrowing(-)	-2.6	-3.9	-5.6	-4.8	-5.5	-6.9	-6.0	-3.2	-3.3	-2.7	-4.0	-3.9
Net lendign(+) or net borrowing(-) Adjusted (b)										-3.4	-3.6	-3.7
Gross public debt	17.6	21.6	26.8	33.1	39.9	45.2	46.2	46.6	42.9	44.2	44.5	45.6

(a) Commission forecasts October-November 1991.

(b) Adjusted for delaying tax reimbursement for General Government in 1989, 1990 and 1991.

Source: Commission Services.

Table 9: Table of flows

Maturity 3/90	9/90	3/91	9/91	3/92	9/92	3/93	9/93	3/94	9/94	3/95	9/95	3/96	9/96	3/97	9/97	3/98	9/98	3/99	9/99	3/2000	9/2000	Total
Interests	99.42	99.42	99.42	99.42	99.42	99.42	95.04	90.47	85.70	80.73	75.46	69.99	64.32	58.36	52.10	45.63	38.87	31.72	24.26	16.90	8.45	
Amortization	--	--	--	--	--	145.82	132.44	159.07	165.70	175.64	182.27	188.90	198.80	208.78	215.41	225.35	238.60	248.55	258.49	268.43	281.69	
Total	99.42	99.42	99.42	99.42	99.42	245.24	247.48	249.54	251.40	256.37	257.73	258.89	263.12	267.14	267.51	270.98	277.47	280.27	282.75	284.93	290.14	
Net present value	93.166	87.30	81.81	76.66	71.846	166.05	157.03	148.37	140.07	133.85	126.10	118.69	113.04	107.55	100.92	95.80	91.92	87.01	82.25	77.67	74.11	2022.74

Source: Commission services.

**Table 10: Central Government Debt
(Distribution of outstanding debt according to the conditions of the issue)**

	1982	1983	1984	1985	1986	1987	1988	1989	1990
1. TOTAL (a) (2 + 3)	3381.4	4984.0	7053.3	9193.7	10853.9	12536.4	14128.1	15467.1	16993.4
2. Issued under special conditions (b)	2209.9	2340.3	3863.9	4087.2	3586.9	3436.6	3410.0	3581.8	3134.4
3. Issued under market conditions (1-2)	1171.5	2643.7	3189.4	5106.5	7267.0	9099.8	10718.1	11885.3	13859.0
4. (3/1) x 100	34.6	53.0	45.2	55.5	67.0	72.6	75.9	76.8	81.6

Source: Direccion General del Tesoro Notes:

(a) Equal to Domestic Public Debt, to External Public Debt and to Bank of Spain financing.

(b) Equal to Treasury Notes submitted to the investment coefficient, to medium- and long-term central government debt previous to 1977, to debt of RUMASA and to financing by the Bank of Spain

Table 11: Central Government Debt (Outstanding debt at the end of the period)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	% over total in 1990
A. Domestic Public Debt	558.0	690.6	833.4	2062.2	4623.1	6280.7	8867.1	10873.5	12750.7	13867.0	15370.4	(20.12)
1. Treasury Notes (effective)	--	27.0	100.5	1133.5	3173.5	4309.1	5245.8	4749.6	4590.3	4214.5	3418.9	--
a. Under investment requirements	--	--	--	--	(1747.9)	(1550.6)	(1720.4)	(1869.7)	(2152.1)	(2115.4)	(1830.7)	--
b. Rest	--	(27.0)	(100.5)	(1133.5)	(1425.6)	(2758.5)	(3525.4)	(2879.9)	(2438.2)	(2099.1)	(1588.2)	--
2. Treasury Bills (effective)	170.0 ^(a)	180.0 ^(a)	--	--	--	--	--	2211.1	3286.7	4742.1	6453.6	(37.98)
3. Medium- and long-term debt	300.0	387.4	499.7	560.7	1107.7	1359.5	3095.6	3418.2	4350.2	4518.6	5085.6	(29.93)
a. Prior to 1977	(65.4)	(54.9)	(49.4)	(44.8)	(39.0)	(36.5)	(33.9)	(31.3)	(28.6)	(25.9)	(23.1)	--
b. Debt or RUMASA	--	--	--	--	(440.0)	(421.0)	(360.1)	(337.2)	(312.1)	(284.5)	(254.3)	--
c. After 1977	(234.6)	(332.5)	(450.3)	(515.9)	(628.7)	(902.0)	(2701.6)	(3049.7)	(4009.5)	(4208.2)	(4808.2)	--
4. Assumed Debt	88.0	96.2	233.2	368.0	341.9	612.1	525.7	494.6	523.5	391.8	412.3	(2.43)
B. External Public Debt	142.0	223.8	387.5	626.3	793.2	833.9	514.3	464.5	460.2	444.1	596.7	(3.51)
C. Bank of Spain (Net)	646.9	1117.6	2160.5	2295.5	1637.0	2079.1	1472.5	1198.4	917.2	1156.0	1026.3	(6.04)
D. TOTAL (A + B + C)	1346.9	2032.0	3381.4	4984.0	7053.3	9193.7	10853.9	12536.4	14128.1	15467.1	16993.4	
E. Bonds for Investment ^(b)	970.3	1092.6	1220.7	1352.0	1523.3	1634.5	1673.4	1536.5	--	--	--	--
F. TOTAL (D + E)	2317.2	3124.6	4602.1	6336.0	8576.6	10828.2	12527.3	14072.9	14128.1	15467.1	16993.4	

Source: Direccion General del Tesoro

Notes: (a) Treasury Bonds; its issue was interrupted in 1982

(b) The Bonds for Investment were devoted to finance the Official Credit. Its issue has been interrupted since mid-1987 and they have become a direct liability of the Institute of Official Credit since January 1988.

**Table 12: Public Debt of Central Government:
Average residual life maturity of outstanding balances on 31 December (1)**

Year	Trasury Notes	Treasury Bills (3)	Medium- and Long-term Central Government debt		Assumed debt	Assumed debt of financial account	Average maturity of domestic debt	Average maturity of external debt (2)	Average residual life maturity of Central Government debt
			Nego-tiable	Non-nego-tiable					
1976	--	0.06	7.19	6.04	15.91	9.16	6.50	5.20	6.36
1977	--	0.08	6.85	6.52	15.25	8.83	6.77	3.70	6.07
1978	--	0.12	5.83	6.78	14.59	8.51	6.13	5.10	5.99
1979	--	0.16	4.50	7.08	13.93	8.23	6.06	4.40	5.89
1980	--	0.12	3.86	6.90	13.28	6.43	5.63	4.50	5.53
1981	0.50	0.15	3.09	6.57	12.64	5.79	5.13	4.40	5.05
1982	0.70	--	2.46	6.49	7.36	5.04	5.27	4.90	5.21
1983	0.76	--	2.25	5.97	5.96	4.25	3.58	5.00	3.80
1984	0.40	--	2.86	5.83	5.22	3.66	2.65	6.50	3.09
1985	0.69	--	3.06	5.37	4.42	3.26	2.45	8.80	3.06
1986	0.81	--	3.43	5.06	3.67	2.79	2.44	5.80	2.59
1987	0.71	0.67	2.60	4.51	4.96	2.37	1.89	6.10	2.05
1988	0.66	0.46	2.00	3.95	4.45	2.04	1.25	5.70	1.41
1989	0.75	0.40	2.31	3.65	3.87	1.97	1.25	5.10	1.37

Source: Direccion General del Tesoro

- Notes: (1) Neither perpetual debt, both domestic and external, nor the credits of the Bank of Spain are included. In the issues where the anticipated reimbursement is foreseeing, redemption in the first possible option for the holders has been considered.
- (2) It includes also the assumed debts in foreign currency.
- (3) In the column of Treasury Bills, the Treasury Bonds are included until 1982.

CHAPTER IV
REGIME APPLICABLE TO CAPITAL MOVEMENTS (*)

Contents

- | | | | |
|---|----|--|----|
| 1. General assessment | 67 | may be incompatible with Community law | 67 |
| 2. List of the provisions in the Spanish exchange control regulations which | | 3. Approaching time limits | 67 |

(*) This chapter was mainly prepared by Victor ANDRES MALDONADO of the Financial Engineering and Capital Movements Directorate

1. General assessment

Since its accession to the European Community on 1 January 1986, Spain has made substantial progress towards the ending of existing exchange controls, even acting well in advance of the time limits laid down, and thus complying with its undertakings.

Despite this fact, some problems still remain : it is possible that some rules do not comply with Community law in force regarding the free movement of capital. The rules concerned are those relating to the admission to the domestic capital market of foreign securities where they are dealt in on a stock exchange and the admission to a foreign capital market of fixed interest domestic securities where they are dealt in on a stock exchange.

2. List of the provisions in the Spanish exchange control regulations which may be incompatible with Community law

- In Spain, the movement of capital is not governed by comprehensive enacting terms, but by a number of different texts; sometimes the responsibility for drafting and implementing these texts lies with several government departments.
- Some of these texts, in particular those relating to direct investments, investments in real estate and portfolio investments, have been supplemented and amended to render them compatible with Community rules. Nevertheless, a provision still remains which contravenes Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty. The provision requires the submission for prior authorization of Spanish direct investments abroad (Royal Decree 2374/86 of 7 November, Article 5(3)) which, because of their size, their nature or their financial characteristics, may have detrimental consequences for the national economy.

Directive 88/361/EEC establishes the obligation that all direct investments abroad by Spanish residents shall be unconditionally liberalized (IB of the Nomenclature).

- Most personal capital movements and operations such as transfers in performance of insurance contracts, authors' royalties, damages, etc., are referred to in a specific text liberalizing current invisible transfers (Ministerial Order of 14 September 1989, subsequently developed by the DGTE Resolution of 25 March 1985). Nevertheless, the current situation poses the following problem : the list of operations liberalized by the said DGTE Resolution, is not exhaustive

and those which are not explicitly mentioned remain subject to prior authorization. In particular, this is the case for certain invisible transfers, which are considered to be capital movements that are unconditionally liberalized under community law (headings X, XI and XIII of the Nomenclature of Directive 88/361/EEC).

- Under Spanish rules, authorization is required for the issue and placing on the domestic capital market of foreign securities where they are dealt in or in the process of introduction to a stock exchange in a Member State. Authorization is also required for the issue and placing of domestic fixed interest securities on a foreign capital market where they are dealt in or in the process of introduction to a stock of exchange in a Member State.

In all the cases mentioned above, Directive 88/361/EEC establishes an obligation for the unconditional liberalization of the capital movements concerned (Annex IV, List II, heading III B of the Nomenclature).

3. Approaching time limits

Council Directive 88/361/EEC for the full liberalization of movements of capital, which entered into force on 1 July 1990, sets a transitional period for Spain which will end on 31 December 1992. At this date, all remaining restrictions will have to be lifted. The restrictions in question apply to the following capital movements :

- admission to the domestic (foreign) capital market of foreign (domestic) securities not dealt in or in the process of introduction to a stock exchange in a Member State (Annex IV, List III, heading III B of the Nomenclature);
- admission to the domestic capital market of the units of foreign collective investment undertakings not subject to Directive 85/611/EEC (Annex IV, List III, heading IV B 1 of the Nomenclature);
- medium-term and long-term financial loans and credits (Annex IV, List III, heading VIII A and B 2 and 3 of the Nomenclature);
- the operations referred to in Annex IV, List IV; these are mainly operations in securities dealt in on the money market, operations in current and deposit accounts with financial institutions and short-term financial loans and credits.

The Minister of the Economy declared in September 1991 that the Spanish Government will eliminate, by the end of 1991, all remaining restrictions on the free movement of capital, well ahead of the deadline established in the Council Directive 88/361/EEC of 31 December 1992.

CHAPTER V THE FINANCIAL SYSTEM (*)

Contents

<p>1. The Credit Institutions69</p> <p>1.1. The Spanish banking system69</p> <p>1.2. Recent trends in the banking system . .69</p> <p>1.3. Operational costs and profitability of credit institutions69</p> <p>1.4. The different types of credit institutions and their relative positions70</p> <p>2. The Stock Exchange72</p> <p>2.1. Principal characteristics73</p>	<p>2.2. The Stock Exchange and the financing of the private sector 73</p> <p>2.3. The modernization of the Stock Exchange : 73</p> <p>2.3.1. The general framework 73</p> <p>2.3.2. The institutional structure 73</p> <p>2.3.3. Technical changes 74</p> <p>2.3.4. Other developments 75</p> <p>3. Conclusions 76</p>
--	--

(*) This chapter was mainly prepared by Victor ANDRES MALDONADO of the Financial Engineering and Capital Movements Directorate.

1. The Credit Institutions

1.1. The Spanish banking system

Spanish banking had been traditionally a closed and heavily regulated system protected from external competition, conservative in terms of innovations and controlled by the large banks which also owned large portions of Spanish industry (at present, the relative importance of banks' ownership in Spanish industry is still large though declining). Because of the fact that the Spanish financial system and private economic agents were very unsophisticated, banks got their main input, deposits, at a very low cost and were required to finance cheaply public expenditure through rather high investment requirements. In exchange, large banks were allowed to coordinate their market strategies in a context of complete regulation of interest rates.

The oil price increases of the 1970s and the resulting industrial crisis imposed a severe shock to the banking system which led as a result to many bank failures and rescues during the 80's. The banking sector crisis caused a reduction in the number of independent banks and slowed down the deregulation process which had begun in the mid 1970s.

In the last fifteen years banking in Spain has undergone a process of liberalization, the result being a banking system with a higher degree of concentration and a profitability level (net profit/total resources) roughly similar to European standards. At the same time, it doesn't seem to be very efficient (because of its comparatively high intermediation margins) though well capitalised in terms of solvency ratio, and a system which looks, maybe paradoxically, overbanked¹ and basically oriented towards the Spain domestic market and, thus, not very involved in foreign trade and international operations.

Removal of barriers, with the completion of the European single market, and the introduction of new financial products and services in the Spanish banking industry, are likely to put some competitive pressure on the industry and to compel financial institutions to streamline their operations.

1.2. Recent trends in the banking system

The banking business not only in Spain but all over the world, has been going through a period of rapid and profound changes. Some of those changes stem from the trend to eliminate regulations and rules that limit the capability, and the commercial and operational activities that can be performed by each entity (*deregulation*). The objective is to get the economic freedom and a common level playing field for all agents working in the financial system. In this context, the importance of the *disintermediation* process through which savers and investors are put in contact directly in order to re-

duce intermediation margins, thus, making the financial system more efficient should be stressed.

