

2. THE SPANISH ECONOMY

2.1 Recent Economic Developments

During the latest two decades the Spanish economy expanded rapidly. Since 1980 gross domestic product at constant prices increased by more than 80 %, which corresponds to an average annual growth rate of 2.8 %. After roughly a decade of rather weak growth following the first oil price shock the Spanish economy received a strong impulse from EU accession in 1986. Boosted by foreign direct investment and transfers from Brussels the growth rate soared to 5.5 % in 1987 and remained high for the following years. Like other European economies Spain fell into a short but deep recession at the beginning of the 1990s. In 1993 gross domestic product decreased by 1 %. In the run-up to European Monetary Union (EMU) interest rates declined sharply and thus facilitated another period of dynamic expansion beyond the launch of the euro. Most recently Spain showed the fastest economic growth among the bigger euro area economies.

During the most recent world wide downturn domestic demand in Spain remained quite resilient. Low real interest rates were among the key driving forces. With mortgage rates partly negative in real terms (Oregui 2004) households had extra funds for consumption expenditure. The favourable employment trends equally contributed to rising consumer spending via rapidly rising disposable income. Further, the savings ratio has decreased by about 4 percentage points since the introduction of the euro.

Strong investment has been the second pillar of domestic demand. Construction activity has been particularly dynamic. Since the middle of the 1990s Spain experienced an unprecedented housing boom. Investment into construction rose by 4.6 % annually. Boosted by tax incentives housing demand has risen even faster (+ 6 %) causing real estate prices to increase by double digit rates in every year since 1999. Although the Bank of Spain (Ayuso, Martínez, Maza, and Restoy 2003) and other institutions have

already warned of a housing bubble, residential construction continues at a fast pace. Most Spaniards live in owner-occupied flats. Thus, Spanish households hold about 70 % of their wealth in real estate (OECD 2003, p.16). As Spaniards usually finance housing with variable rate mortgages the combination of rising house prices and low interest rates exerts a positive influence on consumer spending. However, an unexpected increase in interest rates may put an abrupt end to the boom.

	1981-1990	1991-2000	2000	2001	2002	2003
Aggregate demand at constant prices of 1995:						
Gross domestic product	2.9	2.7	4.4	2.8	2.2	2.5
Private final consumption expenditure	2.5	2.4	4.1	2.8	2.9	2.9
Government consumption expenditure	5.0	3.3	5.6	3.5	4.1	3.9
Gross fixed capital formation	5.5	3.0	5.7	3.0	1.7	3.2
Exports of goods and services	5.5	10.1	10.1	3.6	1.2	2.6
Imports of goods and services	9.2	9.2	10.5	3.9	3.1	4.8
Current account balance (% of nominal GDP)	-0.9	-1.5	-3.4	-2.8	-2.4	-2.8
Unemployment rate (% of labour force)	18.3	19.6	13.9	10.5	11.4	11.3
Total employment	1.1	1.3	3.5	2.4	1.5	1.8
Productivity	1.8	1.4	0.9	0.4	0.7	0.7
Nominal compensation per employee	10.4	5.3	3.8	3.9	4.1	4.2
Unit labour cost	8.4	3.8	2.9	3.5	3.3	3.5
Consumer price index	9.3	3.9	3.4	3.6	3.1	3.0
GDP Deflator	9.4	4.1	3.4	4.2	4.5	4.0
Nominal budget balance (% of GDP)	-4.5	-4.2	-0.9	-0.4	-0.1	0.4
Nominal government debt (% of GDP)	N.A.	59.8	61.2	57.5	54.4	50.7

Table 2.1: Main Macroeconomic Indicators of the Spanish Economy (annual %-change).

