Spain

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Spain, is the second largest country in the European Union (EU) after France. It is also the second most popular tourist destination in the world, again after France. For a major part of the 20th century, Spain was one of the poorer countries in Western Europe. But now, it is rapidly emerging as an industrial power house.

Spain has 17 autonomous regions. The important cities are Madrid the capital, Barcelona, Valencia and Seville. The Spanish people form a diverse group. The desire for political independence is strong among the Catalans and the Basques. Most people in the country are Roman Catholics.

Spain's economic reforms after having started hesitantly, accelerated when the country became a member of the European Economic Community in 1986. Prime Minister Jose Maria Aznar's Government, which came to power in March 1996 has maintained the tempo of reforms. It has reduced government spending significantly and emphasized privatization. Stakes in Telefonica (Telecom), Endesa (Energy), Argentaria (Banking) and Repsol (Energy) have been divested. Laws have also been amended to make the labor markets more flexible.

In 1975, 20 percent of Spain's workers were involved in agriculture. But today, the country is highly industrialized. Since 1994, Spain has been creating jobs at an impressive rate. Spain's openness to the external world has increased significantly in the past few years. Many MNCs have increased their investments in Spain, attracted by the relatively cheap but productive labor. Thanks to the government's privatization efforts, Spain has also produced its own breed of MNCs. Telefonica, has been an aggressive investor in Latin America. Endesa, is another aggressive foreign investor. Today, the Spanish economy, is a net exporter of capital. In 2000, foreign direct investment by Spanish companies added up to 8.6 percent of GDP. The country's public finances are also in good shape. Madrid is considered along with London, Frankfurt, Paris and Stockholm as one of the top stock markets in Europe. Spain's transportation infrastructure is becoming very sophisticated. It is hoped that by 2004, any part of this large country can be reached within four hours.

Despite the government's zealous pursuit of reforms, a lot remains to be done. Unemployment remains high, though much lower than in the early 1990s. The state sector is still of a significant size. The public pension system needs to be reformed. There is still heavy dependence on EU subsidies. Firing workers continues to be expensive. Spain also needs to strengthen its efforts to channel capital into high tech start-ups. Another concern for Spain is a bigger European Union. Currently, 10 out of the 17 regions in the country receive aid because their per capita incomes are less than 75 percent of the EU average. But after the increase, only two of the regions may qualify for aid. As the Financial Times[1] has put it, "Dependence on EU aid sits uncomfortably with Aznar's desire to sit at Europe's high table."

The Spaniards, however, are confident about the future. As the economy booms, they are benchmarking themselves against developed countries like the US, outside continental Europe. Rodrigo Rato, Spain's influential finance minister, recently outlined Spain's strategy[2] : "The new paradigm is not magic. You need basic orthodox macro-economic policies if you want your country to tap new opportunities. The first one is to have your public accounts in balance. It's very clear that if you want to have the financing for strong investment

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development in new technologies, you have to have a balanced budget that will give you financial resources to move ahead. The second is to have very strong liberalization and anti-trust policies as well as tax reductions and tax modernization to support the globalization of industry."

Background Note

Spain's present language, religion and laws stem from the Roman period. The Romans captured Spain in the 2nd century BC and made the region a colony. The last Roman strongholds collapsed only in the 7th century AD. In 711, North Africans invaded the territory. They were driven out only in 1492. The Spanish monarchs, Ferdinand V and Isabelle I became the rulers of Spain. Catholic leaders expelled the Jews in 1492 and attempted to convert Muslims by force. In 1492, Columbus discovered America and the stage was set for the establishment of a colonial empire. By 1512, the unification of the present-day Spain was complete.

During the 16th century, Spain became the most powerful nation in Europe, (and probably in the world) thanks to the immense wealth it generated, through its colonial expansion in the Americas. Under Charles I (1516-1556) Spain entered its golden age. Art, culture and intellectual pursuits flourished. The dominance of the church also grew. Then, the country's decline began under Philips II (1556-98). The defeat of the Spanish Armada in 1588 was a major blow. Spain's plight worsened when France under Napoleon occupied the country during the early 1800s. Throughout the 19th century, the country saw many armed conflicts. Many Spanish colonies in the western hemisphere also revolted. The monarchy was ousted. In the Spanish-American war (1898), Spain lost Cuba, Puerto Rico and Philippines to the US.