The more active international market and the influence of a country's financial system on other countries' financial systems highlights the importance of the process of *internationalisation*. The large scale involvement of banks in international business has added new dimensions to the macroeconomic aspects of banking, partly reflecting a change in the international role of banks in response to, and as a cause of, profound modifications in the financial environment. As a consequence of the deregulation process, the financial system needs higher solvency levels of the different market agents; the trend is to increase the requirements of own resources in relation to risky assets both on investor protection grounds and to prevent and reduce the risks of a systemic crisis (*capitalisation*). In line with this, there is also a trend that could seem contradictory to the liberalisation process referred to above but which is not incompatible, that is the enhancing of the control and supervisory activities on banks in order to make them comply with the prudential rules (*supervision*). Finally, we should point to the *consolidation* trend which emphasizes the fact that nowadays, the banks are not exclusively confined to their traditional banking operations and engage in different activities to become financial holdings. This situation emphasizes the need for a consolidated supervision so as to avoid that a solvency problem generated in a part of the holding could threaten the financial stability of the whole group.

1.3. Operational costs and profitability of credit institutions

Apart from these general trends in banking, the trend towards despecialisation and liberalisation is occurring in Spain in ways similar to that in many European countries. This fact is very important in order to assess the relative profitability and the degree of competition between various financial intermediaries.

Comparing Spanish financial institutions with those in other countries, they seem less efficient because of higher than average intermediation margins (mainly due to the lack of sophistication of Spanish savers and to certain cartel practices which impeded competition between banks²; moreover, operating expenses are also at the top of the range pointing to excessive production costs, in part due to the overstaffing and overbranching of banks.

Intermediation margins are large in Spain in comparison with other countries; those margins are partly distorted because of the existence of compulsory liquidity, solvency and investment ratios. These ratios represent a cost to financial

1 In the sense that the importance of the Spanish banking system compared to other financial and non-financial sectors is relatively higher than in other Western economies. However, in general, big Spanish banks are substantially smaller than their European, American and Japanese counterparts.

2 However, over the last months the first signs of change in this situation have taken place through an increase in competition on the liability side of financial institutions with the introduction of highly-remunerated accounts.

institutions that is passed on to the customer in the "free-funds" operations.

- **Liquidity ratio.** Spanish private and savings banks were required to keep 17% of their liabilities as deposits in the Bank of Spain. A share of these deposits (9,5%) received was remunerated at 7,75%. The level of the ratio as well as its return have been changed by the Bank of Spain quite frequently. This requirement played an important role in the financing of the Spanish public deficit since a high ratio allowed a high rate of growth of the monetary base (and higher seignorage) for the same rate of growth of a broader monetary aggregate. In March 1990, the government lowered the liquidity ratio to 5%, essentially by suppressing the 11,5% part with yield which was replaced by the introduction of Bank of Spain certificates (a financial instrument that will be progressively redeemed by the year 2000), in order to maintain the competitive position of Spanish banks.

- **Solvency ratio.** Since May 1985, Spain regulates the solvency of financial intermediaries through the "coeficiente de garantía" ratio which requires a certain level of capital depending on the risk-weighted measure of total assets. The Spanish banking system does not seem to be suffering from the same solvency problems recently observed in some major world banking systems (the US, Japan, etc.). The Spanish banks are well capitalised, the Spanish solvency ratio being one of the highest in the Western world³.

The Cook Report (Basle) proposed a solvency ratio of 8% to make homogeneous throughout the world the different solvency ratios of banks and financial institutions; on this line, an EC directive on the solvency ratio of credit institutions was adopted at the end of 1989. In 1987, Spain started to implement these recommendations by requiring that no single risk could exceed 40% of the capital of a credit institution. Moreover, loans to group firms (or board members) are risk-weighted penalized. The very high level of the solvency ratio of Spanish credit institutions stems from the fact that the Spanish regulations in this field are, at present, stricter than both the EEC directive and the Cook Committee recommendations.

- **Investment ratio.** Since 1987, this ratio applies almost exclusively to public debt holdings⁴. In October 1988 the investment ratio was 11% (10% devoted to public debt). The Government committed itself (January 1989) to a gradual phasing out of this ratio, which will disappear completely by January 1st 1993. At present it is fixed at 6,2%.

Table 1: Spanish banks' profitability ratios (%)

	Commercial Banks				Savings Banks			
	1986	1987	1988	1989	1986	1987	1988	1989
Net profits/ Total assets	0.83	1.02	1.38	1.54	0.96	1.34	0.78	1.10
Net profits/ Own resources	14.2	16.9	19.6	21.1	16.1	21.8	12.7	18.9

Source : Bank of Spain - Boletín Económico - Abril 1990

Another important point is the degree of profitability of Spanish credit institutions. Both measures, the level of net profits on total assets and the return on own resources, are above EEC averages. Rather high intermediation margins are partly compensated by excessive operating costs. Thus, the result is a quite healthy level of profitability, though it is not remarkably above their European counterparts.

1.4. The different types of credit institutions and their relative positions

The basic institutions of the Spanish financial system can be classified in the following categories: regulatory institutions, banking institutions, official credit institutions and other financial institutions.

The Bank of Spain is the sole regulatory body of the credit system. The Central Bank is the banker of the state and performs all the functions usually entrusted to a central bank (supervision and control of banks⁵, implementation of monetary policy and lender of last resort). Since the early 1980s, legal changes have been made to increase the independence of the Central Bank from the Treasury. Nowadays, the Central Bank is not yet formally independent of the Treasury but the implementation of the monetary policy has become more flexible and a change in operational procedures has taken place.

The credit system includes :

- Banking institutions

- commercial banks (Banca privada) with 60% of the total assets of the credit system.

³ As of 1.1.1990, the solvency ratio calculated on the basis established in the EEC directives was 11,5% for the whole banking system.

⁴ The government had previously financed its deficits mainly, through the central bank until the late 1970's and early 1980's; then, in order to avoid inflationary pressures, it found itself obliged to offset this monetary financing through the sale of its own liabilities (CD's and monetary regulation certificates) to the public. The lack of a market in long maturity debt called for the creation of several money market instruments such as promisory notes, Treasury bills, commercial paper, Treasury savings deposits, etc. Thus money market instruments have supported until now the main burden of public deficit financing.

⁵ As regards this subject it is worthwhile mentioning that the supervisory powers of the Bank of Spain on financial credit institutions were notably enhanced by the law 26/1988.

- ii) Savings banks (Cajas de Ahorro) with less than 1/3 of the total assets.
- iii) Cooperative savings banks (cooperativas de crédito), with 3% of the total assets.
- Official credit institutions: are entities that were created to provide cheap financing for specific needs (housing, industry, local authorities ...), but now they are more market oriented. They hold 8% of the total assets.
- Other financial institutions: money market houses (SMMD), investment funds, stock exchange brokers ...

• *Banking institutions :*

- *Commercial Banks*

There are about 75 domestic commercial banks, 20 merchant banks and more than 50 foreign banks with a total of 16.500 branches. Business has, however, tended to concentrate in a small number of banks (the six big banks control about 50% of the total assets of commercial banks). With the exception of industrial banks and small commercial banks, commercial banks are net borrowers in the interbank market. An important element is the fact that banks are usually of the universal type, hence they control large sections of the industrial base.

The far-reaching changes in the financial environment in Spain - liberalisation, changing customer attitudes, etc... - have had a substantial effect on the banks' assets and liabilities structure. The deposits of the private sector, which accounted for one-half of total liabilities in 1982-83, had dropped to nearly one-third by the end of 1988.

The non-financial private sector has replaced those low-yielding deposits with instruments paying interest closer to market rates, mainly in the form of repurchase agreements and current accounts with high interest. On the asset side, public sector finance has increased. This reflects the increased financing of the public sector on financial markets (short and long-term, but mainly through money market instruments).

Table 2: Comparative importance of Spanish credit institutions (measured by total assets)

	December 1989	
	ESP bn	%
Commercial Banks	38.756	56.3%
Savings Banks	22.944	33.3%
Cooperative Savings Banks	1.804	2.6%
Official Credit institutions	5.235	7.6%
TOTAL	68.739	100

Source : Bank of Spain, Boletín Estadístico.

Table 3: Structure of balance sheets of banking institutions (ESP, bn, end of 1989)

Assets	comercial banks		savings banks		cooperative banks	
	ESP bn	%	ESP bn	%	ESP bn	%
Bank of Spain	3006	7.7	2707	11.5	253	14.3
Financial sector	6287	16.2	2868	12.2	439	24.3
Public sector	5899	15.2	5332	22.6	185	10.2
Private sector	17715	45.7	9817	41.7	807	44.7
Non-residents	2823	7.2	196	0.8	1	0.1
Others	3028	7.8	2026	8.6	119	6.6
Liabilities						
Bank of Spain	1554	4.0	559	2.3	0	0
Financial sector	5935	15.3	739	3.1	87	4.8
Public sector	1657	4.2	1133	4.8	69	3.8
Private sector	19364	49.9	16811	71.5	1380	76.5
Non-residents	4377	11.2	450	1.9	6	0.3
Others	5872	15.1	3253	13.8	260	14.4
TOTAL	38759	100	23504	100	1802	100
Share in total of the banking sector	60.4		36.6		2.8	

- Savings banks

There are about 80 savings banks in Spain and the sector as a whole holds about 30 % of the assets controlled by all credit institutions. This sector is made up of the Post Office Savings Banks (Caja Postal) and savings banks. Its market share has increased continuously during the 1980s, due mainly to the relaxation of the limitations on savings banks' expansion. As a result, the distinction between savings banks and commercial banks has become more blurred and they now compete in many areas for the same business. Nevertheless, this trend towards uniformity among commercial banks and savings banks is not yet completed because, for instance, savings banks have nearly no relationship with the foreign sector and they have a different fund base linked more to small household depositors; they are the main providers of funds on the interbank market and they also hold a relatively larger share of their assets in public sector securities. Savings banks are on average much more orientated towards the retail banking market than the commercial banks (providing 60% of credits to the private sector) and they are less active in financing industrial enterprises.

Moreover, an important concentration process has been taking place in this sector since the beginning of 1990. This fact will undoubtedly introduce a new element of rationalization and increase the competitive edge, both at the national and international levels, of the Spanish savings banks.

- Cooperative Savings Banks

These include two sorts of institutions :

- the rural banks (whose members are agricultural cooperatives)
- general cooperatives.

Their importance, as we can see in Table 2, within the Spanish banking sector is very small (3% of total assets). More than three-quarters of their liabilities take the form of deposits from the private sector, mainly in savings and term deposits. On the asset side, they are traditionally net suppliers to the interbank market.

- Official Credit Institutions

They are state owned limited liability companies that act on behalf of monetary authorities trying to complement private initiatives. They represent less than 10% of the assets of the financial system.

Instituto de Crédito Oficial (ICO) coordinates and directs the official credit institutions and also provides most of their funds (the rest of the funds come from loans from the state and borrowing from the capital and interbank money markets).

The institutions are Banco de Crédito Agrícola, Banco Hipotecario de España, Banco de Crédito Industrial and Banco de Crédito Local. Each of these institutions act in their own field: agriculture, housing, manufacturing industry and local authorities, respectively.

The official Credit Institutions have been recently integrated within a financial holding company: The Corporación Bancaria Española.

- Other Financial Institutions

In view of the development and sophistication of the money market, the authorities permitted in 1981 the establishment of money market intermediary companies - Sociedades Mediadoras en el Mercado de Dinero (SMMD). These shareholding companies are permitted to operate (on their own account or on behalf of third parties) in all money market instruments as well as government debt.

Supervised by the Bank of Spain, they are obliged to hold at least 20% of their assets in short-term public debt securities while their investment in certificates of deposit issued by banks participating in the company, may not exceed 10%. Their operations involve a wide range of activities, but they are mainly active in arranging securities' repurchase agreements. Contrary to the brokers who are only intermediaries between banks, the SMMDs take positions on their own account.

2. The Stock Exchange

The Spanish Stock Exchange is relatively small in comparison to its main European counterparts and the size of the Spanish economy. Thus, its role in channeling private sector savings towards private sector investment projects is a modest one. Aware of the fact that this will put it at a disadvantage in the single financial market which is due to be completed in 1992, the Spanish authorities have embarked on an ambitious modernisation programme to make it more efficient and capable of coping with the challenge of foreign competition.

Table 4: Structural data for the stock exchange in 1989

	Shares	Bonds
Number of Quoted Securities	417	1.351
Market Capitalisation:		
- in billion PTS	13.457	7.647
- in % of GDP	30,0	17,1
- in % of EUR 12	6,3	2,0
Volume of transactions:		
- in billion PTS	3.817	206
- in % of market capitalisation	28.4	2.7

Source: Committee of EEC Stock Exchanges

2.1. Principal characteristics

- Market capitalisation

The Madrid stock exchange represents 6,3% of total EEC stock market capitalisation of shares. It ranks in 6th place just behind the Amsterdam stock exchange and very far away from London, German and French stock exchanges (which represent 35%, 18% and 17%, respectively). As regards its relative importance to the whole economy, it is better placed than some of its main European counterparts with a stock market capitalisation of shares of just 30% (against 78% for London, 26% for Germany and 18% for Paris).

As it can be seen in Table 4, the development and relative importance of the Spanish bond market, which includes basically non-government securities, is even smaller than that of the share market. However, it is worthwhile mentioning the vigorous growth that the off-exchange market for public debt (supervised by the Bank of Spain and based on a extremely efficient book entry system) has experienced since its creation in 1987.

Its market capitalisation represents a very meagre 2% of the whole EEC market and a mere 17,1% relative to GDP, very far behind some other EEC countries (4% and 58% for Amsterdam, 14% and 295% for Milan, 21% and 55% for Germany, etc...).

- Volume of transactions

In terms of capitalisation, the volume of transactions is 28,4% for shares and 2,7% for bonds. Again, despite being relatively smaller, the Spanish share market can be compared to other EEC markets (25,1% for Milan, 32,8% for Paris, 43,9% for London, etc...). On the contrary, the bond market is well behind its European counterparts (31,3% for Amsterdam, 76,6% for Germany, 150% for Paris, 17,5% for London, etc ...).

In both cases, the low level of market capitalisation (primary market) and the very reduced volume of transactions (secondary market) denote a clear lack of development of the Spanish bond market. This loophole should be adequately filled in the future if a harmonious and well-balanced development of the whole financial system is to be achieved.

