The Spanish Economy—Recent Performance
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The introduction of the Euro led the Kingdom of Spain to set its main macroeconomic goal at convergence with other members of the European Economic Community. With goals defined by the European Central Bank, convergence policy entails conservative fiscal plans, target inflation goals to promote real price stability, and reducing unemployment. Spain’s defined goals also include structural reform in financial and goods markets. Currently, Spain appears to be effectively making changes to further the Spanish economy toward convergence with other EU members.

This paper will examine key indicators of Spanish economic performance, and evaluate the real progress toward long-term convergence. Following this discussion, it suggests some possible policies that could help insulate the Spanish economy from risks associated with adopting the Euro and dealing with the current structural unemployment.

Indicators Point to Fast Growth
To assess Spain’s current macroeconomic condition, we examined data published by Banco de Espana, the International Monetary Fund, and the Economist Intelligence Unit. Most of the figures suggested that the Spanish economy is performing well, especially in relation to other countries in the Euro currency region. To narrow the analysis, we focused on the following target policy variables; real GDP, inflation, unemployment, government spending, investment, and the Balance of Payments.

*Overall Growth Rises with Low Inflation:* Spain outpaced the rest of the Euro-region in sustained real growth, hitting a real growth rate of 3.6% in 1999.¹ Main drivers behind this growth include the strong 5% growth in domestic demand and 8.3% increase in gross fixed capital formation. Strong consumer and investor confidence in Spain’s commitment to convergence supported these trends, shifting the goods market equilibrium to higher levels of output. This growth rate was accompanied by slightly higher rate of inflation over the last year at 3.1%. Removing the more volatile food and fuel components, however, shows inflation falling to 2.5%. Many analysts use this to show that increased inflation rose from increased oil prices over the last year.² Increased inflation may also be due to the European Central Bank’s (ECB) decision to increase the money supply last year, intending to stimulate domestic demand to counteract Europe’s fall in real GDP growth following the Asian Crisis.³ In November, the ECB decided to again contract the money supply--but the effects are not yet incorporated into prices.

*Improved Labor Markets:* In the labor market, Spain enjoyed dramatic real job growth. Leading the European Market in job creation, the Spanish economy provided over half of all new jobs between 1996-8, and continues to be a regional leader.⁴ In 1995, the unemployment rate reached over 23%, and has fallen consistently over the last five years. Liberalization was one of several possible sources for this growth. Growth in the services sector provided many of these positions.⁵

The Phillips curve suggests that in the short-run, increased inflation tends to coincide with a fall in unemployment. In the case of Spain, however, when inflation fell from 4.5% in 1993 to 2% in 1997,

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¹ The GDP growth numbers are in terms of year-on-year rate of change in the trend cycle series. Source: Banco de Espana online at www.bde.es
² Quarterly Report on the Spanish Economy. Source: Banco de Espana online.
³ Anonymous. Economist Economic Indicators.
⁴ Edmonson, Gail. Spain’s Success. Business Week.
⁵ See Appendix 2A to see a sector by sector breakdown of jobs in the Spanish economy.
unemployment fell simultaneously from 24.5% in 1994 to 20.5% in 1997. According to the Phillips Curve relationship, this could only result from a very large outside shock or a decrease in expected inflation.\textsuperscript{6} Since no other country experienced a positive external shock to increase employment, that was probably unlikely. Comparing the short and medium term interest rates, we found a small differential on Spanish bonds. From this evidence, it appears that Spain effectively reduced expected inflation through their firm commitment to the convergence goals within the EU.\textsuperscript{7}

\textit{Government Accounts Statistics Improve}: Spain’s general government accounts are improving, representing a smaller share of total real GDP. Part of the European Central Bank’s (ECB) policy guidance for Spain calls for further fiscal tightening. Despite a loss in revenues from personal tax and capital gains tax cuts, overall government revenues increased. Proceeds from privatizing many state-owned industries augmented the fall in tax revenues, leaving total revenues just above 40% of GDP.

