
The Spanish experience in EU accession

Contribution by José Luis Malo de Molina, Director General of Economics, Statistics and Research of the Banco de España, to the panel on "Mediterranean Experiences in Accession" in the Seminar organised jointly by the Central Bank of Malta and SUERF in St. Julian's, Malta, on March 27-28 2003.

SPANISH ACCESSION TO THE EU

Spanish accession to the European Union and progressive external openness have been the driving forces behind the modernisation of the Spanish economy in recent decades. The Spanish economy was relatively closed and the process of integration has seen a rapid opening-up, manifest in a growing intensity of trade and capital flows.

External openness has prompted significant changes. In particular, it has spurred the essential measures of macroeconomic and financial discipline needed to enable Spain to be included among the founding members of Economic and Monetary Union and to position it appropriately in the new globalised economy. Chart 1 displays the intensity and scope of the process.

THE PROCESS OF ADJUSTMENT TO INTEGRATION REQUIREMENTS

Adapting economic policy to the requirements arising from European integration was complex and costly, with bouts of progress interrupted by occasional setbacks. For an overview of key events and features, three different periods may be distinguished. The initial phase runs from EU entry to the European Monetary System (EMS) crisis at end-1992. Thereafter began the difficult process of achieving nominal convergence. And the third period covers Spain's experience in Monetary Union.

The initial phase

In this phase of strongly expanding activity, employment and investment, economic policy goals were geared towards competitiveness and stability. However, the economic policy mix implemented was unbalanced (very restrictive in the case of monetary policy, very expansionary in that of fiscal policy and only a partial use of the exchange rate discipline afforded by the EMS). This inappropriate policy mix had an adverse effect on inflation and the real exchange rate, leading to a build-up of substantial losses in competitiveness (Chart 2).

Appropriate levels of competitiveness were restored after a very costly adjustment resulting

from successive depreciations and from a sharp contraction in output and employment that brought about substantial productivity gains. The exchange rate adjustment was the markets' verdict on inappropriate domestic policies, but it permitted the correction of relative prices and costs and helped restore business surpluses and profits.

Nominal convergence phase (end-1992 to end-1998)

In response to the shortcomings of the macroeconomic policies adopted until then, it was decided to re-balance the underpinnings of the economy for a stability-oriented strategy based on the criteria established under the Maastricht Treaty, as a condition for gaining access to Monetary Union. To this end, tighter budgetary policies were pursued and a new monetary policy strategy based on direct inflation targets was adopted. The success of these policies enabled exchange rate stability to be gradually regained.

Economic discipline spurred the correction of the imbalances, setting in motion a series of virtuous mechanisms which bolstered economic agents' confidence and prompted an adjustment of expectations (essentially regarding prices and the budget deficit). This ultimately proved highly beneficial for implanting an environment of macroeconomic stability (Chart 3).

As a result, nominal convergence was compatible with a fresh expansionary phase marked by robust output and employment growth.

Monetary Union phase

Participation in Economic and Monetary Union since 1999 has allowed Spain to reap the benefits of sharing a common macroeconomic standard with the core European countries. This common standard has two strands.

First, membership of a monetary union, when conditions are right, allows the link between interest rates and the exchange rate with domestic conditioning factors to be broken, permitting greater levels of credibility and confidence to be imported. Breaking this link was particularly important for Spain since, until then, turbulence on financial and foreign exchange markets had often acted as a trigger for bouts of recession via heavy interest rate rises and sharp depreciations, which were frequently disproportionate.

Second, monetary union membership involves assuming commitments that entail restric-

tions on domestic policy action: namely, forgoing the use of the exchange and interest rates as instruments to achieve national economic objectives and to correct potential disequilibria. These restrictions meant other facets of economic policy had to be reinforced. In particular, a more prominent role had to be assigned to budgetary policy as an instrument for medium- and long-term stability, and the liberalisation of the economy had to be speeded up so that the increase in competition might make for more flexible responses by supply to changes in demand.

The establishment of a regime of stability and the momentum given to flexibility in respect of the workings of the markets for factors and products have helped set in place the conditions conducive to sustained growth and for generating more employment. As a result, throughout the monetary union phase to date, growth in Spain has outpaced the euro area average, and headway has been made in real convergence (Chart 4). At the same time, cyclical oscillations have been smoothed, which is particularly relevant given that, in the past, phases of strong growth tended to end in sharp recessions, moving Spain off course from convergence.

Nonetheless, during these four years there has been a persistent inflation differential, which is a threat to the economy's competitiveness. This and other risks will be dealt with in greater detail later on.