2.2. The stock-exchange and the financing of the private sector

The stock exchange's role in financing the private sector investment needs is a modest one. During the last few years a declining trend has been clearly observed which has led to a significant reduction in the relative importance of shares and bonds in financing the private sector (from 32,8% of the total in 1985 to a mere 12,7 in 1989) in favour of credit financing (from 43,9% to 63,0%) (see Table 5). This can be explained by two main reasons: First, an important increase in household borrowing from credit institutions to finance a higher level of durable goods consumption and housing investment because of the wealth effect associated with economic expansion. Second, a much higher use of non-distributed

Table 5: New liabilities of non-financial enterprises and households

Billion PTS	1985	1986	1987	1988	1989
Shares	667	799	817	803	1.043
Bonds	233	291	-110	7	-90
Borrowing	1.205	1.505	3830	4.699	4.727
Commercial paper	36	265	-394	150	229
Other	606	666	861	126	1.591
TOTAL	2.747	3.526	5.004	5.785	7.500

Source: Bank of Spain, Annual Report 1989.

profits (auto-financing) in the investment financing mix of non-financial enterprises because of the improvement in industrial margins throughout the business expansion cycle and the relatively high level of real interest rates.

The role of the stock market in financing the private sector has been clearly declining since 1986 (see Table 6) to reach an almost non-existent one in 1989. The October 1987 market crash and the subsequent instability of the stock market imposed a severe shock on investor confidence which has given few opportunities for enterprises to issue new shares. Moreover, the high level of real interest rates and, to a certain extent, the conversion into shares of important amounts of convertible bonds issued before 1986 has led to the practical disappearance of the bond market as a financial channel for the private sector.

Table 6: New liabilities of non-financial enterprises Public issues through the stock markets

Billion PTS	1985	1986	1987	1988	1989
Shares	152	219	282	242	102
Bonds	216	270	-94	-27	-119
TOTAL	368	489	188	215	-17

Source: Bank of Spain, Statistical bulletin

2.3. The modernization of the stock exchange

2.3.1. The general framework

For the stock exchange to be able to meet the needs of the Spanish economy and in order to make it capable of coping with the challenge and competitive pressures that other EEC financial centres will put on it after the creation of a single financial area throughout the EEC, the Spanish authorities have begun a process of modernising the stock exchange. This process is inserted within a vast transformation programme of the whole financial system which ranges from the

functioning of the public debt market, the creation of pension funds, and so on.

Law 24/1988 of 28.7.1988⁶ constitutes the cornerstone of the stock exchange reform, which has as a general objective the promotion and modernization of the Spanish stock markets. In concrete terms, it aims at:

- a) improving the efficiency and security of the operational aspects of the market by the introduction of a continuous market where transactions are handled through CATS (Computer Assisted Trading System), an electronic system replacing the physical presence of brokers on the trading floor.
- b) promoting a higher degree of competition between market participants by liberalizing the access to market membership, thus abolishing the stockbrokers' monopoly and liberalizing intermediation fees and commissions.
- c) increasing the financial capacity and capital requirements of intermediaries so as to allow them to develop their own commercial networks, as well as to take risks on their own behalf.
- d) establishing adequate channels to diffuse information and improve transparency of the stock market by implementing tighter rules in this field.
- e) upgrading the supervision of market trading and intermediaries by setting up a new public supervisory and regulatory body: the Stock Exchange National Commission.

2.3.2. The institutional structure

The law 24/1988 modified the institutional structure of Spanish stock markets. In Graph 1 the new institutional arrangements can be seen:

- a) The Stock Exchange National Commission⁷: This is the body in charge of the regulation and control of both the primary and secondary stock markets as well as the supervision of all stock market intermediaries.
- b) Securities agencies and companies⁸: They constitute the only market intermediaries. They are subject to a minimum capital requirement (750 millions pesetas for companies and 150 millions for agencies), solvency ratios and liquidity ratios. Securities companies can deal

on their own behalf, deal on credit with their clients and engage in underwriting operations. Both companies and agencies can open branches throughout Spain and abroad, have access to intermediaries on the public debt market, deal in foreign currency operations, engage as portfolio managers and become depositaries of investment funds. They are subject to the supervision of the Stock Exchange National Commission in their stock market operations and of the Bank of Spain in their public debt market and foreign currency operations.

- c) Governing bodies of the Stock Exchanges⁹: One governing body exists for each of the four Spanish Stock Exchanges (Madrid, Barcelona, Bilbao and Valencia). They are legal public companies whose shares are owned by those securities companies and agencies which are members of the Stock Exchange¹⁰. The governing body of a Stock Exchange is in charge of the organisation and functioning of the Stock Exchange, authorising the admission to the official quotation of any security and diffusing any piece of news related to market trading and financial balance sheets of issuers and members of the Stock Exchange.
- d) Stock Exchange Company¹¹: This Company is owned (25%) by each of the governing bodies of the four Stock Exchanges. It is in charge of the functioning of the Interconnected System¹² (or Continuous Market) by which the previously isolated and independent Stock Exchanges of Barcelona, Bilbao, Madrid and Valencia become integrated in a single market. Through this system, a direct connection on a real time basis is established between the four Stock Exchanges so that a single price is settled for the same security at each moment. As a result, the liquidity of the market for any security dealt with through the system is clearly enhanced, since all trading is concentrated in a single market.
- e) Clearing and Settlement Service¹³: All activities related to the Clearing and Settlement of trading carried out in any Stock Market are concentrated in this service.

2.3.3. Technical Changes

Along with the new institutional structure, some important technical changes are underway since the reform took place:

6 It entered fully into force on 29.7.1989.

7 Comisión Nacional del Mercado de Valores (CNMV).

8 Agencias y Sociedades de Valores.

9 Sociedades Rectoras de las Bolsas de Valores.

10 The access to a stock exchange membership is reserved to Securities Companies and agencies. From 1993 onwards able to either buy existing securities companies and agencies or establish new ones, and thus, will have free access to stock market membership. Until 1993 a transitional period is foreseen during which limitations to buy already established companies and agencies are progressively phased out.

11 La Sociedad de Bolsas.

12 Sistema de Interconexión Bursátil (SIB).

13 Servicio de Compensación y Liquidación de Valores (SCLV).

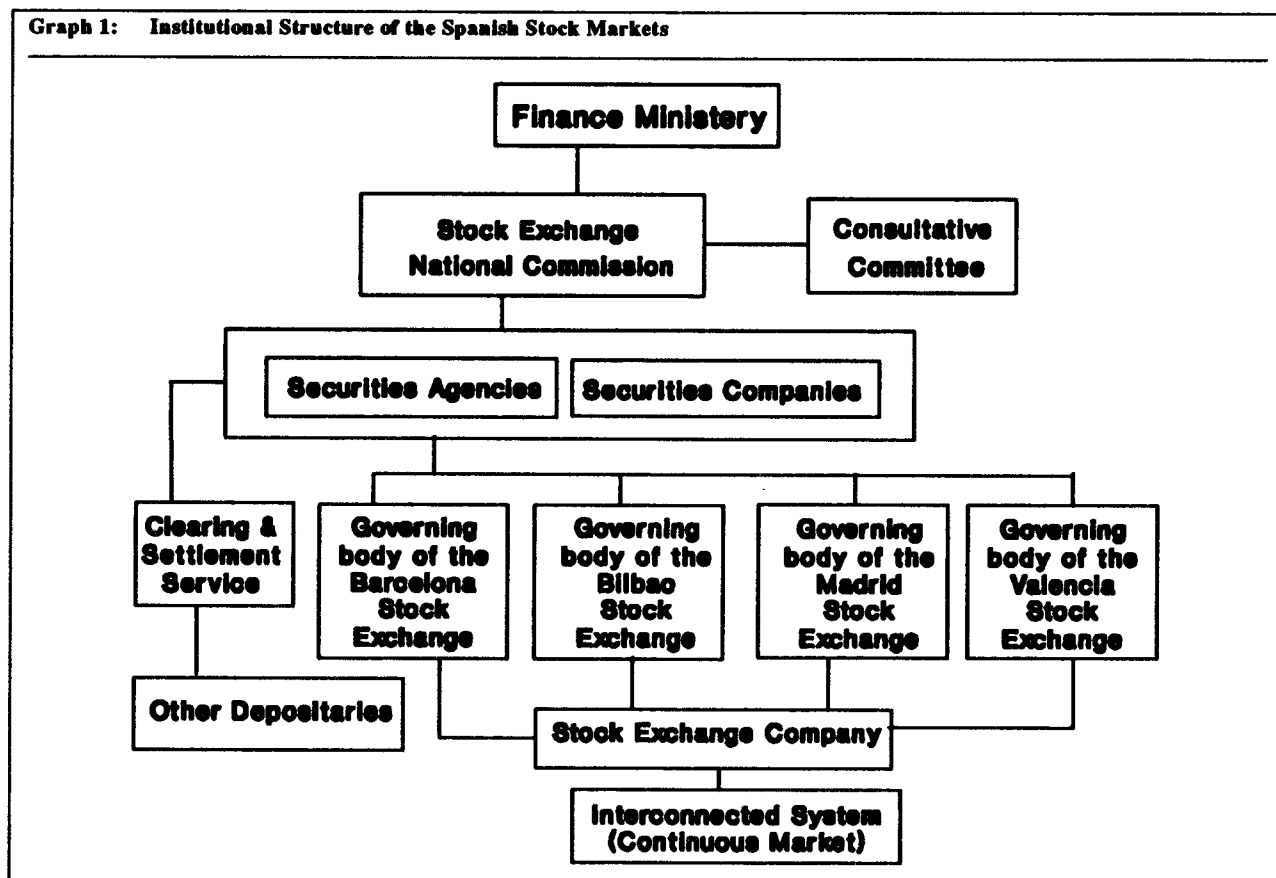
- a) Introduction of CATS (Computer Assisted Trading System), which has replaced on-the-floor stockbrokers trading. It started on 24.4.1989 with five securities and it is foreseen that by the end of 1990 it will reach 85% of the whole volume of transactions and 85% of market capitalisation, leaving the rest to be quoted through the old system ("à la criée"). The continuous market has larger opening hours than the traditional market (10.00 to 17.00 instead of 10.00 to 12.00) and trading on a single security can be carried out during a much longer period (7 hours instead of 10 minutes). The CATS makes the process of "order channelization - execution - matching" easier and safer, thus increasing the efficiency of the whole market.
- b) introduction of different mechanisms which improve information diffusion on a real-time basis to market intermediaries (situation of trading, prices, positions, etc ...) and to the public.
- c) improvement in the clearing and settlement system, in particular in those trades where registered securities are dealt with.

2.3.4. Other developments

In order to improve the attraction of the Spanish Stock Market and make it more competitive internationally, two important steps have been recently taken :

- a) The admission to official quotation of foreign shares: During the second half of 1990 two foreign shares began to be traded for the first time in the continuous market (Volkswagen and Commerzbank) and a few others are foreseen to follow in the near future.
- b) The opening of a futures market in Barcelona (MEFFSA) and an options market in Madrid (OM ibérica)¹⁴ in March 1990 and in November 1989, respectively. These two separated markets have recently constituted a single holding company (MOFFEX) to improve the efficiency and reduce the costs attached to both markets, reorganizing its activities so that in the future the quotation and dealing on futures and options on fixed interest rate instruments will be made in Barcelona and on equity in Madrid.

Graph 1: Institutional Structure of the Spanish Stock Markets



14 Meffsa's 34 shareholders, including the main commercial and savings banks, trade contracts at a national level with a nominal value of 10 million PTAs and a three-year maturity. The average daily trading volume has doubled to 1.250 since the market started, which is still very low by international standards. In October 1990, it began trading contracts based on a 90-day 10 million PTAs deposit linked to the Madrid interbank offered rate (MIBOR). The options market trades similar contracts as the future market. It is foreseen that index-linked contracts could be on the screens by the middle of 1991.

3. Conclusions

The Spanish banking system had been traditionally a closed and heavily regulated system protected from external competition. In the last fifteen years it has undergone a process of liberalisation, the result being a banking system with a higher degree of concentration and a profitability level roughly similar to European standards. Removal of barriers, with the completion of the European single market, and the introduction of new financial products and services are expected to increase competitive pressures in the sector (not only from foreign banks but also between domestic financial institutions). This is already taking place, although it will probably be felt only in a moderate and progressive way in some segments of the banking system (i.e. in the retailing sector, since the cost of either establishing a new, or buying an already existing commercial branch network, could prove

so important a deterrent for the entry of newcomers as a legally binding limitation).

On the other hand, the Spanish stock exchange is relatively small by comparison with its main European counterparts and the size of the Spanish economy. Thus its role in channelling private sector savings towards private sector investment projects is a modest one. Aware of the fact that this will put it at a disadvantage in the future single financial market, the Spanish authorities have embarked on an ambitious modernization programme to make the stock markets more efficient and capable of coping with the challenge of foreign competition. It is expected that this process of reform will harvest high rewards in the coming years. Nevertheless, this does not mean that the Spanish stock market will necessarily increase its weight in Europe to any substantial extent.

CHAPTER VI
THE CONDUCT OF MONETARY POLICY IN SPAIN (*)

Contents

1. Monetary targeting in Spain	78	2.2. Deficit funding and the efficiency of monetary policy	80
1.1. Targets	78	2.3. The ERM constraint and capital flows	81
1.2. Instruments for monetary control	78	3. Monetary targets and indicators in a changing environment	82
2. Difficulties of monetary control	79		
2.1. Financial innovation and monetary aggregates	79		

(*) This chapter was mainly prepared by Manuel SANCHIS I MARCO of the Monetary Directorate.

1. Monetary targeting in Spain

1.1. Targets

The Bank of Spain began in 1971 to establish quantitative targets for the rate of growth of the money supply, abandoning the system of quantitative credit controls applied until then; the policy of monetary control did not start to be pursued in an effective manner until May 1973.

For several years, the target for monetary growth has been fixed in the form of a range of ± 1.5 to ± 2 percentage points around the central rate¹. The target is evaluated at the end of the year, on the basis of monthly averages of daily figures. These are normally values observed for December (variations over 12 months); however, when exceptional factors are involved, the moving average for the last three months of the year is considered.

From 1973 to 1983, *the intermediate target for monetary policy was a growth rate for M3 on a standard definition*². In the early 1980's there was a significant shift of funds away from financial instruments subject to reserve requirements and towards instruments which were not subject to such requirements and could consequently offer higher returns. At the same time, increased taxation induced a shift from financial assets subject to withholding tax towards assets free of withholding tax. Finally, a large number of financial innovations were also introduced from 1983 onwards and a series of non-monetary but very liquid assets and with high return, representing a substitute for money, developed. In particular, the short-term non-monetary liabilities of the banking system grew rapidly.