In 1923, a military dictatorship was established under Primo de Rivera. The leftists took charge in 1936. Around this time, unchecked violence led to the Spanish civil war. During World War II, Spain aided the Axis but did not enter the war.

In 1939, General Francisco Franco took charge. Spain was isolated by the victorious allies after the second world war. But in 1955, it joined the United Nations. Under an IMF stabilization plan launched in 1959,

Table I
Main Economic Indicators, 2000

Real GDP growth (%)	4.1
Unemployment rate (%)	14.1
Consumer price inflation (av; %)	3.4
General government balance (% of GDP)	-0.4(a)
General government debt (% of GDP)	64.0(a)
3-month interbank interest rate (%)	4.4
Current-account balance (% of GDP)	-3.2(a)
Exchange rate Pta:DM (av)	85.07
Exchange rate Pta:US$ (av)	180.68

Source : Economist Intelligence Unit

Spain began liberalizing trade and capital flows. The pace of reforms slowed down in the 1960s while the oil shock of 1973 fuelled inflation. But industrialization and growing economic prosperity facilitated Spain's transition to democracy during the late 1970s.

Until 1975, the Spanish economy was closed. Strict import controls were maintained as the economy evolved from an agrarian into an industrialized one. In 1975, when Franco died, his heir, Juan Carlos (the surviving grandson of the king who had fled the country in 1931), gave the country a new direction. Even today Carlos is a highly respected monarch. A lot of the credit for Spain's economic recovery goes to the (1982-96) Spanish Socialist Workers Party, (PSOE) government of Felipe Gonzalez, who dismantled much of the state ownership inherited from Franco. Gonzalez also led Spain into the EU in 1986. The Socialists returned to power in 1989 and subsequently as a minority government in 1993.

A major turning point in Spain's economic development was the 1993-94 crisis. Employers and trade unions understood they had to change. Companies began to modernize in earnest, cutting payroll, wages and prices to survive. The unions realized that their demand for large wage hikes and excessive job protection, was aggravating the crisis. The government amended labor laws to make firing easier and less costly. Meanwhile, uneasy householders began to spend less.

In 1996, Jose Maria Aznar's Popular Party came to power. Aznar maintained the momentum created

[1] *June 6, 2001*
[2] *Business Week, May 15, 2000*

Table II
Trends in Important Macro Economic Parameters

	1997	1998	1999	2000
GDP per head (USD)	14,264	14,892	15,228	14,200
GDP (% real change pa)	3.94	4.32	4.02	4.07
Government consumption (% of GDP)	17.57	17.51	17.33	17.07
Budget balance (% of GDP)	-3.20	-2.50	-1.10	-0.34
Consumer prices (% change pa; av)	1.96	1.84	2.31	3.44
Public debt (% of GDP)	77.70	78.30	72.40	67.80
Labor costs per hour (USD)	12.24	12.14	12.11	10.77
Recorded unemployment (%)	20.82	18.82	15.87	14.07
Current-account balance/GDP	0.45	-0.54	-2.10	-3.20
Foreign-exchange reserves (bn$)	68	55	33	30

Source : Economist Intelligence Unit

by Gonzalez. He decentralized powers to the provinces and gave a new thrust to privatization, labor market reforms and increased competition. By 1998, Spain's economy was well within most Maastricht guidelines. With an inflation rate of 1.4 percent, an interest rate of 4.9 percent and a government deficit rate of 2.6 percent, Spain could easily make it to the European Monetary Union in 1999.

Since its entry into the currency union, Spain has been one of the better performing economies. On the political front too, the much needed stability has been restored, despite the problem of Basque separatists. Aznar's Popular Party was re-elected in March 2000. Despite its absolute majority, the government has sought consensus wherever key social and economic issues are concerned. At the beginning of the new millenium, Aznar remains one of the most respected leaders and Spain one of the most respected countries in the E U.