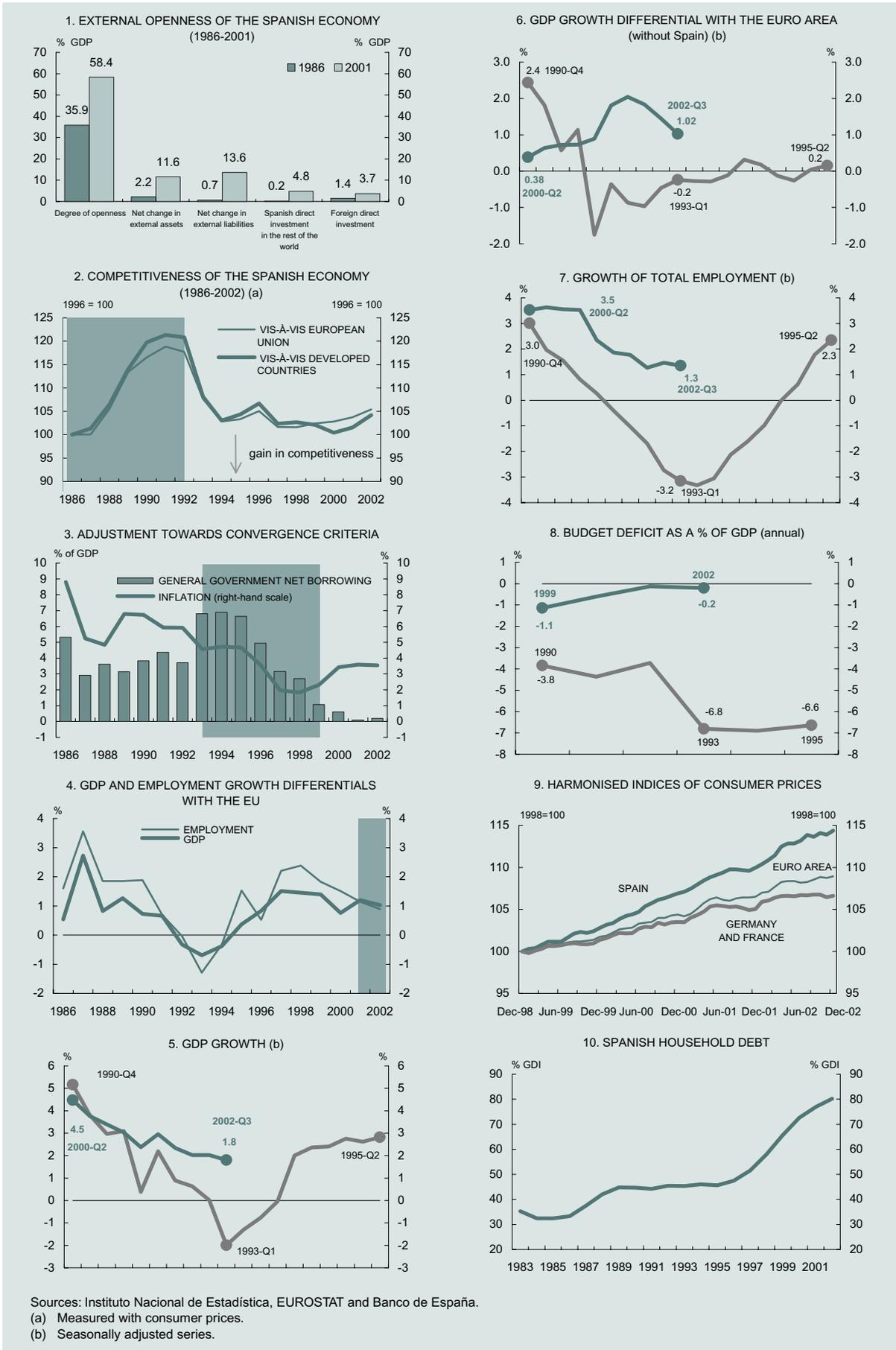
CHANGES IN THE CYCLICAL BEHAVIOUR OF THE SPANISH ECONOMY AFTER JOINING MONETARY UNION

The scale of structural changes in the workings of the Spanish economy can be quite clearly seen if its patterns of behaviour during the current slowdown are compared with those of the last cyclical episode of a similar nature.

Notably, in this respect, over the past two years – approximately in parallel with the current downturn – the Spanish economy has sustained moderate but constantly positive growth rates. These are far removed from the figures posted at the time of the previous cyclical trough (in 1993), when the contraction in output was around 2%. As Chart 5 shows, the changes in the Spanish economy under Monetary Union have been set against the considerable benevolence of the recent downturn, compared with the severity of the recession in the early nineties.

CONTINUITY IN REAL CONVERGENCE

Further, the fact that the Spanish economy has bottomed out at a relatively high growth



Sources: Instituto Nacional de Estadística, EUROSTAT and Banco de España.
 (a) Measured with consumer prices.
 (b) Seasonally adjusted series.

rate has allowed positive growth differences to be maintained with the euro area average and permitted continuing progress in real convergence, even during this current slowdown (Chart 6). That marks a qualitative change from the traditional pattern of the Spanish economy, whereby real convergence would fall back during recessions, losing much if not all of the ground gained during upturns.