All these factors affected the stability, predictability and controllability of M3. The Spanish monetary authorities were thus led in 1984 to select, as a new intermediate quantitative target, *a broader aggregate, namely ALP or liquid assets in the hands of the public, although M3 remained a closely-watched monetary indicator*³. The new target variable was selected on the basis of econometric evidence showing that its relationship with nominal income was more stable and therefore more predictable than that of M3 - a property confirmed by more recent empirical work. The new target, however, has the particularity of being composed of liabilities of both the banking system and the Treasury (on particular Treasury Notes and repos and, since 1987, Treasury Bills); this has direct implications for the conduct of monetary policy. Finally, the authorities announced in 1991 the targeting of ALP and the close monitoring of a wider ALP that in-

cludes commercial paper (credit ceilings - see pages 8 and 9 below - had led to a disintermediation process through the issue of commercial papers by companies; the lifting of ceilings in January 1991 is producing reintermediation and a swelling of traditional ALP). The authorities consider monitoring of an aggregate even wider than ALP as a transitory step before adopting a less broad aggregate like M3, more in line with the current process of harmonization of monetary aggregates within EEC member States.

1.2. Instruments for monetary control

Since 1973, monetary control has relied upon the existence of reserve requirements applied to a majority of the instruments included in M3/ALP. The Bank also influences the evolution of the free reserves of the banking system by lending and borrowing operations, and open market operations.

Since October 1978, there has been a *single required reserve ratio*, common to all institutions⁴ and to all categories of eligible liabilities. The definition of eligible liabilities is very close to the definition of M3/ALP. The Treasury Notes and Bills holdings of the public and the temporal transfer of public assets (repos) by the banking system to the public are now the main instruments not subject to the reserve requirement but included in the monetary aggregate ALP. The required reserves consist of deposits with the Bank of Spain and notes.

The reserve ratio was not changed between 1978 and 1982, but has since been changed several times. The most important changes were made in 1984 and 1990. In 1984, required reserves were increased very substantially and a remunerated tranche was created within them. This replaced the system of special deposits previously used. When making this decision, the authorities took account of the consequences of the reserve requirement on bank profitability and aligned the rate of remuneration on the money market rate, whereas previously special deposits had been remunerated at a distinctly lower rate.

On March 23, 1990 the Bank of Spain⁵ introduced a major reform of the reserve requirements system according to which the coefficient was divided into two tranches: (i) a non-remunerated minimum reserve tranche of 5%; and (ii) a remunerated tranche (increased up to 12%) in force until 2 May 1990, and substituted thereafter by Certificate of Deposits (CD) issued by the Bank of Spain at a 6% interest rate. The banks have to hold these CD's in their portfolio as

1 In 1988, however, the central point was abandoned.

2 That is, notes and coins in the hands of the public plus sight, savings and term deposits.

3 ALP is composed of M3 plus a series of liquid financial assets such as deposits linked with insurance operations, promissory notes, mortgage bonds, endorsements of commercial paper, guaranteed corporate bonds, private and public paper for repurchase agreements and Central Bank paper (certificates of monetary regulation) as well as Treasury Notes and Treasury Bills sold to the public.

4 The entire bank sector (including the savings banks) is subject to reserve requirements. They also apply to other financial institutions, such as credit cooperatives; however, this does not come within the framework of monetary control but is the result of the authorities' determination not to give comparative advantages to certain institutions within the financial system.

5 See circular no 2/1990 of 27 February 1990.

non-negotiable assets but are able to transmit them, within certain limits, between credit institutions. The CD's will be progressively redeemed every six months starting 23 March 1993 and ending September 2000.

The control of money market conditions has been traditionally exerted through action on the liquidity of banks and the level of the minimum reserve requirements. More recently, however, the monetary strategy has shifted from the control of quantities to that of prices and the liquid assets of the banking system has progressively lost its nature of instrumental variable to be controlled in the short-term. Nowadays any overshooting or undershooting of this variable does not trigger an automatic reaction on behalf of the authorities.

Since 1988 the monetary authorities have aimed at stabilizing the overnight interbank deposits rate around a fluctuation band previously established by them. To achieve the latter the Bank of Spain has used two different instruments:

- (i) First, the traditional lending instruments to the banking system, that is, the daily auctions of *Monetary Regulations Loans* (in force from September 1977 until 14 May, 1990) substituted since May 1990 (at a time when the reserve requirements was redefined and reduced) by the ten-day auctions of *Certificates of Deposit* of the Bank of Spain; and
- (ii) Second, the open-market operations with public assets of the portfolio of the Bank of Spain, namely under repurchase agreements, for both to inject and to mop up liquidity, that are called to become the main instrument to regulate the liquidity of the financial intermediaries in the future.

2. Difficulties of monetary control

In spite of the improvements in the monetary instruments held by the Bank of Spain and the almost immediate availability of information of some monetary aggregates (namely ALP), the way in which the Spanish monetary policy has been implemented in the last years has changed due to both financial and macroeconomic factors. Moreover, the monetary financing of the deficits and the constraints imposed by the exchange-rate policy have hindered the efficiency of monetary policy and money stock targets have been overshoot since 1987 (cfr. Table 1).

The traditional approach to monetary policy by means of indirect control of the monetary aggregates has been increasingly affected by financial innovations and financial market integration and by changes in the financial behaviour of the

public and the banks. In view of the uncertain and complex financial environment, the authorities have had increasing recourse to flexibility, discretionality and judgement in implementing monetary policy. They have progressively abandoned an approach to monetary control based on a two level quantitative target and on a normative behaviour for the interventions of the authorities in the money and exchange markets.

2.1. Financial innovation and monetary aggregates

- (i) A first element of uncertainty arises from the reduced capacity of ALP (the broad monetary aggregate, which includes holdings of liquid money-market instruments as well as the traditional components of M3) to give information about the evolution of nominal income and prices. Since 1987 it has become more difficult to distinguish between two alternative interpretations of an overshooting in ALP: an undesired evolution of nominal expenditure - that should, therefore, be corrected - or changes in the relative yields of ALP and non-ALP assets, which should be accommodated.

The development of ALP has been increasingly influenced by changes in financial markets, namely from 1987 onwards. First, the share of ALP composed of very liquid and profitable non-money assets has increased. Second, the distinction between means of settlements and assets held for financial investment purposes has become blurred as a result of financial innovation and a growing degree of substitutability among a large number of financial assets.

- (ii) Moreover, credit controls induced a disintermediation process in 1989 and 1990 as companies have been issuing commercial papers in large quantities. As a result, the authorities have been compelled to look closer the evolution of a wider ALP aggregate which, includes those commercial papers, and to set a tentative target for ALP and commercial paper for 1991.
- iii) The stability of the relation between the intermediate target (ALP) and the instrumental variable (bank liquidity) has also weakened. Instability of the money multiplier has resulted from the more frequent shifts in the portfolio of the public in reaction to changes in the yield and fiscal attributes of certain assets and also from the increasing capacity of bank operators to transform liabilities which are subject to the minimum reserve requirement into those which are excluded from that coefficient.

Table 1: Monetary and credit indicators (annual % change)

	M3		ALP		M1	M2	Domestic Credit Expansion
	Target	Outcome	Target	Outcome			
1980	16-20	16.1			12.2	11.4	19.8
1981	14.5-18.5	15.7			12.5	11.6	19.8
1982	13.5-17.5	15.2	15-19	17.7	6.9	8.0	20.1
1983		12.7	14-18	15.8	6.7	8.7	16.1
1984		12.9	10.5-14.5	14.4	7.7	7.1	11.6
1985		6.3	11.5-14.5	13.3	12.0	11.5	14.8
1986		4.1	9.5-12.5	12.1	13.0	12.9	13.3
1987		6.3	6.5-9.5	14.6	15.2	11.7	14.3
1988		11.2	8-11	12.1	17.8	15.6	15.4
1989		10.5	6.5-9.5	10.4	14.9	11.5	14.8
1990		14.8	6.5-9.5	11.3	27.0	17.9	10.2
1991		15.4	7-11	12.1	16.4	14.0	12.5

Source: Bank of Spain.

2.2. Deficit funding and the efficiency of monetary policy

The fact that the deficit has been directly financed for long periods by the Bank of Spain and/or by the banking system at subsidized conditions, has hindered the efficiency of the monetary policy, since the Bank of Spain was forced to sterilize, not always successfully, the implicit increase of base liquidity.⁶

Moreover, the short-term structure of public debt and the specific commercialization schemes have made monetary policy heavily dependent on the requirements of the debt management policy and has created additional problems for the former. Actually, the fact that Treasury Notes, Treasury Bills and repos of the financial institutions are not liabilities of the banking system but of the Treasury while they are included in the definitions of broad money (ALP) creates three problems for the accurate implementation of monetary policy:

- (i) *its effectiveness as instruments of control of the domestic counterpart of money creation is reduced* since the sale of Treasury Notes, Bills and/or repos from the portfolio of the Bank of Spain to the financial institutions, with the aim of mopping up the bank liquidity will be ineffective if these instruments are resold by the banking system to the public. If this were the case, there is

only a change in the structure of ALP while total amount remains unchanged.

- (ii) the Bank of Spain has to sterilize the excess of bank liquidity arising from the sales to the public of Treasury Notes, Bills and/or repos held in the portfolio of the financial institutions. Such an operation does not imply any increase of ALP but gives way to an increase in the bankliquidity. Actually, those banks reselling to the public those instruments can free reserves since the latter is not a part of the liabilities submitted to the reserves requirements;
- (iii) The scheme of commercialization of public debt developed in recent years has resulted in holdings in the public portfolios at a very short-term maturity. At a time when the demand for credit was strong (since 1986) the financial institutions incentivated the process of transferring repos to their customers since these operations allowed the banking system to free reserves because they were not part of the liabilities of the reserve requirements coefficient but were included in the ALP definition. Moreover, the latter made the public's portfolio less stable making the assessment of the monetary variables more difficult and the influence of Central Bank operations in bank liquidity less predictable.

⁶ The impact of domestic money creation on the monetary aggregates has of course been reduced since ERM entry; given the state of confidence in the currency, greater or lesser sterilization of deficit financing is likely to be largely offset by induced movements in the external counterpart.

2.3. The ERM constraint and capital flows

From mid-1988 onwards the Spanish economy started to show signs of overheating that became more obvious in 1989-1990. At that time, domestic demand was growing fast (6.9% in 1988) and in excess of output (5.2%) leading into price increases and trade balance deterioration.

However, the absence of a wage concertation policy for 1989 and the procyclical stance of fiscal policy made monetary policy the sole instrument then potentially available for fighting inflation. That policy mix imposed some constraints on the efficiency of monetary policy through the well-known dilemma in the face of strong external confidence in the peseta :

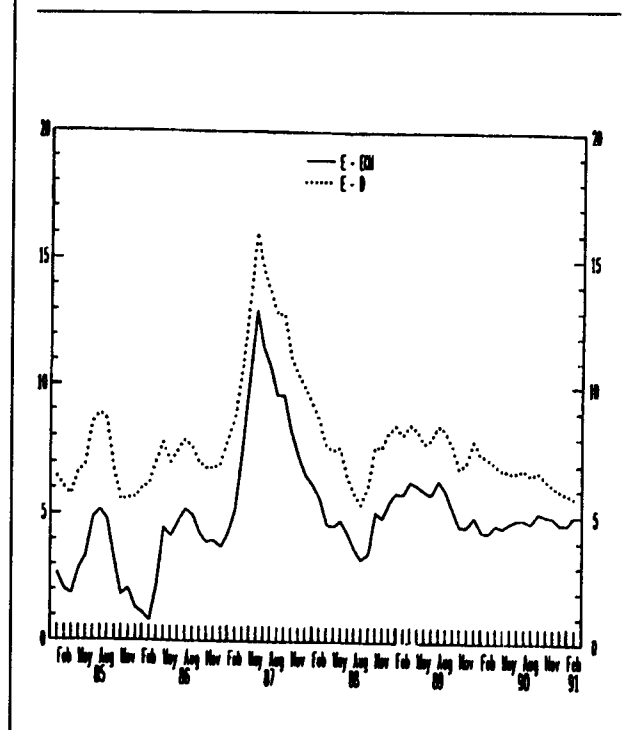
- (i) either to appreciate the peseta, at the expense of a deterioration of the foreign sector, while the trade deficit was already large;
- (ii) or to reduce short-term interest rates, producing in consequence an undesired domestic demand expansion that would contribute to the overheating of the economy.

The restrictive stance of monetary policy induced short-term capital movements that benefit from interest-rate differentials (cf. graph 1) in a framework of favourable expectations of the stability, or even appreciation, of the peseta during 1989. On the other hand, a substitution from internal to foreign credits took place in order to cope with the higher than expected growth of private sector demand for credit (15.4% in 1988 against a 11% targeted). As a result the growth of the targeted monetary aggregate (ALP) accelerated and, subsequently, moved above (outcome of 10.4%) from the upper limit of the target range announced for 1989 (6.5% - 9.5%).

To respond to that situation, the Bank of Spain applied the following restrictive monetary policy measures:

- (i) the compulsory reserve coefficient was raised by 1.5 percentage points on 1 February from 16.5% to 18%. This rise affected only the non-interest bearing part of the coefficient (a rise from 5% to 6.5%);
- (ii) the intervention rate was raised by 1% point to 13.4%. The monetary authorities simultaneously introduced additional measures to discourage capital inflows:
 - (i) banks were required to make special non-interest bearing deposits with the Bank of Spain equivalent to 20% of the registered increase in their short currency positions over the amounts of such positions outstanding on 31 January 1989;
 - (ii) the setting of a mandatory and non-remunerated deposit at the Bank of Spain equivalent to 30% of:
 - (a) the amount of new financial credits and loans (in foreign currency and convertible pesetas) from abroad (the Spanish Treasury is exempt from such a deposit);
 - (b) the amount of new credits and loans (in foreign currency and convertible pesetas) granted by a resident financial intermediary to a resident exporter to finance his contractual trade claims on non-resident importers until the final payment is settled. Nevertheless, the Spanish exporter may freely obtain credits for the same purposes from a non-resident.