Sources: Eurostat, OECD, IMF

With construction and consumer spending expanding rapidly it is not surprising that employment has also risen fast - especially in construction and services. Employment in construction has increased by roughly 50% since 1995 and now accounts for more than 12 % of all jobs in the Spanish economy - in contrast to the EU-15 average of

slightly less than 8% (European Commission 2003). Although total employment is now one third higher than in 1980, the Spanish participation rate is still among the lowest in the EU-15 countries and the unemployment rate is among the highest in the EU-15 countries. Nevertheless, Spain has experienced an enormous improvement of its labour market conditions. The unemployment rate is now less than half of the peak of 24.6% reached in early 1994. As the employment threshold has continuously decreased and amounted to less than 1 % since 1993 (Rietzler 2004), the rapid increase of employment has continued even with the relatively lower growth rates observed most recently. However, the declining employment threshold corresponds to a slowdown of productivity growth. Over the estimation period trend productivity declined from $2\frac{1}{2}\%$ to only $\frac{1}{2}\%$ most recently.

Under these circumstances a stability-oriented wage policy would have meant wage increases of about $2\frac{1}{2}\%$: the ECB's inflation target plus medium term productivity growth. This contrasts sharply with Spain's actual wage increases of roughly 4 % annually during the last 4 years. It is therefore not surprising that Spain's inflation rate has persistently remained well above the euro area average. During most of the time since the launch of the euro the inflation differential amounted to $1\frac{1}{2}$ percentage points. As the ECB's inflation target of below but close to 2% is set for the euro area as a whole, monetary policy does not react to inflation in individual member states as long as the euro area average remains unaffected. At 11% Spain's share in the harmonised index of consumer prices (HICP) is too small to provoke any monetary policy reactions.

With the start of the European Economic and Monetary Union (EMU) in 1999 the framework in which Spanish exporters operate also changed significantly. With the introduction of the common currency Spain lost the possibility to offset a loss of price competitiveness by a devaluation of its currency vis-à-vis its trade partners in the euro area. Between 1980 and the beginning of the EMU there were several substantial devaluations in which the peseta lost roughly one third of its value against¹ the currencies of the other EMU member countries. When devaluations are ruled out, differences in the inflation rates have an immediate effect on the competitiveness of the Spanish

¹ Weighted with Spanish exports to the EU12 countries in each year.

economy. As the euro area accounts for roughly 60% of Spain's exports of goods these mechanisms cannot be ignored. Depending on the price index used in calculating the real effective exchange rate Spain has lost between 4.1 (HICP) and 8.1%(GDP deflator) of its competitiveness vis-à-vis its EMU trade partners since 1999 (European Commission 2004). Thus it comes as no surprise that Spain's trade deficit with the rest of the EMU has widened dramatically since the mid-90s and amounted to 2.7% of nominal GDP in 2002, the end of the estimation period.

2.2 *Institutions*

It is difficult to understand the dynamics of the Spanish economy without some insight into Spain's institutions and their reforms during the latest two decades. Particularly monetary and exchange rate regimes, industrial relations and labour market reforms have had some impact.

2.2.1 *The Monetary Policy Framework*

Using Markov switching methods Ayuso, Kaminsky and López-Salido (2003) have shown that three different monetary policy regimes can be distinguished for the period from 1962 until 2001. The first is one of high and volatile inflation observed during the period from 1962 until 1978. The regime change was then caused by the so-called Moncloa Pacts (Pactos de la Moncloa), an agreement between the government, the trade unions and political parties to reduce inflation (which had reached 25 % at the end of 1977). The main instrument for inflation reduction then was wage policy. For the first time wages should be agreed according to *expected* rather than *actual ex-post* inflation. This wage policy was accompanied by a tightening of the monetary stance via decreasing growth rates for M3. The Bank of Spain continued to pursue an official monetary target for some years, although - due to financial liberalisation measures from the end of the 1970s onwards (Ayuso, Kaminsky, and López-Salido 2003) - the money demand could not be taken as stable. Consequently, the Bank of Spain shifted its focus to the exchange rate. With EU accession in 1986 monetary policy was oriented towards an exchange rate target. When Spain joined the ERM in 1989 this became the official

monetary policy. The constraints of a fixed exchange rate forced the Bank of Spain to keep inflation under control to an even greater extent than before. It is therefore not surprising that the study of Ayuso et al. (2003) found the second regime shift from "medium and almost stable inflation" to "low and stable inflation" around 1990. The probability for this last regime increases further in the middle of the 1990s - the time, when the Bank of Spain became independent (June 1994) and introduced inflation targeting (Debelle 1997). Since the introduction of the euro in 1999, however, a slight upward trend in inflation could be observed. As the ECB's monetary policy is geared towards the EMU average, no sanctions for an inflation rate exceeding the ECB's target have to be feared.