INTENSIVE GROWTH IN EMPLOYMENT GENERATION

Supporting these two major achievements of Spain's EMU experience has been a third differentiating factor, namely the high employment-creating capacity shown over recent years. Chart 7 illustrates how, at the recent cyclical trough, employment continued to grow at a rate of over 1%, while at the previous low a rate of decline of employment of around 3% was recorded. This difference is fundamental for explaining the greater resilience of household spending and the progress in convergence of per-capita income levels.

ELIMINATION OF THE BUDGET DEFICIT

A final difference between the current slowdown and that in the early nineties is the different role played by public finances (Chart 8). During the 1993 recession the budget deficit surged, while the recent phase of weakness has seen the culmination of the budgetary consolidation drive. This factor has been pivotal to allowing balanced integration within the euro area and has eliminated the adverse influences on growth that budgetary imbalances generate. It has thus been possible to introduce elements of rationality into public spending, enabling levels of public investment to be restored that are more in keeping with the need to extend the economy's productive capacity. And tax reforms tending to lower the burden on households and firms have also been implemented, improving the incentives for economic efficiency.

CURRENT RISKS: THE INFLATION DIFFERENTIAL AND SLUGGISH INVESTMENT

However, the positive features of the Spanish economy since it joined Monetary Union should not mask the emergence of certain developments whose persistence over time may alter the steady path of adaptation to economic and monetary union hitherto followed.

In this respect, the persistent differentials with the euro area in the growth rate of final prices are

a cause for concern. Since the outset of EMU, the HICP has grown five percentage points more in Spain than the euro area average (Chart 9). This has largely been due to the growth of prices and margins in the more sheltered sectors, denoting an as yet insufficient level of competition in certain markets, despite progress in recent years. This is not the place for an in-depth discussion of the scope of inflation differentials within a monetary union, a subject on which the Banco de España has published numerous papers (see the accompanying references). Nonetheless, the behaviour of prices in Spain indicates the presence of risks in the price formation area which may affect the future competitiveness of exports. And exports will in the future have to play a key role in the growth model underpinning the Spanish economy.

A second source of concern in recent years is the weakness in business investment in capital goods. Much more so since this slowdown in investment projects has come about despite the fact that the rates of return of companies have far outperformed borrowing costs. This poor performance can be attributed to the inhibiting effect exerted by heightened economic uncertainty, the failure to turn a profit on certain large-scale investment projects and the sharp correction of stock market prices. However, investment must regain its past buoyancy, since the incorporation of technological innovation into the productive process and improved productivity depend on it.

THE RISKS OF HIGH DEBT

A third factor of risk is the strong increase seen in household debt to finance the robust expansion of consumption, and the acquisition of financial assets and of housing, against the backdrop of heavy cuts in interest rates and rises in wealth that accompanied the culmination of nominal convergence and euro area entry.

Household debt as a proportion of disposable income stood at perhaps 80% in 2002 (Chart 10), a level not far different from the euro area average and below that in the United States, but one which has grown most briskly since 1995 (when it was 45%). In principle, this increase in the level of household indebtedness may reflect solely the adjustment to a new equilibrium, with much lower interest rate levels. If that is the case, the proportion of debt to disposable income will tend to stabilise. However, there are elements of inertia related to the dynamism of credit for house purchases that may sustain continued growth.

In this respect, an additional factor of risk is that the financial equilibria of the household

sector are very sensitive to house prices. Thus, an adjustment in these prices in the future might endanger the sector's financial sustainability and any recovery in spending.

THE CHALLENGES AHEAD

The main challenge facing the Spanish economy in the medium term, once the temporary expansionary effects accompanying the transition to the third stage of EMU have faded, is to maintain higher growth rates than those of the more advanced countries and to continue reducing differences in economic well-being. The cuts in interest rates and the increase in the value of wealth prompted an expansionary momentum that is not repeatable. Future growth will have to reside on the economy's own capacity in an environment of strong competition, which will intensify following the enlargement of the EU.

Growth should thus be investment- and export-led, and certain constraints must be overcome, among others those imposed by specific features of the Spanish economy's productive and trade specialisation, namely: the excessive weight of the construction sector; the concentration of exports in a limited number of productive branches; and the loss of weight of imports of high-technology products.

To address these challenges successfully, it is vital to ensure the economy's competitiveness in the medium and long term, a matter which hinges crucially on the performance of productivity. Reforms will be called for in several areas: to enhance the efficiency of productive and organisational structures; to adopt leading-edge technologies; and to see through measures providing for the flexible working of goods and services markets and of institutions, in line with those pursued in recent years. The scope of such reform will be crucial.

The relative success of the Spanish economy since EU accession and, above all, since

EMU participation is due to it having proven capable of adapting its macroeconomic regime to standards of stability and promoting the structural reforms so vitally needed to ensure adaptation by markets, economic agents and institutions. Success in economic performance is hard to maintain for long. For Spain's success to persist over time and be sufficiently sound, structural reform along the lines of that approved at the Lisbon and Barcelona summits must be continued and deepened. Indeed, this is a valid prescription, in one way or another, for all present and future EU member countries.

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