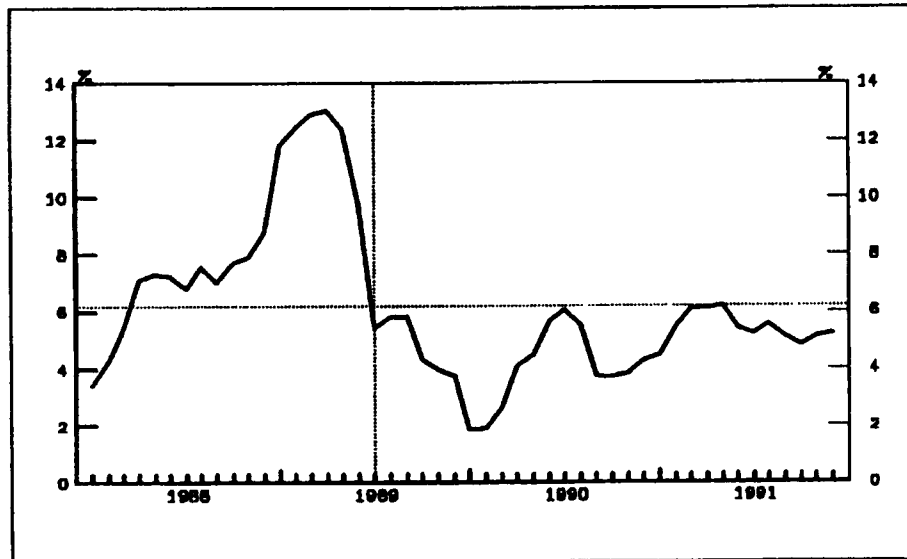
Graph 1: Nominal short-term interest rates differentials



The decision to enter the peseta into the ERM, on 19 June 1989, emphasized the need to control inflation. As a result, in early July 1989 the Government and the Bank of Spain approved additional restrictive fiscal and monetary measures. The Bank of Spain increased its intervention rate to 14.5%, raised the minimum reserve requirements by 1 point to 19%, and introduced new and more stringent banking regulations on the transfer of loans by banks to customers. However, the main measure, on the monetary side, was the introduction of a system of *credit ceilings* for each individual bank. These controls set a limit of 17% for the growth of the credit to the private sector in 1989. On the fiscal side, the authorities increased the withholding tax on capital interest and dividend income from 20 to 25%.

As the above-mentioned measures proved to be effective in decelerating domestic demand in the second half of 1989 and through 1990 (4.3%), the authorities relaxed some regulations and controls. The 20% special non-interest bearing deposit with the Bank of Spain on new foreign borrowing by Banks - which was introduced on 1 February 1989 - was suppressed on 25 November 1989. In addition, the 30% non-remunerated deposit of the amount of new financial credits and loans was abolished on March 1991.

The Spanish experience has again proved that in a context where capital movements have become more intense and interest rate sensitive and within an adjustable-peg regime as such the EMS, domestic monetary policy reduces its margin of manoeuvre since it is impossible to fix simultaneously and independently two nominal anchors, that is, a specific target for money stock growth and an exchange-rate commitment. A restrictive monetary policy engineered in order to face an overheating of the economy led to high interest-rate differentials, generated strong capital inflows and put an appreciating pressure on the exchange rate. The latter obliged the

Graph 2: Bilateral spread between the Peseta and the weakest ERM currency

authorities to intervene in the exchange markets with the subsequent impact on the external counterpart of the monetary base and make the restrictive stance of monetary policy in jeopardy.

On the other hand, the entry into the ERM reduced immediately after the short-term capital movements of a speculative nature since the expectations of further appreciation of the peseta were frustrated, but upgraded the status of the currency vis-à-vis the international investors and attracted more permanent capital flows given the prevailing high interest-rate differential. Interventions in the exchange market by the authorities have been less frequent than in the pre-ERM period and the volatility of the exchange rate decreased.

However, the participation in the ERM has increased the credibility of monetary policy, contributed to moderate inflation expectations, influenced domestic costs and led to a reassessment by the authorities of the previous strategy for monetary control. As a result, the monetary authorities have enlarged its discretionary character and widened the range of indicators to control, that is, money and credit aggregates, exchange rate, yield curves and interest-rate differentials.

3. Monetary targets and indicators in a changing environment

The monetary authorities have currently faced some difficulties - and are likely to face some more in the perspective of a free market for financial services - in relying exclusively on monetary aggregates as indicators of the monetary stance. These problems are potentially serious for a monetary policy based on rules, but are also relevant wherever monetary aggregates are used as indicators.

Problems of two kinds have emerged. First, there is the technical problem of the specification of the variables thought to determine money demand. But a more fundamental difficulty is structural in nature. The process of financial innovation seems to be causing a weakening of the conventional relationships between monetary aggregates on the one hand and economic activity and prices on the other. In Spain, the problem of instability of money demand seems to be more severe for narrow definitions of the money stock (namely M2 and M3) than for broader ones (ALP) and as a result authorities have turned to a broader concept of money (ALP or the new ALP and commercial paper). This downward shift of narrow money demand is mainly attributed to more frequent transfers from non-interest bearing assets to higher yielding alternatives. In turn, this is the result of the introduction of new technologies (new means of payments), increased sophistication in the banking sector, and reactions to new monetary control methods.

Over the last few years, however, fundamental changes in the competitive structure of the Spanish banking industry have occurred. As a result, competition between financial intermediaries on the money market has very much increased and the breakdown of the previous "gentlemen agreement" between the major Spanish banks on competition to increase the banks' liabilities has induced transfers from non-monetary to monetary assets, now also offering attractive yields. It could be argued that this still-ongoing process of deregulation and increased competition will become more and more important as a result of the liberalization of financial services in a 1992 framework. Spanish companies would look for cheaper financing on foreign banks while foreign savings will be attracted by the opportunity to be transformed by the Spanish banks into high yield deposits disturbing the relation between domestic liquidity and expenditure.

However, during Stage one of EMU, a new rank of priorities within the current range of monetary indicators and the targets might prove to be necessary. Even if the approach still remains flexible, priority might be given to the establishing of the exchange rate as the intermediate variable of monetary policy. As a result, the authorities should be ready to allow for temporary overshooting of the monetary aggregate if a conflict between domestic needs (ALP control) and external requirement (external rate stability) emerges. ALP should play a minor role compared with the past since the assessment of the monetary policy will have to be based in a wide

range of monetary indicators (other money or credit aggregates, interest rates, yield curve movements) and real (commodity prices, exchange rate behaviour).

In order to pave the way for a successful narrowing of the bands and to avoid pressure for a downward realignment of the peseta before the inception of Stage two, the reduction in internal imbalances should continue by means of enhanced supply-side measures, increased competition and by a medium-term financial strategy aiming at budgetary consolidation.

CHAPTER VII
REGIONAL DISEQUILIBRIA: UNBALANCED REGIONAL GROWTH,
ASYMMETRIES AND CONSEQUENCES (*)

1. Introduction . . . . .	.85	5.1. Motivation	88
2. Income disparities and growth in the Spanish regions . . . . .	.85	5.2. National instruments	88
2.1. The Mediterranean region . . . . .	.85	5.3. Regional development strategy and Community support	89
2.2. The declining industrial regions . . . . .	.86	5.3.1. The regional plans	89
2.3. The backward regions . . . . .	.86	5.3.2. The Community structural funds	89
2.4. Other regions . . . . .	.86	5.3.3. The objective 1 CSF	89
3. Investment trends . . . . .	.86	6. Conclusions	90
4. Labour market . . . . .	.87		
5. Regional policies . . . . .	.88		

(*) This chapter was mainly prepared by Pedro SANTOS of the Economic Evaluation of Community Policies Directorate.

1. Introduction

With a population of 38.8 million and a territory of 504,800 Km², Spain is among the EC's largest Member States, and shows a considerable degree of differentiation and specialization among its regions.

The most common level of regional analysis in the EC is that of NUTS II regions, which in Spain correspond to the 17 "Comunidades Autónomas" (see Figure 1) plus the cities of Ceuta and Melilla. The Comunidades Autónomas play an important role in the design and implementation of domestic and EC structural policies and statistical information is increasingly presented at that level. The definition of the Comunidades Autónomas, during the regionalization process of the last decade, did not in general follow homogeneity or other economic criteria which should ideally be used in the definition of planning regions of a country. They are more the outcome of political agreements and cultural and historical links between the regions. Hence, while the region of Andalucía consists of 8 provinces with 98,616 square kilometres and a population of 7.9 million, Cantabria is only one province with 5,034 Km² and 0.3 million population.

With that proviso in mind, a first picture can be drawn by looking at the distribution of GDP per head among NUTS II regions of Spain, as in Table 1. The following main characteristics emerge:

- The distribution of GDP per head is less asymmetric in Spain than in other EC Member States, as indicated by the usual measures of dispersion. However, given the overall lower level of development, Spain contains a larger number of 'problem' regions from the EC point of view.
- A clear regional dualism is not present, with the borderline between the prosperous and the less developed regions not being as well defined as, for example, in Italy. There is, however, a general North-East / South-West gradient.
- The spatial structure of the Spanish economy does not show a clear unipolar or centre-to-periphery pattern as, for example, in France. Instead, there are at least three 'poles' - Madrid, Cataluña and the País Vasco (Basque Country), while the geographic centre contains some of the country's poorest areas.

2. Income disparities and economic growth in the Spanish regions

As happened in most EC members, the high growth period of the Spanish economy before 1973 was characterized by a convergence of income levels between its regions. At the same time, the catching-up process with respect to the rest of Europe showed an even more marked advance; measured in

terms of GDP per head in purchasing power standards, Spain as a whole progressed from 59% of EUR 12 in 1960 to 80% in 1975 (see Table 1).

The years between 1973 and 1985 were a generally depressed period for the Spanish economy, with an average growth rate of 2.3%. The manufacturing and building sectors had a particularly bad performance. The crisis had a very unequal incidence over the various regions of the country, due to the diversity of their economic structures at the outset. The industrial North and North-East were particularly hit.

In the recent upswing in economic activity from 1985 onwards, a convergent trend in regional output levels, similar to what happened in the 1960s, is so far not discernible. This is the same trend observed in other EC regions¹, and it cannot be said with certainty that growth has been generally stronger in the more backward regions or in the prosperous ones. On the other hand, the regional disparities of the levels of disposable incomes of households have been significantly reduced since 1975, and are still decreasing².

All the above-mentioned developments had important implications, still to be fully realized, for the regional outlook and the spatial distribution of economic activities in the country, which are now examined in more detail.

2.1. The Mediterranean regions

The main axis of growth which has emerged in recent years is the coastal strip between Gerona and Murcia and, to some extent, its prolongations towards Almería and Málaga, and along the Ebro valley. The economy of these regions was mainly boosted, in recent years, by the growth of the mass tourism industry, which had a strong multiplier effect on the rest of the economy; this multiplier effect was favoured by the high degree of integration, or inter-dependence, between the economic activities of the Mediterranean axis. The existence of a good communications infrastructure (motorway) also plays a role here. The location pattern alongside this axis (especially in the Cataluña, Valencia and Murcia regions) is also a rather balanced one, with a multipolar structure of large and intermediate urban centres, favouring the creation of new economic activities without excessive pressure on the infrastructure and environmental problems.

Productive activities in the Mediterranean regions are more export-oriented than in the average of Spanish regions. That applies not only to tourism but also to its industrial sectors with a considerable endogenous growth potential, and the intensive and efficient segments of the agricultural sector. Therefore, this region is poised to benefit most from the opening of the Spanish economy and European integration. This seems to be confirmed by its recent performance, although the difficulties in the tourism sector may well have negative repercussions in some areas.

1 See e.g. EC Commission (1991) *The regions in the 1990s: fourth periodic report on the social and economic situation and the development of the regions of the Community*

2 See for instance Quintana et al. (1991) "El desarrollo económico español y la España desigual de las autonomías", *Papeles de Economía Española*, 45:2-61.

2.2. The declining industrial regions

The stagnation years were particularly felt in the traditional northern industrial regions, which experienced an even more sluggish growth than the rest of the economy (less than 1% per year in the Basque Country, about 1% in Asturias). These regions were heavily specialized in some basic industrial sectors like steel, coal, chemicals etc. Such patterns of specialization remained unchanged for a long time, and their imprint on the economic structure of these regions (infrastructure, skills, services) limits their capacity to adapt to the requirements of modern activities.

As a result, there were strong employment losses until 1985, and in some cases an absolute decrease of output. The low investment rates and lack of creation of new employment denote the failure of these regions to compensate for the decline of the traditional industrial sectors by the creation of tertiary or other activities. More recently, there are signs of recovery in some of these regions (e.g. Cantabria) but it is too early to assess its long-term significance.

2.3. The backward regions

The traditionally lagging regions (Castilla-la-Mancha, Castilla-León, Extremadura, Galicia and Andalucía) experienced sluggish growth until 1985 in line with the rest of the country and suffered, in most cases, large employment losses. In the four years up to 1989 their growth rate, though considerable (above 4% per year) was still below the national average, which casts some doubts on their prospects of catching up on the more developed regions.

In general, these backward regions exhibit a low population density (except for Galicia), poor communication and other infrastructure, and a relatively strong dependence on low-productivity agriculture. However, within this group of regions, there is considerable diversity of income levels and dynamic performance, not always discernible at the NUTS II level. Some provinces within Galicia (La Coruña), Castilla-León (Valladolid, Burgos) and Andalucía (Sevilla) are indeed in a better position than the rest.

2.4. Other regions

Madrid constitutes a relatively small region, served by a good infrastructure and benefiting from its position as home to the central government. Its industry and service sectors underwent an extensive restructuring process in the years up to 1985, and it has since resumed a high growth rate which allows it to remain near the top of the regional income league.

The Balears and Canary Islands have both a large weight of the services sector (mainly related to tourism) and have shown the highest growth rates in the 1985-1988 period. In 1989, however, they were strongly hit by the contraction of the tourist market.

3. Investment trends

The previous analysis in terms of GDP growth can be usefully complemented by some more forward-looking indicators of investment activities in the different regions. A high investment rate, though not sufficient to ensure economic development, is the main motor of regional growth and reflects the potential competitiveness of regions and their capacity to attract new economic activities. Unfortunately, there are no complete data on gross fixed capital formation by region, only partial information concerning manufacturing, foreign and public investment.

Table 2 shows a regional breakdown of investment in manufacturing, either in new plants or expansion of existing ones³. This breakdown is then compared with the regional shares of industrial value added. The regions which stand out as particularly dynamic in terms of manufacturing investment are:

- The Rioja, Navarra, Cataluña and Valencia regions, which belong to the already mentioned Ebro-Mediterranean strong growth axis.
- The "re-conversion" regions of Cantabria and País Vasco. This confirms the beginning of recovery of these regions, checking what could otherwise be a widening of divergences.
- The "backward" regions of Galicia and Andalucía, especially in terms of new investment. This is a positive development as far as regional convergence is concerned.

On the negative side, there seems to be no surge of investment in the declining industrial region of Asturias, nor in the backward Castillas and Extremadura. This observation is corroborated by the fact that the pattern of industrial specialization in the lagging regions (with a few exceptions) is dominated by sectors of medium and low demand growth.

Foreign direct investment in Spain has boomed since 1984, especially after the liberalization introduced in 1986. A rather unbalanced picture emerges from the regional distribution of that investment (columns 1 and 5 of Table 3). Cataluña, and to a lesser extent Aragón, La Rioja and Madrid absorb very large shares, while the lagging regions perform rather badly. In general, the eastern regions (closer to Europe) seem to have been favoured by foreign investors. The figures presented do not include foreigners' acquisition of real estate, which is strongly concentrated in the coast of Andalucía and other Mediterranean regions. Its value is about 50% of that of foreign direct investment but, unlike the latter, it does not lead to an increase in regional growth except perhaps through a demand multiplier effect.