Spain reduced its budget deficit within the guidelines of the Maastrict treaty, though the task was probably made easier by the high GDP growth rate since the guidelines are measured as a percent of GDP. This allowed spending to increase in real terms, while Spain met ECB goals. Between 1998 and 1999, Spain’s yearly deficit fell from 2.3% of GDP to 1.3%. Spain moved spending to reduce the country’s overall debt from 64.8% to 63.5% of yearly GDP. Projections for the future show Spain running a budget surplus, and bringing total debt as a fraction of GDP to 8%. Though impressive, these numbers represent percent of total output. Projections also rely on continued strong GDP growth (over 3% annually), and do not represent major decreases in actual spending.\textsuperscript{8}

\textit{Balancing Identities--Savings and Investment, Net Exports and the Capital Account}: The increase in disposable income did not result in increased private saving as real interest rates fell. Rather, private indebtedness to banks rose, outweighing the small increase in government savings last year. Net national savings declined as a result. Despite lower domestic savings, investment remains strong. As total savings falls short of investment, we expected to see a worsening net export. Currently, Spain’s trade deficit amounts to just under 2% of GDP, while the capital account surplus is larger than the current account shortfall.\textsuperscript{9} Spain’s positive balance of payments reflects demand for investment that exceeds net domestic savings, and an inflow of foreign capital to cover the shortfall. Trend data suggests that the savings-investment gap and ensuing positive balance of payments is increasing.\textsuperscript{10}

\textbf{Priority Concerns}

To maintain the high levels of consumer and investor confidence, Spain’s macroeconomic policy should focus on the weakest points of their new growth. These include the still-troubled labor market and balance of payments problems. The loss of monetary policy with adopting the Euro exacerbates these, and reduces the available policy remedies.

\textbf{Unemployment}: Continued high unemployment still ranks highly among Spain’s concerns. Even with continued economic growth, the population growth rate is greater than the number of new jobs created. Although unemployment rates have fallen in the recent economic upswings, they still haven’t recovered completely from the severe recession of 1992-1993, when it reached 24.5%. Moreover, recent data suggests that the unemployment rate is on the rise for the first time in several

\textsuperscript{6} See Appendix I for a review of the Phillips curve, and Appendix 2-2 and 2-3 to see the Unemployment Rate over time and the relationship between Unemployment and Inflation.

\textsuperscript{7} See Appendix 1-1

\textsuperscript{8} Banco de Espana Quarterly Report on the Economy March 2000

\textsuperscript{9} In 1999, Spain’s current account totaled -11672.3 million Euros and it’s capital account reached 6690.5 million Euros.

\textsuperscript{10} See Appendix 2-(3-5).
Across all categories, the fall in unemployment rates appears to be slowing over the last year. Moreover, new entrance to the labor force filled the bulk of the new jobs, so job creation had less impact than expected on unemployment.

**Structural and Seasonal Unemployment in Agriculture and Tourism:** Looking at the sector by sector breakdown, many were left unemployed in the structural shift away from agriculture towards industrial and services industries. Currently agricultural production accounts for only 4% of Spanish GDP and it is the only sector to experience consistently high rates of job loss. The tourist industry provides a huge number of jobs, but they are not year-round positions.

**Inefficient Labor Market:** Spain’s steps toward liberalizing labor markets and to increase wage responsiveness and labor flexibility have not yet taken hold. New regulations to increase the permanence of part-time employment have begun to show results but not necessarily the intended ones. Removing restrictions against part-time employment promoted a greater increase in part-time than in full-time employment in 1999. Though this increases employment, it could be replacing it with underemployment. People may not find enough work—especially if many firms hire part-time workers, they may avoid paying higher benefits packages and social insurance for full time workers. This is especially difficult in sectors affected by seasonal cycles.