2.2.2 *Collective Bargaining*

When inflation and wage developments are analysed, it is essential to take the system of collective bargaining into account. Although only about 15 % of all employees were members of a trade union in 1998, the agreements between employers and trade unions are binding for roughly 90 % of the employees. This is one of the highest shares in the EU - only surpassed by France, which has a similarly low trade union density (OECD 2004, pp. 145-146). The legal basis for the automatic extension of collective agreements is the Estatuto de los Trabajadores of 1980. Since then collective bargaining coverage has increased from 60 to 90 %, whereas trade union density grew only from 7 (1982) to roughly 15 % (OECD 2004, Izquierdo, Moral, and Urtasun 2003). Some flexibility was introduced with opt-out clauses in the labour market reform of 1994.

The majority of all collective agreements refer to the provincial level for the respective industries. The analysis of all collective agreements from 1990 until 2001 carried out by Izquierdo et al. (2003) came to the conclusion that wage increases at this intermediate level tend to be higher than those agreed either at company level (13.3 % of all agreements on average during reference period) or on the national level (26.6 %). However, in years of high unexpected inflation this effect is offset by the indexation clauses (clausulas de salvaguarda) that applied to more than 70 % of all collective agreements in 2001 (Izquierdo, Moral, and Urtasun 2003, p.42).

In the initial period of disinflation indexation proved helpful to stabilise inflation expectations, but in the context of EMU, where the central bank does not react to regional inflation, indexation causes price shocks to generate a wage-price-spiral, which is not stopped in the short run. Only when the loss of competitiveness threatens jobs, there may be a moderation of wage increases. However, as we can see in the next paragraph there are institutional reasons, why the effect of unemployment on wages can be expected to be low in Spain.

2.2.3 *Labour Market Reform*

The Spanish labour market is characterised by high unemployment and a high degree of segmentation. Roughly one third of all work contracts are fixed-term contracts. No other EU country shows an equally high share of fixed-term employment (European Commission 2003). Employment protection was loosened a little with the latest labour market reforms in 1997, but it is still high by international standards (Lopes 2001, p.9). It is easy to imagine the macroeconomic effect of high employment protection and the ensuing segmentation in combination with an automatic extension of wage agreements. The level of unemployment or the share of precarious employment hardly have any effect on wage increases, because the latter are the result of wage bargaining by protected insiders.

The introduction of fixed-term employment, which was originally designed to reduce unemployment by creating a more flexible labour market, has not influenced the *level* of employment, but rather its *structure*. It helped to reduce long-term unemployment (Dolado, García-Serrano, and Jimeno 2001). Nevertheless, the excessive use of fixed-term contracts induced the government to restrict the use of this contract type and liberalise employment protection slightly in 1994. As the reform of 1994 was regarded as insufficient, further steps were taken in 1997. Employment protection was reduced significantly for new hires. Severance payments for the new employees amounted to less than half of the level prior to reform². Dolado et al. (2001) argue that the partial

² However, some groups of employees that easily find employment were excluded from the new regulation, which was also subsidised via social security rebates (Dolado, García-Serrano, and Jimeno 2001, p. 10)

dismantling of employment protection with the reform of 1997 contributed to the strong decrease of the unemployment rate since then. However, this can be doubted. As Bentolila and Jimeno (2003, p.8) found out the reduction of the share of fixed-term contracts in new hires decreased only marginally (to 91%) after the reform. This means that in practice the new contracts with reduced employment protection accounted for less than 10 % of all new hires. This share is certainly too small to serve as an argument for unemployment reduction. It seems much more probable that the high growth rates for several years in a row, which are due to the excessively expansionary effect of European monetary policy on the Spanish economy, were the decisive factor in bringing down Spanish unemployment.