Public investment, on the other hand (columns 2 and 6 of Table 3) has a strong "equalizing" bias which attempts to compensate the regions for their lack of competitiveness and

economic capacity. The regions affected by industrial decline and the backward regions are relatively favoured⁴; this is the result of two factors:

- Some 30% of public investment is allocated through the Fondo de Compensacion Interterritorial (FCI). The rules of allocation for the FCI are based on the income per head, migration flows, unemployment and surface area of each region.
- The EC structural funds (columns 3 and 7 of Table 3) represent a significant part of public investment and development expenditure in Spain. Their allocation criteria (namely objectives 1, 2 and 5b) have a dominant regional component.

4. Labour market

The situation of global imbalance in the Spanish labour market can be summarized by the national unemployment rate of 16.1% in 1990 and by the fact that, of the 17 regions, all but one have a level of unemployment well above the EC average (see Table 4). This overall high level of unemployment, can be attributed to structural rigidities in the labour market⁵ and its distribution among the regions is very uneven, ranging from 7.3% in Rioja to 25.4% in Andalucia. It is in general the lagging regions which experience the highest unemployment rates: the average rate for objective 1 regions (see section 5.3.2) is 18.7% and for other regions 13.3%.

These figures suggest that there are structural features of the lagging regions which further impair their adjustment to shocks affecting the whole economy and which are a cause for concern about the possibility of achieving a reduction in regional disparities. Indeed, high regional unemployment is associated with both the level and growth of regional GDP, through its negative effects upon local demand and investment.

Regional unemployment could be checked basically through the reduction of labour costs or labour mobility. High unemployment rates should bring about a moderation in real wages in the region. That would encourage the expansion of employment, both through the attraction of new investment and through a change in the processes of local industry in favour of a greater use of the available labour. Migration of workers towards high-activity regions would contribute to reducing unemployment. At the same time, their income transfers back to the regions of origin stimulate demand there.

Reduction of relative labour costs has been hindered by a number of rigidities which affect the labour market in the country as a whole. Their impact upon the problem regions is made worse by a system of national bargaining which was reinforced after 1977, resulting in a lower dispersion of regional wages in recent years, as confirmed by empirical studies. It is also known that in lagging regions there is a strong tendency to resort to informal work, given the barriers that exist in the formal and permanent sectors and rural traditions of family work and family support - favoured, moreover, by better social benefits and early retirement schemes. Barriers to formal employment have a particularly serious impact on the registered unemployment rates among young people, which reach over 40% in some regions. Industrial declining regions such as Asturias, Cantabria and the Pais Vasco suffer from relatively high youth unemployment rates (Table 4).

The other mechanism which should respond to localized unemployment and promote regional convergence is labour migration. Many Spanish regions, with high birth rates, have in the past supplied large numbers of workers both abroad and to other regions. These flows have however been on a declining trend since around 1960. The decline was strongest in the 1970s, mostly due to high unemployment in the receiving countries and regions, which discouraged potential emigrants. At the beginning of the 1980s, the pace of adjustment and industrial re-conversion meant that a number of older workers lost their jobs, with little incentive to migrate to more prosperous regions, where employment prospects were not much better anyway. Furthermore, rigidities in the housing market in Spain, especially in urban areas, pose further obstacles to the mobility of workers. Migration flows have since remained moderate, as Table 5 suggests and in line with what has been observed in other EC countries⁶ and are not expected to resume the prominent role they had in past decades. The continuing demographic pressure in some of the lagging regions (though not in all, as Table 5 also shows) and the still very low activity rates in European terms, thus imply that jobs will have to be created in those regions at a faster pace than in the rest.

The failure of regional unemployment to induce either an adjustment in local wages and labour demand, or equilibrating out-migration flows is largely explained, moreover, by mismatch of skills of the labour force. These reflect 1) different sectoral and professional structures in low-activity and high-activity regions and 2) the failure of the local education and training system to provide the types of labour required by expanding sectors.

4 The figures refer to fixed investment by the general government sector plus capital transfers to enterprises. To relate them to GDP shares (column 6) is not a perfect way of expressing the relation between the "supply and demand" of infrastructure. Infrastructure needs of the regions depend on many factors, like for instance surface area and population.

5 See Chapter 1 to this study.

6 See EC Commission op. cit., page 29.

The first aspect is illustrated by Table 6, where it can be seen that agriculture still represents a large part of employment in most lagging regions. On the other hand, the service sector and administrative and liberal professions are under-represented. Since it is known that the majority of the unemployed in those regions come from agriculture, construction, or have never worked, the key to solving regional unemployment seems to lie in an improvement of skills of the local labour force.

A study carried out for the EC Commission⁷ shows that the participation rates of the corresponding age groups in education or vocational training is much lower in lagging regions, and estimated the number of additional training places required (Table 7). These figures show a wide variation in the degree of preparedness of local training and education structures, especially in the case of objective 1 regions. In those regions, a considerable effort is required to reach parity with the national average, and even more if a target of two years training were agreed.

5. Regional policies

5.1. Motivation

In recent years, regional problems and policies have come back high on the policy agenda of Spain, due to the consolidation of the decentralization process, the importance of the Comunidades Autonomas, EC membership and the reform of the Community Structural Funds. Also, the recent favourable economic environment and the persistence, in spite of it, of important regional disparities provide both more headroom and motivation for these issues to be tackled. These disparities are seen, not only as unacceptable from the political point of view, but a problem that must be answered if the present economic recovery is to be sustained in a balanced and durable way.

Putting aside, for the present purpose, the questions of equity and political cohesion between the regions of a country, the link between spatial asymmetries and global economic performance, as a guide for regional policy, is not simple. Clearly, space is not homogeneous and one cannot aim at a uniform distribution of economic activities. There are, however, some strictly economic arguments which plead in favour of active regional policies to promote a more evenly distributed growth among the regions:

- The external effects of location decisions. Often, the benefits of conglomeration are internalized by firms while its costs are not.
- Regional unemployment. Without labour mobility, efficient use of resources will also call for investment and growth to be channelled to the regions where there is (highest) unemployment.
- The growth argument. Even with high overall growth, the continuous restructuring of the economy's sectors (which has in practice a regional dimension) calls for policies to facilitate adjustment. The existence of depressed or backward regions also represents a fiscal burden, and limits the potential market of the growing regions.
- The stabilization argument. This is based upon observed rigidities in the labour market. The tendency for the uniformization of wages would bring demand-pull inflation in concentration areas, and cost-push inflation in depressed areas.

5.2. National instruments

The modern instruments of regional policy in Spain originated in the principles of local finance set by the 1977 Constitution (establishing the FCI) and in the severe adjustment problems faced by some regions in the early 1980s (the so-called Zonas de Urgente Reindustrializacion). The prospect of EC membership brought the need to review and rationalize the regional aid system inherited from the 1960s, leading to the 1985 Ley de Incentivos Regionales.

At present the main instruments of regional policy at national level are:

- The 3- or 5-year Plans which are now elaborated in accordance with the scope and objectives of the EC structural funds. They follow a first generation of plans issued in 1985, and encompass all the instruments, with domestic and Community resources, under medium-term sectoral or regional strategies. The most important are the 1988-1993 Regional Development Plan (corresponding to objective 1 of the Structural Funds) and the Social and Regional Reconversion Plan (objective 2).
- The investment plan of the public sector, especially the FCI, which has just been reformed⁸. The new rules specify that the FCI applies now only to objective 1 (lagging) regions, and the corresponding investments are to be exclusively directed to regional development. Table 8 shows the shares of the regions in FCI outlays, the total of which (around 30% of public investment) is henceforth related to indicators of the relative situation of these regions. In connection with the introduction in Spain of the EC structural funds and their subsequent reinforcement, public investment has accelerated strongly after 1985, from 3.0% of GDP in 1984 to an estimated 5.2% in 1992.
- The regional incentives system. This is far more selective and geographically concentrated than the previous (up to 1985) regime. Government regional aids to private investment in 1990 amounted to 713 MECU, or about 25% of the total investment in the 1575 projects supported. This amount does not include the expenditure of the regional governments or the EC.

7 R. Derenbach (1990) "Human capital and related infrastructure endowments: investment required in problem regions", study for the EC Commission.

8 Law n 29/1990 of 26.12.1990.

5.3. Regional development strategy and EC support

5.3.1. The regional plans

The 1989-1993 Regional Development Plan was elaborated in a relatively short time, in order to comply with the requirements of the reform of the EC structural funds. It is nevertheless supported by a substantial preparatory work, and reflects a national consensus, both technical and political, on the priorities and strategies of development for the lagging regions.

The plan explicitly sets the final objective that the GDP gap between the richer and poorer regions be progressively reduced, and the two strategic priorities of boosting local employment and improving the infrastructure endowment of the lagging regions. Four types of regions are distinguished, of which two are relevant for the objectives of the Plan :

- The lagging regions of the Centre-West, North-West and South. For the first two, the development of the border with Portugal (Galicia, Castilla-Leon, Extremadura) is a priority, as well as the development of the small and medium urban centres and the articulation of the Douro and Ebro valleys (Castilla-la-Mancha). As for the South (Murcia and Andalusia) the main opportunity lies in the connexion with the developed Mediterranean axis, the development and rationalisation of agriculture and tourism, and the creation of a few industrial poles.
- The regions of intermediate level of development : Cantabria and Valencia. The first needs to improve its transport links (namely towards France), while the second seeks a better balance between its coastal and inland areas. For both regions, support to productive investment in industry and services is stressed, as well as environmental constraints.

Another group of regions are those undergoing a process of industrial re-conversion (Basque Country and Asturias). These are the main, though not exclusive, object of another Plan : the Regional and Social Re-conversion Plan. The priorities here are somewhat different from the previous : private investment in new activities, or modernization of existing ones, comes first with an emphasis on small and medium enterprise. Vocational training and other manpower measures also figure prominently.

The final group of regions are those with an autonomous growth capacity (Madrid, Rioja, Navarra, Aragon, Cataluña and Baleares). Structural problems in these regions are, naturally, much more limited and localized.

5.3.2. The Community structural funds in Spain

After the 1988 reform of the EC structural funds Spain became the largest beneficiary of Community support, having been allocated in 1990 a total of 2,826 million ECU. Most of the Spanish territory, about 82% of the population, fall within the scope of one of the objectives of the Structural Funds with a regional scope, as follows :

- Objective 1 (lagging regions) : the regions of Andalusia, Asturias, Castilla-León, Castilla-la-Mancha, Ceuta y Melilla, Comunidad Valenciana, Extremadura, Galicia, Cana-

rias and Murcia, corresponding to 57.8% of the country's population.

- Objective 2 (industrial decline) : most of Pais Vasco and Cantabria and parts of Aragón, Cataluña, Madrid, Navarra and La Rioja, amounting to 21.8% of the population.
- Objective 5b (rural areas) : parts of Aragón, Baleares, Cantabria, Cataluña, Madrid, Navarra, La Rioja and Pais Vasco, or 2.5% of the national population.

Table 9 summarizes, by Fund and Objective, the EC resources allocated to Spain through the Community Support Frameworks (CSF), which came into effect in 1989 and 1990. Spain also benefits from Community initiative programmes (such as ENVIREG, INTERREG, STRIDE etc.) and the Community loan instruments (EIB, NIC).

5.3.3. The objective 1 CSF

Resource transfers under Objective 1 are by far the most important, reaching 9,8 billion ECU (1989 prices) for the 5-year period 1989 - 1993. In the Objective 1 regions, the CSF can be regarded as having a macroeconomic impact, and will reach about 1.4% of regional GDP by 1992. If one includes the Community initiatives and loan instruments, this percentage rises to some 2%. These impacts are obviously more important in terms of investment, and particularly public investment, of which 35-40%, in objective 1 regions, are co-financed by the EC. If, moreover, one looks at the FCI, which is the main financial instrument of domestic regional policy, its interventions on a per capita basis reach only half the importance of those of the combined EC funds.

The CSF for the objective 1 regions of Spain was adopted on the 31.10.1989 on the basis of the Regional Development Plan, mentioned above.

The analysis of this Plan by the Commission services, within the spirit of partnership and taking into consideration the overall financial constraints on the Community funds, led to the definition of 6 main axes of intervention in the CSF:

1. Improving communications
2. Industry, crafts sector and business services
3. Tourism
4. Agriculture and rural development
5. Infrastructure to support economic activity
6. Human resources

Table 10 shows the breakdown of the objective 1 CSF by these 6 axes. Axis 1, which consists of transport and communications infrastructure, clearly received a high priority and gets the largest share of financing, followed by Axis 5.

The CSF has been broken down into 11 regional sub-CSFs plus a multiregional one. The latter absorbs 60% of total financial resources, which may be interpreted as an emphasis on the global and international articulation of the territory in line with Community objectives, relative to purely local projects. The regional distribution of Community financing in the CSF also shows a stronger "bias" in favour of regions

with the lowest income than the pattern of total public investments before the CSF, as can be easily seen from Table 3.⁹

6. Conclusions

In the 1950s and 1960s there was an overall high level of growth and convergence of income levels of the Spanish regions. However, neither in the period of stagnation between 1973 and 1985 nor in the more dynamic post-accession period, has there been a clear trend of convergence or divergence. There is instead a diversity of situations within both backward and prosperous regions, and Spain's economic geography shows a rather complex and changing pattern. Although the economic centre of gravity of the country seems to be changing to the South and to the East, this evolution cannot be simply characterized in terms of two groups of developed and lagging regions, or even in terms of whole *Comunidades Autonomas*.

A balanced distribution of regional growth towards a more decisive convergence of regional income levels would probably contribute to the achievement of the overall macroeconomic objectives of the Spanish authorities: to sustain the present high levels of real GDP growth, without incurring excessive internal and external imbalances that would jeopardize Spain's participation in the EMS and EMU.

In the post-1985 period, the failure to achieve greater real convergence within Spanish regions cannot be put down to a poor performance of the lagging regions (which have been catching up with respect to the rest of the EC), but to an even better performance of the most developed ones.

Two dominant trends have been: the emergence of the Mediterranean axis of growth, and the decline of the industrial North. More recently, some of the latter areas have started to recover. The whole East of the Peninsula seems set to become economically dominant in the future.

The regional distribution of private investment in manufacturing, and in particular foreign direct investment, does not seem to be contributing as much as desired to the reduction of regional inequalities within the country, although there are no comprehensive data.

The severity of unemployment problems in lagging regions, which can impair their catching-up prospects, is due to particular rigidities of the labour market. There is evidence of a considerable role played by labour skills mismatch. Migration flows from low to high activity regions are not likely to resume at the same scale as in the past. This points to the need for specific policies directed to improve the flexibility and quality of labour in these regions, some of which continue to be affected by a higher than average increase of the labour force.