**Lack of Monetary Freedom**
In fixing it’s exchange rate to the Euro, Spain received increased inflation stability and financial integration with other Euro countries, but also opened itself to a new set of risks. Leading up to the Euro, Spain’s convergence policy led to economic recession as officials corrected the overvalued peseta, and the recession of 1993 helped readjust the balance of payments. The increased stability in the inflation rate and credibility gained over the last few years benefited the Spanish economy. But now, with the ECB controlling monetary variables, monetary policy must balance regional interests. Actions taken by the ECB may not reflect the optimal policy for the Spanish economy.

**Balance of Payments--Trade and Financial Flows:** Supporting a fixed exchange rate with its main trading partners may pose particular problems for Spain in the near future. Although Spain currently enjoys a very high growth rate, the low interest rate provides little incentive for saving, and is driving investment far above net domestic savings. The negative current account has worsened with the growth in GDP, as Spain imports more and foreign demand has still not fully revived exports. Foreign capital funds an increasing portion of investment.

These problems are even more complex given the uneven growth patterns in the Euro currency zone. Already, the Euro zone has experienced differential interest rates between Germany and Spain. Lag time and magnitude of monetary policy by the ECB varies across countries. Research shows that EU countries like Spain bottom out 5-6 months after a contraction, while others like Germany can take 10-12 months. The relative impact on Spanish output is half the magnitude of the impact on Germany. Also, the countries that tend to fall together in terms of growth do not fall into the same groups that have these disparate monetary policy effects. Should the ECB take action to expand the money supply and spur investment, it might exacerbate the current account imbalances.

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11 Banco de Espana Main Economic Indicators Weekly Update. 7 April 2000
12 Economist Intelligence Unit.
13 See Appendix 1-3 to see the tradeoff triangle—courtesy Kathryn Dominguez
14 Banco De Espana
15 Ramaswamy, Ramana; Slok, Torsten. The Real Effects of Monetary Policy in European Union: What are the Differences? International Monetary Fund, June 1998. Ramaswamy and Slok’s analysis finds that EU countries fall into two main groups. 1) Spain, Sweden, Italy, France, Portugal, and Denmark show the full effects of monetary shock in half the time as the other group 2) Where the effects are half as deep as those on Austria, Belgium, Finland, Germany, the Netherlands and the UK.
in Spain. Meanwhile, as their trading partners recover, expectations of higher inflation may push Spain to higher inflation rates without lowering unemployment.

If and when monetary policy contracts to slow other economies down, it would drive Euro interest rates up, it would increase the cost of Spain’s public and private Euro-denominated debt. Given that their balance of payments shows them to be a borrowing country, and that trend continues upwards, it could cause a liquidity crunch as loans come due. If interest rates rose and the Euro appreciated, the cost of debt may require serious government spending re-allocations.

Policy Proposals
Lacking automatic stabilizers like flexible exchange rates, interest rates, or other monetary tools, our policy prescriptions focus on smart fiscal planning and increased liberalization. To assist in building the model, we’re assuming that Spain is a small country (price taker) with a fixed exchange rate.

Fiscal Side—Smart Spending
Restructuring Social Spending: Government spending currently feeds into labor market distortions identified earlier. A low threshold to unemployment benefits reduces incentives for people to actively seek work. Spain should establish a maximum time limit and reduce unemployment benefits to reduce incentives for people that can work to remain unemployed. Current estimates place Spain’s NAIRU at 17%. Such a high rate suggests size a large distortion in the labor market, or that real wages are so high that a small change in unemployment will accelerate inflation.

Some of the funds from these changes should be applied to job training programs, education and other human capital investments. Spain has been fairly successful in implementing similar programs, and should continue along this path given that the highest rates in job growth were in the services sector. This would ease the structural unemployment, providing new opportunities for displaced agricultural workers, and allocate labor resources more efficiently. Moreover, investments in human capital would counteract depreciation. The Solow growth model suggests that such improvements would increase the overall steady state capital ratio, as well as the income per capita. This would also increase consumption as the distance between the production function and the savings function is greater at k'.