Economic & Social Policies

Agriculture, forestry and fisheries account for 3.6 percent of GDP, manufacturing for 21.7 percent, construction for 8.8 percent and services for 65.9 percent (2000 figures). The construction sector accounts for a high proportion of GDP due to the huge demand for infrastructure in a vast country and heavy investments in tourism related buildings and second homes.

As mentioned earlier, Spain has been one of the faster growing countries in the EU. Between 1997 and 2000, real output grew at over four percent. This created more than two million jobs, bringing the rate of unemployment down from 21.5 percent to 13.6 percent. Towards the end of 2001, economic growth slowed down. But for 2001 taken as a whole, Spain still grew by an impressive 2.8 percent. In 2002, growth is expected to slow down to 1.9 percent. Inflation is expected to fall to 2.2 percent in 2002 due to weaker demand and lower producer prices. The budget deficit for 2002 has been projected as 0.6 percent of GDP. This is fairly a comfortable situation compared to France and Germany.

The Spanish government influences the economy less through ownership and more through regulations. But the Government does own part or all of a few of the country's largest companies. Under Aznar, Spain has been quite serious about privatization. Successful examples of privatization include Telefonica, Gas Natural and the petrochemical company Repsol.

The Spanish Government has been taking various steps to encourage the development of value adding industries such as automobiles and pharmaceuticals as opposed to traditional ones like coal and steel. Realizing the importance of research & development, Aznar has revamped the industry department and created a new Science & Technology Ministry. A blueprint has been drawn up for increasing R&D spending from the current 0.8 percent to 2 percent of GDP by 2003. The government has also announced fiscal incentives for new technology investments in specified sectors. Though Spain has gone further and faster than most other European countries in privatization, much still needs to be done to inject competition in some sectors. The Government has been understandably hesitant in saying a flat no to the "national champion" notion, which is popular in the country. 80 percent of the electricity market is still in the hands of just two companies.

Many analysts feel that Spain's regulators lack both independence and the required powers. The Government has also been a bit slow when it comes to reforming corporate governance practices. It has been keen on preserving the network of close relationships that exist between politicians and Spain's largest companies. Compliance to a voluntary code of conduct framed by an independent stock market regulator in 1998, has been weak. The country's takeover code is also outdated.

Table III
Comparative Economic Indicators, 2000

	Spain	France	Germany	Italy	UK
GDP (US $ bn)	558(b)	1,289(b)	1,878(b)	1,077(b)	1,414(b)
GDP per head (US $ at purchasing power parity)	19,245(b)	23,531(b)	24,693(b)	23,215(b)	23,285(b)
Consumer price inflation (av; %)	3.4(b)	1.7(b)	2.0(b)	2.6(b)	2.1(b)
Current-account balance (% of GDP)	-3.2	1.8	-1.6	-0.2	-1.2
Exports of goods fob (US $ bn)	121	307	579	243	283
Imports of goods fob (US $ bn)	154	294	507	232	323
Unemployment (%)	14.1(b)	9.7(b)	9.6(b)	10.6	3.7(b)

Source : Economist Intelligence Unit (b) denotes Actual

The recent economic and political turmoil in Argentina has adversely affected Spanish companies, which have invested heavily in South America's second largest nation. Five large companies, including Repsol and Endesa are expected to lose billions of euros because of the default on Argentine Government debt and the devaluation of the Argentine peso.

Spain has continued to make progress on the education front. In 1990, Spain extended compulsory schooling from age 14 to 16. Number of Universities have also increased sharply in recent times. But, there is a lot of scope for improvement. Many students enrol in programs only for lack of a job. Parental pride in sending children to the university has prevented students from entering into more practical areas such as biotechnology or hotel management. Some students who want vocational training are unable to join the course of their choice. As a result, there is shortage of skills, in areas like informatics. The new education policies aim at steering disinterested kids into practical or vocational training. In 1991 Spain had 890,000 students in post-school vocational training. Today, this number has dipped to 520,000.