The prospects for the inland, Atlantic and border regions (with Portugal) depend on their ability to diversify towards new economic activities, generate new growth poles and improve communications with the rest of the Peninsula. In this respect, the EC with its Community Support Frameworks, and the Spanish instruments of the FCI and regional incentives policy point the right direction.

9 See also CADMOS (1991) *Evaluation macro-économique du CCA 1989-1993 relative aux régions de l'objectif 1 en Espagne*, study financed by the European Commission.

Table 1 : GDP per head with respect to EC, in pps

	1960	1975	1985	1989
Andalucía	41.8	58.7	50.9	54.0
Aragón	63.3	80.8	79.8	85.1
Asturias	69.7	84.4	68.9	72.4
Baleares	66.5	95.2	107.4	107.5
Canarias	45.4	63.2	66.2	73.9
Cantabria	80.6	83.4	70.6	72.5
Castilla-la-M	39.4	62.6	55.2	60.0
Castilla-León	47.3	69.0	64.4	68.3
Cataluña	86.4	102.7	88.9	94.7
C. Valenciana	70.3	81.7	76.5	81.8
Extremadura	36.8	47.2	47.2	49.3
Galicia	41.0	60.1	57.1	60.9
Madrid	81.4	104.4	94.6	96.3
Murcia	45.4	68.3	60.2	64.8
Navarra	69.2	90.3	78.8	86.0
Pais Vasco	99.3	109.9	81.1	83.7
Rioja	68.2	82.5	78.6	82.8
ESPAÑA	59.2	80.4	71.8	76.0
EUR 12	100.0	100.0	100.0	100.0
Gini index	0.195	0.150	0.134	0.135

Sources: Quintana et al. (1991) "El desarrollo económico español y la España desigual de las autonomías", Papeles de Economía Española, 45:2-61.

Table 2: Investment in manufacturing, 1985-1987							%
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Andalucía	10.9	8.0	9.4	11.2	97	71	84
Aragón	2.6	2.3	2.4	4.0	66	58	61
Asturias	0.6	0.4	0.5	3.9	16	10	13
Baleares	0.8	0.1	0.5	1.3	60	8	38
Canarias	2.8	1.6	2.2	2.4	117	67	92
Cantabria	0.7	5.2	3.0	1.4	52	384	221
Castilla-la-M	6.6	3.1	4.8	6.9	95	45	69
Castilla-León	3.7	1.6	2.7	3.7	100	43	73
Cataluña	19.1	21.0	20.1	21.6	88	97	93
C. Valenciana	10.5	10.6	10.6	10.2	103	104	104
Extremadura	0.5	0.5	0.5	1.6	32	32	32
Galicia	21.8	7.1	14.3	5.9	372	121	244
Madrid	8.7	9.7	9.2	11.7	75	83	79
Murcia	1.6	0.7	1.2	2.0	78	34	59
Navarra	2.5	6.9	4.7	1.9	129	357	243
Pais Vasco	5.7	20.2	13.1	9.4	61	215	140
Rioja	0.7	1.2	1.0	1.0	74	126	105
ESPAÑA	100	100	100	100	100	100	100
(1) =	% share of region in new investment 1985-1987						
(2) =	% share of region in expansion investments 1985-1987						
(3) =	% share of region in total investment 1985-1987						
(4) =	% share of region in industrial value added 1987						
(5) =	% (1)/(4)						
(6) =	% (2)/(4)						
(7) =	% (3)/(4)						
Sources:	Ministerio de Economía y Hacienda (1990) <u>El Crecimiento Regional Español ante la Integración Europea</u> . Instituto Nacional de Estadística <u>España en Cifras</u> , 1989 Own calculations.						

Table 3: Foreign and public investment							%
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Andalucía	4.7	18.6	26.4	13.6	35	137	194
Aragón	7.2	4.4	0.5	3.4	212	130	16
Asturias	0.3	2.8	3.9	3.0	10	94	131
Baleares	0.0	0.0	--	2.7	2	0	--
Canarias	0.5	3.5	7.0	3.6	13	98	193
Cantabria	0.5	1.7	0.4	1.3	41	131	28
Castilla-la-M	1.3	6.4	9.3	3.6	19	177	260
Castilla-León	3.0	8.8	12.8	6.7	35	132	191
Cataluña	52.1	9.1	3.3	17.9	45	51	18
C. Valenciana	3.3	5.6	8.6	9.9	33	56	87
Extremadura	0.2	4.4	7.7	1.9	10	233	404
Galicia	1.5	8.1	13.5	6.2	24	130	217
Madrid	17.0	11.1	0.7	14.7	116	75	5
Murcia	0.1	2.7	3.4	2.3	3	117	147
Navarra	0.9	2.2	0.3	1.6	53	143	18
Pais Vasco	4.8	9.5	2.1	6.7	71	142	31
Rioja	2.6	1.0	0.1	0.8	327	121	16
ESPAÑA	100	100	100	100	100	100	100
(1) =	% share of region in foreign direct investment 1986-1988						
(2) =	% share of region in public investment 1989-1993						
(3) =	% share of region in the EC Structural Funds 1989-1993						
(4) =	% share of region in total value added 1987						
(5) =	% (1)/(4)						
(6) =	% (2)/(4)						
(7) =	% (3)/(4)						
Sources:	Ministerio de Economía y Hacienda (1990) <u>El Crecimiento Regional Español ante la Integración Europea</u> Zaragoza Rameau, J. A. (1990) "El resurgimiento de la política regional: la nueva política comunitaria y la política regional española", <u>Información Comercial Española - Revista de Economía</u> , 679:27-37						

	(1)	(2)	(3)	(4)
Andalucía	25.4	6.4	41.6	20.3
Aragón	9.2	2.2	19.9	6.9
Asturias	17.0	7.0	39.9	12.5
Baleares	10.0	2.0	19.3	7.9
Canarias	22.7	6.4	36.7	18.5
Cantabria	16.6	5.9	36.4	12.9
Castilla-la-M	13.1	2.8	22.6	10.4
Castilla-León	15.3	5.4	34.4	11.3
Cataluña	12.5	3.0	23.5	9.7
C. Valenciana	13.9	2.7	22.7	11.6
Extremadura	24.8	6.0	42.6	19.8
Galicia	11.8	3.2	24.1	9.8
Madrid	12.4	3.3	23.0	9.9
Murcia	15.5	3.8	28.9	11.0
Navarra	10.8	2.6	24.9	8.0
Pais Vasco	19.0	7.7	44.7	13.8
Rioja	7.3	2.7	11.2	6.5
ESPAÑA	16.1	4.4	30.3	12.5
EUR 12	8.4	--	15.5	6.8

(1) = 1990 total unemployment rate
(2) = in search of first employment
(3) = < 25years old
(4) = > 25 years old
Source: EUROSTAT, Regions - Statistiques Rapides
Instituto Nacional de Estadística - Encuesta de Población Activa, 1990.

	(1)	(2)	(3)	(4)
Andalucia	13.6	7.8	1.5	45.1
Aragón	8.7	9.2	1.2	45.1
Asturias	8.3	9.4	1.1	46.2
Baleares	12.5	10.0	0.6	49.3
Canarias	13.1	6.8	0.8	48.5
Cantabria	9.7	8.4	1.7	46.1
Castilla-la-M	11.3	8.8	0.8	43.8
Castilla-León	8.9	8.5	1.2	44.9
Cataluña	9.7	7.9	1.5	50.3
C. Valenciana	10.9	8.6	1.7	48.9
Extremadura	12.4	8.9	0.4	43.4
Galicia	8.7	9.0	1.3	50.9
Madrid	10.9	6.4	1.9	46.0
Murcia	14.2	7.6	1.5	47.3
Navarra	9.3	8.2	1.1	45.8
Pais Vasco	8.6	6.8	0.5	47.3
Rioja	9.3	8.8	1.4	46.5
ESPAÑA	10.8	8.0	1.3	47.2
EUR 12	11.8	9.9	0.8	54.1
(1) =	‰ birth rate (1987)			
(2) =	‰ mortality rate (1987)			
(3) =	‰ net migration rate (1987)			
(4) =	‰ activity rate (1988)			
Source:	EUROSTAT			

	1975				1989			
	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)
Andalucía	30.7	18.7	9.8	40.8	16.3	14.8	11.3	57.6
Aragón	25.6	28.2	8.3	37.9	14.0	26.6	8.1	51.3
Asturias	31.1	30.4	7.3	31.2	17.6	25.6	8.5	48.3
Baleares	16.8	17.8	12.3	53.1	4.8	17.8	12.2	65.2
Canarias	23.0	12.3	11.8	52.9	9.6	10.9	11.6	67.9
Cantabria	31.5	28.9	7.3	32.3	17.2	23.1	9.4	50.3
Castilla-la-M	37.8	18.6	10.9	32.7	21.0	21.9	12.3	44.8
Castilla-León	37.1	18.6	7.7	36.6	22.5	16.7	9.5	48.3
Cataluña	8.2	40.8	11.3	39.7	4.4	35.7	8.4	51.4
C. Valenciana	17.9	33.1	10.0	39.0	10.7	28.5	8.3	52.5
Extremadura	46.7	11.4	7.6	34.3	27.4	9.8	12.5	50.3
Galicia	50.7	14.8	7.2	27.3	36.7	14.9	8.9	39.5
Madrid	1.9	26.1	12.5	59.5	1.0	22.8	7.6	68.6
Murcia	25.8	24.4	9.4	40.4	15.5	22.1	10.0	52.4
Navarra	20.9	36.8	8.8	33.5	10.2	33.3	8.2	48.3
Pais Vasco	8.3	45.9	8.7	37.1	4.4	33.7	7.2	54.7
Rioja	30.9	30.5	7.7	30.9	14.8	31.3	7.7	46.2
ESPAÑA	23.4	27.2	9.6	39.8	12.1	22.2	8.9	56.8
(1) =	% employed in agriculture and fisheries							
(2) =	% employed in industry							
(3) =	% employed in construction							
(4) =	% employed in services							
Source:	EUROSTAT							

**Table 7 : Increase in training places required for adolescents aged 15-19
(% of places available in 1985)**

	(1)	(2)	(3)	(4)	(5)
Andalucia	17.3	30.8	48.1	27.7	68.4
Asturias	26.0	46.4	72.4	-14.5	12.7
Castilla-Leon	23.9	42.4	66.3	-7.2	22.3
Castilla-la-Mancha	16.4	29.0	45.4	35.1	78.0
Ceuta y Melilla	13.9	34.3	48.4	59.4	110.1
Com. Valenciana	19.1	35.3	54.4	15.8	52.7
Extremadura	13.4	30.0	43.4	65.0	117.5
Galicia	19.5	35.5	55.0	13.4	49.5
Canarias	19.1	33.9	53.0	15.6	52.4
Murcia	25.9	34.3	60.2	-15.0	12.0
Total Objective 1	19.2	34.2	53.4	15.3	51.9
Aragon	26.1	42.6	68.7	-14.8	12.3
Baleares	19.5	34.9	54.5	13.3	49.3
Cantabria	28.8	39.6	68.3	-23.2	1.2
Cataluña	28.8	38.0	66.9	-23.2	1.2
Rioja	33.2	39.9	73.1	-33.2	-12.0
Madrid	22.3	51.7	74.0	-0.5	31.1
Navarra	27.4	41.4	68.8	-19.2	6.5
Pais Vasco	28.9	44.3	73.1	-22.9	1.6
Total España	22.1	38.0	60.0	0.0	31.8

Participation rates:

- (1) = initial training
(2) = general education
(3) = total

Increase in places required to reach

- (4) = national average initial training
(5) = Community target of 2 years training

Source: R. Derenbach (1990) "Human capital and related infrastructure endowments: investment required in problem regions", study for the EC Commission.

Table 8: Distribution of the Fondo de Compensación Interterritorial in Objective 1 regions

	(1)	(2)	(3)	(4)
Andalucia	26.8	23.3	39.6	1.3
Asturias	2.3	2.2	0.9	0.2
Canarias	6.7	5.5	8.3	1.3
Castilla-la-M.	6.6	7.0	9.6	1.3
Castilla-León	8.9	7.5	6.7	0.6
C. Valenciana	5.9	6.3	6.0	0.4
Extremadura	7.6	5.9	8.8	1.8
Galicia	10.7	10.7	16.2	1.3
Murcia	2.0	2.1	3.9	0.9
Total obj. 1	78.0	71.2	100.0	1.0
Total Spain	100.0	100.0	100.0	1.0

(1) = share of region in the FCI, 1983
(2) = share of region in the FCI, 1989
(3) = share of region in the FCI, 1989 according to the new system (simulation)
(4) = idem, expressed as FCI per capita relative to average
Source: CADMOS (1991) Evaluation macro-economique du CCA 1989-1993 relative aux régions de l'objectif 1 en Espagne, study financed by the European Commission.

Table 9: Community Support Frameworks, MECU, 1989 prices

	1989	1990	1991	1992	1993
Objective 1	1603.0	1719.0	1914.0	2147.0	2396.0
ERDF	1102.0	1090.0	1213.0	1361.0	1433.0
ESF	386.0	394.0	431.0	486.0	651.0
EAGGF	115.0	235.0	270.0	300.0	312.0
Objective 2	212.4 ⁽¹⁾	247.3	263.7	--	--
ERDF	183.4 ⁽¹⁾	188.8	192.2	--	--
ESF	29.0 ⁽¹⁾	58.5	51.5	--	--
Objectives 3+4	--	203.0	168.2	191.8	--
ESF	--	203.0	168.2	191.8	--
Objective 5 b ²	16.5	27.7	55.4	88.1	97.4
ERDF	2.6	6.7	11.0	18.5	22.3
ESF	9.0	0.9	6.0	10.5	12.6
EAGGF	4.9	20.1	38.4	59.1	62.5

¹ Ongoing measures (191.8 MECU) have been included in 1989
² Objective 5 a is not translated into a separate CSF
Source: EC Commission (1991) Annual Report on the implementation of the reform of the Structural Funds.