Limitations—Output Falls: The IS-LM model shows how a reduction in Government Spending would cause a contraction in the goods market, represented by an inward shift in the IS curve. Given Spain’s exchange rate and interest rate are fixed to the Euro, such a contraction would have a larger negative effect on output than if they floated, given the need to contract the money supply at the same time. The balance of payments curve, however, probably has a positive slope. This means that the money supply can only contract until it meets the BoP, lowering the interest rate. Given the negative real interest rates for saving, this may lead to a greater fall in saving. Spain would likely have to spend foreign reserves to purchase more Euro and maintain domestic interest rates. The current account may improve with a fall in output, but with sticky prices and wages, the fall in output may make it even harder for people to obtain work in the short run. It also may take time for the investment in education to shift out the δ+η+γ curve.

Spain has been slow to implement fiscal constraint it due to political pressures. Last month’s presidential election left both parties reluctant to suggest a cut in entitlements, despite criticism from the ECB. When dealing with high levels of structural unemployment, it may be hard for the government to determine what kind of job training or other placement programs would work best. Also there’s the immobility of labor. Since some people would rather not work than move from their homes, it might present another obstacle to labor law liberalization.

16 See Appendix I.
Hedging Against a Downturn—Improving the Balance of Payments

Increase Domestic Savings: As a country, Spain should try to increase the savings rate if it wants to sustain the high level of growth it enjoys. While this would not mitigate the negative impact from an immediate monetary contraction, it could lower their exposure as external debt is repaid. Under increasing interest rates, capital account surpluses are more costly. Increasing domestic savings reduces demand for foreign borrowing.

Revenues from Privatization can Increase Savings: Rather than spend privatization revenues on unemployment benefits or fueling other consumption, the government should increase public savings. Developing policy to change consumer behavior is difficult if not impossible, so the Kingdom of Spain needs to focus on things it can affect. The current spending directly on consumption could increase expectations for continued government assistance, and may have a negative effect on private savings.17

Saving against Monetary Contraction—Reduce the Public Debt or Undergird Social Safety Net: Using these funds to augment government savings would reduce dependence on foreign capital. Shifting from the consumption-focused spending can reduce distortions, and mitigate risk through savings. Faster repayment of public-held external debt may promote stable growth. Research shows that an "average" decrease in public capital financed by external debt can improve economic growth in an amount equal to some .25% per year. An "above average" increase in public capital where both quality and efficiency of public capital grows stimulates less than half the growth.18 So while they could have a positive effect by spending, it makes more sense to save.

Limitations: If expectations are driving the investment, somehow rising the "animal spirits" component of investment, it’s unclear that fiscal policy can address these factors. Increasing government savings may not be sufficient to reduce the amount of external debt if it keeps increasing at current rates. A sudden shift in expectations could affect Spain’s risk premium—or investor expectations that Spain can repay the debt. While Spain is not considered a developing country, it’s still very vulnerable to sudden swings in expectations.

Redirecting the proceeds from privatization away from consumption based government spending will be politically unpopular, especially given that they are mostly entitlements like health care, pensions, and unemployment. Even if such reductions reduce distortions, they can be extremely painful, and cause a real fall in welfare of the most vulnerable populations.

Conclusion
If Spain still had monetary policy, it may have had an easier time hedging against some of the above risks, but not all of them. While it’s clear that monetary freedom could ease transition through asymmetric shocks, or in reducing unemployment given lower sustained inflation, the country’s historical problems could return to haunt them if expectations fell. That aside, given the current strengths of the Spanish economy, they may not have any reason to be concerned at all. Enjoying the highest job creation rate relative to other Euro states, and the high levels of consumer and investor confidence, slow but careful reform may be the best way to preserve the winning formula.

17 A similar effect was seen in many oil-producing countries in the Middle East when oil-prices fell. Those directly dependent on state spending for transfer payments were left substantially worse off when the “security” income was no longer available.