Labor costs have fallen due to liberalization of the labor market. In the manufacturing industry, labor costs are about $12.1 per hour compared to $26.2 in Germany and $16.6 in the UK. But skilled labor shortage continues to be a pressing problem.

Under Franco, the 'insiders' were protected strongly. But by the 1990s, the cost of the rigidities in labor markets was becoming evident. In 1994, the socialist government introduced short-term contracts that could be ended without paying any compensation. But other workers remained entitled to 45 days of pay per year in the job, as retrenchment compensation, subject to a ceiling of 3.5 years of pay. The short-term contracts became very popular. (In early 2001, about a third of the labor force was covered by such contracts.) In 1997, Aznar pushed through a national agreement between employers and union to ease labor market rigidities. A key feature of this agreement was that different hiring arrangements were restored which reduced the cost of dismissals by about 40 percent. The government also reduced severance pay to 33 days from 45 with a cap of two years of pay for most of the new hires. But people on short-term contracts became entitled to get eight days of pay for every year of work. It also announced subsidies to encourage hiring of young women, women returning to the workforce after child birth and older workers who often struggle to get a job.

Foreign Investments

Foreign investments have played a significant role in modernizing the Spanish economy during the past three decades. Attracted by Spain's large domestic market, export possibilities and growth potential, foreign companies have entered the country in large numbers. Aznar's Government has been extending a warm welcome to foreign investors. Spanish law permits foreign investment of up to 100 percent of equity, except in a few strategic sectors. Capital movements have been completely liberalized in recent times.

Spain's automotive industry is almost entirely foreign-owned. Multinationals control, half of the food production companies, a third of chemical firms and

The Rise of Spanish MNCs

The Spanish Government has actively encouraged investment by domestic companies abroad. Though Spain's presence is still small in most regions of the world, in Latin America it is strong. Spain is the largest foreign investor in the region after United States. Spanish companies (Some of them are ex-state-owned monopolies, recently privatized) have acquired a controlling interest in some of the largest companies in sectors such as energy, utilities, telecommunications and banking in Brazil, Argentina, Chile, Peru, and Venezuela.

In 1999, Spain's dominant energy company Repsol bought YPF, the Argentine petroleum company, for $13.5 bn. In 1998, Telefonica, Spain's newly privatized telecommunications company, paid almost $5 bn for part of Brazil's telephone monopoly Telebras when it was privatized. After its purchase (in 2000), of Motorola's interests in Mexico, Telefonica has been running mobile phones in every sizeable Latin American country. It will have 10 million subscribers, not too far behind its 13 million in Spain.

Since the early 1990s, Spanish acquisition has been a regular phenomenon in the region. In banking, BBVA and BSCH have become market leader or number two, almost everywhere. Endesa has large power interests in Argentina. Union Fenosa, a smaller player is expanding its presence in Mexico. Iberdrola has a presence in Brazil. Prisa, Spain's biggest publishing group, has interests in Colombia and Chile. Sol Melia, with nine hotels in Brazil, plans ten more. Other Spanish enterprises have been growing their operations in some of the smaller economies of Central America, such as the Dominican Republic and Cuba.

The biggest-ever Spanish deal abroad, Repsol's of Argentina's YPF, was well timed, when the price of oil was only $10 a barrel. Some of the investments however, have run into trouble. For example Iberia and Spain's state holding company, SEPI, made a hasty move into Aerolineas Argentinas.

two-thirds of the cement sector. Several foreign banks operate in the country. Foreign firms control close to one third of the insurance market.

Under the 1991 Budget Act (Law 31 of December 27, 1990), EU-resident companies began to receive the same treatment as Spanish companies in strategic sectors (national defense, radio and TV broadcasting, air transportation and gambling). Previously, non-Spanish companies required prior authorization from the Executive for investments in these areas. Some foreign ownership ceilings also existed. But most of these barriers have been lifted, except for investment by foreign investors in munition companies and telecommunication services which still require prior authorization. In line with the WTO negotiations on Basic Telecommunications Service, Spain opened this sector on a reciprocal basis to foreign competition on December 1, 1998.