Table 10: Community grants in the objective 1 CSF, by axis

	(1)	(2)
1. Improved communications	3218	34.2
1.1 Motorways and other roads	2051	21.8
1.2. Railways	636	6.7
1.3. Ports	101	1.0
1.4. Airports	103	1.1
1.5. Inland waterways	0	0.0
1.6. Other means of transport	18	0.1
1.7. Telecommunication of which approx.ECU 112 million STAR/ERDF	308	3.2
2. Industry, crafts sector and business services	699	7.4
2.1. Support for industry and crafts sector	373	3.9
2.2. Support for business services	71	0.7
2.3. Local development	132	1.4
2.4. Industrial/handicraft estates	123	1.3
3. Tourism	182	1.9
3.1. Support for investment in tourism	68	0.7
3.2. Development of cultural resources of interest for tourism	113	1.2
4. Agriculture and rural development	1441	15.3
4.1. Improvement of the conditions of production	793	8.4
4.2. Protection of the environment and conserv. of nat. resources	100	1.0
4.3. Horizontal measures (Objective 5a)	477	5.0
4.4. Reorientation of production and improvements in quality	70	0.7
5. Infrastructure to support economic activity	1652	17.5
5.1. Water	652	6.9
5.2. Energy (of which approx. ECU 63 million Valoren/ERDF)	117	1.2
5.3. Protection and improvement of the environment	575	6.1
5.4. Research, development and innovation	123	1.3
5.5. Training facilities	104	1.1
5.6. Health facilities	81	0.8
6. Development of human resources	891	9.4
6.1. Measures directly linked to development priorities	302	3.2
6.2. Multi-priority measures	151	1.6
6.3. Measures referred to in Art. 1 (5) and (6) of Reg. 4255/88 (training outside the firm)	239	2.5
6.4. Measures referred to in Art. 1(2) of Reg. 4255/88 (studies, innovative measures...)	7	0.0
7. Technical assistance	44	0.4
8. Objectives 3 and 4	1265	13.4
Total	9393	100.0

(1)= in MECU at 1989 prices

(2)= in % of total

Source: Community Support Framework

Figure 1: Spain: Comunidades Autónomas

Country Studies

See also Economic Papers No.79 (The United Kingdom), No.81 (The Netherlands) and No.82 (Belgium).

No. 1 The Federal Republic of Germany (September 1990)

No. 2 Portugal (February 1991)

No. 3 United Kingdom (March 1991)

No. 4 Denmark (April 1991)

No. 5 France (août 1991)

No. 6 Ireland (September 1991)

No. 7 Spain (March 1992)

Economic Papers*

The following papers have been issued. Copies may be obtained by applying to the address mentioned on the inside front cover.

- No. 1 EEC-DG II inflationary expectations. Survey based inflationary expectations for the EEC countries, by F. Papadia and V. Basano (May 1981).
- No. 3 A review of the informal economy in the European Community, by Adrian Smith (July 1981).
- No. 4 Problems of interdependence in a multipolar world, by Tommaso Padoa-Schioppa (August 1981).
- No. 5 European Dimensions in the Adjustment Problems, by Michael Emerson (August 1981).
- No. 6 The bilateral trade linkages of the Eurolink Model : An analysis of foreign trade and competitiveness, by P. Ranuzzi (January 1982).
- No. 7 United Kingdom, Medium term economic trends and problems, by D. Adams, S. Gillespie, M. Green and H. Wortmann (February 1982).
- No. 8 Où en est la théorie macroéconomique, par E. Malinvaud (juin 1982).
- No. 9 Marginal Employment Subsidies : An Effective Policy to Generate Employment, by Carl Chiarella and Alfred Steinherr (November 1982).
- No. 10 The Great Depression : A Repeat in the 1980s ?, by Alfred Steinherr (November 1982).
- No. 11 Evolution et problèmes structurels de l'économie néerlandaise, par D.C. Breedveld, C. Depoortere, A. Finetti, Dr. J.M.G. Pieters et C. Vanbelle (mars 1983).
- No. 12 Macroeconomic prospects and policies for the European Community, by Giorgio Basevi, Olivier Blanchard, Willem Buiters, Rudiger Dornbusch, and Richard Layard (April 1983).
- No. 13 The supply of output equations in the EC-countries and the use of the survey-based inflationary expectations, by Paul De Grauwe and Mustapha Nabli (May 1983).
- No. 14 Structural trends of financial systems and capital accumulation : France, Germany, Italy, by G. Nardozi (May 1983).
- No. 15 Monetary assets and inflation induced distortions of the national accounts - conceptual issues and correction of sectoral income flows in 5 EEC countries, by Alex Cukierman and Jorgen Mortensen (May 1983).
- No. 16 Federal Republic of Germany. Medium-term economic trends and problems, by F. Allgayer, S. Gillespie, M. Green and H. Wortmann (June 1983).
- No. 17 The employment miracle in the US and stagnation employment in the EC, by M. Wegner (July 1983).
- No. 18 Productive Performance in West German Manufacturing Industry 1970-1980; A Farrell Frontier Characterisation, by D. Todd (August 1983).
- No. 19 Central-Bank Policy and the Financing of Government Budget Deficits : A Cross-Country Comparison, by G. Demopoulos, G. Katsimbris and S. Miller (September 1983).
- No. 20 Monetary assets and inflation induced distortions of the national accounts. The case of Belgium, by Ken Lennan (October 1983).

* "Economic Papers" are written by the Staff of the Directorate-General for Economic and Financial Affairs, or by experts working in association with them. The "Papers" are intended to increase awareness of the technical work being done by the staff and to seek comments and suggestions for the further analyses. They may not be quoted without authorisation. Views expressed represent exclusively the positions of the author and do not necessarily correspond with those of the Commission of the European Communities. Comments and enquiries should be addressed to:

The Directorate-General for Economic and Financial Affairs,
 Commission of the European Communities,
 200, rue de la Loi
 1049 Brussels, Belgium

- No. 21 Actifs financiers et distorsions des flux sectoriels dues à l'inflation : le cas de la France, par J.-P. Baché (octobre 1983).
- No. 22 Approche pragmatique pour une politique de plein emploi : les subventions à la création d'emplois, par A. Steinherr et B. Van Haepere (octobre 1983).
- No. 23 Income Distribution and Employment in the European Communities 1960-1982, by A. Steinherr (December 1983).
- No. 24 U.S. Deficits, the dollar and Europe, by O. Blanchard and R. Dornbusch (December 1983).
- No. 25 Monetary Assets and inflation induced distortions of the national accounts. The case of the Federal Republic of Germany, by H. Wittelsberger (January 1984).
- No. 26 Actifs financiers et distorsions des flux sectoriels dues à l'inflation : le cas de l'Italie, par A. Reati (janvier 1984).
- No. 27 Evolution et problèmes structurels de l'économie italienne, par Q. Ciardelli, F. Colasanti et X. Lannes (janvier 1984).
- No. 28 International Co-operation in Macro-economic Policies, by J.E. Meade (February 1984).
- No. 29 The Growth of Public Expenditure in the EEC Countries 1960-1981 : Some Reflections, by Douglas Todd (December 1983).
- No. 30 The integration of EEC qualitative consumer survey results in econometric modelling : an application to the consumption function, by Peter Praet (February 1984).
- No. 31 Report of the CEPS Macroeconomic Policy Group. EUROPE : The case for unsustainable growth, by R. Layard, G. Basevi, O. Blanchard, W. Buiter and R. Dornbusch (April 1984).
- No. 32 Total Factor Productivity Growth and the Productivity Slowdown in the West German Industrial Sector, 1970-1981, by Douglas Todd (April 1984).
- No. 33 An analytical Formulation and Evaluation of the Existing Structure of Legal Reserve Requirements of the Greek Economy : An Uncommon Case, by G. Demopoulos (June 1984).
- No. 34 Factor Productivity Growth in Four EEC Countries, 1960-1981, by Douglas Todd (October 1984).
- No. 35 Rate of profit, business cycles and capital accumulation in U.K. industry, 1959-1981, by Angelo Reati (November 1984).
- No. 36 Report of the CEPS Macroeconomic Policy Group. Employment and Growth in Europe : A Two-Handed Approach by P. Blanchard, R. Dornbusch, J. Drèze, H. Giersch, R. Layard and M. Monti (June 1985).
- No. 37 Schemas for the construction of an "auxiliary econometric model" for the social security system, by A. Coppini and G. Laina (June 1985).
- No. 38 Seasonal and Cyclical Variations in Relationship among Expectations, Plans and Realizations in Business Test Surveys , by H. König and M. Nerlove (July 1985).
- No. 39 Analysis of the stabilisation mechanisms of macroeconomic models : a comparison of the Eurolink models by A. Bucher and V. Rossi (July 1985).
- No. 40 Rate of profit, business cycles and capital accumulation in West German industry, 1960-1981, by A. Reati (July 1985).
- No. 41 Inflation induced redistributions via monetary assets in five European countries : 1974-1982, by A. Cukierman, K. Lennan and F. Papadia (September 1985).
- No. 42 Work Sharing : Why ? How ? How not ..., by Jacques H. Drèze (December 1985).
- No. 43 Toward Understanding Major Fluctuations of the Dollar by P. Armington (January 1986).
- No. 44 Predictive value of firms' manpower expectations and policy implications, by G. Nerb (March 1986).
- No. 45 Le taux de profit et ses composantes dans l'industrie française de 1959 à 1981, par Angelo Reati (Mars 1986).
- No. 46 Forecasting aggregate demand components with opinions surveys in the four main EC-Countries - Experience with the BUSY model , by M. Biart and P. Praet (May 1986).
- No. 47 Report of CEPS Macroeconomic Policy Group : Reducing Unemployment in Europe : The Role of Capital Formation, by F. Modigliani, M. Monti, J. Drèze, H. Giersch and R. Layard (July 1986).

- No. 48 Evolution et problèmes structurels de l'économie française, par X. Lannes, B. Philippe et P. Lenain (août 1986).
- No. 49 Long run implications of the increase in taxation and public debt for employment and economic growth in Europe by G. Tullio (August 1986).
- No. 50 Consumers Expectations and Aggregate Personal Savings by Daniel Weiserbs and Peter Simmons (November 1986).
- No. 51 Do after tax interest affect private consumption and savings ? Empirical evidence for 8 industrial countries : 1970-1983 by G. Tullio and Fr. Contesso (December 1986).
- No. 52 Validity and limits of applied exchange rate models : a brief survey of some recent contributions by G. Tullio (December 1986).
- No. 53 Monetary and Exchange Rate Policies for International Financial Stability : a Proposal by Ronald I. McKinnon (November 1986).
- No. 54 Internal and External Liberalisation for Faster Growth by Herbert Giersch (February 1987).
- No. 55 Regulation or Deregulation of the Labour Market : Policy Regimes for the Recruitment and Dismissal of Employees in the Industrialised Countries by Michael Emerson (June 1987).
- No. 56 Causes of the development of the private ECU and the behaviour of its interest rates : October 1982 - September 1985 by G. Tullio and Fr. Contesso (July 1987).
- No. 57 Capital/Labour substitution and its impact on employment by Fabienne Ilzkovitz (September 1987).
- No. 58 The Determinants of the German Official Discount Rate and of Liquidity Ratios during the classical gold standard : 1876-1913 by Andrea Sommariva and Giuseppe Tullio (September 1987).
- No. 59 Profitability, real interest rates and fiscal crowding out in the OECD area 1960-1985 (An examination of the crowding out hypothesis within a portfolio model) by Jorgen Mortensen (October 1987).
- No. 60 The two-handed growth strategy for Europe : Autonomy through flexible cooperation by J. Drèze, Ch. Wyplosz, Ch. Bean, Fr. Giavazzi and H. Giersch (October 1987).
- No. 61 Collusive Behaviour, R & D, and European Policy by Alexis Jacquemin (November 1987).
- No. 62 Inflation adjusted government budget deficits and their impact on the business cycle : empirical evidence for 8 industrial countries by G. Tullio (November 1987).
- No. 63 Monetary Policy Coordination Within the EMS : Is There a Rule ? by M. Russo and G. Tullio (April 1988).
- No. 64 Le Découplage de la Finance et de l'Economie - Contribution à l'Evaluation des Enjeux Européens dans la Révolution du Système Financier International par J.-Y. Haberer (Mai 1988).
- No. 65 The completion of the internal market : results of macroeconomic model simulations by M. Catinat, E. Donni and A. Italianer (September 1988).
- No. 66 Europe after the crash : economic policy in an era of adjustment by Charles Bean (September 1988).
- No. 67 A Survey of the Economies of Scale by Cliff Pratten (October 1988).
- No. 68 Economies of Scale and Intra-Community trade by Joachim Schwalbach (October 1988).
- No. 69 Economies of Scale and the Integration of the European Economy : the Case of Italy by Rodolfo Helg and Pippo Ranci (October 1988).
- No. 70 The Costs of Non-Europe - An assessment based on a formal Model of Imperfect Competition and Economies of Scale by A. Smith and A. Venables (October 1988).
- No. 71 Competition and Innovation by P.A. Geroski (October 1988).
- No. 72 Commerce Intra-Branche - Performances des firmes et analyse des échanges commerciaux dans la Communauté européenne par le Centre d'Etudes Prospectives et d'Informations Internationales de Paris (octobre 1988).
- No. 73 Partial Equilibrium Calculations of the Impact of Internal Market Barriers in the European Community by Richard Cawley and Michael Davenport (October 1988).
- No. 74 The exchange-rate question in Europe by Francesco Giavazzi (January 1989).

- No. 75** The QUEST model (Version 1988) by Peter Bekx, Anne Bucher, Alexander Italianer, Matthias Mors (March 1989).
- No. 76** Europe's Prospects for the 1990s by Herbert Giersch (May 1989)
- No. 77** 1992, Hype or Hope : A review by Alexander Italianer (February 1990)
- No. 78** European labour markets : a long run view (CEPS Macroeconomic Policy Group 1989 Annual Report) by J.-P. Danthine, Ch. Bean, P. Bernholz and E. Malinvaud (February 1990)
- No. 79** **Country Studies** - The United Kingdom by Tassos Belessiotis and Ralph Wilkinson (July 1990)
- No. 80** See "Länderstudien" No. 1
- No. 81** **Country Studies** - The Netherlands by Filip Keereman, Françoise Moreau and Cyriel Vanbelle (July 1990)
- No. 82** **Country Studies** - Belgium by Johan Baras, Filip Keereman and Françoise Moreau (July 1990)
- No. 83** Completion of the internal market : An application of Public Choice Theory by Manfred Teutemann (August 1990)
- No. 84** Monetary and Fiscal Rules for Public Debt Sustainability by Marco Buti (September 1990)
- No. 85** Are we at the beginning of a new long term expansion induced by technological change?, by Angelo Reati (August 1991)
- No. 86** Labour Mobility, Fiscal Solidarity and the Exchange Rate Regime: a Parable of European Union and Cohesion, by Jorge Braga de Macedo (October 1991)
- No. 87** The Economics of Policies to Stabilize or Reduce Greenhouse Gas Emissions: the Case of CO₂, by Mathias Mors (October 1991)
- No. 88** The Adequacy and Allocation of World Savings, by Javier Santillán (December 1991)
- No. 89** Microeconomics of Saving, by Barbara Kauffmann (December 1991)
- No. 90** Exchange Rate Policy for Eastern Europe and a Peg to the ECU, by Michael Davenport (March 1992)