A legislation introduced on February 1, 1992, has eliminated remaining foreign exchange and capital controls. It provides complete freedom with regard to financial transactions between Spanish residents and non-residents. Previous requirements for prior clearance of technology transfer and technical assistance agreements have been eliminated. The liberal provisions of this law apply to payments, receipts, and transfers generated by foreign investments in Spain.

Another legislation introduced in April, 1999 has removed all forms of portfolio authorization and allows free movement of capital in and out of the country. After the investment is made, it must be registered. Registration requirements are, however, simple, except in sectors subject to special consideration.

In recent times, Spain may have lost some of its cost advantages, compared to central and east European nations but it is still cheap relative to most of western Europe. The country continues to attract foreign investments in traditional industries such as textiles and apparel, food and beverages. Spain has also become an attractive destination for more value-adding investments.

Madrid, the administrative and financial center, is the headquarters for many international companies. Barcelona, traditionally, Spain's industrial backbone, is also attracting many overseas headquarters. Hewlett-Packard located its European headquarters in the city, which is also attracting many shared services and call centers.

In 1998, Spain attracted $11.4 bn of foreign direct investment, almost double that of the previous year. By September, 1999, Spain had received $13.6 bn; an improvement of over $5 bn compared to the same period in 1998. Between 1990 and 1999, net FDI inflows into Spain amounted to $98 bn. The largest investors in Spain are the Netherlands, France, the

Some Important Industries

Spanish industry produces textiles, iron and steel products, ships, automobiles, processed foods, chemicals and various other kinds of consumer and industrial goods. The country has rich deposits of iron, coal and zinc. Spain also produces petroleum and copper.

Telecommunications: The telecommunications services subsector generated approximately $18.5 bn in revenues in 1999, an 18 percent increase over the previous year. Mobile telephony showed a record growth rate of 47 percent over 1998. Approximately 14 million cell phones were sold during 1999. The sector is expected to grow at approximately 19-25 percent per year due to the multiple services offered by new technologies, increased use of Internet and e-commerce.

Telefonica is one of the leading players in the global telecom services business. The company which was originally a government enterprise, was privatized in 1997. Since then the company has made impressive strides both within and outside Spain. Indeed, the Spanish telecom market has come in a remarkable way since the early 1980s when there was a shortage of telephone lines, long waiting lists for new connections and poor quality of service. By the mid 1990s, Telefonica had succeeded in eliminating the waiting list, digitalizing several telephone lines, reducing line failures and significantly improving the quality of service. Among the overseas markets which Telefonica has entered are Chile, Argentina, Peru, Venezuela, Puerto Rico, Portugal, Colombia and Romania.

In the fixed telephony market, Telefonica is now facing aggressive competition from new operators. On December 1, 1998, a new operator, Lince entered the market. Lince's projected investment is expected to be approximately $1.3 bn over the next ten years. By 2008, this operator expects to gain 7.5 percent of the total market share. The real battle in the fixed telephony market is for business accounts, which need value-added services.

The major cellular operator in Spain is Telefonica's GSM service Movistar with 11.3 million subscribers. A second operator, Airtel Movil (now controlled by Vodafone and BT but originally associated with Airtouch), began operating in 1995 and currently has nearly 5.4 million subscribers. In January 1999, Retevision Moviles came on the scene. The three operators combined have 18 million users.

Spain's Internet market is booming but is on the verge of a major shakeout. While there are approximately 380 Internet Service Providers (ISPs) in the market, the number will reduce sharply over the next few years. Industry experts agree that many small ISPs will be acquired by large groups already established in the market. Voice applications over Internet is a fast emerging business in Spain. Many foreign companies are considering entry into the Spanish market. Estimated numbers of Internet users in Spain for 1999, 2000 and 2001 are 3.6 million, 5.75 million and 8.75 million respectively.

Automobiles: Spain is currently the third largest automobile manufacturer in the EU, and the fifth largest in the world (after USA, Japan, Germany and France) with over 2.2 million units. It has surpassed the UK (with 2.0 million units), but is behind France (with 2.3 million units) and Germany (with 5.1 million units). In 1999, Spain produced over 2.2 mn automobiles and exported 1.8 million automobiles, or five percent of all automobiles manufactured in the world. The automobile sector accounts for six percent of Spain's GDP.

Automotive parts and accessories have become one of the most dynamic sectors in the Spanish economy. Demand is expected to increase in the coming years. The ratio of automobiles to drivers in Spain, is lower than the EU average. Spain has only 308 automobiles for every 1,000 people against 400 for the EU. This ratio is expected to increase until it nears the EU average. The large number of old automobiles which are in circulation, will require replacement parts. Spaniards typically replace their cars every eight to ten years. The "Prever Plan", launched in April 1997, gives automobile buyers who turn in their old automobile, a $533 sales tax rebate on the purchase of a new automobile. Spain has also become increasingly receptive to new distribution channels. These include auto repair service franchises, specialized service auto shops, hypermarkets, etc. Such outlets are creating new opportunities for automobile parts and accessories manufacturers.

With confidence in the economy high, car sales grew 25 percent in the first half of 1999 compared to the same period in 1998. In 1999, Mercedes-Benz beat all previous records in the country, selling 20,473 cars and recording a turnover of over $2.4 bn. When Mercedes was looking for a location to produce a new version of its Vito light industrial van in the summer of 1999, it located its plant in Vitoria in the Basque Country.

Apparel: Spain has a thriving apparel industry. Nothing symbolises this better than the highly successful retail chain, Zara. In early 2001, Zara had 450 stores in 30 countries. In this age of outsourcing, Zara has gone against conventional wisdom. It uses a vertically integrated model that enables it to respond to the changing fashion trends more effectively. Real time sales data has enabled the Spanish retailer to minimise inventory and avoids the need for warehousing. Zara can launch a new product line from start to finish in three weeks against an industry average of nine months. Zara's business model makes it very price competitive. Unlike other retailers who commit 60 percent of their production at the start of the season, Zara commits only 15 percent, giving it more flexibility to drop a slow moving product line. At a time when retailers like Marks & Spencer have been struggling, Zara has continued to thrive. The main worry for Zara as it expands in overseas markets is whether it can replicate its strong distribution capabilities at home.

Table IV
Break Up of Exports & Imports, 2000

Exports	**Total (in percent)**	**Imports**	**Total (in percent)**
Raw materials& intermediate goods	43.1	Raw materials& intermediate goods	45.3
Consumer goods	39.4	Consumer goods	24.6
Capital goods	13.3	Capital goods	18.0
Energy	3.6	Energy	12.1
Leading Markets	**Total (in percent)**	**Leading Suppliers**	**Total (in percent)**
France	19.4	France	17.1
Germany	12.4	Germany	14.9
Italy	9.4	Italy	8.8
Portugal	8.8	UK	7.0
EU	70.6	EU	63.1

Source: Economist Intelligence Unit

United States, the United Kingdom and Germany.

Future Outlook

Through Aznar has been a remarkable success as Prime Minister, there is one thorny problem he has still to come to grips with, i.e., the Basque separatists. Aznar's Government has had problems dealing with both the ETA terrorist group and the non-violent Basques. The ETA, founded in1959, has launched terrorist strikes at Spanish security forces, military personnel and Spanish government officials from time to time. One particularly ticklish issue is the need to hold a referendum on self-determination for the Basque territory. Aznar is naturally apprehensive that this may lead to secession. Aznar has continued to play the card of national unity. He has argued that the autonomy granted to the Basques is adequate. But not withstanding this delicate political problem, Spain's economic success in recent times has indeed been remarkable. The important lesson from Spain is that enlightened leadership and conservative macro economic policies go a long way in making a country globally competitive. ■

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